

**Enforcing Liberalism:  
Political Advisory Networks and New Economic Institutions**  
*Case Studies of Bulgaria and Ecuador*

by

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A dissertation submitted to the Graduate Faculty in Political Science in partial fulfillment  
of the requirements of the degree of Doctor of Philosophy,  
The City University of New York

2009

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This manuscript has been read and accepted for the  
Graduate Faculty in Political Science in satisfaction of the  
dissertation requirement for the degree of Doctor of Philosophy.

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## ABSTRACT

Enforcing Liberalism:  
Political Advisory Networks and New Economic Institutions  
*Comparative Case Studies of Ecuador and Bulgaria*  
By Karen E. Young

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This dissertation examines two cases of extreme monetary policies (currency boards or dollarization) in response to inflationary and bank crises. The research asks why, after major currency and banking failures, governments struggle to restructure and reform their bank systems—both public and private—to prevent future crises. The dissertation complements traditional institutional, interest-based, and domestic corruption explanations for stalled or incomplete liberal reforms which have overlooked an important agent in the regulation of the financial sector: the interaction of formal and informal rule-making institutions. Informal rule-making institutions, namely political advisory networks in the domestic and international finance sector, can inform the scope, timing, and legitimacy of changes in both monetary and banking policy attempted by formal rule-making institutions--the executive and legislative powers of government. The research seeks to descriptively model advisory networks and their sources of strength. I compare two cases, Bulgaria and Ecuador, using elite ethnographic interviews that study up and study through levels and processes of economic institutional change. The dissertation has two key findings: 1) that informal advisory networks can originate and execute extreme monetary policy changes with little deliberative advice from national political or international financial institutions, and 2) where liberal advisory networks are strong, the network can dominate the monetary and bank reform agenda, which often results in a stubborn persistence of liberal policies which reject protection mechanisms (credit ceilings, credit bureaus, state supervision) even through partisan changes in subsequent governments.

## Acknowledgments

I am grateful to my teachers and advisors for giving me the space to pursue this topic and for their ability to gently (and directly) challenge me to make my ideas more clear.

Professor Susan L. Woodward has made tireless efforts to improve my thinking and writing over the last five years. I am indebted to her for teaching me how to teach others, and how to garner facts to support my ideas. She sets the bar high, which I will continue to strive to meet. I am grateful to Professor Tom Weiss for his encouragement, for teaching me how to edit and work with co-authors, and for his generous spirit. Many professors at the Graduate Center have been supportive and collegial; it is a wonderful place to study and work. I would like to thank Professor Ruth O'Brien, Professor John Bowman, Professor Stephanie Golob, Professor Charles Tien, Professor Peter Liberman, Professor Kenneth Erickson, and Professor Lenny Markovitz for making the department such a good place to be.

The seeds of this project were planted in Ecuador at the Universidad Andina where I studied with Professor Cesar Montufar, Professor Marco Romero, Professor Alfredo Mancero, and Professor Wilma Salgado. They were excellent teachers and gave me a critical lens to begin to think about political economy and the politics of development and economic crisis.

In my research, I am grateful to a number of scholars, bankers, and central bankers who opened their doors to me and introduced me to their own network of friends and colleagues. In Sofia, Krassen Stanchev was incredibly generous with his Rolodex. In New York and Quito, Xavier Valencia and Hector Barrahoa, respectively, were willing to let an academic into their network.

I also benefited from generous fellowships from the Fulbright program (Ecuador 1997, Bulgaria 2005), the American Council of Learned Societies, the International Research and Exchanges Board, the CUNY Graduate Center, the Woodrow Wilson Center, and the Alumnae Association of Wellesley College.

At the Graduate Center, a number of colleagues made the course work, research, and dissertation writing stages fun; my sincere thanks to Evren Balta, Arianna Farinelli, Sumie Nakaya, and Deniz Sert.

I am grateful most of all to my family. They knew I could do this when I was not sure I could.

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## List of Abbreviations

AGD-Agencia para la Garantía de Depósitos  
BANU- Bulgarian Agrarian National Union  
BCBS- Basel Committee on Bank Supervision  
BCE- Banco Central del Ecuador  
BCP- Bulgarian Communist Party  
BIS- Bank of International Settlements  
BNB- Bulgarian National Bank  
BSP- Bulgarian Socialist Party  
CEE- Central and Eastern Europe  
CLS- Centre for Liberal Strategies  
COMECON- Council for Mutual Economic Assistance  
CSP-Center for Social Practices  
EU- European Union  
FDI- foreign direct investment  
FLACSO- Facultad Latino Americana de Ciencias Sociales  
GDP- gross domestic product  
GNP- gross national product  
IME- Institute for Market Economics  
IMF- International Monetary Fund  
LGISF- Ley General de Instituciones del Sistema Financiero  
MRF- Movement for Rights and Freedoms  
NATO- North Atlantic Treaty Organization  
NGO- non-governmental organization  
NIE- New Institutional Economics  
NSI- National Statistics Institute  
OECD- Organization for Economic Co-operation and Development  
OPEC- Organization of the Petroleum Exporting Countries  
PHARE- Poland and Hungary: Assistance for Restructuring their Economies (EU)  
PSC- Partido Social Cristiano  
RCI- Rational Choice Institutionalism  
SEED- Support for Eastern European Democracy Act  
SME- small and medium size enterprise  
SOE- state-owned enterprise  
UDF- Union of Democratic Forces  
UNEP- United Nations Environment Program  
USAID- United States Agency for International Development  
WIDER- World Institute for Development Economics Research  
ZUNK- Law on the Settlement of Non-Performing Credits (Bulgarian)

## **Chapter 1 - Enforcing Liberalism: Political Advisory Networks and New Economic Institutions**

### ***Introduction***

Since the early 1980's, one of the most important developments in the global political economy—and international politics in general—has been the opening of national economies to global market forces. Liberalization, in one form or another, continues to be a major policy objective of nearly every state in the global system. This dissertation considers the context of recent liberalization efforts in two extreme cases of financial crises with similar political remedies, yet with divergent political and cultural environments—dollarization and a currency board plan in Ecuador and Bulgaria, respectively. The title “Enforcing Liberalism” aims to suggest that liberalization is not a natural progression, in economic or political terms, and that the enactment of liberal economic policies involves social negotiations and power bargains among a variety of actors across public and private, domestic, and international boundaries.

Scholars in the last decade have focused on how institutional changes welcome or hinder economic liberalization and the accepted notion that provided the right mix, or compatible set, of state institutions and business “climates,” liberalization can create opportunities and wealth across societies in transition from either socialist pasts or corrupt regimes.<sup>1</sup> Establishing institutions that support liberal economic ideas will then create incentives for actors to operate in a more efficient, more wealth-distributing, rule-bound market—so the logic goes. Defining the right mix of institutions that provides the incentives for liberalization to take hold and create wealth remains elusive to both

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<sup>1</sup> In the case of Latin America, corrupt regimes would also include *caudallismo*, or a political-military head of authoritarian power based on populist ideology and support.

scholars and policymakers. The subsequent explanations for why liberalization efforts often fail or stall then center on either policy choice, policy implementation, or some type of localized ineptness, either culturally or socially, to “get it right.” This logic perpetuates a center-periphery conception of development, in its ideational exchanges and in the directional flow of resources. It also overlooks how existing rules, practices, and formal institutions are socially and historically constituted and it assumes that, given the right incentives, actors will reform existing institutions to make them more efficient and market-friendly.

The prevailing institutionalist view neglects a careful examination of not just *why* actors behave the way they do (in terms of their economic institution-building), but more importantly, *who* they are and what binds them together. This dissertation takes a different, though complementary, approach to explain how new economic institutions emerge in liberalization processes, and why reforms often stall. The focus of the dissertation is not economic theory in practice, but the politics of how national macro-economic planning takes place, what influences policy choice and implementation, and who benefits. This is a study of how governments—with the help (invited or not) of political advisory networks—build new economic institutions and regulate their financial sectors. To that end, the topic positions itself in a series of very political, often tumultuous, processes.

The processes of a liberal economic agenda normally have proceeded in the following order: liberalization, the opening to foreign investment by loosening capital controls and trade restrictions, encouraging floating exchange regimes, stabilization, and then privatization (Eichengreen 1996; Simmons and Elkins 2004). Beginning in the mid-

1990s, however, we find that states have gone through this sequence and later find it necessary to restrict their monetary policy options, particularly when states find it difficult to meet two key demands of the liberal economic reform agenda. These demands are 1) controlling domestic inflation, and 2) establishing credibility to foreign investors. These demands are achieved through a tight monetary policy, restricting a government's ability to finance debt through increasing the money supply (Frieden and Broz 2001; Bernard, Broz and Clark 2002).

The choice to “tie the hands” of politicians through restricted monetary policy is perhaps a last resort to implement the neo-liberal agenda. Until recently, a restricted monetary policy has been unorthodox, and even considered reckless and inflexible by many international institution advisors. There is evidence, however, in staff changes at the U.S. Treasury Department and recent publications at the IMF that orthodox standards are beginning to change.<sup>2</sup> The existing literature on monetary policy tends to focus on the variables influencing policy choice, rather than common disappointing policy outcomes or the localized origins of liberal economic movements. The common variables of analysis have tended to be international institution advice and constraints, domestic political bargaining, and international policy spillover effects.

There is a dearth of studies that begin to question the way in which economic policy actors, in both an international and domestic context, interact and interconnect through their own network systems and social ties; and subsequently, how these network structures influence institutional choice and policy outcome. By explaining similarities in

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<sup>2</sup> From personal communication with U.S. Treasury Department officials, as well as the hiring of Kurt Schuler to the International Affairs department within the Treasury in the summer of 2004.

the regulation and operation of liberal finance regimes in post-socialist and developing political economies, this work seeks to address that void in the literature and analysis.

### ***The Argument in Brief***

The dissertation argues that conventional institutional, interest-based, and domestic corruption explanations for stalled or incomplete economic reforms have overlooked a key factor of the efficacy of liberalization regimes in transition environments: the interaction of formal and informal rule-making institutions. Informal rule-making institutions, namely advisory networks in the domestic and international finance sector, can inform the scope, timing, and legitimacy of reforms attempted by formal rule-making institutions, the executive and legislative powers of government. The effects of informal institutions in the formulation and execution of economic policy are specified by the structure of advisory networks and how these networks compete for political influence in monetary and finance regulation. I compare two cases, Ecuador and Bulgaria, using elite ethnographic interviews that study up and study through levels and processes of economic institutional change. The interviews create an original mapping of power and decision networks across two diverse political economies and the global finance system in which these networks operate. The dissertation will attempt to demonstrate then that countries with weak executives and formal rule-makers are often unwilling or unable to independently put forward monetary and bank policy reforms because of the influence of liberal advisory networks. Conversely, when a liberal advisory network is weak, there may exist more of a possibility of executive-mandated reform. Solely executive-led reform, though, may lack necessary support across business, academic, and international institutional sectors. The cross-sector support of monetary and bank reform is measurable and evident in social ties and network connections

between political actors. This dissertation attempts to descriptively model how a liberal advisory network is composed, from where it draws strength, and why the network as a unit of analysis may shed new light on understanding the politics of economic reform and the failure of liberalization policies to bring consistent economic growth and stability.

### ***Monetary Policy as Liberalization Policy***

Many states in the developing world and in post-communist transitions are selecting restricted monetary policies, either in common currency areas like the European Union, currency boards, or in dollarization policies popular in Latin America and the Caribbean. This type of economic reform policy has not been studied in relation to its social and political origins or consequences.

A restricted monetary policy has three major forms. One form is a one-to-one parity scheme or hard-peg, such as the gold standard used during the period of British hegemony from 1887-1914 (Eichengreen 1996; O'Brien and Williams 2004). A second is a dollarized scheme, or the circulation of any foreign currency inside national boundaries. Third is a currency board, a monetary authority that issues notes and coins convertible into a foreign anchor currency or commodity (also called the reserve currency) at a truly fixed rate and on demand.<sup>3</sup> These restrictive policies are not inventions of the liberal economic agenda, but have been in use since the 18<sup>th</sup> century, particularly in efforts of colonial expansion (O'Brien and Williams 2004). In fact, the territorial currency, or national money, is a more recent invention in international economic relations (Helleiner 2003; Cohen 1998). National currencies are tied in many ways to national identity projects and imperial expansion. For example, the period of the

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<sup>3</sup> See <http://users.erols.com/kurrency/intro.htm> for detailed lists of monetary policy systems world-wide, maintained by economist Kurt Schuler.

British gold standard from 1875-1914 enabled the British Empire to consolidate its trade networks with colonial outposts and to isolate global transactions to the City of London banking system.

Some theorists see the emerging narrowing of the currency choice (currency unions, boards, and dollarization) as a second wave of these kinds of hegemonic politics (Helleiner 2003). As post-communist transition countries lean towards the political ideal of the European state, the *euro* became a symbolic measure of their economic viability and their social transformation towards a liberal market economy and democracy. A currency board tied to the *euro* operates on the same logic. Similarly, in Latin America the use of the U.S. dollar solidifies a long-standing trading and political relationship with the powerful neighbor to the North. These historical examples and the ideational literature on monetary policy are important to the research agenda here because they document the political elements of a national money. Money becomes more than an exchange mechanism, but symbolic of global power relationships and trends in the international political economy.

One common variable in cases of restricted monetary policy largely unexamined is the *interaction* and *network of relationships* between international institutional advisors, foreign governments (notably the United States and its aid agencies), and domestic economic policymakers and public and private banking actors. These actors, in both the domestic and international spheres, can be broadly labeled as the developing finance sector. It is multi-national, overlapping public and private enterprises, and culturally diverse. Yet, this sector can be a tight-knit group, a true network of individuals who negotiate fundamental rules about how new and delicate capitalist markets will

function. Their negotiations and the structure of institutions in which they operate are often informal, personal, and most importantly, predictable in their similarity across national borders.

Without diminishing the importance of power dynamics between international capital lenders and their counterparts in developing finance sectors, the dissertation argues that these actors form a cohesive network with shared ideas about the role of the state in the market and shared understandings of the structure of their global environment. The way they communicate with each other and negotiate these shared understandings of power, place, and value can alter a sequence of institutional changes, specifically a sequence of reforms in the banking sector. In the case research here, the evidence is illustrated by efforts to implement bank supervision reforms following the 1997 Basel Accord recommendations—the global standard in liberal bank practice—in two cases of macro-economic stabilization settings across regions: Bulgaria and Ecuador.

In a fragile economic reform environment, in a country that is either in a transition towards capitalist markets or is furthering a long and difficult movement towards open markets, what explains the choice and sequencing of new economic institutions after a severe stabilization effort? Besides combating inflation, macroeconomic stabilization in the form of restricted monetary policy is expected to spur efficient institutionalization in private and public banking. The general expectation is that the lack of monetary stability (in the price of money and a government's ability to manage the fluctuation of that price) is the central obstacle to the growth of financial institutions which, in turn, allow people to borrow money to grow businesses, to trade, to invest, and most importantly, to create mechanisms to verify information regarding

financial institutions and transactions. The problem is that securing the price of money through dollarization or currency board plans does not seem to spur this growth.

Pairing Bulgaria and Ecuador as representative cases of restricted monetary policy, this dissertation examines how the two countries move towards international liberal finance standards.<sup>4</sup> A severe stabilization effort implies the involvement of the international financial community, though in the cases elected here, the level of direct intervention varies. More importantly, the process of market building in its most fundamental capacity—the availability and administration of financing, the mechanism of capital mobility—is under the microscope, and the election, promotion, and sequencing of further bank reforms or new institutions are subject to analysis.

The economic policy implications of a restricted monetary system, as in a currency board or dollarization scheme, are restrictive in that they limit the central bank's ability to control the value or supply of money and lead that institution to focus instead on creating stability and credibility in domestic financial markets. The role of the central bank then becomes largely about bank supervision and protecting consumers/citizens. This problem is particularly difficult in the case of developing and transitioning political economies: their enforcement systems are weak, they are vulnerable to capital flight, and they are restricted often by heavy debt and aid conditionality.

Bank reform is a central aspect of successful liberalization, as a strong financial architecture is seen as the foundation of a functioning market economy. The success of other market reforms depends on the health of the financial system; yet efforts to reform

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<sup>4</sup> <http://www.bis.org/bcbs/index.htm>. There are twenty five core principles of the 1997 Basel Core Principles which relate to what businesses can call themselves banks, how creditors will be evaluated and assessed for risk, how much government bank supervisors can access risk information from banks, and how bank supervisors can impose limits on a bank's ability to extend credit: <http://www.bis.org/publ/bcbs30a.htm>

it cannot proceed independently of those other reforms. Much of the literature on bank reform in transition environments focuses on how poor management skills, lack of experience in assessing risk, and too close ties between government and banks lead to underperforming banking systems, and fragile systems that are vulnerable to crises (Mörner 1997). The explanations are focused on the domestic environment—cultural legacies or particular socialist transition problems.

The role of the central bank--the state's bank--is especially important in building and regulating a national financial system. As long as the central bank maintains a floating exchange rate regime, its capacity to control its own macro-economic policy is not impaired. The situation changes, however, when the central bank elects a fixed exchange rate. The extent can vary from a unified exchange rate, as in the *euro* zone, through dollarization, as in Ecuador, through to a currency board regime, as in Bulgaria.<sup>5</sup> In each case the central bank loses the power to control macro-economic monetary policy. The sole purpose of the central bank then becomes its ability to supervise private banking activity and to assure the public of the credibility of the financial system (Goodhart 2000).

One mechanism of standardization of the financial sector, across national boundaries, is by the agreement of codes, or principles, of good conduct in these fields. The Basel Accords on bank supervision of 1997 (often called Basel I, as Basel II is a second agreement on financial regulation of 2004 and implemented in 2006) is one attempt to provide guidance to central banks on how to create a credible and stable

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<sup>5</sup> As part of Bulgaria's accession process into the European Union, the currency board will phase into full *euro* zone participation with the *euro* in local circulation, planned for 2010. At the time of EU membership in January 2007, the local currency, the *lev*, remained in circulation with a value set and guaranteed by the Bulgarian National Bank at approximately a 2:1 ratio, *lev* to *euro*.

banking sector. The implementation of Basel I, and its guidelines for creating a stable and credible financial system within national territories, is a process that this research seeks to explain and to critique. The implementation of Basel I and its suggested rules for the banking sector is built on the relationships of the finance sector, both domestic and international in scope, and is largely informal. This example is an appropriate one to evaluate: 1) the logic and shared ideals of the supervisors of financial liberalization in practice in transitional markets, 2) the “progress” and sequence of these agreed standards, and 3) why explanations for the incomplete institutionalization of transitional markets might be better understood as a network process, rather than a problem of cultural legacies, greedy “early winners,”<sup>6</sup> or purely domestic elite bargaining. A closer examination of cases in which attempts to adhere to the Basel standards are made, yet bank vulnerabilities clearly persist, begs the question of why global banking standards allow for such crisis risk.

### ***Relevant Literatures on Economic Development and the State***

This dissertation research seeks to understand what compels domestic economic institution building, and how the interaction of domestic and international policy networks may determine the sequence and structure of certain reforms. Economic reform in developing, post-transition, and especially post-conflict environments is a critical issue for political scientists to consider now. As new institutional arrangements and economic

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<sup>6</sup> The early winners hypothesis originally appears in work by Joel Hellman; see J. Hellman (1998) “Winners Take All: The Politics of Partial Reform in Postcommunist Transitions,” *World Politics*, Volume 50, no. 2, pp. 203-234. Hellman argues that there are self-interested actors early in the transition who can manipulate or stall reform to ensure that their financial and power gains as first entrepreneurs (or those closely connected to state institutions) are maintained. One problem with this argument is that it stylizes the post-transition political economy as closed and concentrates on a population of domestic actors alone. This dissertation argues that the social ties between domestic and international actors are essential to the reform process and that shared ideas about reforming and liberalizing the economy can be as motivating as self-interest to preserve power and wealth in a policy process.

reforms emerge in Iraq, the Balkans, and the EU accession countries, one must consider why best efforts at understanding economic growth have revealed disappointing empirical conclusions. Instead of understanding institutional outcomes as victim to rent-seeking, poor implementation, and crony-capitalism, an alternative approach is to consider how social ties and shared ideas between advisors, policymakers, and financiers work in time and a certain policy space to frame results. This section examines relevant literatures to the study of economic policy reform as a process of state-building and economic transition.

First, there is the literature addressing economic development as dependent on the design of political and economic institutions, proceeding in three phases. In the primary phase, from modernization theorists like Rostow, Lerner, and Lipset, scholars saw stages of social and economic development as a linear trajectory for industrializing countries (Rostow 1960; Lerner 1958; Lipset 1960).

In the secondary phase of the economic-development-as-dependent-on-institutional-design literature, scholars addressed the role of the state in promoting growth and political capacity. Huntington focused on political organizations and party identity formation as a pre-condition for economic and social development, while later work more directly focused on state institutional capacity (Huntington 1968; Evans, Reuschemeyer, and Skocpol 1985). In the third phase, the literature began to inform economic development policy directly, specifically with the theory of rent-seeking that questioned the state's ability to direct the economy efficiently and allocate benefits fairly (Krueger 1974).

In fact, the economic development literature focuses on necessary and preliminary factors (systemic, political, cultural) for economic growth, which have direct policy implications. Economic development theory creates a narrative for explaining poor economic outcomes. For example, the explanation of the failure of import substitution policies as the fault of an overly interventionist state triggered a redirection in the literature toward market-led solutions—the neo-liberal economic agenda. More recent scholarship attacks the international network of economic development advice that creates a “world economic culture,” the ideas that motivate international financial institutions and national policymakers to choose different policy options (Woodruff 1999). New work by Elliot Posner illustrates that international institutions and their bureaucracies can create inefficient liberal institutions in their efforts to build new liberal market mechanisms, as in the creation of stock markets across Europe by EU bureaucrats (Posner 2005). This work points to the cultural and social dimensions of building markets. The ontology of the perfect market distorted by human error is refined by questions of *who builds a market*, and *for what purpose?*

The second aspect of the economic development literature is the question of governance—how democratic regimes might influence economic performance and how economic reforms influence democratic regimes. This literature is relevant to the research here because as democracies in post-socialist and developing economies make economic reforms and stabilization choices, these policy choices create winners and losers who can express themselves via elections with destabilizing political and social effects. There is a range of data on how economic performance affects or correlates with democracy (Przeworski and Limongi 1997; Boix and Stokes 2003; Siegle, Weinstein,

Halperin 2004). Economic wealth tends to correspond to democratic regimes. New work also explores how the lack of resources and poor economic development generates political conflict (Collier, et. al. 2003). Paul Collier and his colleagues at the World Bank have argued that the poorest “marginalized” countries (particularly those that have failed at implementing a liberal economic agenda, are dependent on primary commodities, and have highly unequal income distribution) are most at risk to internal conflict or civil war, and more likely to sustain conflict once it begins (Collier, et. al. 2003:4).

Therefore, the research question here is in conversation with a long literature on economic development and political institutions. What accounts for policy or economic institutional choice, reform sequencing, and performance in a post-stabilization reform setting? It challenges the evolving line of thought in economic development by combining domestic and international actors as an analytic unit, as well as time and space as parameters of economic policymaking. The network environment can be more revealing than traditional analytic concepts like systemic power (im)balances, domestic elite bargaining, and the design of democratic political institutions. Conceptualizing the architects of new economic institutions as a group in themselves, tied together by education, career opportunities, and theoretical understandings, rather than as national versus international adversaries, makes sense of the choices (and timing of choices) they make.

### ***Institutionalism, Interests, and Corruption Accounts in the Literature***

#### *International Political Economy (IPE) Approaches*

The literature on monetary policy centers on the question of how governments choose particular kinds of monetary arrangements and what factors (e.g., domestic interests, international financial institutions, spill-over effects) influence policy choice. This

literature is relevant to the research question here because it positions monetary policy directly in the international political economy scholarship that recognizes the competing roles of domestic politics, international power relations, and the more constructivist approaches to the role of norm dynamics and policy change.

Scholarly work addressing the causes and influences of foreign economic policy-making is generally limited to three explanations: 1) domestic and international sources of bargaining (Frieden 2002; Frieden and Rogowski 1996), 2) international financial institution constraints and financial (fiscal or monetary) crisis (Stallings 1992; Haggard and Kaufman 1992; Haggard 2004), and 3) learning patterns among country competitors and socio-cultural peers (Simmons and Elkins 2004). Empirical evidence suggests that there is great alternation and variation in exchange rate regime choice among sovereign nations (Bernard, Clark and Broz 2002). New evidence suggests that transitions to economic liberalization cluster in time and space. That is, there is a domino or spillover effect of dollarization and currency board policies within regions (Simmons and Elkins 2004). One limitation of this work on learning patterns and contagion or spillover policy effects is its isolation of emerging market makers from their counterparts in international financial institutions and rich countries. New evidence also suggests that certain kinds of countries, mostly developing democracies, are more likely to choose fixed exchange rate regimes if they are dependent on foreign direct investment (Shambaugh 2004). In fact, Shambaugh shows that the so-called “triangle” dilemma that countries may have only two of three policy options (freedom of monetary policy, free capital movement, or fixed exchange) is not accurate. Small open economies may never achieve freedom of monetary policy, as they must compete for mobile capital, and their exchange rate and

interest rate policies always must be tied to the largest market economies' policies. Choosing to peg or fix an exchange rate, therefore, is the formalization of an inevitable policy, presenting a difficult tension for states attempting to manage their monetary policies along with weak fiscal conditions.

Each of these explanations for policy choice (domestic, international, normative/network focused) assumes the same expectation for optimal policy outcome: a country's economic stability and performance is tied to its ability to tame inflation and create favorable environments for foreign direct investment. The institutions, political actors, and ideas influencing monetary policy choice have the same priorities—to stabilize inflation, create investor confidence, and improve economic performance. The shortfall of the literature is that it does not address how one might expect political economies to transform and perform *after* a monetary policy choice is made, why that specific choice occurs in a “contagion” effect, and if follow-up reforms depend on how international and domestic policy networks interact.

*Institutional Explanations for Economic Performance and Economic Behavior*

Many developing economies and transition economies are characterized by corruption, illegal shadow economic activity, weak judicial systems, and poor tax enforcement. There are generally two types of explanations for poor performance and unexpected political and social outcomes in economic reform processes: individual interest-based explanations and New Institutional Economics (NIE) explanations that focus on the power of institutions to delay or create economic change. Both are grounded in institutional theory, though the first privileges actors and the second gives more causal weight to notions of path-dependent institutional legacies and cultural repertoires.

Methodologically, both may be rational-choice approaches, though the path-dependent arguments are not limited to this approach.

#### *Individual Interest-based Explanations*

The first explanation is interest-based. One variant argues that macro-economic stability and growth depend on how political actors select and implement institutions based on their interests (Frieden 2001; Hough 2001; Gaddy and Ickes 2002). Liberal economic theory, from Adam Smith to Milton Friedman, argues that market efficiency derives from self-interested actors. Their behavior, therefore, should be anticipated regardless of historical legacy or cultural environment. Following this logic, given the opportunity, individuals will cheat to survive. Hough calls the *mafia* “normal economic men”. More explicitly, Gaddy and Ickes apply the survival-oriented enterprise argument to explain the early political and economic transition in Russia after 1989 (Hough 2001; Gaddy and Ickes 2002).

There are plenty of empirical examples of market-driven reform processes that seem to halt or idle. When these actors choose institutions and arrangements that are prone to corruption or rent-seeking, analysts offer an explanation that the reform process stalled as “early winners” reaped the benefits of managing the endeavor (Hellman 1998; Knight 1992). In this view, there are incentives to those who initially benefit from the insecurity of the transition to limit the inclusion of others in an expanding economy by stalling economic reforms and creating barriers to enforcement mechanisms. For example, many see the manipulation of privatization reforms by an elite few as evidence of the “early winners” hypothesis.

A second variant of the interest-based argument focuses on the interests of key advisors and political actors. International institutions like the IMF may have agendas of their own in recommending certain macro-economic policies (Stone 2002; Stiglitz 2002; Foot, MacFarlane and Mastanduno 2003). For example, Stone argues that “lending credibility” to the Russian government during its negotiations for a loan agreement with the IMF had less to do with Russia’s economic future than with the political agenda of the Clinton Administration and its ability to signal confidence to U.S. and international investors.

Interest-based explanations of outcomes in economic transitions focus on how rent-seeking behavior becomes a logical survival mechanism. According to these approaches, economic actors create alternative mechanisms of exchange (social services, barter, non-monetary exchange) and thereby “destroy” real value creation in the economy (Gaddy and Ickes 2002; Hough 2001; Krueger 1974).

#### *New Institutional Economics (NIE)*

Explanations in the new institutional economics focus on how institutions structure economic inefficiencies and incentives (North 1990; Knight 1992). Explanations focused on path dependencies explore how political institutions react to abrupt changes—as may result from a major policy change, like a dollarization policy that mitigates the need and legitimacy for a central bank—and how political institutions may stagnate and avoid changes that might improve the institution’s efficient operation—what is termed path-dependency (Pierson 2000; Thelen 1999; DiMaggio and Powell 1991).

Douglass North argues that explanations for poor economic performance and corruption derived from neo-classical theory are not satisfactory because, while the

models may account for most of the differences in performance between economies on the basis of differential investment in education, savings rates, etc., they do not account for why economies would fail to undertake the appropriate policies given the payoffs (North 1990). Institutions then determine the payoffs.

Institutions are the structures that humans impose on human interaction and therefore define the incentives that determine the choices that individuals make that shape the performance of societies and economies over time. These choices are limited by cognitive abilities, as well as social and cultural norms. Jack Knight's contribution illustrates how institutions not only structure informal rules of the game—those norms and codes of behavior—but also how they create political conflict when change is contemplated because they have distributional consequences (Knight 1992).

The concept of path dependency explains how institutions may be reluctant to change, as individuals within them protect their positions and their benefits. Peter Hall illustrates how institutions contain vested interests, making transitions and efficient cut-backs difficult—an interests-within-institutions approach (Hall 1992). DiMaggio and Powell explain how social and cultural norms create pathways and ways of thinking that are difficult to change, particularly when a new institution is formed or an older institution is eradicated (DiMaggio and Powell 1991). The politics within the institution can become “sticky” or resistant to changes, as do the politics outside of the institution responding to change. People must learn new ways of interacting with state authorities. In the path dependency literature, these moments of change are termed critical junctures.

The strength of the new institutional economics (NIE) literature, and its relevance to the approach in this dissertation, is the emphasis on the role of informal institutions

(such as networks) and the process of institutional origin and change.<sup>7</sup> Douglass North is the pioneer in this field, though he is wary to open the “black box” of norms, cultural beliefs, and unwritten codes of behavior. The analytical challenge, as Victor Nee suggests, is to specify and explicate the social mechanisms determining the relationship between the informal social organization of close-knit groups and the formal rules of institutional structures monitored and enforced by organizations and states (Nee 2003).

Here the literature seems to divide and lean heavily towards one approach based on rational choice methodologies borrowed from economics. Scholars working with this approach have asked how informal social organization and formal rules combine to shape the performance of organizations and economies (Przeworski 1991; Greif 2006; Greif and Laitin 2004; Gel'man 2004; Hellman 1998). The divide has been called the “economic turn” of comparative politics and comparative political economy, more generally (Levi 2000). These scholars assign a “maximand” (or ordering of preferences) for actors involved in an economic policy choice or economic behavior they seek to explain. The methodological individualism used in the approach has advantages in its isolation of actors as agents of change. The ability to predict behavior, or explain unexpected outcomes, on a large scale, and to generate clearly testable hypotheses are considered the strengths of this approach.

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<sup>7</sup> For an overview of the NIE literature and its origins in economics and sociology, see Victor Nee, “The New Institutionalism in Economics and Sociology,” Working Paper #4, Center for the Study of Economy and Society, Cornell University 2003, forthcoming in the *Handbook of Economic Sociology* by Richard Swedberg and Neil Smelser; and in political science, see Ellen Immergut, “The Theoretical Core of the New Institutionalism,” (1998) *Politics and Society*, Vol. 26, no. 1, pp. 5-34.

The limitation of a rational choice approach is the rare use of in-depth case studies<sup>8</sup> and field research, which leaves little empirical data for other scholars to challenge and defend (Laitin 1998; Bates, et. al. 1998). A second limitation is a lack of analysis on social groups, codes of behavior, ideas, and networks and the influence of these variables in institutional change. North's black box of informal institutions is too often an unexamined set of empirical evidence to explain how economies perform, how policy choices are made, and particularly, how the timing of reforms takes place.

#### *Networks and Informal Institutions*

There is an emerging literature and set of empirical case studies which more seriously consider informal institutions as an analytical concept and their causal role in building and changing economic and political institutions. More sociological studies, in political science and economic sociology, are exploring ways to further the concept of informal institutions, particularly the role of social networks, without rational choice assumptions (Fligstein 2004, Swedberg and Granovetter 1992; Helmsky and Levitsky 2004; Woodruff 1999; Portes 1997). Helmsky and Levitsky argue consideration of informal rules is also often critical to explaining institutional outcomes. Informal structures shape the performance of formal institutions in important and often unanticipated ways.

They define informal institutions as: socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels (Helmsky and Levitsky 2004: 727). Also key to their definition of the concept is the exclusion of other analytic concepts like culture and informal organizations. Drawing from Douglass

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<sup>8</sup> One effort to combine different methodological approaches to an institutional study of neoliberalism, using case studies, is by John Campbell and Ove Pederson, eds. (2001) *The Rise of Neoliberalism and Institutional Analysis*. Princeton: Princeton University Press. The volume includes a case study using a rational choice approach, as well as work by sociologists and economic sociologists.

North, they argue that informal institutions are separate from the “players” that populate them—“separating the players from the rules they follow.” Therefore, informal organizations like clans and mafias are not institutions, though their activities may contain codes and rules of behavior that could be considered informal institutions. This distinction may seem confusing, and there are undoubtedly scholars who focus on clans and mafias who might dispute this definition. However, in this work, the Helmsky and Levitsky definition will be followed to help further the concept and line of research.

A second distinction is necessary in separating the concept of informal institutions from culture. As Helmsky and Levitsky outline:

In our view, however, the best way to pursue this agenda is to cast informal institutions in relatively narrow terms by defining informal institution in terms of shared expectations rather than shared values. Shared expectations may or may not be rooted in broader societal values. Distinguishing between shared values and shared expectations allows future scholars to analyze potential causal relationships between culture and informal institutions, such as whether societal values reinforce or undermine particular informal institutions (Helmsky and Levitsky 2004: 728).

The research agenda for informal institutions is under construction now, and this dissertation seeks to contribute to building the concept and providing evidence that networks in development finance function with certain shared expectations, unwritten rules for negotiating the terms of reforms and ways of structuring capitalist markets.

Building a concept of informal institutions and establishing their causal weight also draws from recent work in fields more comfortable with the empiricism of social ties, unwritten codes that facilitate transactions and economies in transition to the formalized system of capitalist markets.

***Building a Sociological Approach to Economic Transitions***

Taking a sociological approach to economic change means reconceptualizing the role of the state in market transition as an agent of that change. As Roger Schoenman argues, the state itself is a site of struggle among social forces.<sup>9</sup> The state is not a unitary actor; in fact, actors within the state do not act collectively and often maintain ideological and social ties to diverse groups, both at home and abroad. In recent efforts at understanding post-socialist transitions, especially in the Russian case, scholarship on economic reforms adopts a more sociological understanding of the transformation of value and property (Woodruff 1999). Woodruff details a sociological institutionalist theory of money in which he rejects a notion of economic value as an objectively existing numerical entity that measures value solely by prices and accounting procedures. The value of social networks, transaction costs, enforcement mechanisms, and trust are not equivalent to price values. These social ties become informal institutions that are equally important in the performance of market economies (as they were in socialist economies) and the ability to regulate economic behavior.

The political science literature on the non-monetary exchange in Russia, including the proliferation of illegal commercial operations, and extended social-business networks, complements work in anthropology on economic reforms and transitions in other parts of the post-socialist landscape (Woodruff 1999, Verdery 2003; Eyal, Szelenyi and Townsley 1998; Stark and Bruszt 1998). These theorists find that changes in economic policies--specifically, privatization and macro-economic stabilization--create certain changes in social and political behaviors. This literature is important to the dissertation research because it signals that explanations for the outcomes of economic reforms are as much a

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<sup>9</sup> Schoenman, Roger (2005) "Captains or Pirates? Elites, Conflicts and the State," *doctoral dissertation*, Columbia University, Department of Political Science, pp. 30.

social process as they are about rebalancing political institutional arrangements and economic interests.

As Katherine Verdery details the case of privatization in Romania, the decision to make an institutional change from state management of property and resources to individual property ownership and management is highly political and a transformative social process. The parameters of this social process go beyond domestic borders, as international organizations, consultants, local elites, banks, courts, and even fertilizer producers have a stake in the outcome. The privatization process combines a tendency to rely on the past, on historical ways of coping and manipulating institutional change, with a necessity to make decisions based on the immediacy of the present (Verdery 2003:12).

The sociological changes of privatization, such as community status based on property accumulation, displacement of the state as caregiver, and volatility of “value” as an organizing concept of labor and production, all transform existing patterns of behavior and mechanisms of organizing everyday life. In the Romanian case, one can see how privatization is a process of reconfigured state-society relations. Verdery uses a narrative to show how land can quickly acquire a new kind of value (monetary, individually held, and transferable) and then become a symbol of social status and community membership. As families reclaimed land based on vertical kinship ties, which under socialism had little importance in everyday life, they re-aligned their loyalties within their communities, while also reclaiming old status symbols from pre-socialist eras. To be someone was to have a large farm, a store supply of grain, and a family that worked together for a profit. As decollectivization proceeded, new entrepreneurial family farms found it impossible to compete with the demands of economies of scale. By the end of Verdery’s village

narrative (symbolic of privatization schemes across the post-socialist landscape), the actual monetary value of land begins to decline--families find the small family farm undesirable and impossible to make a living--while commercial farming and tenant farming increases.

Woodruff theorizes that economic reforms not only reconfigure the institutions regulating money and transactions, but the informal institutions that structure how people evaluate property, each other, and their futures. Social relationships, perceptions of the future, and the stability of the state can determine the value of things. Similarly, scholars of southeastern Europe theorize changes in value systems and political identities not as nostalgia for a socialist past, but as strategies to cope with transition economies (Creed 1998; Woodruff 1999; Stark and Bruszt 1998; Eyal, Szelenyi and Townsley 1998). These analysts see economic behavior and the transformation of economic institutions not in terms of bounded rationality, but in terms of rational or commonsensical social survival strategies and society's re-evaluation of changing political and economic environments.

New work by Stark and Vedres addresses more specifically the role of social networks in periods of economic transition (Stark and Vedres 2006). Their analysis of inter-enterprise networks and foreign investment in Hungary from 1987 to 2001 clearly documents that high levels of foreign investment are linked to persistent domestic ownership networks. The evidence then suggests that globalization and the reproduction of network embeddedness are not necessarily opposed; in fact, embedded domestic business networks can attract investment and create growth perhaps more efficiently than external sources of investment and ownership alone. In more common studies of post-socialist transitions, scholars see social ties and trust networks as temporary fixes for

incomplete capitalist institutional development (Guseva and Rona-Tas 2001). For the dissertation here, the research and methodology of Stark and Vedres confirms that even liberalized and dramatically opening markets remain tied to the evolution and sustaining of social ties.<sup>10</sup>

A sociological approach finds its roots in early political economy approaches by Polanyi, as well as Hirschman. The notion that transactions and economic life are based solely on a balance of supply and demand was fictitious to Polanyi, and he emphasized the real nature of objects like land versus the imagined value of objects like money (Polanyi 1944; Block 2003). Value is constituted in social and political realities, in human relationships, and social networks.

### ***Case Models***

Currently, twelve economies use a currency board system and thirty-two use a dollarized system, or a foreign currency in local circulation. Of these forty-four economies combined, two have a population over 7 million people and a gross national product over \$35 billion. They are Bulgaria and Ecuador.<sup>11</sup> Hong Kong meets these requirements as well, but cannot be considered an independent state. The next closest contender is El

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<sup>10</sup> See Roger Schoenman (2005) “Captains or Pirates? Elites, Conflicts and the State,” *doctoral dissertation*, Department of Political Science, Columbia University. Schoenman expertly uses the concepts of networks and groups to describe how corruption manipulates and distorts business and privatization efforts in post-socialist Europe. His casework in Bulgaria parallels my focus on network ties, though we come to different (though not necessarily conflicting) conclusions and focus on different sets of networks. Schoenman argues that where political competition between elites is polarized and networks are dense, relationships between firms and parties are stable and focus on long-term collective gains. He sees network ties in Bulgaria between firms and parties as sparse, enabling more corrupt and informal gangs/groups to dominate political competition and create instability. His methodological focus is not on collective action and identifying interests, but in describing and mapping groups and network ties between firms and parties. His network analysis focuses on firms, where he finds them lacking dense ties and not well-organized, whereas my focus is a network of pro-liberal reformers in the bank sector in which I find rich connections and long term ties.

<sup>11</sup> Kurt Schuler (1999) “Encouraging Official Dollarization in Emerging Markets,” staff report, Office of the Chairman, Joint Economic Committee, U.S. Congress. See also, Andres Solimano (2003) “Crisis y Dolarizacion: Vision General” in Paul Beckerman and Andres Solimano, eds., *Crisis y Dolarizacion en el Ecuador*. Quito: Observatorio Social del Ecuador. (Translation by Fausto Maldonado.)

Salvador, with a much smaller population at 6 million, and a gross national product (GNP) of only \$24 billion. The data then narrow, with Bosnia-Herzegovina coming closest with 3.8 million people,<sup>12</sup> and a GNP of only \$6.2 billion, followed by Estonia.

These are the two most significant cases of restricted monetary policy because of their population size and economic wealth. The timing of monetary policy restructuring in each case is comparable as well. Ecuador officially dollarized in 2000, while Bulgaria began the process with a currency board pegged to the German *mark* in 1997, and then to a more formal currency board arrangement with the *euro* in 2001. Both policy changes were preceded by severe economic crises with hyperinflation and low credibility among foreign investors. Their shared attempts to conform to international standards of banking stability and transparent banking regulations, as evidenced in the Basel I standards, make them logical cases for comparison.

Bulgaria and Ecuador are also most different cases, as they share little besides the variable of restricted monetary policy and a movement towards financial liberalization and credibility within the larger international political economy. The most different cases approach can demonstrate the more widespread social network process of building economic institutions this dissertation seeks to explain. If outcomes are similar, and the cases only share a monetary policy and banking reform effort, we can conclude that a similar social process is involved across barriers of regions, social divisions and historical backgrounds (Bennett and George 2005).

The comparisons of East European simultaneous transitions to democracy and market economies with economic reforms in Latin America are problematic for many

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<sup>12</sup> An unofficial census in 1996 by United Nations High Commissioner for Refugees recorded a post-war population of 3.9 million. Its 2007 residential population is estimated at approximately 4 million.

scholars (Bunce 1995). Some scholars have suggested the economic transformation in Latin America is not comparable to the drastic economic system change in Eastern Europe (Stark and Bruszt 1998). However, others, including Schmitter and Karl, Przeworski, and Linz and Stepan, have found that cross-regional comparisons, particularly in the East European and Latin American cases, are useful for their similar experiences with economic reform processes, the input of international financial institutions, and powerful economic ideas (Schmitter and Karl 1994; Przeworski 1991; Linz and Stepan 1996). Clearly, this dissertation defends the latter position and attempts to contribute to the debate between the two schools of thought.

### ***Study Design***

There are several methodological choices that are tailored to this case pairing. First, the explanation of the institutional reform process and its completeness and performance focuses on a set of social ties within the finance sector. These networks and informal rules are the causal variable in the dissertation's explanation. The broader theoretical aim here is to contribute empirical evidence to a theory of informal institutions in economic institutional change. It is the intersection of organizations and institutions like the International Monetary Fund, central banks, the U.S. government and its aid agencies, and private international and local bankers that constitute this sector, and subsequently populate these networks and build rules together about how to communicate, how to make policy, and strategize how and when to further their shared goals of making a liberal and open market. The outcomes of their policy choices and decision-making are often disappointing economic performance, private banks prone to vulnerabilities in lending beyond their means, and a persistent informal or non-regulated economic activity (that is sometimes criminal, but mostly just untapped state revenue that

could further broader development goals), further income and social disparity in a local and a global context.

In its comparative approach, the dissertation addresses two cases focusing on the background of their monetary policy shift, in both a domestic and international political context, and then delves more specifically into the field research component documenting the network relationships in banking reform efforts. Chapter Two outlines the argument and its alternative arguments in further detail, while also providing an overview of the state of the art in international monetary and bank policy norms. The chapter puts forward the argument that the structure of advisory networks can alter the nature of bank sector reforms, and subsequently, alter stability and government transparency in the bank sector. The second chapter also discusses why networks, as the unit of analysis, might reveal new empirical data of the late market liberalization process in ways in which alternative studies of the state (as unitary actor), corruption, industry interest groups, or the “mega” institution approach (lumping international financial institutions together) cannot. A model of liberal advisory network strength lays out the basic differences between the advisory networks active in Bulgaria and Ecuador, highlighting the measures of strength in each case and operationalizing the concept. The case study chapters work from a historical perspective to give background on each country’s move to liberalize its economy and create an open financial architecture beginning in the late 1980s-early 1990s. The case studies also explain the case details of the model of liberal advisory network set out in Chapter Two with specific empirical data on network membership and action. Chapter Three focuses specifically on interview data and archival research in Bulgaria on the decision to adopt the currency board and subsequent efforts to build

stability and credibility in its finance sector, according to Basel I principles. The Bulgaria case evidence reveals how a liberal advisory network can originate and execute a shift in monetary policy, and then dominate any subsequent bank reform effort. Chapter Four then represents field research from the Ecuador case, explaining the move to dollarize and the subsequent efforts to reform the banking sector in line with international standards. The concluding chapter seeks to reconcile the two cases, highlighting the timeliness of research into monetary and bank policies, drawing conclusions about the role of advisory networks in new economic institutions, and the power of networks to alter the landscape of national political competition. The conclusion then offers some proposals for further investigation of informal institutions in economic activity and policy.

In terms of research design, both countries experience the same kind of economic crisis, with restricted monetary policy outcomes, and disappointing results in economic performance, growth of the informal economy, and continued vulnerability in private banks. In Bulgaria, a liberal advisory network manages the monetary policy shift and obfuscates further bank sector reform. The dissertation positions Ecuador in contrast and finds that, though outcomes are similar, a different kind of advisory network is in place amidst a more complex landscape of political actors. In fact, it is the unique social ties in each case, products of the post-socialist transition in Bulgaria and remnant class and race hierarchies of Ecuador that influence how liberal advisory networks can operate. The network is stronger in Bulgaria and more directly influences the lack of stringent state supervision in the bank sector based on commitments to liberalism enforced through network ties in academia, research and consultancy organizations, and through political

parties. In Ecuador, the lack of external or foreign support for liberal institutions in both the private and public realm decrease the nascent network's ability to guide economic policy and bank sector supervision in the same way the Bulgaria network so actively operates. These findings, detailed in the following chapters, justify the need for a more complete explanation for monetary policy choice and difficult bank sector reform after financial crisis to complement and clarify standard explanations of international institutional pressure, domestic corruption, and weak national institutions.

## **Chapter 2 – Networks and Economic Institutions: Why Whom You Know Matters in Economic Policy**

### ***Introduction***

Traditional approaches to questions of political economy center on how interest groups, national or international, struggle over policy choices with distributional consequences. Theory-building and case studies in political economy then try to create some prescriptive for creating the most optimal, efficient economic policy for growth. This usually means a focus on institutions—creating new ones, copying successful ones, curtailing the state’s bureaucracies of existing ones, and so on. The literature and the policy prescriptions rarely examine the informal nature of economic institutions and the people who create them, work in them, and imagine their possibilities for change (and gain). This study takes the approach that an examination of informal institutions, specifically the role of informal advisory networks, can reveal in new ways: 1) the process of macro-economic reforms after inflationary crisis and 2) why fragility and instability often follow in efforts of bank sector reform.

This chapter will set out an argument that links the structure of informal advisory networks to outcomes in macroeconomic policy and bank supervision, in a moment of national economic crisis. How an advisory network functions (its strength in membership, in international support, in public credibility) in relation to other sources of economic policymaking can then determine the scope of liberalization reforms in the bank sector that follow the macro-economic stabilization, either dollarization or currency board plan. Therefore, “whom you know” in the formulation of economic policy matters as ties between government policymakers and individuals working in academic institutions, private foundations, and international organizations can influence the

trajectory of monetary and bank policy based on shared liberal ideals and policy goals. This dissertation argues that using tools of network analysis and drawing from sociological theories of institutions, one can better understand these extreme liberalization efforts in times of economic crisis.

Advisory networks are critical in post-socialist and developing nations because they represent the larger social transition active in the euphemized move to join the global economy. Just as democratization has not occurred in a vacuum, liberalization depends on cultural and social movements and interactions. People experiencing these changes often rely on established norms and patterns, as well as a sense of trust, to make political choices and offer their work and efforts to a political cause. In that sense, the political movement of liberalization is tied to the political ideology of liberalism, which in post-socialist and developing societies can become a movement of its own. Identifying as a liberal or reformer is an affinity for many with a notion of wealth, of independent thinking, of the freedom to move outside of class boundaries, and of internationalism.

The sections that follow first outline current conceptions of institutions and an institutional approach to political economy questions. The chapter addresses case selection, empirical evidence of the effects of lack of credibility and stability in a national bank system, and follows with background on international norms and standards of monetary policy and bank supervision, and the weaknesses of existing global institutions, specifically the Bank of International Settlements and the Basel Accords. The chapter then discusses standard explanations for why Bulgaria and Ecuador might move to dollarize or elect a currency board and then stall further reform of their bank systems. The last section then discusses an alternative approach to understanding economic

policymaking in crisis, using networks as informal institutions to understand liberalization changes within economic institutions in Bulgaria and Ecuador. A descriptive model of liberal advisory networks illustrates ways of measuring the strength and breadth of networks in monetary and bank reform processes. The chapter concludes with a statement of the argument: the structure of informal relationships within formal economic institutions can determine the initiative, scope, and legitimacy of new economic policies.

### ***Approaches to Conceptualizing Economic Institutions***

At the center of this research is a question of how economic liberalization works, or fails to work, in transitioning political economies. The institutional approach, the dominant academic and policy response to the problem of economic reforms and the spread of open economies globally since the 1980s, has essentially argued that “institutions matter”—which economic institutions, when implemented, and the degree they are protected from corruption are the key discussions. This dissertation argues that, yes, institutions do matter, but one might consider *what kinds* of institutions--the informal ones such as networks--when assessing the process and performance of economic liberalization. Specifically, the structure of informal institutions and relationships between people with the power to create and advise formal economic institutions can determine the outcomes of these liberalizing efforts.

Scholars in the New Institutional Economics (NIE) and rational choice institutionalism (RCI) schools both argue that institutions shape behavior through payoffs or incentives. Strategic interactions are the moments when either individuals or institutions evaluate the risk or benefit to a change in behavior. Douglass North argues specifically that the stability and dependability of political institutions can foster

economic growth. In political economy, the political institutions or rules enforced on the economy determine successful economic growth and development. Therefore, the “rules of the game” become paramount over the players. North’s argument has been tremendous in its influence on the understanding of development economics and developing countries.

There are some limitations, however, to the approach of strategic interaction used in both NIE and RCI. First, one only sees localized strategic interactions, which tend to put blame on local politicians and groups for policy failures, rather than fully developing a structural picture of how new economic rules emerge in their local and international contexts. Second, game theory (the backbone of strategic interaction) limits the ability to see relationships in a temporal context, how they emerge, and hold individuals to ideals through time, and how ideas motivate and invite a sense of shared purpose for those in a position to create and change (economic) institutions. In contrast, network approaches can account for structure, as well as perception and the nuance of relationships between actors. For instance, linking actors through a network goes beyond the moment of strategic interaction, to their previous connections and their perceptions of future encounters. A network focus allows one to follow relationships through time, observe how they web and connect, and address questions of both agency and structure.

The previous chapter elaborated how a sociological approach to institutions has grown out of the New Institutional Economics and how various scholars use this approach, particularly in studies of post-socialist environments. More formal network analysis, in some ways like game theory, looks at the interactions of individuals along a dimension (over time, or a series of strategic interaction). Both consider individual

positions (or nodes, in network analysis) and their constraints. In game theory, the basis of rational choice arguments, individual action is motivated by payoffs to a particular choice, but in network analysis, individual action is constrained and determined more by the structure of the network, or ties between individual actors. These ties also can contain payoffs or incentives, but also may be ideological ties, prestige, and more normative constraints like culture or loyalty. Roger Schoenman makes these distinctions between rational choice institutionalism and network analysis (also described as a sociological approach to institutions) and emphasizes that in studying networks one is considering the guiding role of opportunity created by relationships, which are “socially relevant dynamics,” rather than “strategies within institutions” (Schoenman 2005: 39).

Networks then are the lasting connections that generate expectations of reciprocity (Granovetter 1985), or a sense of identification or membership. In questions of building and sustaining new economic institutions, a network model allows one to see how policy choices are made through relationships to international financial institutions and their in-country representatives, local bankers, government officials and technocrats, and politicians.

### ***Historical Antecedents and Cross-Disciplinary Network Approaches***

A network approach is not new in analyses of political economy. The term “embeddedness” means that the economy is not autonomous, but acts in coordination with politics, religion, and social relations. Karl Polanyi’s work has influenced current understandings, even in the New Institutional Economics, that market transactions depend on trust, networks, and legal enforcement of contracts. Instead of the pre-capitalist pattern of subordinating the economy to society, a system of self-regulating

markets requires subordinating society to the logic of the market. For Polanyi, the logic of the market is simply not sufficient to explain how economic change takes place.

Polanyi's concept of embeddedness has been borrowed and elaborated on by many scholars, including John Ruggie, Mark Granovetter, and Peter Evans. What Ruggie terms the “embedded liberalism compromise,” is the compact between the postwar industrialization state and its society to mediate the damaging social effects of liberalization—which, he argues, is increasingly at risk (Ruggie 1982; Ruggie 2006). Granovetter stresses the foundational (and inherently social) relationship of trust in economic exchange (Granovetter 1985). Evans uses the notion of embedded autonomy to describe how dense ties between firms and the state helped create rapid growth in key industries in some Asian economies in the “take-off” period of the 1980s (Evans 1995). More recently, the concept of embeddedness has occupied a dominant space in International Political Economy, but its academic roots are in the 1940s.

In *The Great Transformation*, Polanyi begins by emphasizing that the tradition of modern economic thought rests on the conception of the economy as an interlocking system of markets that automatically adjusts supply and demand through the price mechanism (Polanyi 1944). Even when economists acknowledge that the market system at times needs government assistance to overcome market failure, they depend on this conceptualization as an equilibrating system of integrated markets. Polanyi argues that the reality of human societies is to the contrary—economic life is embedded in social life. Polanyi's conceptualization was a precursor to recent work finding that market transactions depend on trust, mutual understanding, and legal enforcement of contracts (Levi and Stoker 2000; North and Weingast 1989, Fukuyama 1995, De Soto 2000).

Polanyi's argument is often understood to be saying that, with the rise of capitalism in the nineteenth century, the economy was successfully disembedded from society and came to dominate it (Block 2003). However, he repeatedly says that the goal of a fully self-regulating market economy that is disembedded is a utopian project; it is something that does not exist. He writes:

Our thesis is that the idea of a self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness (Polanyi 1944: 3).

Therefore, even as liberalization and the expanse of capitalist markets grow, social ties remain the basis of economic life and economic action.

Polanyi's enduring contribution is that economics, as a social science, must be firmly rooted in the study of society. Economics is the study of scarcity (of resources, of information, among others) within boundaries of social relationships. A key theoretical debate in economics and its sister disciplines of sociology and political science is then how one sees social institutions and efficiency. In neoclassical economics, social institutions are assumed to perform some efficiency, or they would not be used. For most economists, social structural mechanisms (reputation, networks, contracting relations, ownership relations) can help produce efficient outcomes in uncertain environments.

Theoretically, efficiency is important because it helps to explain economic performance and/or economic institutionalization. Even with social structures (networks, status, ownership relations) as explanatory variables, one needs to be able to account for when one can and cannot achieve efficient outcomes (Fligstein 2001). In effect, if one views efficiency as a given of rational, profit-maximizing behavior, then social institutions may be designed to further efficiency, but fail for lack of resources such as

imperfect information<sup>13</sup> and asymmetries of power (North 1990; Knight 1992). But, one may also see efficiency as a social construction, making social institutions more important explanatory variables for their ability to account for the inefficient motivations of actors--in this case, economic policymakers, governments, firms, and international institutions in building stable markets.

As Neil Fligstein suggests, for sociological understandings of political economy to move forward, one needs more theoretical guides of actors' goals and their cognitive and environmental constraints to be more explicit in what he calls a "model of action" (Fligstein 2001: 12). Fligstein calls for an advance in theorizing the sociology of markets and suggests one means is to ask how a social view of what actors seek to do in markets is different from an economic view. By moving away from traditional economic explanations that focus on profit-maximizing as a key assumption in explaining actors' behaviors, this dissertation seeks to move in the direction of a social view that models how social institutions, also called informal institutions, direct and guide actors' goals and behaviors with important impacts on the creation and coordination of market institutions and policies.

A sociological approach using networks as a key concept works for political economy studies of state-economy relations, as well as studies involving international state actors. From an international relations theoretical perspective, Anna Leander argues that a sociological institutionalist approach can have great explanatory power in

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<sup>13</sup> See also in the mainstream economics literature accounts of imperfect information, social institutions and their effects on efficiency: M. Jensen and W. Meckling (1976) "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, no. 4, pp. 305-360; D. Kreps and R. Wilson (1982) "Sequential Equilibria," *Econometrica*, Vol. 50, no. 4, pp. 863-894; P. Milgrom and J. Roberts (1982) "Limit Pricing and Entry under Incomplete Information: An Equilibrium Analysis," *Econometrica*, Vol. 50, no. 2, pp. 443-459.

international political economy.<sup>14</sup> Leander sees a sociological approach in line with theoretical explorations of constructivism in international relations and international political economy. She argues that compared with historical institutionalism, sociological institutionalism places a greater emphasis on non-materialist aspects of institutions. Its research on these inter-subjective meanings focuses specifically, but not exclusively, on shared understandings and practices which inform human action. Consequently, “institutions” in sociological institutionalism include world-views, cognitive maps, codes of behavior, discourses, symbols, or mental frames for Leander.

Theoretically, sociological institutionalism raises questions about how institutions develop and change, and how they shape identities, interests, behavior, firms’ strategies, production, states, and politics. In opposition to theoretical approaches focused on individual choice, Leander explains:

(I)n sociological institutionalism social reality is seen as logically and empirically prior to behavior: it gives the reasons for action, as opposed to constraints or causes; it defines identities and hence actors’ interests (Ruggie 1998: 22). As opposed to materialist approaches, sociological institutionalism stresses that behaviour, identities and interests are emergent through shared understandings of social reality and are not mere epi-phenomena of some underlying material reality. They are part of shaping this reality (Leander 2000: 186).

These theoretical advances and multiple uses of sociological approaches and the concept of networks all point to current understandings of economic policy, in particular understandings of liberalism, and neglect the social nature of their theoretical formulation as well as their subject.

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<sup>14</sup> For a detailed discussion of the use of sociological institutionalism and economic sociology in the field of International Political Economy, and how other scholars are approaching the social and spatial spheres of international economic relations, see Anna Leander (2000), “A Nebbish Presence: Undervalued contributions of sociological institutionalism to IPE,” in Ronan Palan, ed., *Global Political Economy*. London: Routledge Press, pp. 184-196.

Economic historians have demonstrated how ideas about markets, and the theories that become policies to implement them, are not scientific proofs or universal formulae, but are socially motivated and constructions of certain historical moments and intellectual relationships. Bruce Caldwell traces the evolution of Friedrich A. Hayek's work, his struggle with building a methodological ground for understanding how knowledge and information are disseminated (and scarce) in markets and his ideological views on the problems of socialism (Caldwell 2004). Hayek is a key example because his theories are foundational to the field of political economy and its common assumption of rational economic man and individual choice. Yet Hayek was against methodological individualism, though he was also a strict supporter of the idea of an unfettered market that could operate in an ideal (though difficult to empirically specify) equilibrium. The contradiction is all the more important because Hayek's ideas were constantly changing in relation to his community of scholarly peers, and his own position as an outsider for most of his academic career. Caldwell, as a historian, is able to point to the networks that influenced Hayek, revealing the economist's vulnerabilities as a scholar and the inconsistencies between his economic theories and the social practice of creating those theories.

These constructions of economic ideas come from what others call epistemic communities, social relationships built on the exchange and debate of ideas given the challenges of their economic, political, and cultural realities. Peter Haas defines the term as a network of knowledge-based experts or groups with an authoritative claim to policy-relevant knowledge within the domain of their expertise (Haas 1992: 27). Members hold

a common set of causal beliefs and share notions of validity based on internally defined criteria for evaluation, common policy projects, and shared normative commitments.

Max Weber distinguished the role of ideas and individual interest in institutional origin. He wrote:

Not ideas, but material and ideal interests, directly govern men's conduct. Yet very frequently the “world images” that have been created by “ideas” have, like switchmen, determined the tracks along which action has been pushed by the dynamic of interest (Weber, from Gerth and Mills 1958: 280).

Weber’s concept of rational economic man has been expanded and critiqued,<sup>15</sup> but the point here is that a space for idea-making and sharing, combined with a force of social institutions, informal rules and shared norms of how a capitalist economy will function (what Weber termed “world images”), must have a causal role in economic rule-making and performance.

### ***Case Selection***

On my first trip to Bulgaria in August of 2004, one of the first conversations held with a local expert on the economic and political transition from socialism centered on the case selection of the dissertation project. Why would a political economist compare Bulgaria and Ecuador? Again and again, this question arose in the research. This finding was fascinating from a cultural perspective, as Bulgarians consider their country more developed and their population more European than Ecuador’s, while Ecuadorians consider their country less corrupt and historically richer (and more closely linked to the West, especially the United States) than Bulgaria. Often when presented the comparison

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<sup>15</sup> In political economy and recent studies of economic change, this debate is most visible in the divide between interest-based rational choice explanations (Frieden 2001; Hough 2001; Gaddy and Ickes 2002) and historical/sociological institutional explanations that focus on path dependencies and more structural constraints to economic change (Pierson 2000; Steinmo, Thelen 1992; DiMaggio and Powell 1991). A third variant is the introduction of network and informal institutional analysis, as advocated here and exemplified in the work of many (Fligstein 2004, Swedberg and Granovetter 1992; Helmsky and Levitsky 2004; Woodruff 1999; Portes 1997).

in terms of the size of both economies, their histories of hyperinflation, and their experiences with negotiations with the IMF and particularly with US aid agencies and military strategists, there was an immediate recognition of the other as a parallel and intriguing partner in the struggle to create economic growth given the pressures of global finance. A deputy director of the Bulgarian National Bank (BNB) stated, “We are trying to be the Ireland of Southeastern Europe,” just as a leading private banker in Quito explained, “Our rules are made to make our country a Switzerland of South America.”<sup>16</sup> These men saw themselves as part of a global economy, though located in small state “outposts” or underdogs in their regions. Their challenge was to make the best of their locations and opportunities, while sacrificing much to compete with their larger and often richer neighbors.

Both countries share important and politically active minority populations, which often shoulder a deep resentment for economic and social problems in both states. The indigenous population of Ecuador unites over forty distinct ethnic groups from the Incan descendent Quichua of Otovalo to the Shu’ar of the Amazon region, comprising almost half of the country’s population.<sup>17</sup> In Bulgaria, the Turkish minority and the Roma communities are less than twenty percent of the total population, but their presence (and their population growth in comparison to a negative birthrate among the general population) is often a scapegoat for the country’s economic setbacks and efforts to

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<sup>16</sup> From an interview with Tsvetan Manchev, Deputy Director of the Bulgarian National Bank, 5 October 2005; and in a personal conversation with Hector Barahona, Managing Director of Lexvalor, a legal trust fund and consulting firm to the Superintendent of Banks, in Quito, Ecuador, 18 February 2005.

<sup>17</sup> Population data depend on how ethnic identity is assigned or identified by census respondents. Since the 1970s much of the indigenous population has migrated towards cities and many choose to identify as “mestizo” once they live a more urban lifestyle. See Norman Whitten, ed. (1981) *Cultural Transformation and Ethnicity in Modern Ecuador*, Chicago: University of Chicago Press. Also see, Mary Crain (1990) “The Social Construction of National Identity in Highland Ecuador,” *Anthropological Quarterly*, Vol. 15, no. 3, pp. 43-59.

present a more “European” identity.<sup>18</sup> These are deep cultural stereotypes about Latin America and former socialist countries of Eastern Europe that seep even into understandings of economic performance and institutional change. These misunderstandings provided encouragement to pursue the comparison further.

The research design hinges on a case comparison in which the causal or independent variable is the degree of networked interaction (measured through a series of informal institutions that are rule-based social ties and practices) between international and domestic finance actors. The outcome or dependent variable is the resulting macroeconomic and bank sector policy, which is evaluated by monetary policy as well as subsequent bank supervision reforms. As Stephen Van Evera suggests, case studies can be methodologically strong in theory-building and theory-testing when they rely on congruence procedures and process tracing to compare a similar (or uniform) policy experience with some variation on the study variable (Van Evera 1997: 50-52).

In this study, the study variable (the independent variable) is an advisory network—a kind of informal institution—in the finance sector. There is some variance in this sector in each case based on the disparate cultural and regional nature of the case countries and the origins of their respective elite finance networks. Van Evera also argues that cases selected on the dependent variable (monetary and bank policies in this

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<sup>18</sup> The Roma population is especially disenfranchised from mainstream Bulgarian life and Roma identity tends to be flexible and difficult to measure, though most conservative estimates count the Bulgarian Roma at about 10 percent of the total population of eight million. See Janos Ladanyi and Ivan Szelenyi (2001) “The Social Construction of Roma Ethnicity in Bulgaria, Romania and Hungary During Market Transition,” *Review of Sociology*, Vol. 7, no. 2. Social exclusion of the Roma is severe, but there is also a history of state repression and violence of the Turkish minority in Bulgaria, particularly in the early to mid-1980s through the 1990s. See Vassil Garnizov (1998) “The Violence, the Nostalgia and the Guilt,” in Evgenii Dainov, Vassil Garnizov and Svetoslav Zanev, eds., *The Government and the People: Conflicts in Bulgarian Society in the Middle of the 1990s*. Sofia: Centre for Social Practices and New Bulgarian University. Also see, Deyan Kiuranov, et. al. (1998) *The Changes*. Sofia: Centre for Social Practices and Centre for Liberal Strategies, (in Bulgarian). Information provided in an interview with sociologist Deyan Kiuranov in August 2004, Sofia.

study) are excellent research design models<sup>19</sup> as long as the cases meet three criteria: first, if cases can be compared to a general situation; second, if cases have within case variance on the study variable; third, if cases are data rich and allow for process tracing<sup>20</sup> (Van Evera 1997: 46-47). In comparing Ecuador and Bulgaria, the two cases are part of a broad category of countries undergoing severe liberalization efforts in both macroeconomic and fiscal policies. There is variance, as noted above, in their historical experiences with political economic systems and social organization which influence the kinds of advisory networks that emerge. The policy change process is indeed rich and this dissertation seeks to elaborate and trace the monetary and bank policy changes in both cases.

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<sup>19</sup> Van Evera makes this assertion in contrast to other standard guides of political science methodology. See Gary King, Robert Keohane and Sidney Verba (1994) *Designing Social Inquiry: Scientific Inference in Qualitative Research*, Princeton: Princeton University Press, for the argument that selecting on the dependent variable creates selection bias, in that we are not able to determine causal effects because of the similarity of the cases. In this research design, however, the cases are so different in many ways except their recent experiences with implementing neoliberal economic reforms and severe monetary policy that the deduction of the causal variable of networks and informal institutions, discovered through field work, makes the cases even more important to compare for the likelihood that the findings are applicable to a number of other case countries, thereby inviting further research. For another rebuttal of King, Keohane and Verba, see Ronald Rogowski (1995) "The Role of Scientific Theory and Anomaly in Social Scientific Inference," *American Political Science Review*, Vol. 89, pp. 467-70.

<sup>20</sup> Process tracing is a method of analysis that seeks to trace or track "the decision process by which various initial conditions are translated into outcomes," according to Alexander George and Timothy J. McKeown. See Alexander George and Timothy J. McKeown (1985) "Case Studies and Theories of Organizational Decision Making," in *Advances in Information Processing in Organizations*, pp. 21-58. Greenwich: JAI Press. For more recent scholarship on this method and its central place in comparative political science analysis, see Andrew Bennett and Colin Elman (2006) "Qualitative Research: Recent Developments in Case Study Methods," *Annual Review of Political Science*, Vol. 9, no. 1, pp. 455-476. Peter Hall also makes an important argument for how small-*N* studies can be testing grounds for causal inference, as useful as their large-*N* counterparts, when analysts use systematic process review, or in depth case comparison and process tracing. See Peter Hall (2006) "Systematic process analysis: when and how to use it," *European Management Review*, Vol. 3, no. 1, pp. 23-31. For further background on Bennett and George's work on process-tracing and case selection, see the following: Andrew Bennett and Alexander L. George, "Research Design Tasks in Case Study Methods"; "Process Tracing in Case Study Methods"; "Lost in the Translation: Big N Misinterpretations of Case Study Research"; "Developing and Using Typological Theories in Case Study Research," all from the MacArthur Workshop, Harvard University, October 17-19, 1997. (All available on-line: <http://www.asu.edu/clas/polisci/cqrm/papers.html>; access date May 2, 2006.) See also the edited published version of these essays: Andrew Bennett and Alexander George (2005) *Case Studies and Theory Development in the Social Sciences*, Cambridge: MIT Press.

These two cases are experiencing a global financial movement—demands for capital movement and investment opportunities—that is not concerned with regional difference or past political and economic systems. As David Woodruff has phrased this phenomenon, Ecuador and Bulgaria share exposure to, and engagement with, a “world economic culture” (Woodruff 1999; see also Panitch and Gindin 2005). The cases also share what one might call an investment climate; and within this climate, the finance sector must build connections to international institutions and mobile capital. These cases are part of a class of developing and post-socialist political economies. Countries that have opened themselves to trade and foreign investors, as well as substantial debt, find there are limited economic policy options, particularly in their macroeconomic policy and in banking regulations. In effect, Bulgaria and Ecuador are in a common situation, in terms of their position as small states seeking to compete in the global economy.

These cases vary in that the causal variable—an economic policy advisory network—has very different social and cultural origins in each country. It is a difference that created a number of objections and requests for clarification from some of the interview subjects for this dissertation. Many were quick to differentiate their position vis-à-vis a post-socialist transition and the widening of an economic transition already underway. As noted, there is a wide literature on the issue of the singularity and peculiarity of the post-socialist and post-communist experience, particularly the role of elites in state-society relations (McAuley 1997; Bunce 1999; Stark and Bruszt 1998). For example, in both cases the economic elites tend to keep generational ties in the finance sector that go back and forth from the public to private sectors. This elite group in Ecuador is based on a long tradition of land-holding and commercial wealth that dates

back to the colonial era. It is a class and race-segregated elite. While in the case of Bulgaria, the families of the elite during the communist era, the *nomenklatura*, maintain their leadership status, based sometimes on wealth, but often on access to education abroad and connections within government bureaucracies. Social networks in both cases are key to explaining how economic reforms happen, but the material of those networks—how they are populated and their origins—are quite distinct. Because of the nature of these two distinct advisory networks—one built on a recent transition experience of the educated dissident elite, the other built of class and wealth positions maintained for centuries—the networks operate in very different kinds of political landscapes in which they compete for influence and policy control.

This dissertation does not question the dramatic nature of the post-socialist experience. It does, however, reject the notion that there are no common social ways of dealing with and negotiating major political and economic change. In this analysis, the politics of economic institutional change cannot be regionally or culturally specific.

The two cases share some interesting puzzles in economic performance after their monetary policy and banking reforms that provide some rich data to supplement the decision-making and process tracing analyses. As is true in most poor and institutionally fragile<sup>21</sup> political economies, the informal sector is strong and growing in both Ecuador

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<sup>21</sup> There is a wide and disparate literature on the issue and definition of state and institutional fragility. For a succinct critique of the literature and definition of state failure and fragility (among other terms used), see Susan L. Woodward, “Workshop on State Failure: Reframing the International Economic and Political Agenda, Introduction to the Meeting,” a manuscript/memo prepared for a meeting in May 2005 at the City University of New York, The Graduate Center, available at: <http://web.gc.cuny.edu/ralphbuncheinstitute/pss/state.html>. This dissertation follows the donor community, which defines fragile states as those with either critically poor policies or poorly performing institutions, or both. The general literature is based in the aid sector and addresses how aid can be more effective, with the widely held principle that more aid funds are more effective at promoting economic growth and reducing poverty where there are effective policy regimes, or efficient state institutions. See, US Agency for International Development (2005) *Fragile States Strategy*. Washington: USAID, for the American

and Bulgaria.<sup>22</sup> Recent economic growth (particularly from 1997-2006) in both economies seems to rely on certain kinds of assets, mostly property in the form of new housing construction and expansion of home mortgage lending in the bank sector. These facts are important because, as the results of dollarization and currency board reforms are measured, these indicators of low interest rates and increased credit access are often touted as the proven success of the stabilization reforms. The problem is that these outcomes are not singular evidence of the successful convergence of liberalization policies and stable macro-economic policy. A low interest rate does not make people safe or provide for their families, nor does it guarantee their government's ability to further a long-term development plan. If one interprets the data on home construction and the expansion of personal credit in relation to changing social patterns (like out migration and ways to safeguard remittance monies, and lending as part of a larger process of international banks expanding to "emerging" credit markets and local banks operating

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government policy, which clearly puts weak economic institutions, particularly hyperinflation, within the purview of the fragile state problem. See Mark McGillivray (2006) "Aid Allocation and Fragile States," WIDER Discussion Papers, No. 2006/01, Geneva: United Nations University; also see, C. Burnside and David Dollar (2000) "Aid, Policies and Growth," *American Economic Review*, Vol. 90, no. 4, pp. 847-68, for evidence supporting the claim that state policies and institutions affect aid effectiveness. This dissertation classifies Bulgaria and Ecuador as states with fragile economic and political institutions.

<sup>22</sup>Based on evidence from the Central Bank of Ecuador, data from the National Statistics Institute of Ecuador, independent studies from the Institute of Market Economics in Bulgaria and studies on both countries from the International Finance Corporation, the informal economy is impossible to measure exactly, but most measures point to a consistent presence in the economy since stabilization efforts or even an increase. See, Steven Kyle, Andrew Warner, Lubomir Dimitrov, Radoslav Krustev, Svetlana Alexandrova, and Krassen Stanchev (2001) "The Shadow Economy in Bulgaria," Working Paper, Institute of Market Economics, Sofia, Bulgaria; Economic Forecasting Agency, Sofia, Bulgaria; Cornell University, Ithaca. Internet Access:

<http://unpan1.un.org/intrdoc/groups/public/documents/NISPAcee/UNPAN004708.pdf>

See also: Institute for Market Economics (2002) "Study of Incentives, Characteristics, and Strategies of Firms Operating in the Shadows," Functional Borders and Sustainable Security: Integrating the Balkans in the European Union, IBEU (CT-2002-00131).

And further, Martin Dimitrov (2004) *The Hidden Economy in Bulgaria*. Sofia: Vitoshka Research.

<http://www.csd.bg/fileSrc.php?id=977>

Data for Ecuador: National Statistical Institute, Ecuador. Data current as of June 2005.

[http://www.inec.gov.ec/interna.asp?inc=enc\\_tabla&idTabla=165](http://www.inec.gov.ec/interna.asp?inc=enc_tabla&idTabla=165)

under a weak supervisory system), a different picture of the success of stabilization and liberalization reforms emerges. The bank and monetary crises that Bulgaria and Ecuador experience are part of a larger trend in global finance. Moreover, these shared experiences underline shared vulnerabilities to trends in global credit markets and the movement (and skittishness) of global capital.

There are similarities in the challenges the two countries face, given their selected monetary policies and recent banking crises, which warrant comparison in how they rebuild their banking institutions and economic policies. This study interprets and articulates this market-building by exploring ways that:

- 1) markets are based on social relationships and shared understandings of value;
- 2) that international and domestic social ties are informal institutions that can manipulate market-building and reform, and;
- 3) networks are mechanisms of institutional change.

The following section details empirical evidence of the growth of informal economies after monetary stabilization in each case (dollarization and currency board, respectively). The growth of informal economies along with the evidence of surging home construction and real estate markets gives a picture of the kinds of economic and development policies encouraged in small democratic liberalizing states like Ecuador and Bulgaria. The implication of this data is that it represents larger trends occurring in newly open political economies and how governments choose to react or incorporate this grey economy. The lack of interest in reigning in the informal economy speaks to the larger ideological basis of economic policies in countries dedicated to liberalism even with its high social cost. The chapter then discusses the international standards of bank supervision, which

countries like Bulgaria and Ecuador strive to meet in order to compete for sources of credit and finance, and to attract foreign investment. As noted below, the international norms in banking are non-binding and generally as minimally interventionist (that is, liberal) as possible. The chapter details the Basel system and the Bank of International Settlements as evidence of the increasing risks private banks take on, the scarcity of information-sharing, and weak enforcement of good banking practices globally while highlighting the common (and problematic) view that in the developed capitalist economies all banks are safe.

### ***The Informal Economy After Monetary Stabilization***

The original intention of the research was to investigate a link between an increase in the level of informal economic activity (what is often termed the black or grey economy) after monetary stabilization in each case. The literature on informality of economic activity along with empirical evidence in each case directed the initial research agenda of the dissertation. The evidence is clear: after monetary stabilization, the informal economy (unregulated, untaxed, cash-based economic exchange) surges as a signal of continued mistrust of the state's ability to regulate and supervise the value of money and the behavior of banks and other financial institutions. In conducting interviews with central bankers and economists in each case, but particularly in Bulgaria, a parallel finding began to take shape. Informal economic activity is a vibrant part of economic life in transitioning political economies. It is based on social ties, ideas of reciprocity, and a system of exchange outside of government control. In fieldwork and interviews with central bankers regarding the twin crises of Bulgaria and Ecuador, a similar picture of economic *governance* emerges; social ties and ideological ties informed policy processes more than formal political institutions. The evidence and the argument

for liberal advisory networks as key factors in the formulation of monetary policy and the execution of bank reform then began to take shape. The Bulgaria case evidence initiated this hypothesis, as a mapping of individuals in decision-making positions unfolded through interview data. The Ecuador case served as a test. As informal institutions, networks function in many ways like similar mechanisms of trust, legitimacy, and verification among street peddlers and black market vendors in the informal or unregulated economy.

Informal economies are built on social networks and relationships of trust, often in environments where formal institutional arrangements of verification and contract enforcement do not exist (Capecchi 1989; Itzigsohn 2000; Portes and Itzigsohn 1997; Perez Sainz 1997; De Soto 2001). Informal economies are defined as, “those actions of economic agents that fail to adhere to the established institutional rules or are denied their protection” (Feige 1990: 990). Or, alternatively, informal economic activities are “all income-earning activities that are not regulated by the state in social environments where similar activities are regulated” (Castells and Portes 1989:12). In both definitions, the role of institutions is key, one focuses on the formal aspect of institutional enforcement, while the latter focuses on the parallel division made by social distinctions, or informal institutions.

Economic crisis increases the size of the informal economy. In a study by the World Institute for Development Economics Research (WIDER) of the United Nations University research system, economists found that the size of the population employed in the informal economy increased from about 12.5 percent before the 1996-1997 crisis to about 47 percent immediately after the crisis in Bulgaria (Dimova, Lang, Landon-Lane

2005: 13). The point here is to see these practices as persistent aspects of economic life that may have had a strong place under socialism and its immediate transition to capitalism, but that also have a way of pervading in capitalist systems as a resource, especially in moments of financial crisis.

In a 2001 study conducted by researchers from Cornell University, Harvard University, and the Institute for Market Economics (IME) in Sofia, Bulgaria, over 530 firms responded to an extensive survey on incentives and disincentives to operate in the shadow or informal economy in Bulgaria (Kyle, Warner, Dimitrov, Kristov, Alexandrova, Stanchev 2001). In this study, the researchers probe the distinction between informal and illegal activity. The research found that the Bulgarian shadow economy in 1998 declined below the estimated base year (1989) proportion of 30 percent. According to their calculations, the proportion of the shadow economy in 1998 GDP in Bulgaria was 22 percent. The largest proportions were observed in 1990 (32.2 percent) and 1996 (34.4 percent), declining thereafter. The team's 2001 estimates for the size of the informal economy hover between 20 and 25 percent of the total economy activity in the country. The research indicates that while illegal and shadow economic activity may be decreasing since the transition, overall activity in the informal economy has not declined significantly (Kyle, et. al. 2001).

A subsequent study from 2002-2004 by IME researcher Martin Dimitrov surveyed over 1,000 households and found that more than half of the country's population is involved in some form of the informal sector of the economy.<sup>23</sup> The study found that the gray or hidden economy had not decreased at all, but expanded in the period. The joint

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<sup>23</sup> See Martin Dimitrov (2004) "The Hidden Economy in Bulgaria," Sofia: Vitosha Research. Internet Access: <http://www.csd.bg/fileSrc.php?id=977>

Harvard-IME study made some important findings about how business operators explain their informal activities, and the perceptions of activities by others in their industry. The survey shows that 54 percent of the companies make and receive payments in cash and only 32 percent of the respondents use bank transactions as a payment mechanism. Nearly 65 percent of respondents stated they always preferred transactions in cash, while over fourteen percent considered bank transactions risky and saw the banking options poor in quality. Up to 15 percent of the companies acknowledged hiring employees without contracts or reporting taxes. Many companies reported claiming an average of 35 percent below real incomes for contracted employees on their tax and pension liabilities to the state (Dimitrov 2004: 93).

A 2003 study funded by USAID and directed by the Urban Institute in Washington, D.C. on the growth of the mortgage market and development of the banking sector in Bulgaria made some interesting findings about the parallel boom in housing sales and construction in Bulgaria, along with a disappointing expansion of the mortgage sector. The study finds that bank lending to individuals for housing remains a new field as credibility in the private bank system continues to build. Of the 100,000 real estate sales in 2002, estimates are that only 2-15 percent of those sales were financed with mortgages.<sup>24</sup> There is a lag not just in the development of a mortgage market (there have been laws and private banks created for this purpose), but a lag in the use and everyday practice of taking home loans. Economic actors find housing a safe and credible

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<sup>24</sup> See Sally Merrill and Carol Rabenhorst (2003) "Developing Secondary Mortgage Markets in Southeast Europe: Assessment of the Mortgage Market in Bulgaria," Working Paper. Washington, D.C.: Urban Institute. Internet access: [http://www.ceemortgagefinance.org/pdfs/Bulgaria\\_assessment.pdf](http://www.ceemortgagefinance.org/pdfs/Bulgaria_assessment.pdf)

investment, but the financial and legal institutions upholding these practices remain underused.

Housing prices rose by 10.6 percent in the first quarter of 2005, compared to the last quarter of the previous year, in reports by the National Statistics Institute (NSI). Bulgarian housing prices rose by 47.5 percent in 2004. However, in 2005 the number of houses on offer was 466 percent higher than the same month in 2004. From the fourth quarter of 2003 to the fourth quarter of 2004, Bulgaria recorded an average increase of 31 percent in a one-year period.<sup>25</sup> Brick and mortar investments are often cash based, can be shared among a number of investors (or family members), and have the appearance of guarding resources more tangibly than bank accounts or stock shares. Housing investments, particularly those that do not require bank financing, also lend themselves to contractual arrangements that are informal and enforceable through social relationships, rather than legal codes.

In Ecuador as well, there is good evidence from the central bank that the size of the informal economy has indeed grown since the installation of the dollarization plan in January 2000. From January 2001 to June 2005, the informal sector of Quito has grown from 34 percent of the employed to 49 percent of the employed. While it is true that the state as a resource for employment has diminished in size, there has also been an expansion in the growth of the overall economy, giving the impression that new businesses have been started and new jobs offered. What is striking is, as in the Bulgarian case, new job growth seems to be emerging in the informal sector rather than in regulated business activity. For comparison, 91 percent of the businesses in Bulgaria

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<sup>25</sup> Ivan Vatahov (2005) "Real Estate: limits and potential" *Sofia Echo*, 2 May 2005. Web access: [http://www.sofiaecho.com/article/real-estate-limits-and-potential/id\\_11246/catid\\_23](http://www.sofiaecho.com/article/real-estate-limits-and-potential/id_11246/catid_23)

are small enterprises with less than five employees. These businesses are the bulk of the Bulgarian economy, yet they do not seem to be increasing in size, in terms of employees and infrastructure. There is evidence, from the International Finance Corporation, that 99 percent of the businesses in Ecuador are small or medium businesses, defined as having fifty employees or less.<sup>26</sup> It is reasonable to hypothesize that largest part of that group consists of businesses with five to ten employees and most that are family-owned and operating by informal (non-regulated) standards.

Trends in Ecuador also suggest that there is a surge, since the dollarization stabilization plan, in new construction and real estate investment. The National Statistical Institute finds that construction expenditures have increased 200 percent from 2000 to June 2005.<sup>27</sup> In a recent study by the Center for Urban Development Studies at Harvard University, researchers examined Cuenca, the third largest city in Ecuador, and found a marked increase in housing prices and new construction financed in cash payments and largely from family remittances.<sup>28</sup> They link the pre-dollarization crisis and new policy to increased out-migration and then to increased asset-building in a home city

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<sup>26</sup> International Finance Corporation, "The Case for SME's," Web Access: [http://www2.ifc.org/sme/html/the\\_case\\_for\\_smes.html](http://www2.ifc.org/sme/html/the_case_for_smes.html). An intriguing survey report of 76 developing economies by World Bank economists in 2003 found that there is not a causal link between countries with high levels of small to medium-sized businesses and reducing poverty. This report finds that 55 percent of Ecuador's economy is made up of small-to-medium-sized businesses numbering 250 employees or less. See: Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine, "SMEs, Growth and Poverty: Cross Country Evidence," 5 November 2003. Web access: <http://www.worldbank.org/research/bios/tbeck/sme.pdf>. The research is related here because banking and monetary policies that seek to formalize the informal cash economy often include efforts at funding small and medium businesses. If the research is correct in arguing that an increase in small and medium businesses does not necessarily create broad avenues for poverty reduction, then many of the aid policies that seek to eradicate poverty through economic liberalization and a focus on regulated entrepreneurial activity are flawed, or at the least, overly optimistic in their impact on improving the lives of the poor.

<sup>27</sup> National Statistical Institute, Ecuador. Data current as of June 2005. [http://www.inec.gov.ec/interna.asp?inc=enc\\_tabla&idTabla=165](http://www.inec.gov.ec/interna.asp?inc=enc_tabla&idTabla=165)

<sup>28</sup> See Mona Serageldin, Yves Cabannes, Elda Solloso, and Luis Valenzuela (2004) "Migratory Flows, Poverty and Social Inclusion in Latin America," paper prepared for the World Bank Urban Research Symposium, Harvard University, Center for Urban Development Studies.

through construction and housing demand. Investing at home, through cash influges to families and networks, can offer stability and security in a difficult transnational economic life.

These data spurred the fieldwork to investigate the concept of informality, as in networks as a type of informal institution, applied to the policymaking process. The monetary stabilization packages in both cases failed to create confidence in their respective financial systems. The data then suggest that something about the policy process, and the lack of legislative and supervisory action, informed this crisis of confidence in the financial systems. The research task then became to understand how the decision to restrict monetary policy was made, and why significant overhauls of the bank sector did not follow, with the hypothesis that some kind of informal institution—a network—informed decision-making and influenced policy outcomes. The evidence of the increase in informal economic activity also suggests the state (in both Bulgaria and Ecuador) has been unwilling or unable to guide its economic development process. The premise is that liberal economies grow better unfettered by government intervention.

The understudied aspect of this “grass-roots” or informal growth is the risk practices it encourages and receives from domestic financial institutions. Put simply, banks that extend loans and mortgages to businesses that do not pay taxes, grant social service benefits to their employees, or report real assets or income are putting other bank creditors and borrowers at risk. Hence, the adage that lending booms precede credit and bank crises should make governments keen to monitor the expansive growth of informal economic activity and its relation to lax expansion of local credit markets. There is little incentive or guidance from international norms, however, for governments to link risk in

the growth of their informal economies to unprecedented growth in domestic banking sector. The guiding international policies and standards on bank reform (discussed below) are not binding or particularly stringent.

The following section explains in detail the only global standards in bank supervision and central bank policy. The goal of this discussion is to raise two points: 1) In an effort to promote liberal economic policies, the Basel standards make little distinction of how credit allocation and government supervision of private banks might need to differ in countries more vulnerable to capital flight; and 2) The tradition of risk in banking and the expansion of liberal economic policy have directed the growth and trajectory of global capital markets in the post-Bretton Woods era without much academic or public scrutiny. Accepting risk has, until the 2008 credit crisis, had little negative effect in the American and Western European financial capital markets. However, since the 1980's there have been more bank failures and credit crises globally than in the years post-Bretton Woods to the general expansion of liberal economic policy beginning in the late 1970s (Smick 2008).

### ***State of the Art in Bank Supervision and Interdependent Monetary Policy***

The Bank of International Settlements (BIS) is an international organization that acts as a policy forum for central banks,<sup>29</sup> a research center, and an active bank for central banks (mostly in currency trading), though not for private clients or businesses. Part of the BIS

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<sup>29</sup> The fifty-five members (represented by central banks or their respective monetary authorities) of the BIS are the following countries: Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, the Republic of Macedonia, Malaysia, Mexico, the Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom and the United States, plus the European Central Bank. Source: Bank for International Settlements, web access: <http://www.bis.org/about/orggov.htm>.

and its policy forum capacity are standing committees, of which the Basel Committee on Bank Supervision (BCBS, or Basel Committee) is one. The head office of the BIS is located in Basel, Switzerland, though there are two other offices in Hong Kong and in Mexico City. The Basel accords are two sets of recommendations made by the BCBS, the first in 1988 (Basel I) and the second (Basel II) in 2004. The BCBS is made up of thirteen members at present, though its original composition was the so-called Group of Ten, which refers to the group of countries that agreed to participate in the General Agreements to Borrow (GAB). The GAB was established in 1962 when the governments of eight International Monetary Fund (IMF) members—Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, and the United States—and the central banks of two others, Germany and Sweden, agreed to make resources available to the IMF for drawings by participants and non-participants. Switzerland joined in 1964, but the group name was not changed. The Group of Ten is significant because it also heralded in the age of floating exchange rates in 1971 (when the US was no longer able to defend the dollar-based gold peg) by signing the Smithsonian Agreement in December 1971.

The Basel Committee is comprised of country members (and their respective central bankers) appointed by the Group of Ten in 1974. The membership has not changed since its creation and includes: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. This committee's core recommendations on bank supervision policies are meant to help prevent banking crises, currency crises, and to give legitimacy to legislative efforts at reform. There is no enforcement mechanism of the committee. But,

there is also not exactly a democratic or power-sharing nature to the committee membership or the BIS Group of Ten either. The leadership of global monetary policy and bank supervision standards is a network of national economic power that is a remnant of the post-World War II era and the managed consensus of the shift from a gold-backed exchange rate in the early 1970s. The United States and its partners in the Group of Ten established this international institution to maintain a hierarchy of leading financial centers, while also limiting any international body from firmly regulating cross-border flows and the growth of the multinational bank.

The Basel I accords are seen as a failure by most economists and monetary policy experts (Steil 2006). The Basel Capital Standards were a policy recommendation set out in the Basel I accords that suggested an eight percent capital standard for all internationally active banks to be achieved by 1992. The idea was that if a bank kept at least eight percent of the amount of its extended loans in deposits, it would run a lesser risk to its depositors and any domestic authorities in charge of protecting depositor assets. There are two widely accepted reasons why the Basel I accords are viewed as a failure: 1) there were not uniformly enforced in times of recession by their leading (and richest) members (the US, France, Germany and Japan), and 2) the definitions of kinds of capital and ways to account for bad loans allowed a great deal of difference in accounting standards across individual banks and national economies. As Benn Steil argues, the accord made no effort to distinguish between risks of different kinds of loans (commercial or consumer), nor risk rating differences among developing country OECD members (e.g., Mexico) and richer countries (Steil 2006: 20).

Basel II is at the outset of its framework implementation and it seeks to remedy some of the failures of Basel I. Basel II builds on the capital requirements of Basel I and has three main components or “pillars”: calculation of minimal capital requirements for credit risk, bank supervision review, and promoting market discipline. Basel II at least acknowledges the weight of its committee recommendations in developing and transition economies by noting that the IMF and World Bank share the view that national banking systems that choose not to implement the recommendations will not be judged for loans according to its standards, but to the standards they choose for themselves.<sup>30</sup> This is a difficult position to support, as all countries with an international commercial bank presence are in one location or another exposed to these standards. The Ecuadorian case is an excellent example, as the country is not a member of the BIS, but the central bank and private banks are acutely aware of the Basel standards and seek to meet them because of pressures of their own creditors.

The Basel Committee and its organizational parent, the BIS, are key examples of the limited formal institutions that exist to regulate the global system based on principles of economic liberalism. Interestingly, the few institutions and non-binding rules existing on bank supervision and discussion places for monetary policy are essentially artifacts of political power sharing between the dominant powers before and after World War II. Their recommendations and research data give the idea of transparency, but their membership systems and hierarchy suggest a longer-lasting network of both formal political institutions and the informal institutions of the economists and bankers who people these institutions through time, bound by the shared expectation of the gains of a

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<sup>30</sup> Bank of International Settlements, “Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework,” November 2005. Web access: <http://www.bis.org/publ/bcbs118.htm>

non-regulated liberal economic system, and the ability to shape that system from positions of power and wealth within its founding membership.

With that tension between formal and informal institutions available to set the standards of successful banking systems, and the shared ideological commitment to not regulate financial activity across national borders, there are some clear challenges to a transitional banking system like the ones emerging in Bulgaria and Ecuador in the 1990s. The lack of specific rules, no enforcement bodies, and a disparity between recommendations of the BIS and the two most important lenders for a transition country, the World Bank and the IMF make the policy choices of transition or developing country all the more difficult.

The most recent and only large-N study of the impact of Basel recommendations (Basel I and Basel II) suggests that they do not correlate with more sound, less fragile, and growth-promoting bank systems (Barth, Caprio, and Levine 2006). In fact, James Barth, Gerard Caprio, and Ross Levine argue that domestic political institutions and their ability to define their own checks and balances on market openness and internal checks on the private bank sector are more likely to result in reduced poverty, safer bank systems, and more credible central bank policies. Meeting the Basel bank supervision standards, on their own, does not make banks less prone to failure (Barth, Caprio, and Levine 2006: 253). Their research, an empirical study of over 150 countries that have tried to implement Basel I and II, is critical of the Basel process as overly technical in advice, but it might also be interpreted as an indication of the complexity of the political and social process for central bankers and policymakers. As they argue from their cross-national survey:

The results suggest that bank regulatory and supervisory strategies that focus on empowering private sector monitoring of banks work better than strategies that rely excessively on official supervision...Bank regulatory and supervisory strategies reflect deeply rooted national institutions and attitudes toward the role of government in society. Indeed, it is the role the government plays in a society that sets the tone for regulation and supervision. To better understand both the determinants of bank regulatory and supervisory policies and effective strategies for reforming those policies, future research should use country case studies to trace the forces shaping the evolution of bank regulation and supervision (Barth, Caprio, and Levine 2006: 253).

In the 1990s, much of the academic discourse focused on the conditionality of development loans and the so-called Washington Consensus (Williamson 1990), which often tied the hands of domestic economic policymakers in indebted countries. Severe macroeconomic reforms and international banking institutions are a second wave of economic conditionality. Today one might define a new, more subtle conditionality: Banks are likely to lose investors if they do not create some standards for protecting their clients, yet if they follow the Basel recommendations to the letter, they are not guaranteed better performance or a more secure banking system. Given these decision-making structures and pressures, contacts between international lenders (public and private), domestic economic policymakers, and local private bankers become essential information channels. As Barth, Caprio, and Levine invite, this dissertation attempts to demonstrate—with two diverse country studies—the more social and informal nature of the forces shaping bank regulation and monetary policy formation.

### ***Fieldwork and Data***

The cases are built on elite-level interviews with policymakers within the National Bank of Bulgaria (BNB), the Central Bank (Banco Central) of Ecuador, former and current IMF representatives in the case countries, USAID officials and United States State department officials in the case country embassies, American investors and business

people, senior bankers covering “emerging markets” with particular coverage of Bulgaria and Ecuador at various banks, including: Goldman Sachs, United Bank of Switzerland, and Credit Suisse in New York. Interviews were conducted with other public sector and international aid officials, including United Nations Development Programme staff in the case countries, academic researchers covering the political and sociological nature of economic change, and local experts in the NGO and consulting sectors of both countries. Politicians and elected officials with tenure during the crises in each case provided personal recollections of bargaining and private meetings with individuals listed above.

Archival research in the financial press, research from local economic analysts and institutes, and data sets from government finance ministries (unofficially), and official measures from the World Bank and similar international organizations helped paint a larger picture of the financial situation in both cases before, during, and after the crises.

Some of the interviews were confidential, though most are attributed to the individual respondents. Many interviews were semi-structured (among central bankers, for example), though most were unstructured. There was no common questionnaire. Background research and elite ethnographic research was conducted with field exposure of six months in Bulgaria (2005, plus an introductory trip in 2004) and almost two years in Ecuador (August 1997-February 1999), with complementary research trips in 2000, 2002, 2004 and 2006. Some interviews were conducted in New York and Washington, D.C.

Selecting and identifying interview informants, and in some cases network members, involved establishing key contacts with principle architects of each major

policy decision—in Ecuador, this identification process involved meeting with finance officials of the Mahuad administration and central bank director, in Bulgaria, the process required meeting with members of the Kostov administration, and the director of the central bank during the 1997 crisis. These first identifications led to a series of other contacts, and prioritizing both junior and senior officials and bankers to provide a top-down and bottom-up perspective of the monetary and bank crises in each case. Eventually, through webs of interview contacts, a two-generation picture of the policy process emerged which uncovered aspects of training, selection and recruitment, affiliations with universities and foreign sources of financial and ideological support. These institutional connections in universities, research centers, and the donor community then served as the secondary sites for further interview research. A trail of network activity emerges. In this sense, the dissertation is a mapping of both individuals in the policy process, and sites or locales of policy influence.

### ***Existing Explanations for Monetary and Bank Reforms After Financial Crisis***

This section discusses how existing explanations in the literature of institutional analysis in political science and political economy have tackled the problem of monetary policy choice and economic reform. The dissertation seeks to go beyond these traditional explanations and to complement them. Traditional explanations categorize the choice to dollarize or enact a currency board as externally driven by lenders (a power-based explanation), or as policy osmosis, in the sense that countries have shared policy values and must compete with one another (based on the assumption that the state is a unitary actor). Further institutional reform or stagnation is explained by path dependency, or by self-interested actors orchestrating reform failure within institutions for personal gain (also known as corruption or “early winners” explanations). Traditional institutional

analysis uses these concepts (path dependency, corruption or rent-seeking by self-interested actors, and international economic balance of power) to individuate policy choices and outcomes in economic reforms. Social structures like race and class hierarchies may also impede the economic reform process, as centers of power and wealth may manipulate reforms. This explanation is a general corruption argument that is domestically-focused and tends to block analysis of multiple and external factors. Usually, each of these explanations serves to explain perceived cases of reform failure.

These explanations offer some important insights to understanding both the monetary and bank policy reform process in each case. Below, details of the cases reveal how these standard explanations in the literature do have relevance. This section treats these existing explanations in turn: 1) International politics, particularly the influence of powerful states in the international system and their proxy presence in international financial institutions, can steer monetary policy choice and discourage independent national efforts at increased bank supervision. 2) Policy osmosis, or a convergence of theories and practices in economic reform based on trends in the international system, is an ideational and powerful influence in monetary policy choice and financial reform implementation. 3) Various domestic actors, including lobby groups, politicians, and business elites may skew the reform process to their own personal benefits. 4) Historical legacies, as social structures and sources of persistent inequality, may influence the economic reform process and its often disappointing outcomes.

#### *Existing Explanations Applied to Bulgaria*

In Bulgaria, the decision to create currency board in 1997 and the problematic reform of the private bank sector that followed both were results of a major financial crisis—a

currency crisis and a major collapse of the private bank system in a newly liberalized democratic country. The background and causes of this financial crisis leading up to 1997 help justify some existing explanations of the monetary and bank reform after 1997.

In 1989, Bulgaria made a quick and relatively smooth transition to democracy. Two major political parties formed with large followings (even with few name changes in the case of former socialist party leaders), the Bulgarian Socialist Party, BSP, and the United Democratic Front, UDF (which is popularly known as CDC, its Bulgarian acronym) as the country adopted parliamentary democracy to replace the one-party rule of the socialist era. The transition on the economic front, however, was not as smooth. As the COMECON trading arrangement dissolved between the Soviet Union and its client states, the Bulgarian economy came under particularly severe pressure.<sup>31</sup> Combined first with declining trade activity in the former Yugoslavia due to wars and secondly, the sanctions imposed on three of Bulgaria's other key trade partners, Iraq, Iran, and Libya, the opportunities for exports, much less the production needed to sustain them, dwindled. International sanctions against Iraq and Libya effectively froze the servicing of more than \$2 billion in debt to Bulgaria. Wars in the former Yugoslavia damaged trade flows and created new markets for criminal activity, particularly in smuggling non-criminal items like alcohol and cigarettes from Bulgaria across the border to Serbia and Bosnia (Ganev and Wyzan 2004). By 1991, Bulgarian exports to COMECON countries had declined by about 60 percent, and its exports to other countries by about 25 percent (Yakimova, Bhaumik and Shivarov 2002).

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<sup>31</sup> In 1987, 82.5 percent of Bulgaria's exports and 80.5 percent of its imports were with communist partners. Almost 60 percent of Bulgaria's trade was with the Soviet Union in 1988. See Juanita Adams, ed. (1989) "Background Notes on Bulgaria," US Department of State, Washington, D.C.: US Department of State, Bureau of Public Affairs.

One of the major shifts in political economy in Bulgaria since 1990 has been the move to privatize state assets. A formal privatization institution or agency within the government was not established until 1992. The state privatization agency made slow progress, and by 1997 only 20 percent of state assets were privatized (OECD 1999). Price liberalization began in February 1991, with dramatic increases in inflation immediately to over 400 percent.<sup>32</sup> The inflation would be difficult in any economy, but the social transition from state-controlled prices to major price volatility caused panic. In order to relieve social pressures of the transition, the government began to subsidize some prices in food and essential commodities from 1992 to 1996, leading to market distortions and a pattern of government fiscal mismanagement (Berlemann, Hristov and Nenovsky 2002). The privatization process was not only slow, but it was also at considerable cost to the Bulgarian people as the failing balance sheets of state-owned enterprises were converted into national debt and consistently monetized or written-off by the Bulgarian National Bank in the form of loans to the government (Berlemann, Hristov and Nenovsky 2002; Vincelle 2001). Inflation was chronic, as the currency depreciated from 0.0152 (new) *leva* per USD to 0.0660 (new) *leva* per USD from 1990-1994.

In September 1996, the BNB raised the benchmark interest rate to 300 percent. Under increasing pressure from the public devastated by the inflation, the ruling coalition of the BSP was forced to dissolve its government, but there was not such a quick fix to resolve the central bank's and the government's financial problems. The deficit was

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<sup>32</sup> Inflation spiked across Central and Eastern Europe in the early 1990s as governments released price controls and began to use macroeconomic tools to control interest rates and inflation, on average nearly sixty percent annually. In Bulgaria, inflation had leveled off to around thirty-five percent (annual) by 1995, which was higher than Estonia, but better than many of its closer regional neighbors. See Carlo Cottarelli and Peter Doyle (1999) "Taming Inflation in the Transition Countries," *Finance and Development*, Vol. 36, no. 2.

monetized, which meant a further depreciation of the *lev*. Inflation rose from an already high 310.8 percent in 1996 to an overwhelming 578.6 percent in early 1997 (Yakimova, Bhaumik and Shivarov 2002; see also, Berlemann, Hristov and Nenovsky 2002). The inflation and the impossible cost of living (including basic necessities like bread) led to massive street protests and, ultimately, the dismissal of the government and demands for an innovative economic policy to curb inflation and reorganize the failing bank system. The currency board was the solution in 1997, though the IMF support of the monetary stabilization package and the follow-on stand-by agreement had no stipulation for reform of bank supervision in the private sector.

The purpose of recounting this basic history of Bulgaria's economic transition to a capitalist system and its first major macroeconomic crisis underlines some key domestic and international vulnerabilities. There were clearly some necessary interventions from international financial institutions in the policy process to alleviate the hyperinflation and find some stable ground for economic recovery. Because Bulgaria began its liberalization process in such poor conditions (low foreign reserves, few trading partners, even fewer foreign investors), the country's ability to borrow money on international capital markets was limited to international financial institutions, particularly the IMF. The IMF, then, had a strong role in advocating a currency board plan to the struggling government in early 1997. In the recovery from the twin currency and bank crises after 1997, several international political factors had a strong influence on policy choice and implementation.

First, the role of international lenders helped limit major economic policy innovation by either a liberal or socialist government as major objectives (privatization programs, the elimination state subsidies in gas and basic necessities, the imperative to

welcome foreign capital) were part of on-going debt obligation agreements between Bulgaria and its lenders. One might argue that the demands of maintaining a good standing with the IMF after such a difficult economic crisis left Bulgaria uninterested or unwilling to instigate any policy reform without first receiving some instruction from abroad. Furthermore, the IMF made no stipulations in its loan agreements that the private bank sector receive more scrutiny or regulation from the Bulgarian central bank. The European Union accession process also falls into this category, in which Bulgaria first prioritized loosening financial regulations before endeavoring to create new checks on its bank practices. Bulgaria maintained a close relationship with the United States between 1997 and 2005 for two distinct reasons. First, the influx of funding to post-socialist countries via USAID began as a means to create investment opportunities for American businesses and interests, including the development of a mortgage market through the Bulgarian American Enterprise Fund. Second, the aid funding continued after its original mandate when Bulgaria's strategic location made the country an important ally in the wars in the former Yugoslavia in the early 1990s and then again as a staging point to the Middle East in 2003. These vulnerabilities are evidence of the important role international financial institutions and more powerful foreign governments have had in steering Bulgaria's macroeconomic policy since the transition and after the crisis of 1997.

Second, Bulgaria sought to borrow and replicate policy expertise from abroad in its effort to create a capitalist economy. Though a currency board program was not common in post-socialist states in the mid-1990s, the fundamental ideas of the liberalization regime that followed the currency board and the Bulgarian National Bank's loose supervision of the private bank sector could be viewed as part of a larger process of

policy osmosis. Particularly in the area of bank regulation, Bulgaria has consistently used the Basel standards as a Baseline for policy change. The convergence on this international, non-binding, and minimally-restrictive standard has actually loosened supervision on private banks instead of strengthening them. The causal role of policy osmosis is not very clear in the case of Bulgaria, because the currency board was quite novel, but the more general liberalization scheme and hesitancy to create rules on the bank sector reflect more general trends in the global political economy (stemming from Basel best practices) and a larger ideological commitments to economic liberalism.

Third, Bulgaria did not have an active private bankers' lobby or commercial association to advocate against strong regulation by the central bank after the bank crisis, but it did have experience with close ties between the government bank (the Bulgarian National Bank), new private banks, and businesses. In fact, most private banks in Bulgaria in 1997 were only recently in private hands and most had loyalties to specific industries (Vincellette 2001). Because most industrial or commercial entities were formerly state-run and maintained ownership structures related to members of the former regime elite, the ties between banks and industry were close. However, the standard arguments of interest groups lobbying for specific bank reforms or economic policies does not hold well in the case of Bulgaria, as an established capitalist class of bankers and entrepreneurs with an organized policy approach did not exist. The argument for "early winners" or those who maintained positions of power and wealth early in the transition process and were able to use their influence to steer policy and legislation to the benefit of private enterprise is also difficult to make for Bulgaria. Many post-socialist elites preferred to hold on to state enterprises and connections to the state rather than use

privatization as a means to acquire wealth. The state remained a central site of wealth extraction, leaving macroeconomic policy the concern of technocrats and ideologues, rather than organized business lobbies.

In Bulgaria, the role of elites, ideas, and the influence of international politics and foreign governments clearly played some role in the way the macroeconomic and bank policy reforms took place. There is not much evidence to suggest that a systematic class structure or identity structure motivated reform efforts, or quelled reform proposals. The nature of the post-socialist transition and the quick shift in identity for many politicians, academics, and entrepreneurs over-rode in many cases previous social hierarchies.

#### *Existing Explanations Applied to Ecuador*

Ecuador's currency crisis began in 1998, while dollarization followed in early 2000. The crisis of dollarization was preceded by several important international events as well as a domestic reshuffling of the banking system and run on the domestic currency, the *sucre*. As it affected Bulgaria, the deterioration of the investment image of emerging market countries which began with the Mexican "Tequila" crisis of 1995, and then passed to the Asian crisis in 1997-1998 impacted banks in Ecuador as international capital flows tended to diminish, at least in the form of direct investments. Ecuador was also hit with a series of natural disasters. *El Niño*, the tropical flood that devastated the coast of Ecuador in 1997-98 also destroyed two of Ecuador's main export commodities—the shrimp and banana industries. Ecuador has been vulnerable to the oil industry since it was discovered (by foreign companies) in the 1960s. Ecuador is vulnerable to the fluctuation price of oil for state revenue, but also to private companies that extract oil with very favorable contracts to the companies negotiated in the 1960s and 1970s. The global

market price of oil also fluctuated wildly in the mid-1990s, reducing government revenues.

It was a combination of natural, domestic, and global events that led to increasing pressure on national banks to extend extra credit to coastal enterprises at the expense of their reserves and to their ability to guarantee deposits. The environmental disaster deflated the domestic economy, along with a lack of new investments, and pressure on the *sucre* began to build. Difficulties in maintaining political stability, a chronic problem of presidential turn-over, peaceful overthrows of democratically-elected presidents, and the brief intervention of the military in 2000, have made governing Ecuador's economy all the more difficult. The architect of dollarization, President Jamil Mahuad, was thrown out of office just two weeks after announcing dollarization on January 21, 2000.

The effect of the crisis was palpable. The proportion of Ecuador's population in poverty reached almost 45 percent in 1999, up by a third since 1995. Meanwhile, unemployment doubled to 17 percent in the calendar year of 1998.<sup>33</sup> By 2000, half of the operating banks in the country had failed. At the beginning of the crisis in 1998, the government promised to guarantee all bank deposits, though by 1999 most bank accounts (and all dollar accounts) had been frozen by the government. The banking sector required (but did not receive) a complete overhaul in state supervision and in private efforts to recoup lost revenues and personal savings.

This brief summary of some of the domestic challenges facing Ecuador in financial crisis (political instability, poverty) and in unpredictable obstacles to growth (natural disaster, natural resource dependency, global credit fluctuations) gives some

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<sup>33</sup> See Stanley Fischer, "Memo on Ecuador and the IMF." 19 May 2000. Available at: <http://www.imf.org/external/np/speeches/2000/051900.htm>

indication of the myriad of factors influencing the election of macroeconomic reform policies and potential explanations for the hesitancy to rebuild the bank system with a strong role for state supervision. As in Bulgaria, there are multiple existing explanations for why the country chose to dollarize in 2000, and why subsequent reform of the bank system has proven difficult for Ecuador. These explanations are again treated in turn below.

First, the role of international political institutions and foreign governments has clearly been important in Ecuador's efforts to confront its financial challenges. Dollarization, however, was not a policy recommendation from the outside, or part of a debt negotiation as in Bulgaria. The policy proposal was organic and purely domestic, though this research details how a cabinet level envoy of Ecuador did try to approach the U.S. government for minimal support in the fall of 1999. Dollarization was an executive decision made with network support in a financial crisis. That crisis, however, did have international roots: the fall of emerging markets as a destination for foreign investment, the fluctuation in the global price of oil (Ecuador's primary source of foreign reserves), and more general pressures from international financial institutions beginning in the 1980s to curtail fiscal spending on social programs and industrial subsidies and open national markets to foreign investors.

Second, the notion of policy osmosis as a factor encouraging the adoption of the U.S. dollar in local circulation in Ecuador is tentative, at best. Panama and Costa Rica had similar experimentations, though the "trend" of dollarization was not established in late 1999. Separately, policy osmosis in terms of bank regulation and adherence to the non-binding Basel standards in bank supervision had begun to gain traction in Ecuador,

as well as most developing and transition economies in the late 1990s. This trend had its base in a larger ideological commitment to liberalism as an economic orientation and more informally in the international banking community as a standard of best practice. Because Ecuador had such limited success in attracting foreign banks to operate and open credit lines to the domestic economy, local banks with regional aspirations made very public (if not administrative) efforts to support the Basel standards. Most of these banks did not succeed, but their public commitment to assume these policy goals was clear and evidence of a larger policy osmosis in process across regional boundaries.

Third, in Ecuador there is wide acceptance of the argument that corruption plays an important determining role in the success of any administration and its economic policies. Pinpointing the sources and motivations of corrupt actors, is, however, more complicated. Corruption accounts generally stop at national borders and fail to appreciate how international factors may be intertwined. One source of influence in bank regulation in Ecuador is certain: there is an active bank lobby and commercial interest groups in both Quito and Guayaquil. These organizations are established with decades of experience and membership that draws from a sub-population of concentrated wealth and political power. Commercial interests (mainly agricultural) have traditionally dominated the bank industry and literally owned the banks as subsidiary organizations to larger industrial conglomerates.

To the fourth established argument on social legacies, bank owners then are generally land-owners, industry-owners, and members of a political and social elite that draws its strength from a remnant colonial system of unequal land distribution, class divisions, and racial hierarchies. These bases of social power and wealth are

concentrated and represent established interests, but are not usually an organized source of specific policy prescriptions. The origination of economic policy ideas continues to come from the executive office, with technocratic support from a cadre of trained professionals in the central bank. It is not unusual however, for those with access to an advanced education and training at the central bank to share a background of privilege similar (though on a lesser scale) to those who own and operate private banks.

Problematically, bank owners have had a habit of operating above the law and few have faced severe legal consequences for their mishandling of bank funds during the 1998-2000 crisis. The currency crisis occurred as banks failed and those with the opportunity and knowledge to transfer or exchange dollar accounts abroad did so rapidly, leaving remaining small depositors with no funds to withdraw. The advantages in crisis of wealth and connections between a few major businesses and their connected banks served as a brutal reminder of the disparity in Ecuadorian society, and further impeded efforts to reform the bank system. One outcome in the longer term has been the public outcry against corrupt bank owners and more recent efforts to confront instability in the bank system by a left-leaning president, Raul Correa (2005-2009).

***Statement of the Argument: Exploring the Influence of Advisory Networks***

Most explanations for the way the decision to restrict monetary policy (which usually resolves the inflation crisis) but then neglecting, or choosing not to aggressively monitor and regulate the private bank sector, separate these actions as different political choices and distinct processes. For most analysts, the monetary policy choice and the bank sector reform options are two separate questions; yet in this study, they are necessarily conjoined because the answer to both is directly related to the same actors responsible for the policies and subsequent lack of reform. Opting for a restricted monetary policy tied

to a major global currency also demands a shift, and an automatic demand for transparency, in the operation of a central bank, which one would expect to impact measures for transparency and accountability in the private bank sector, put in force by central bank regulators. To separate the issues of bank reform and monetary policy choice would make a simpler dissertation, but one that could not explain the powerful network linkages between these policies. Understanding economic transition and reform as a social process, rather than a series of isolated and atomized choices, allows the more nuanced, alternative explanation in this dissertation to emerge.

Therefore, I argue that informal rule-making institutions, namely advisory networks in the domestic and international finance sector, can inform the scope, timing, and legitimacy of reforms attempted by formal rule-making institutions, the executive and legislative powers of government. The effects of informal institutions in the formulation and execution of economic policy are specified by the structure of advisory networks and how these networks compete for political influence in monetary and finance regulation.

A network is a social structure made of individuals who are linked to one another by interdependency, which can be in values, ideas, financial exchange or kinship.<sup>34</sup> Networks form through individual contact called “ties” and can be face-to-face professional relationships in organizations, personal relationships, as well as long-distance ideological affinities. Affiliation and membership are fluid and self-directed. In

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<sup>34</sup> For established concept definitions of networks, see Stanley Wasserman and Katherine Faust (1994) *Social Networks Analysis: Methods and Applications*. Cambridge: Cambridge University Press. See also Mark Granovetter (1973), “The Strength of Weak Ties,” *American Journal of Sociology*, Vol. 78, no. 6, pp. 1360-1380, for a seminal article on using the concept of network ties to examine economic behavior. Granovetter initiated a multi-disciplinary discussion on the concept of “embeddedness” to describe how individuals and firms operate in an economy not through idealized market incentives, but through social ties.

this sense, networks can be traced and diagramed in visual representations in which “nodes” signify individuals linked by ties, but these representations are never constant. Networks grow and change as their members gain or lose resources and influence. In this way, an advisory network in liberal economic policy can be dynamic, meaning it has the constant capacity to change and enlist new support, and also deeply embedded in long-standing practices and institutions, such as ties to educational institutions.

The structure of advisory networks in economic policy consists of individuals inside and outside of government economic policymaking positions, including: central bankers, private bankers, economists (at domestic and international institutions) and other academics. Ties between these individuals form the scaffold of the network. The structure grows stronger when dense ties form and are tested over time, as network members move between academic and government positions and gain support for their ideas and policy proposals through the support of foreign donors and governments.

When there are scarce resources of foreign support and opportunities to work independently of government agencies, the network is weaker. Network members may focus more on individual mentoring relationships that lead to job opportunities and political appointments, rather than relationships to expand the prominence of their shared ideas and policy recommendations. Differences in wealth, access to educational training, work and affiliation with financial institutions and donors abroad determine the strength and longevity of advisory networks. A powerful liberal advisory network can surpass the role of the executive in government to suggest and determine the “right” mix of economic policy. A liberal advisory network achieves this influence using its prestige, lobby effort, presence in public debate, and external support. A weak liberal advisory network also

may draw on long-standing ties to academic institutions and common identities and experiences (graduate training abroad, class-based allegiances, training programs). However, weaker networks may depend more on ties between individuals with similar backgrounds (e.g., employees within the central bank, specific university alumni), rather than reaching out to a broader set of ties between institutions, both foreign and domestic. A weaker economic advisory network often draws on the state as a major source of employment, making it difficult to present sustained economic ideas in conflict with sitting politicians.

Instability or volatile political systems may then allow for more opportunities at economic intervention (at least legislation and institutional changes in monetary policy and bank reform) than more stable political environments. These variants of political competition inform how a network interacts with existing decision-making structures. Educational training, career opportunities within the state central bank, and party identification (particularly in a time of political transition and struggle) all can encourage and sustain network ties. The following chart identifies some specific aspects and measures of the liberal advisory networks at work in Bulgaria and Ecuador. The case study chapters elaborate the descriptions here.

In the table below, I compare the two existent liberal advisory networks uncovered in this research in both Bulgaria and Ecuador. These networks are compared on the basis of five categories, each representing a source of support and strength for the liberal policies advocated by the network beginning with the adoption of a restricted monetary policy and followed by specific policies that either delayed or negated increased state regulation over private bank activity and consumer protection

mechanisms. The objective of the research is to shed light on some patterns of policy advocacy, origination, and negotiation that often go un-noticed and unanalyzed in traditional explanations of macroeconomic reform and financial sector reform processes.

The five categories might also be grouped into three larger sources of network strength and support: ideational, international, and domestic. These measures are elaborated below:

1) Ideational strength means to describe how networks justify their policy positions and the bonds between members. A network is a shared set of expectations, rather than values. The expectation of liberal economic theory is its ability to create growth and produce a self-regulating market. A liberal advisory network may have different cultural and social identities and values, but share this core expectation.

2) International sources of policy proposals (including suggestions to form a currency board or to dollarize) and proximity or inclusion in a local liberal advisory network can be a major source of legitimacy. Sources of foreign aid, both from foreign governments and private institutions (e.g., Soros funds) can also provide legitimacy to network policies and proposals, but more importantly, the material resources allow a network to operate outside of traditional employment boundaries (universities, central banks, private banks) which create alternative spaces of authority, links to larger international policy initiatives, and the opportunity for idea exchange and learning. Networks that can attract foreign aid and donors may do so not only on the merit of their ideas, but generally because of larger geopolitical priorities that single the networks as necessary partners in a region. For example, in Bulgaria, the massive influx of foreign aid to liberal economic and democratic civil society organizations allowed many network

members' careers to move beyond government and university positions, including the expansion of publication opportunities and employment.

3) Domestic measures of network strength include a network's ability to compete with other national political institutions as sources of policy origination and advocacy. Environments in which economic policy is de-politicized or pushed to the expertise of technocrats (for a series of possible reasons, discussed below) may allow a liberal advisory network to use that opening to monopolize a reform agenda. Conversely, as is the case in Ecuador, a strong presidential capacity to push through executive mandate economic policy can limit a network's ability to sustain long-term policy positions, particularly when other factors are weak. In Ecuador, there is little foreign support for policy innovation in the form of think tanks or research organizations, leaving liberal advisory network members more isolated and dependent on employment from the central bank, the president, or few universities. In Bulgaria, however, presidents and prime ministers steered clear of controversial changes in economic policy, particularly after 2000, in an effort to avoid any opposition to the European Union accession process underway. Domestic political identities are also important checks to network membership loyalties and shared expectations in liberalism as an ideal economic theory and practice. In Bulgaria, many former social scientists and philosophers of the socialist era reinvented themselves as liberal economists after 1990. The expertise and ability to work outside of the state as a consultant and advisor allowed many network members to move beyond new party identifications to a more general identity of expert in liberal economic policy, creating multiple opportunities in and outside of government. In Ecuador, party identity is also weak, but the lack of alternative opportunities besides the

central bank and a few universities, makes liberal advisors more dependent on the presidential initiative for career advancement. Social ties, specifically class-based ties among the business and banking elite can trump network ideological identity in many cases. In sum, the weight of international ties of a network can provide a major fortification of its legitimacy, material resources, and ability to out-maneuver domestic political opposition.

**Table 2.1 Measuring Liberal Advisory Network Strength**

	<b>[Ideational]</b>	<b>[International]</b>		<b>[Domestic]</b>	
	<b>Academic Links and Liberal Ideological Bases</b>	<b>IFI ties to Network (IMF, World Bank)</b>	<b>Foreign Aid-Private Donor Support to Network</b>	<b>Network Position (vis-à-vis National Political Institutions)</b>	<b>Network Identity vs. Competing Social Structures/Legacies</b>
<b>Bulgaria</b>	Rich opportunities for study abroad; central bank exposure in Western Europe; major support in E. Europe for liberalization after 1989; private study groups, e.g., Hayek Society	Loose ties to IMF, more ties to private international banks, consultancies; IMF supported currency board plan early on and conditioned lending to macro-ec stability.	Multiple sources: Soros, USAID, university links (Am. U. Bulgaria), foundation support	Parliamentary system allowed input from opposing parties in finance/key ministries; central bank left to technocrats; Network members well-connected to banks, UDF, liberal parties	Liberal network identity can transcend class, party identification. Economist becomes synonymous with liberal advisor from many academic backgrounds and social bases
<b>Ecuador</b>	Strong recruiting tradition between U. Catolica and Banco Central; limited foreign exposure, but some fellowships	Strong individual tie to IMF-World Bank senior staff, advised dollarization plan privately	None, weak USAID support or interest	Presidential position outweighs technocrats on policy origination; frequent turnover and zero party loyalty keeps network technocrats working for multiple parties	Not easily changed, as class identities and limited opportunities for employment make liberal advisors dependent on presidential appointments and demands of private banks/businesses

***Conclusion***

This chapter has proposed an argument about the impact of advisory networks on economic policymaking. It has provided relevant background on each of the cases in their

paths to deal with financial crisis and create open markets. The next chapters will analyze in detail the two cases and specify the mechanisms within the network and how the network competes with other political institutions to inform and challenge the state's ability to manipulate tools of monetary policy and bank supervision.

### **Chapter 3 - Informal Institutions, Monetary Regimes and Banking Reforms: The Social Enforcement of Liberalism in Bulgaria**

#### ***Introduction***

Bulgaria experienced a major economic crisis in 1996-97 that led to hyperinflation, a collapse of many private banks, and social protest and hardship. The emergency rescue plan of a currency board was initiated and installed in April 1997, alleviating inflation, but creating further challenges to reorganize the role of the central bank and reform the state supervision of the private bank sector. In the aftermath of the crisis, the state was not willing or able to reform its supervision and regulation of the bank sector, which left many of the vulnerabilities that caused the crisis intact.

This chapter explains how the economic crisis of 1996-97 enabled a liberal advisory network to radically change Bulgaria's monetary policy and then entrench a liberal and hands-off approach to regulating the bank sector that has endured a decade of political changes, including a resurgence of the Socialist party and a unification process with Europe. This liberal advisory network and its international contacts have purposefully bypassed opportunities to grow the state's ability to regulate finance in the hopes of creating more economic growth. This chapter explains how that commitment to private-sector led growth has been at the expense of developing political institutions that would serve to monitor and distribute the economic benefits of an open market to Bulgaria's citizens.

The chapter argues that the structure of the network, complete with local and international members decades in the making, as well as the opportunity created by the 1996-97 economic crisis, combine to form a critical juncture in Bulgaria's political economy that welcomes liberal ideas at the expense of prudent bank regulation,

supervision, and a long-term state development agenda. The structure of the network is apparent following the measures of network strength outlined in the previous chapter.

Throughout this chapter, the case research highlights and analyses each area of strength:

- 1) academic links and ideological bases of support,
- 2) ties to international financial institutions,
- 3) foreign aid and foreign donors,
- 4) network position with respect to existing domestic political institutions, and
- 5) network identity in competition with class and party identities.

This chapter discusses the transformation of banking and monetary institutions in Bulgaria beginning with the privatization of commercial banks in 1991 to the introduction of the currency board in 1997 and its implementation and tie to the *euro* in 1999. The focus of the chapter is historical in its account of the changes of bank and monetary systems, covering roughly the period from 1991 to 2002. There is special focus on the development of a liberal advisory network, revealing its membership, actions, structure, and longevity, as well as the changing nature of domestic politics as democracy solidifies and the multi-party system becomes more established. Using secondary literature and primary materials from interviews with central bankers, finance ministry officials, social scientists working in Bulgaria, and local development experts, the chapter builds a more comprehensive picture of the role of international and domestic advisory networks—how they form, how they influence policy, and what social and historical variables increase their relevance in a transitioning financial architecture.

***Banking and Monetary Systems in Bulgaria: The Status of Banks in Bulgaria in the 1990's***

Like the other former socialist and Soviet bloc countries, after the fall of the communist regime, the one bank system in Bulgaria transformed to a private bank system with a central bank and, ostensibly, a broader financial sector that would include non-bank financial services like insurance and private pensions, as well as investment vehicles like a stock market. Creating a banking system based on principles of an open economy meant creating a full range of financial intermediation. In Bulgaria, the growth of the market was slow, from the entry of foreign banks to the privatization process. All of these changes are connected, but depend foremost on the development of a banking system that issues, values, trades, and stores a currency. The banking crisis and the currency crisis are certainly linked; but so is the process of privatization and international mediation and lending. With so many processes overlapping, this analysis will focus on the bank and monetary policy changes, but the others must be briefly acknowledged because their interaction is often the focus of competing explanations for the sluggishness of market development in Bulgaria.

There are two general approaches to explain the volatile start of Bulgaria's twin banking and currency crisis of 1996. Some analysts see the structural adjustment policies mandated by the IMF as the start to Bulgaria's fiscal deficit problems in 1995 that then deteriorated confidence in the currency, which led to hyperinflation in 1996, and subsequently the emergency currency board plan of 1997 (Minassian 1998). Other analysts place more emphasis on the lack of will of political leaders to embrace privatization and the end of state-owned enterprises and their reliance on the central bank as a financier of their projects, all of which delayed the market liberalization process and flawed the efficiency of banks and private enterprise (Vincellette 2001). Most

interpretations take either the international institutions or domestic political backwardness and socialist legacies<sup>35</sup> as the key explanations of poor economic performance and laggard progress in opening economies. There is evidence in both explanations, but a fuller picture details the connections between the two spheres, international and domestic, and probes the line between public and private institutions.

The crisis Bulgaria experienced in 1996-1997 is a critical juncture when a new leadership emerged and a new ideological shift towards liberal economic policies took hold through relationships built in the government, the central bank, private banks, and the international finance community. Arriving at that critical juncture, though, required a major financial crisis and deep social ties and shared understandings of the appropriate relationship between state finance and private finance.

One of the most important relationships in the dramatic shift in economic policy in Bulgaria was between the central bank and the ruling Socialist party at the time of the crisis. The end of the central bank as *monobank* in the communist countries placed a great deal of pressure on the government's relationship with its former sole source of capital as well as pressure on individuals and families who had experienced shortages and were finally eager to use their household savings accounts to buy newly available goods. In the macro-economy, this combination was disastrous for many countries, particularly those that could not control state bailouts of banks and businesses.

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<sup>35</sup> See also, Venelin Ganev (1999) "Preying on the State: Political Capitalism After Communism," *doctoral dissertation*, Department of Political Science, University of Chicago, for the classic rent-seeking explanation of the banking and currency crisis failures due to entrenched socialist elites within the government and their operatives within state-owned enterprises and spin-off banks from the Bulgarian National Bank.

Eric Berglof and Patrick Bolton describe the difference in performance of post-communist economies in achieving macro-economic stability and success in liberalization programs as the great divide (Berglof and Bolton 2002). Berglof and Bolton describe a monetary overhang in which household savings of the communist era flowed into the economy after price liberalization causing inflation, hoarding, and increased use of barter when the banking system should have been creating incentives for providing credit and facilitating money flows. The birth of new banks had a universal reaction by monetary authorities tightening credit lines, and businesses reacted with inertia, leaving bills and workers unpaid. According to Berglof and Bolton, the countries that crossed the divide to stable monetary policy and created economic growth were those (e.g., Estonia) that could quickly take control over monetary policy by creating a currency board. The alternative case example is Bulgaria (Romania and Russia are others) where central bank authorities did not or could not control pressures for financial relief, which meant bailouts of banks, state-owned enterprises, and the government at large (Berglof and Bolton 2002: 79-80).

The first step in the transition to the new system was to liberalize the entry of new banks into the Bulgarian financial sector. By the end of 1990, there were seventy commercial banks, all emerging from branches of the Bulgarian National Bank. Of these, seven were sector-specific (agriculture, etc.), two specialized in government savings and foreign trade (the State Savings Bank and the Foreign Trade Bank), and 59 were purely commercial (see Table 3.1).

**Table 3.1: Bulgarian Banking Sector Structure, 1990–1996**

Banks	1990	1991	1992	1993	1994	1995	1996
Total banks	70	78	59	41	45	47	35
Foreign	0	0	0	1	3	5	7
Licensed	61	8	2	7	10	4	2
Foreign licensed	0	0	0	1	2	1	2
Consolidated	0	0	22	29	9	3	0

*Source:* Vincelette, G.A. (2001) “Bulgarian Banking Sector Development, Post-1989,” *Southeast European Politics*, Vol. 2, No. 1, p. 6.

After creating so many new banks, the Bulgarian National Bank needed institutions to supervise their activities, to determine minimum deposit ratios, and to plan for protecting depositors. In fact, Bulgaria and the Bulgarian National Bank took extreme efforts to abide by the Basel I standards, but only after they experienced a full blown banking crisis and currency crisis in 1996. Up to that point, most regulation revolved around privatization issues, leaving bankruptcy issues, any kind of credit register or credit bureau, and minimum capital requirements untouched.

In June 1991, the *Law on the Bulgarian National Bank* came into effect, altering the roles, objectives, and functions of Bulgaria’s central and commercial banks. In 1992, another key piece of financial legislation, the *Law on Banks and Credit Activity*, was passed. This law established the regulatory framework for the activities of banking institutions. Under the law, all banks, even state-owned banks, were given significant autonomy, and little oversight infrastructure or policies were made to supervise their activities (Miller and Petranov 2001: 42). In fact, so little attention was paid to the regulation of these new banks and the supervisory power of the Bulgarian National Bank that former National Assembly member and economic analyst Krassen Stanchev observed:

Practically no public discussion on the role, mission and values of the central bank took place in 1991-1992 (the first laws on the central bank, commercial banks and crediting after the onset of transition in Bulgaria). Neither was there a substantial National Assembly debate. The brief minutes of the respective sittings in the National Assembly show that its members have spent much more time discussing the remuneration of central bankers than on what their work should be (Stanchev 1999, *manuscript*: 1).

New private banks in Bulgaria enjoyed a six-year period of almost no regulation. From 1991 to 1997 there was a major transformation in the way money was valued and exchanged in Bulgaria when compared to the socialist period. The norms and practices of this transformation, however, were very much in line with practices under socialism. The state remained involved in the accounting standards of banks, often demanding write-offs for government loans and government enterprises. Major staff changes in the Bulgarian National Bank did not occur until 1997. In fact, it was not until the new Banking Act of 1997 that substantial bank reform began.

The new Banking Act of 1997 replaced the previous Banking and Credit Act of 1992 and surpassed the minimum standards of the 1997 Basel Accords. Part of the 1997 Act included BNB Regulation No. 8 dealing with capital adequacy and minimal founding capital requirements. All banks in Bulgaria were required to have eight percent capital adequacy ratio by the end of 1997, ten percent capital adequacy ratio at the end of 1998, and twelve percent at the end of 1999 (Yonkova, Alexandranova, Bogdanov 1999). By over-reaching the Basel II recommendations, the Bank Act of 1997 appears overly cautious, as if the BNB wanted to create a cushion for depositors above international standards. However, the attempts to abide by international standards were part of a larger effort on the part of the Ministry of Finance and the Bulgarian National Bank to create an

aura of credibility and a market-friendly reputation for the Bulgarian banking and financial system.

In reality, the increased required ratio was paltry and did nothing to protect depositors from excessive lending. These reversals of policy focus in 1997 (evidenced by the currency board plan, the Banking Act, and the effort to build a credit register, all to be discussed) were products of a major shift in the government's embrace of liberalism and in the rise of a new cadre of economic thinkers and policymakers within key public and private institutions. This cadre, or network, of individuals within the finance sector functioned to provide information between international and domestic institutions at a crisis moment when external aid and loans were critical to the stability of the state, not just the economy. The Banking Act of 1997 did not begin a prolonged interest or intervention practice in state regulation of the bank sector. Instead, it set the conditions for a liberal financial structure that would discourage further state regulation, and set a precedent for advisory practices (i.e., the use of informal networks) between the private and public sectors.

The reliance on networks in Bulgaria, however, is not a novel policymaking tool. There was continuity in the state's involvement in economic activities, from the privatization and division of the Bulgarian National Bank to state-owned businesses and industrial projects. This continuity depended on relationships between insiders and elites—a well-documented aspect of the post-socialist transitions in Eastern European (Schoenman 2005; Eyal, Szelenyi, Townsley 1998). This reliance on relationships is a legacy of post-socialist social structure. The composition of that social structure has changed, so that the transition to a private bank system, a stable monetary policy, and an

effort at reaching foreign investment standards, has required the durability of relationships between individuals working in the Finance Ministry, the Bulgarian National Bank, private banks, and state-owned enterprises. The individuals in these positions who come of age and come to power in the mid-1990s were part of a rupture in the social structure of the post-socialist state. The shift in relationships from domestic elite networks connected to the state to a new form of advisory networks composed of local expert elites with international connections begins with the crisis of 1996-97. A moment of economic crisis creates an opening for new, liberal ideas and opportunities for a liberal government (the UDF government) and its political and economic “engineers”—those ideologues who work as entrepreneurs, economists, consultants, and academics—to reshape the Bulgarian political economy.

The following section explains the depth of state and bank network relationships from the beginning of liberalization and democratization in 1990 to the start of the economic crisis of 1996. The tradition of close ties between the state and the bank sector transforms to a reliance on the liberal advisory network to manage both policy and modes of communication and coordination between the growing private banking environment and the state and its counterparts in international financial organizations and foreign governments.

### ***Bank-State Relationships***

The legacy of state-owned enterprises (SOEs) is important to understand the patterns of communication and coordination between the state and the new private sector because it influenced relationships between the central bank, private banks, and the state for years after 1990, and was one of the major causal factors that led to the banking/currency crisis that provoked the currency board plan in 1997. The Bulgarian National Bank (BNB)

made a series of large credits to SOEs under central planning, but when banks were spun-off from the BNB as private enterprises, these banks assumed the credits as outstanding loans. As Miller and Petranov detail, the change from a state credit to a loan created enormous accounting problems for the new banks (Miller and Petranov 2001: 42). The loans would only have value if they were re-paid. Yet, most of the SOEs were not growing in the early 1990s due to production inefficiencies and the end of trade agreements (and obligated markets) between communist governments. Banks were faced with insolvency if they acknowledged and wrote off these bad loans. Meanwhile, SOEs were faced with a growing debt as interest rates rose in response to increasing inflation. (Most of the loans were denominated in foreign currencies, which only made them more difficult to repay as inflation decreased the trading value of the *lev*.)

The government's close interaction with the new banks helped keep these growing debts from becoming public knowledge. To close the SOEs would mean more unemployment, and to disclose their finances would put new banks at risk. Miller and Petranov cite instances where the Ministry of Industry issued official ordinances to SOEs to suspend debt repayment to banks between 1991-1996 (Miller and Petranov 2001: 43). Protecting newly privatized banks was not just an effort to keep the general public unaware of the vulnerability of the financial system, but also to protect government supporters within these new banks.

A second interesting aspect of the Miller and Petranov work is its collegial origin, which also provides evidence of early international links (mostly American academic and market-friendly advisory service promotion) at the Bulgarian National Bank that seems to increase after 1997. Miller and Petranov worked as part of a collaborative research team

from the Bulgarian National Bank and the University of Delaware, funded by USAID in Sofia, to document the banking transformation in Bulgaria for economic students in local universities. The team began work in 1991, publishing their first text in 1992 and a second edition in 1996. The third edition was delayed due to the crisis of 1996-97 in an effort to wait for the substantial reforms to take hold and then to be able to describe them fully in the third edition published by the BNB and paid for by a USAID-funded private sector strengthening company, FLAG International LLC, in 2001. They state that there was no macroeconomic textbook available to explain the kinds of policy options available to central bankers (Miller and Petranov 2001: 6).

In interviews conducted with at least ten current and former researchers and high-level directors of the BNB, all interview subjects had received training abroad in macroeconomics (most before 1995) and several had interned with central banks in England and France. There did not seem to be a major lack of exposure to liberal macroeconomic principles. The question of exposure for Bulgarian economics students reflects the bilateral effort (though unilaterally funded by American agencies) to publish an official BNB teaching device that chronicles the trend of liberal economic policymaking in Bulgaria.

Garabed Minassian, an economist and former researcher at the Bulgarian National Bank, documents how the ruling party of the early transition, the Bulgarian Socialist Party (BSP), put forward candidates for local elections who were private bank executives. The financial status of these banks was protected, at least as long as their executives were associated with the BSP. According to Minassian, when V. Yossifov, governor of First Private Bank Ltd., lost the election for mayor of Sofia as a BSP candidate in 1995, six

months later the state of the bank's finances became public and it quickly went bankrupt. Minassian also discusses the Orion bank and its protected status. The bank did dissolve, but was offered provisions by the BNB to protect its main depositors, which Minassian sees as evidence of its preferential treatment by the BSP (Minassian 1998: 340-341).

As a stopgap measure, the BSP attempted to protect a number of newly private banks by refinancing much of the debt from state enterprises. Instead of increasing bank supervision or gradually liquidating the non-performing SOEs, the socialist-led government in 1993 suggested a piece of legislation that would buy out the bad loans negotiated before 31 December 1990 through the issuance of new government bonds called ZUNK bonds (named for the Bulgarian acronym of *Law on the Settlement of Non-Performing Credits*). ZUNK bonds solved the problem of providing public accounting of banks as proper businesses, and in some ways lent legitimacy to the private banks that sought foreign investors or buyers. ZUNK bonds did not improve the reality of bank performance, however. New banks formed easily because there were low minimum capital requirements to form a bank according to the 1992 Banking and Credit law. Banks that formed from the BNB decentralization were often meant to act only as lenders to SOEs poised to fail.

Yonkova, Alexandranova, and Bogdanov argue that most of the private banks served to lend to their own top-level management, while others lent to non-performing SOEs with no intention of collecting the loans. They cite evidence from BNB data that by the end of 1995 more than forty percent of all loans made by both state and private banks were unrecoverable and nearly the same amount, thirty-nine percent, of total loans by private banks were not in active repayment at all (Yonkova, Alexandranova, and

Bogdanov 1999: 12). Moreover, at the time there were no legal procedures for bankruptcy proceedings against failing SOEs (Yonkova, Alexandranova, Bogdanov 1999). From 1991 to 1996, banks and the state acted in partnership to extract public resources, protect certain enterprises, and delay mass privatization and liberalization regulations that would have opened opportunities to outsiders and foreigners.

### ***The Twin Crises***

The weaknesses of the banking system in the first half of the 1990s are clear: no supervision, little capital requirements, poor collection of loans and political interventions in balance sheets. There were a number of other economic factors that led to the twin crises in the bank system and in the value of the currency in the late fall of 1996 to early spring of 1997. Energy pricing became a problem in 1995, as the World Bank and the IMF required that Bulgaria ease its subsidies on gas and electricity to make domestic prices more competitive to international ones. This was a problem, as only a third of the gas consumed in the country was actually paid for in 1995. Government firms (SOEs) rarely paid for their energy costs, and household collection was not efficient. Bulgaria was also facing the end of a favorable gas supply agreement with Russia on the first of January 1997 and, for that reason, the IMF sought to wean the country from its cheap energy supplier (Minassian 1998: 337).

The government did comply and raised energy prices by over forty percent, but the same harsh fiscal discipline in other subsidized sectors and public expenditure was not possible. The higher energy prices put strains on the capacity of industrial export production and the trade balance suffered. The state budget of 1995 was never implemented and the National Assembly voted in December 1995 to increase the deficit by 9.2 billion *leva*, almost twenty percent higher than forecasted. The domestic debt was

externally financed through international lenders (many of them private banks) and surged to 11.7 billion *leva*. By the end of the year, the government had to finance nearly 70 billion *leva* (or 8 percent of GDP that year) through bonds to meet the budget deficit. The result was inflation.<sup>36</sup> The BNB was unsuccessful in its attempts to intervene on the foreign exchange market in 1995 and 1996 to contain inflation, either because it simply did not have the resources to intervene adequately, or because it was not able to plan appropriately and coordinate interest rates, which the bank did not raise until February 1996. Ultimately, the BNB raised interest rates six times in 1996, setting a record high of twenty-five percent a month by the end of that year.<sup>37</sup>

The privatization process, particularly in the privatization of banks, was very slow in Bulgaria. As the Director of the Bulgarian National Bank, Tsvetan Manchev recounted in an interview in 2005, “privatization is not Bulgarian,” arguing that, at the time, the reform was a culturally unfamiliar concept particularly for those in the banking and state development businesses.<sup>38</sup> Given the close relationships between state bankers and state planners, this cultural aversion to the selling off of banks as assets seems logical. Georgy Ganev, economist and researcher at the Centre for Liberal Strategies in Sofia, has argued that the pace of bank privatization was a political process and alignment of shared interests of the ruling Socialist party, entrenched elites (party *nomenclatura* who made

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<sup>36</sup> Ibid, see Minassian (1998) pp. 337-338 for these data. Also see the International Monetary Fund (1996) *International Financial Statistics Yearbook*. Washington: International Monetary Fund, p. 113 for inflation measures.

<sup>37</sup> See Minassian 1998: 338, also *BNB Yearly Report 1996*.

<sup>38</sup> Interview with Tsvetan Manchev, 5 October 2005, Sofia, Bulgarian National Bank.

successful transitions to capitalist business owners and politicians) and central bankers.

As Ganev writes in a manuscript:<sup>39</sup>

In early 1995, the Bulgarian Socialist Party, the heir to the Bulgarian Communist Party, came to power after winning a full majority in National Assembly in a landslide victory in December 1994. The main message in its political program was the implementation of socially friendly reforms, which among other things included slowing down of many measures, return to some controls of the government over the economy, and avoidance of the “painful” Washington consensus conditionality by breaking relations with the international financial institutions. Whether on purpose or not, all these actions played into the hands of the dominant elites, and their behavior reached its fullest scale. Possibly the starkest example of this coincidence of interests was the statement, made by the Socialist Minister of Industry in early 1995, in which he explicitly encouraged state-owned enterprises NOT to worry to service their debts to banks and to concentrate on production. Naturally, these policies and processes were unsustainable and the only question was when they were going to lead to a crash (Ganev, *manuscript*, original emphasis).

Both experts, Manchev and Ganev, see a linkage between expectations, behaviors, and interests of those in charge of economic reforms and those in control of economic institutions. Privatization of banks proceeded slowly, but also inefficiently--so much that between the spring of 1996 and the spring of 1997, eighteen banks were closed and put under special supervision by the BNB. The institutional reform of privatization required a necessary institutional protection for the failure of private banks—bankruptcy. In May 1996, the National Assembly amended the Banking Law and created a legal procedure for bank bankruptcy. By year-end, fourteen banks began court-mandated bankruptcy procedures.<sup>40</sup> These fourteen banks held twenty-four percent of total assets in the

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<sup>39</sup> See Georgy Ganev, “The Bulgarian Currency Crisis of 1996-97,” *manuscript*, Sofia: Centre for Liberal Strategies. Ganev furthered this argument in a pair of interviews in Sofia on 25 August 2004 and on 10 October 2005.

<sup>40</sup> Yonkova, Alexandranova, and Bogdanov detail how Balkanbank, Mollov Commercial Bank, Businessbank, Slavyani Commercial Bank, Trade and Savings Bank, Yambol Commercial Bank, Dobrudja Commercial Bank, Elitebank, Crystalbank, Private Agricultural and Investment Bank, Mineralbank, First Private Bank, and Agrobusiness Commercial Bank were placed under special bankruptcy action, though the court procedures were often separate and uncoordinated to BNB bank supervision efforts, placing doubt on the state’s ability to coordinate reforms in the judicial branch and the monetary authority.

banking system at the beginning of 1996, making their suspension all the more difficult for the system to ignore (Yonkova, Alexandranova, Bogdanov: 1999: 12).

Energy supply and price management, poor fiscal control, difficulty in foreign exchange intervention, and lastly, the pace of privatization all helped create a twin currency and banking crisis. This crisis was so severe that the government was forced to resign, a caretaker government installed, and mass protests stopped traffic and normal life in the capital. Tellingly, it was not the rise of bank failures, the swelling budget deficit, or fear of the growing external debt<sup>41</sup> that first ignited the street protests. The soaring price of bread weakened the state. The price increased due to a cut in wheat production and farm subsidies mandated by the IMF as part of a renewed loan package in 1996—as there was no agreement signed in 1995 as planned—and the impact on working families was enough to tip the tide of public anger against the Bulgarian Socialist Party’s majority in the National Assembly (G. Ganev, *manuscript*). This was a tipping point<sup>42</sup> in the economic and political crisis that helped assure public support for a radical change in economic policy—a moment which the liberal advisory network and the UDF may not have predicted, but seized immediately.

Venelin Ganev, a Bulgarian political scientist based in the US, describes the dramatic street protests as a “sea change” in which citizens calmly retake their state from an “arrogant neo-communist dominated National Assembly” which could not fix the socioeconomic pressures on the working class (V. Ganev 1997: 125). After forty days of

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<sup>41</sup> See Roumen Avramov and Jerome Sgard (1996) “Bulgaria: from Enterprise Indiscipline to Financial Crisis,” *MOCT-MOST*, No. 4, pp. 71-102, for an explanation of the current account deficit and the problematic refinancing of Bulgarian external debt in the form of Brady Bonds.

<sup>42</sup> The term “tipping point” is used here descriptively, though it is also used in the post-socialist literature as an analytic concept to explain sudden and large-scale changes in political behavior in groups of boundedly rational actors. See work by Timur Kuran, Susanne Lohmann, and David Laitin on sudden group behavior changes as anti-regime mobilization, protest behavior, and language adoption, respectively.

strikes, street demonstrations and student protests, new elections were called and a new coalition of the United Democratic Forces won an absolute majority in the National Assembly. These protests, however, were not the sole cause of the crisis or the opening for the UDF, but a public outcry that demanded state attention to several issues: hyperinflation, frustration with the sluggish Socialist agenda, and economic hardship.

The resignation of the Socialist party was an opportunity for a total change of politics and economic orientation in Bulgaria. It was in many ways the beginning of the pro-market democratic system that was meant to begin in 1991. There is some debate among scholars, however, of the inevitability of simultaneous liberal economic and democratic political reforms in Eastern Europe after 1990. New observations on the role of liberal ideas in post-socialist change challenge the explanation that a wave of liberalism, as an ideational force, was solely responsible for the vast changes in economic and political systems following the collapse of communist regimes (V. Ganey 2005; Dawisha and V. Ganey 2005; Bunce 2005).

Venelin Ganey asserts that ideas alone cannot account for the rapid institutional changes of Eastern Europe after 1990, and he is particularly skeptical of a perceived bias by Western academics (he names Adam Przeworski<sup>43</sup> specifically) against neoliberal ideas (V. Ganey 2005: 344). Ganey claims that social scientists of the West have misunderstood the ideology of liberalism, vilifying the neoliberal economic agenda and giving it unrealistic causal power. Venelin Ganey is a Bulgarian, and given the lethargic pace of neoliberal change he and his family witnessed in Bulgaria, he is right to question

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<sup>43</sup> Venelin Ganey refers to a seminal article in understanding post-socialist change by Adam Przeworski. See Adam Przeworski (1992) "The Neoliberal Fallacy," *Journal of Democracy*, Vol. 3, no. 3, pp. 45-59.

why the force of neoliberal ideology cannot explain all institutional shifts in the early transition period.

This dissertation's interpretation falls somewhat between Przeworski's emphasis on the power of neoliberal thinking and the more methodological point that Ganev stresses on the weakness of ideas alone in accounting for major social and economic change. This dissertation seeks to demonstrate how individuals in positions of policy influence use ideas about liberalism to structure a banking system based on an ideal free market. Their idealism and commitment to liberalism, however, has a fault in that these liberals use the ideal of a free market to impede the logical growth of political institutions (like the supervisory capacity of the central bank, bankruptcy protection, and credit reporting or centralized information sharing). To understand Bulgaria's embrace of liberal economic policies—specifically in bank regulation and monetary policy—after financial crisis, this study must explain 1) how a liberal network emerges as a surrogate for state decision-makers, and 2) why the structure of the network with national and international contacts prefers little regulation, or regulation only by international standards, to domestic or locally devised plans.

Bulgaria's late shift towards a liberal economic monetary and banking policy is an excellent case example of how a powerful wave of ideational change in a region is not enough for institutional congruity inside domestic boundaries. Bulgaria's shift again in 2005 away from its neoliberal-friendly politicians (those who strongly supported the currency board in 1997) with a socialist party victory is also a warning against any perceived completeness of this liberal ideological immersion.

To be clear—liberal economic ideas do not always need liberal politicians to sustain them. Socialist parties are again in power in Bulgaria, yet the institutional changes that the neoliberal reformers made in the late 1990s remain in effect. The Bulgarian case, like many of the region, justifies Ganev’s call for a more detailed account of how market-friendly institutions originated in the post-socialist landscape. One should also question why some liberal economic policies and institutions are “sticky” (or stuck in their initial incarnations), and others seem fragile and sensitive to political change.

This study builds on the work of scholars who analyzed the initial transition and the power of economic ideas in that period of “extraordinary politics”<sup>44</sup> of the early 1990s; but the extraordinary power of these first opening ideas remains. The crisis of 1996-97 created some conditions among Bulgarians and their liberal-minded academic and politicians that allowed for extreme policy options to be considered seriously. The shift, however, was not just an ideological wave or simply an electoral turnover from a socialist to a liberal-minded party. The critical juncture of 1997 was a dramatic shift in the position and influence of market-friendly social networks. The networks were made up of like-minded economic thinkers and their counterparts in international institutions, which shared a goal to redesign the political economy of Bulgaria. It is also not accurate to characterize these individuals as rote followers of a neoliberal economic agenda.

To understand the restructuring of economic institutions, one must account for ideational change, but there must also be an understanding of the complexity of

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<sup>44</sup> See Leszek Balcerowicz (1995) *Socialism, Capitalism, Transformation*. Budapest: Central European University Press. Balcerowicz, a Polish economist, has held positions as Deputy Prime Minister and Finance Minister of Poland (September 1989-August 1991), Finance Minister (October 1997 to June 2000), and Governor of the National Bank of Poland (2000-2007), and was responsible for the shock therapy liberalization plan implemented with consultation from American academics (Jeffrey Sachs and David Lipton) and international financial institutions (IMF, World Bank) from September 1989 to August 1991.

institutional choice and a healthy respect for the social resources and knowledge of the people in the capacity to make these economic plans. These networks orchestrated new economic institution designs (currency board, bank law, and Basel implementation) that often had little precedent (or limited chronological empirical evidence of their performance) in other developing and post-socialist states.

### ***Choices in Macro-Economic Policy: Currency Board and Bank Sector Reforms***

The following section elaborates how the crisis of 1996-97 brought new liberal-friendly networks into a sphere of political influence. Sub-sections address in more detail how a series of informal institutions functioned to further a liberalizing agenda by specifically naming and identifying members of the network and their relationships to the UDF, private banks, external lenders, and donors. These sections also explain how a liberal economic agenda is enforced, not by a rubber stamp of domestic elite approval, but through social processes. The chapter argues that the monetary reforms (and obstruction of certain institutional reforms) that take place beginning with the currency board are possible for three reasons: 1) an electoral change in government, bringing the UDF to power and changing the structure of political competition after socialism, 2) a network of committed economic liberals established in positions of authority, and 3) connections between this liberal advisory network and international financial institutions and foreign donors, specifically connections between the United States State Department and its subsidiary, the Agency for International Development, the International Monetary Fund, and donors such as the Soros Foundation.

### ***The Liberal Shift and the Liberal Network: The Pro-Market Shift of 1997***

Bulgaria's early political transition was marked by the steadfast presence of communist elites,<sup>45</sup> particularly from 1990 to 1996 (Bojicic-Dzelilovic and Bojkov 2005). Though the Union of Democratic Forces<sup>46</sup> party, or UDF, was successful in its first round National Assembly elections in the early transition (holding a majority in National Assembly for one year, 1991-1992), the victory was not enough for the party to secure key ministerial positions in privatization and defense for extended periods, which might have changed the early course of Bulgaria's move to free market democracy. In the Bulgarian National Assembly system, separate elections are held for the presidential and National Assembly positions, which in turn, determine the prime minister and cabinet posts. There have been a number of mixed party coalitions and mixed president and prime minister pairs from opposing parties. The presidential position is not completely ceremonial, as the president is also head of the Bulgarian Armed Forces and can name some key cabinet posts (e.g., Minister of Finance) when the two positions represent opposing parties. The lack of a strong, consistent, and unified pro-liberal party in the first six years of the transition, along with the continued prominence of connections between SOE's, banks and politicians of all parties, delayed a market reform agenda.<sup>47</sup>

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<sup>45</sup> See Stephan E. Nikolov (1995) *A Quasi-Elite in Bulgaria*. Warsaw: Polish Academy of Sciences. Nikolov's study finds that 63 percent of Bulgarian business leaders (of 1993) held important positions in the Communist party. Also related, see: John Higley, Judith Kullberg and Jan Pakulski (1996) "The Persistence of Post-Communist Elites," *Journal of Democracy*, Vol. 2, no. 7, pp. 133-147. See also new work by Emilia Zankina, Ph.D. Candidate at the University of Pittsburgh and her forthcoming dissertation entitled, "Bulgaria's Post-Communist Political Elites" which tracks individuals and familial networks from communist positions of power to early and even current positions within Bulgaria's political and economic elite networks.

<sup>46</sup> The UDF has been an acronym for both the United Democratic Forces and the Union of Democratic Forces. The UDF translates as the Bulgarian acronym SDS of *Sayuz na Demokratichnite Sili*. It was the Union of Democratic Forces that first formed in 1990 as the democratic alternative to the communist party. Later the party expanded its coalition and renamed itself the United Democratic Forces.

<sup>47</sup> The UDF did have a presidential victory through its candidate Zhelyu Zhelev from 1990-1997, though Zhelev's success did not translate into broad or long-standing prominence for his party in those years. In 1997 he was replaced by UDF candidate Petar Stoyanov as President. Zhelev was also a Ph.D. in Philosophy from Sofia University, and a well-known political dissident in the 1970s and 1980s. For a more

It was the Bulgarian Socialist Party (BSP), a democratized version of the former communist leadership, which was able to manage the first six years of the transition and slow the pace of economic reforms and privatization. The UDF's lag in organizing and winning a majority in the National Assembly did create some unique opportunities in the fall 1996 presidential elections and in the April 1997 National Assembly elections that fell in the midst of political and economic crisis. The six years of early transition also gave supporters of the democratic and free market movement time to gather material resources and contacts abroad, as well as time to train a new cohort of economists and social scientists in alternative ways of thinking about political power, the role of the state in the economy, and the strategic use of international institutions (both public and private) to achieve longer term development goals. This period of incubation was essential for the nascent liberal advisory network to develop an ideological commitment to liberal economic policies and a cohort with an identity separate from the UDF.

Central to the argument here that liberal networks create and continue to manipulate macroeconomic policy and bank regulation in Bulgaria after 1997, is the necessary condition that these ideational networks must be in place at a critical moment of political and economic upheaval. The crisis of 1996 could have ended differently if the UDF and the larger network of pro-liberal academics, financiers, and international lenders had not shared a commitment to liberalism that was materially supported by

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detailed discussion of the lag of reforms from 1990-1996 and the UDF's inability to gain a strong foothold in government or a clear mandate from its leadership and supporters, see Boyko Nikolov, Nikolay Markov, Nasko Dochev, Dimitar Dimitrov, Rumyana Kolarova and Rumen Dobrinsky (2004) "Understanding Reform: A Country Study for Bulgaria," Global Development Network Southeast Europe, Working Paper. Internet Access: [http://www.esiweb.org/pdf/bulgaria\\_WIIW-understanding%20reform\\_bulgaria-2004.pdf](http://www.esiweb.org/pdf/bulgaria_WIIW-understanding%20reform_bulgaria-2004.pdf). Nikolov, et. al. argue that the first six years of the transition before the crisis, the UDF shared support from SOE managers and employees with the BSP, making it difficult for the UDF leadership to agree on a unified liberal economic policy and to challenge the prominence of entrenched elites in the state-owned enterprises and banks.

externally funded research institutes, academic exchange opportunities, employment experience abroad, and communication links to international finance advisors in the early to mid-1990s.<sup>48</sup> The network had a base at the moment of crisis that was able to grow in influence and status through the next electoral cycle in 2000-2001. In fact, it is the pro-liberal network that lasts to the present through informal organizations, research institutes, the central bank, and private banks.

By the elections of 2005, the UDF had lost much of its organizing influence and National Assembly representation. It is the longevity of these informal groups and their social ties that have made lasting liberal economic policy changes and institutional configurations, not necessarily the official pro-liberal political party. In fact, the unraveling of the UDF and power-sharing coalitions that strengthened with the 2001 elections solidified the role of external advisors and also made it nearly impossible for a socialist (or non-liberal) executive to mandate reforms of the bank sector by decree.

However, the organizing initiative of the UDF, before 1990 and immediately after, created a self-identifying process for members of the liberal network, to vet ideas and test loyalties. To this end, the argument in this dissertation requires an explanation of the development of the early UDF and its symbiotic relationship to a network of liberal advisors. The relationship is symbiotic because the UDF nurtures these advisors, but eventually they become separate from the party and extend their sphere of influence within private and public organizations, and among Bulgaria's political parties of the center right and even the center left. The ability of the network to transcend a rigid affiliation with a single political party allowed the network more flexibility, and

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<sup>48</sup> See Eleanor Smollett (1993) "America the Beautiful: Made in Bulgaria," *Anthropology Today*, Vol. 9, no. 2, pp. 9-13, for a brief ethnographic view of American influence via the American Republican Party, US AID funds, Fulbright programs, and the Soros Foundation in the early emergence of the UDF.

ultimately, authority to continue to lead in policy origination. The central bank and its research leadership, particularly under Nikolai Nenovsky and his mentor Roumen Avramov (detailed below), have maintained control of the dialogue process on bank supervision reform, management of the currency board, and currency union with the Euro.

### ***Union of Democratic Forces Party Development and the Liberal Network***

In 1989, opposition to the communist regime grew and Todor Zhivkov (party head since 1954 and head of state since 1971) lost power in a non-violent palace coup. A coalition of more than twenty opposition groups then formed the Union of Democratic Forces (UDF). The UDF, which emerged as the chief opposition faction to the Bulgarian Communist Party (BCP) after 1989, was a diverse coalition of several major and many minor parties and groups. Some of the parties, such as BANU,<sup>49</sup> predated the communist era by more than forty years and remained a part of active political dialogue during the communist regime. Most UDF coalition members, including the Green Party, were organized after the overthrow of Zhivkov. When the UDF was founded in December 1989, it included ten organizations; by the spring of 1990, six more parties and movements had joined.

The founding members of the UDF drew from dissidents and dissident groups that formed under the faltering Zhivkov regime in the late 1980s. The all-European Ecoforum of October 1989 provided an opportunity for these groups to meet and also legitimated their role as an organizing (if not organized) opposition. After the Zhivkov regime fell, a small group of dissidents who had participated in the Ecoforum and worked together in

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<sup>49</sup> BANU is the acronym of the Bulgarian Agrarian National Union, a peasant farmer organization formed in 1899. The Union became a leading force in Bulgarian politics in the early to mid-twentieth century and remained an operating party under the communist system, though it was discredited for its supposed links to the bourgeoisie. See John D. Bell (1977) *Peasants in Power: Alexander Stamboliski and the Bulgarian Agrarian National Union, 1899-1923*. Princeton: Princeton University Press.

opposition to a particular policy of the Zhivkov regime issued a declaration outlining a loose confederation of dissident groups as the new UDF party. The dissident philosopher Zheliu Zhelev was elected chairman and Peter Beron, an environmental scientist, was elected as secretary.<sup>50</sup>

Of these early members, many were academics, and their unification and interest in first protesting the communist regime seems to have stemmed from the widespread opposition to Zhivkov's Turkish assimilation programs of the 1980s. A total of 310,000 ethnic Turks were expelled or emigrated voluntarily in 1989. In July 1989, over a hundred Bulgarian intellectuals petitioned the National Assembly to restore rights to the ethnic Turks suffering forced emigration.<sup>51</sup> These intellectuals were motivated by an ideal of democratic values, at least as a basic notion of what constituted an over-reach of state authority in the abuse of Bulgarian citizens of minority ethnicities. It was a quiet political mobilization on an ideal of justice and human rights that put many otherwise politically inactive intellectuals in visible and vocal positions against the communist party.

In an interview with Deyan Kiuranov, a sociologist/philosopher and dissident leader, he explained that the repression of ethnic Turks became a symbol of frustration with the communist regime and an opening to public discussions of the role of

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<sup>50</sup> See the Library of Congress (2005) "Country Studies: Bulgaria," for a detailed account of UDF formation and activities in the early transition, among other topics. Web Access: <http://lcweb2.loc.gov/frd/cs/bgtoc.html#bg0171>. Also see, Gerald W. Creed (1995) "The Politics of Agriculture: Identity and Socialist Sentiment in Bulgaria," *Slavic Review*, Vol. 54, no. 4, pp. 848-850, for a short discussion of some of the early coalition parties as communist party opposition, including the role of the BANU.

<sup>51</sup> See Darina Vasileva (1992) "Bulgarian Turkish Emigration and Return," *International Migration Review*, Vol. 26, no. 2, pp. 342-352. Vasileva describes how the Zhivkov-led regime mounted an anti-Turk campaign in 1984, rampaging villages and destroying religious items as well as identity cards and personal property of ethnic Turks in an effort to force them to assimilate by changing their names to Bulgarian (Christian) names. Vasileva also documents how migration patterns (of ethnic Turks moving from Bulgaria to Turkey) fluctuated throughout the twentieth century and increased in the early transition.

democratic principles in a new kind of government.<sup>52</sup>

Kiuranov is a key example of the other kind of elite transformation (i.e., a non-communist party elite) that began through the political mobilizations of the UDF and other anti-communist groups. Kiuranov is a Ph.D. in Philosophy, a former research fellow at Sofia University during the transition, and now a research director of a major pro-liberal (and largely economic policy focused) think tank, the Centre for Liberal Strategies in Sofia. Like many of the subjects interviewed for this research, Kiuranov has a career history that mirrors the strengthening of the UDF party and the pro-liberal reformers between 1990 and 1996, and also illustrates how private institutions, rather than parties, have maintained ties to international policy circles, research institutes, and foundations abroad. For Kiuranov and many others, the Turkish repression of the late 1980's created an opportunity to move outside of academia and outside of their disciplines to engage broader questions of economic opportunity, liberal ideals of economic openness, and the simple political freedom to discuss and debate ways of organizing a political economy.

One major influence on the political environment (and the development of a liberal advisory network) in this early period of the 1990s was the injection of private research funds from abroad, notably from the Soros Foundation, which helped many academics with humanities backgrounds move out of their university posts and into private institutional settings with a focus on economic and political reform. Kiuranov, for example, trained and taught at the University of Sofia. From 1987-1990, he held a position as a research fellow in the university's department of Political Science. These three years would have been difficult in terms of receiving a reliable salary and in

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<sup>52</sup> Interview with Deyan Kiuranov, Sofia, Bulgaria, 12 August 2004.

negotiating political research at moments of critical change. Kiuranov translated this experience into an expertise in political survey research and from 1990-1992 held positions as a survey director with the Center for the Study of Democracy (a then newly funded research organization) and as Director and board member of the Bulgarian Soros Open Society Foundation office.

Other early UDF members were able to combine academic careers with political careers, again with support from international foundations and pro-liberal foreign aid programs in local embassies. These men (and it is a male dominant cohort at this juncture) were part of a first generation of reformers, trained as philosophers and historians rather than economists, often with some secondary or university experience abroad. Three key individuals illustrate this career trajectory and longevity in economic affairs in Bulgaria: Krassen Stanchev, Roumen Avramov, and Evgenii Dainov. They are key individuals because they share a similar (and prolonged) academic training under the socialist system, an early entrée into political and economic reform leadership, a vanguard presence as independent research organization leaders, and their continued interest and participation in major economic policymaking in the late 1990s--particularly their vital roles in the currency board reform.

There is a pattern to their intellectual development, their participation and fluidity between academic, research, and governmental organizations, and their current standing as leading policy analysts. This pattern of fluidity between early democratic political organization, to public service, and then entrepreneurial advising reveals the structure of opportunities for advisory network influence in the decade following the socialist transition. This fluidity also indicates how class and party identifications of the socialist

period could shift after the transition, as the social structure opened to allow political and academic entrepreneurship, in addition to the traditional view of business entrepreneurship. Many people could reinvent themselves and use the ideology of liberalism to signal a willingness to participate and change traditional roles as professor or businessperson. This particularity of the post-socialist experience is an important factor to consider in the development of the liberal advisory network in Bulgaria. Self-identification and reinvention were common, rather than rigid party affiliation or class-based identities. In the second case study of the liberal advisory network in Ecuador, this difference becomes more marked, as class identities and opportunities for career shifts are less flexible.

Stanchev trained as a philosopher, and found work as an academic or graduate student until 1989. He did undergraduate and graduate work at St. Petersburg University in Russia in the 1970s and returned to Bulgaria to complete his Ph.D. in philosophy at the Institute of Philosophy and Economic University in 1988. He then joined the UDF and ran for a position in the National Assembly working largely on a platform of environmental issues from 1990-91. In 1991-92, he also was asked to join the new board of the Soros Open Society Foundation office in Sofia. The following year he worked with a German foundation, the Freidrich Naumann Stiftung, as a grant maker. In 1993 he also began teaching at the New Bulgarian University, a university founded with public and private funds in 1990. (Changes in the university system are discussed below.) His most substantive experience in policymaking and advising has been as founding Director of the Institute for Market Economics (IME) in Sofia (formed in 1993) where he has used his contacts inside of government and in international organizations to build a consultancy

with a distinct ideological framework, exclusively free market in orientation, with policy recommendations ranging from the currency board implementation to tax structure reform and business competitiveness.

The topics of the research of the institute follow initiatives set by outside funders. For example, the recent research project on business competitiveness is funded by the World Bank's program on small and medium sized businesses and promoting competitiveness among developing economies. The World Bank's "Doing Business" report<sup>53</sup> tries to create an empirical picture of obstacles to small business development, including corruption and government obstruction. The theory behind these projects rests on an entrepreneurial understanding of economic development and change, based on the actions of individuals. Stanchev's own use of outside and international funds to maintain his research staff and presence in Sofia's political circles is also an indication of his entrepreneurial skills.<sup>54</sup> The research agenda of the IME then is connected to broader trends in economic development among international institutions and foundations. It is the director's job to evaluate these trends and look for opportunities for his organization; it is also his job to see that these research questions find relevance to Bulgarian politicians and government officials in order to secure their cooperation. It is a balancing effort one finds across different research organizations.

What is most compelling is how a group of academics (often unemployed or working outside of the major universities), and with expertise in fields other than politics

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<sup>53</sup> See the World Bank project website, access date 19 September 2006: <http://www.doingbusiness.org/>

<sup>54</sup> Krassen Stanchev was interviewed multiple times in Sofia in August 2004 and in the fall of 2005 for this dissertation. He provided the initial contact list of elites involved in the currency board plan. His open door policy is well-known and many foreign researchers are welcomed to the Institute for Market Economics. It is one way of reinforcing his own position in policy circles, and also to continually provide new resources and contacts for his group's research. Stanchev spoke openly about the need for small research organizations to remain relevant to policy circles and funding institutions and of the competition between research organizations for scarce research funding opportunities.

and political economy, transform themselves into leaders in the research business, political insiders, and policy advisors in the course of a five-year period. Their transformation, importantly, is not an individual process, but rather a shared experience among a cohort who compete with one another through their respective organizations for external funding, but also depend on each other as fellow experts and advisors. It is a consultative tradition that likely has roots in their early beginnings as graduate students, dissidents, foundation officers, and UDF insiders in the early transition.

This is an older generation, trained under communist academic institutions, but with entrepreneurial leadership skills, able to be flexible in their career expertise and in their movement between public and private institutions. A third example and member of this cohort is Roumen Avramov, an economic historian who spent most of his pre-transition career as a research fellow at the Bulgarian Academy of Sciences, from 1976-1990. As a high school student, he studied in Chile at a French lycée from 1964-69, a privileged experience abroad and likely an influential exposure to an iconic development story in progress. The Chilean miracle is an often cited success story of the later named “shock therapy” variety of free market theory, executed by the “Chicago Boys,” a group of liberal economists trained at the University of Chicago in the 1960s following the teachings of Hayek and their professor in situ, Milton Friedman. Avramov returned to Bulgaria and pursued a graduate degree from the Higher Institute of Economics, earning his Ph.D. in 1986.

Avramov is the preeminent regional<sup>55</sup> scholar on Bulgarian economic history, authoring seven books and dozens of articles in English and Bulgarian on the subject.

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<sup>55</sup> In a conversation with John Lampe, the leading American authority on Bulgarian economic history, Lampe reiterated Avramov’s high standing in the Bulgarian academic community and abroad. Meeting with John Lampe, Wye River, Maryland, 12 August 2006.

Like other members of his cohort, his major academic writing and career contributions have been after the transition. In the early transition, he worked as a policy advisor inside the newly democratic government. From 1990-91 he was an economic advisor to the newly elected President of Bulgaria (UDF), Zheliu Zhelev. Avramov then took a position as head of the Agency for Economic Coordination and Development, a new state-led development board, from 1991-94. In 1994 he left the public sector, like many of his cohort, and joined a new private research think tank, the Centre for Liberal Strategies (CLS) as a Program Director in economic research. Like the IME, the CLS built an expertise with former government contacts, UDF members, as well as material support from organizations abroad. Early foreign supporters included the Open Society Institute in Sofia, as well as USAID and the Freidrich Naumann Stiftung.

Avramov has built a career as an advisor and an authority on economic policy in an open market. His demeanor in interviews is open and professorial, with an objectivity that lends his views on political economy an air of correctness.<sup>56</sup> His personality and his experience have made him a role model to young policymakers and researchers in Sofia. He is a regular lecturer at the Bulgarian National Bank in its informal seminars for junior staff and researchers. He is also a member of the Hayek Society, a kind of economic salon dedicated to free market principles and policy. The society (discussed in more detail below) meets at a local university, and is led by a mentee of Avramov, Nikolay Nenovsky, who is also director of research at the Bulgarian National Bank. Avramov's UDF background also makes him a frequent consultant to the Ministry of Finance and to the local European Union mission (before accession in January 2007).

Evgenii Dainov is a fourth example of the founders of a liberal network in Bulgaria.

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<sup>56</sup> Interview with Roumen Avramov at the Centre for Liberal Strategies, Sofia, November 2005.

A leader of the democratic transition who has embraced the concept of a free market with social protections, Dainov founded the Center for Social Practices, a research organization in Sofia that has documented the plight of minority groups in Bulgaria, natural resource development issues, as well as the growth of the informal economy and its impact on marginal communities.<sup>57</sup> Though the focus of CSP is not liberal economic reform, its primary ideological commitment is to a free market of ideas, as well as goods and services.

In communist Bulgaria, Dainov was privileged to study abroad before the transition, as a secondary student in London and then as a graduate student at Oxford. At the moment of transition, Dainov was working as a journalist in London, writing about the changes across Eastern Europe. This connection to Western Europe, as students and as young adults, is a pattern among early leaders of the liberal and UDF movement. Returning to Sofia from London in 1992, Dainov became editor of an English-language magazine for the international community in Bulgaria, the *Sofia Insider*. He also began a teaching position as a lecturer in Politics and Society at the New Bulgarian University in 1994.

The primacy of the state university, Sofia University (formally named Sofia University St. Kliment Ohridski), changed after 1990, and private universities began to take the lead in training a new cohort of economists and political scientists who then form the leadership of the economic reform policymakers in the late 1990s. Three new universities were founded or politically realigned in the early 1990s to challenge established ways of thinking and teaching about political economy, with emphasis on

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<sup>57</sup> Background information on the Center for Social Practices and its leadership under Dainov provided by Maria Pancheva, Executive Director, CSP, in a series of interviews, August 2004 and November 2005, Sofia.

liberal economic theory: University of the National and World Economy, New Bulgarian University, and the American University of Bulgaria. Dainov's position at the New Bulgarian University is an example of a larger trend of repositioning academics with training abroad and institutionalizing contact between foreign donors and private academic institutions. The graduate students attending these universities became mentees of Dainov and thinkers like him, and these students have since found positions within the main economic policy institutions of the government of Bulgaria, further linking and sustaining the network of economic liberals. These universities received the bulk of their funding from organizations like the Soros Foundation. Dainov leveraged his teaching position with his interest in civil society (and expatriate society) to found the Center for Social Practices in 1994 with Soros funding through the Open Society programs. He was named chairman of the local Open Society office board of directors in 1998.

These men were early pillars of the UDF who have built their own non-governmental organizations and reputations outside of a party identity and are known as pro-liberal experts. The most important liberal research organizations in the country are founded by members of this network: the Centre for Liberal Strategies (CLS), the Institute for Market Economics (IME), the Center for the Study of Democracy (CSD), and the Center for Social Practices (CSP). More recently, funding has increased from the European Union PHARE programs, from European corporations (including the Volkswagen Foundation, among others) and from the World Bank for specific research programs. In the early years, particularly from 1993-1996, research funds and start-up funds came primarily from the Soros Open Society program in Bulgaria and American government funds from subsidiary units such as the Bulgarian-American Enterprise

Fund.

It is also important to note that a pro-liberal identification for these network members does not have the joint connotation of social conservative that is common in American (or Chilean) politics. The more recent non-party identification, or more independent identification, allows them to move freely between academic, political, and business sector environments dispensing advice and influencing policy choices. The structure of this network is built on a history of expertise and grassroots organizing that became a formal group. At the pinnacle of this structure are the early reformers, who are supported by younger ideologically aligned technocrats and researchers. These individuals have organizing skills, public speaking skills, and most importantly, strong beliefs about how a liberal economy should function. They are also highly entrepreneurial, turning their academic credentials and dissident experiences to careers in national politics. In fact, these three individuals are central figures in the currency board reform (Avramov and Stanchev, directly) and remain the most sought-after experts in the local press on issues related to financial reform, pre-accession efforts, and understanding the informal economy.

### ***Repositioning the Academic Community: Next Generation Network Members***

The influx of resources to new academic institutions and research centers in the early 1990s attracted students to pursue graduate work in economics and politics with aspirations to build a new Bulgaria based on market principles. This section elaborates some of the experiences of the younger generation of liberal scholars and technocrats in Bulgaria and shows how these individuals found mentorship and career opportunities through the first generation of liberal reformers discussed above. The purpose here is to specify nodes of the network and map the positions at the moment of the economic crisis.

The network relationships become essential for the creation of the emergency currency board and later helped determine government policy regulating banks. The focus on academic institutions and the changing environment of academic life and spaces for policy critique is important because it maps the locales in which network activity can take place and helps to explain how ideological bases of support for liberal ideas and policy are also in motion. Foreign study and academic exchange is important for the transfer of liberal economic ideas, but the ability to create new universities and programs of study devoted to the practice of liberal economic policymaking is a major accomplishment for the network.

Three of these scholar-technocrats: Nikolay Nenovsky, Tsvetan Manchev, and Kalin Hristov have made careers in economic policymaking and central banking. These younger scholars, now in their mid-30s to mid-40s, are a part of a first generation professional class after the fall of communism. They have had opportunities to study on scholarships abroad, to train at new universities in Bulgaria, and to build careers in which their beliefs about economic systems are assets allowing them to move between appointed positions in government to private banks to academic posts. Holding the top management and research positions at the Bulgarian National Bank (BNB), their careers and political activism (that is, their commitment to economic liberalism) are necessarily linked.

Nenovsky created the Hayek Society, a study and discussion group dedicated to understanding liberal economic principles in practice, with members from government positions, academic posts, private banks, as well as graduate students at the University of the National and World Economy, where Nenovsky has been a lecturer and faculty

member since 1995. The discussion group facilitates the interactions between liberal network members in Sofia, and it also places Nenovsky at the logistical center of policy debates. He can measure and compare support for government policies in the academic and business communities through group discussions. He also can act as a gatekeeper of network members, inviting guest speakers and politicians to the society's functions.

In his official capacity as director of research at the Bulgarian National Bank, and as a member of its governing council, Nenovsky is responsible for the theoretical defense of the central bank's policies, particularly the performance of the currency board and the bank's supervision of private banks. Before his tenure as research director, he worked as an expert advisor and a researcher for the BNB from 1995-2002. Before completing his doctorate at the Bulgarian Academy of Sciences in 1996, the premier research academy pre-1990, he studied abroad in France and the Soviet Union and worked briefly for COMECON in Moscow. He spent the early years of the transition as a student in France and then as a private banker at Société Générale in Luxembourg. Returning to Bulgaria in 1995, he stayed only briefly to leave again during the crisis of 1996-1997 for another academic program in France. Returning after the crisis, he became a fierce supporter of the currency board plan and joined the BNB with a wave of young professionals returning to a new liberal Bulgaria.

This wave of liberal reformers and young professionals joining the government from private banks and experience abroad after the economic crisis of 1997 is a well-documented occurrence in Bulgarian social history.<sup>58</sup> As the early 1990s created an impetus to move abroad to study or find work, the stabilization of a liberal government

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<sup>58</sup> See Vesselin Mintchev and Venelin Boshnakov (2007) "Stay or Leave Again? New Evidence for Bulgarian Return Migration," *Economic Thought*, Issue 7, pp. 107-126. Mintchev and Boshnakov discuss trends in young Bulgarian emigration and social motivations for return since the 1997 economic crisis.

and an end to hyperinflation made a return to Bulgaria possible and enticing for many young, educated professionals. Ganev describes this wave as changing the fundamental nature of Bulgarian politics from the “corrupt state” to a “development state,” as young professionals with education and exposure from Western Europe returned to Bulgaria with the promise of rebuilding a new kind of political economy.<sup>59</sup> Nenovsky, Hristov, and Manchev were part of this wave, and they turned to leaders like Stanchev, Avramov, and Dainov as mentors. Nenovsky regularly invites Avramov to speak at the BNB as an expert and sits on the board of Stanchev’s Institute for Market Economics.

Kalin Hristov and Tsevetan Manchev share similar experiences, working their way into government positions or political appointments through research positions at economic forecasting agencies, banks, and affiliations with the (then) new non-profit organizations led by senior liberal reformers. Hristov entered the BNB as a research aid in 1997, a kind of low-level political appointment through the UDF. The first governor of the bank under the currency board regime was Martin Zaimov, a major political player in the UDF and contemporary of Stanchev, Avramov, and Dainov. Zaimov also served as chairman of the board of directors of the Institute for Market Economics, among many business and research affiliations he maintains. Hristov worked for Zaimov and so impressed the senior politician that Zaimov recommended Hristov serve as interim bank governor when Zaimov left for a private bank position in 2003. Hristov remained at the bank as advisor to the governor through 2006.

These career trajectories have been possible because of structural changes in

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<sup>59</sup> See Venelin Ganev (2006) “Ballots, Bribes and State Building in Bulgaria,” *Journal of Democracy*, Vol 17, no. 1, pp. 75-89, for an inside approach to the role of young liberals and academics transforming the Bulgarian political landscape after the 1996-1997 economic crisis. Ganev himself is a Bulgarian of this generation and social network.

Bulgarian political and social life in the early 1990s, particularly the emergence of private universities, scholarships to study abroad, and the beginning of a revolving door of employment between the state, academia, and private business. The University for the National and World Economy, formerly the Karl Marx Institute for Higher Economics, was renamed and repositioned by the National Assembly in 1990, incorporating more liberal economic theory into its curriculum and expanding its faculty. Resources from the Open Society funded the American University in Bulgaria, which is also closely connected to the U.S. Embassy in Sofia, with many American faculty members<sup>60</sup> and Fulbright scholarship recipients.

The inauguration of a liberal government with Western support and financial backing fostered a liberal idealism and a practical calm with an emergency remedy to the hyperinflation. This end to the financial crisis had a political and social effect of encouraging young qualified Bulgarians, many of them returning from abroad, to want to work for the state to reform it, following principles of market economics. This period following the crisis was different for young professionals in their 30s and 40s than recent emigration patterns.

In a series of interviews with the next generation of bankers, economists, sociologists and political scientists—those who were undergraduates in the mid-1990s—their career trajectories have been very different.<sup>61</sup> These are the young graduates who saw the European Union as their immediate future. They are the “brain-drain” generation,

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<sup>60</sup> Interviews with Professor Robert “Bobby” Phillips of the political science department at the American University of Bulgaria were very influential in understanding the changing experience and opportunities for Bulgarian students in the mid-1990s to the present. Phillips has taught at the university since 1995.

<sup>61</sup> Informal interviews were conducted for this research over a two-year period (2005-2007) with a group of ten peers from Bulgaria, including: junior bankers in Sofia, Bulgarian academics studying at American universities, and young Bulgarian professionals and diplomats working in New York.

those who have left Bulgaria for the United States and Europe to study or work without concrete plans to return. These are young Bulgarians who see themselves as European, rather than only Bulgarian. Because of the massive political energies devoted to European accession after 2002, these young people see their opportunities as connected to Europe through Bulgaria, rather than limited to rebuilding the Bulgarian state and economy.

Therefore, the network that emerged in the mid-1990s is the defining liberal network of Bulgaria's transition to an open economy. Because it is structured with at least two generations of like-minded people (those who came of age as dissidents and those whose careers took off as part of the remedy to the financial crisis)--the network is able to populate both appointed political positions (ministers, central bank heads), senior bankers, and leading academic authorities, as well as junior staff members and young technocrats--the group can dominate the state apparatus of economic institutions at a critical moment of policy change. Network members populate both positions of thinking and doing, from policy conception and theoretical defense to policy execution.

### ***Crisis and Opportunity for the Liberal Network (1996-97)***

The liberal network, then, is a creation of a political and social moment, a critical juncture in which mentors are in place in private research organizations, universities are aligned toward promoting student research in the private sector and sending them abroad to continue their studies, and culturally, young people have an incentive to work for their government with an ideal of change. The crisis of 1996-97 allows the network to surge into action.

Bulgaria held presidential elections in October and November 1996. In an effort to unite the non-Socialist opposition parties, the UDF, Agrarian Union, and the Movement

for Rights and Freedoms (a party devoted to concerns of the minority Turkish population, MRF) put forth a shared candidate determined by a primary election. The UDF (and allied parties) candidate, Petar Stoyanov, defeated the incumbent President Zhelev by a wide margin. Encouraged by their victory in the presidential race, the UDF and other opposition parties made plans to call for early National Assembly elections. Stoyanov was sworn in as president on January 19, 1997. Just two weeks earlier, however, the BSP leadership seemed to be disintegrating and public trust eroding. On January 10, 1997, riot police violently repressed a protest on the economic crisis and blockade of the National Assembly building. The Socialist prime minister Zhan Videnov (1995-1997) resigned from party leadership, and the party replacement candidate, Nikolay Ddobrev, could not garner support from senior leadership to form a new government. This infighting and disorganization in an already difficult economic situation led Bulgaria's creditors (mainly the IMF) to suspend negotiations for an economic stabilization package until a new, cohesive government was appointed.<sup>62</sup>

Political competition at this time in Bulgaria meant competition *within* the Socialist party, and occasional threats from the opposition—a singular term meant to encompass the many new political organizations vying for potential votes and public attention.

Therefore, the victory of the UDF and its allied parties in early National Assembly

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<sup>62</sup> This discussion draws from the account by Vesna Bojicic - Dzelilovic and Victor D. Bojkov (2005) "Informality in Post-Communist Transition: Determinants and Consequences of the Privatization Process in Bulgaria," *Southeast European and Black Sea Studies*, Vol. 5, no. 1, pp. 69–88. Bojicic – Dzelilovic and Bojkov argue that informal networks are a crucial choice of partnership in implementing economic policies and key to understanding privatization in Bulgaria, while networks also function as bargaining tools and protection mechanisms for parties and individuals. Bojicic-Dzelilovic and Bojkov focus on networks as protection mechanisms, ways to secure prestige or place or financial stability from identification with a group, while my own conception of liberal advisory networks in Bulgaria is based on an ideological commitment that is more fluid between political party or other social group identification, and not a means of protection from social or economic exclusion.

elections in April 1997 became a real success and a defining moment in the opening of political competition and political identification in the country. The UDF's former problems of sharing elite constituents from SOE's with the Socialist party seemed to end. There was a growing political identification with liberal economic principles and democratic reforms. The BSP's concession to hold elections signaled the seriousness of the economic situation and the governing stalemate with the socialists' inability to agree to a cabinet or a mandate to deal with the bank collapses and rising inflation.

The UDF coalition (comprised of the UDF, the Popular Union, and the Bulgarian Social Democratic Party) came in first with an absolute majority of the vote (52.3 percent) and seats in National Assembly (137 out of 240) in the April elections of 1997—a major upset. The BSP came in second with 22.1 percent. The UDF emerged organized and ready to make agreements with Bulgaria's international creditors and to deepen relations with the West, particular with the United States. This preparation began in the early months of 1997, as the UDF used its academic ties, its members with research organizations, and connections to bankers to plan the financial rescue package before the party was officially elected. Ivan Kostov headed the UDF and, when elected, assumed the position of prime minister.

In an interview with Kostov, he described the months leading up to the April 1997 elections as a period of crisis in the country, but a moment of solidarity within the UDF.<sup>63</sup> In fact, there were a series of small, very private discussions among senior UDF members and their contacts in the U.S. Embassy, the country delegation and senior management of the International Monetary Fund in order to develop the currency board rescue package. These discussions solidified the prestige and camaraderie of an inner circle of the liberal

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<sup>63</sup> Interview with Ivan Kostov, Sofia, October 2005.

advisory network. Informal idea exchange served as a blue print for the redesign of the Bulgarian political economy.

***Network in Action: The Currency Board Plan and Execution***

In interviews with former Prime Minister Kostov, Roumen Avramov, Krassen Stanchev, Nikolay Nenovsky, Kalin Hristov, a former IMF country representative in Bulgaria, Gregory Dahl, USAID officials, and local political analysts, a socially nuanced account of the currency board process emerged. Many accounts of the economic crisis and currency board plan rely on the idea of foreign intervention and rescue to explain the policy choice and actors involved. The research here identifies an earlier, Bulgarian plan to reorganize the monetary system, and identifies the influence of network members outside of the UDF government who led the policy discussions in coordination with recommendations from the IMF representatives and leaders in private banking.

The first serious proposal of a currency board occurred as early as 1994, according to Gregory Dahl, then the IMF representative for Bulgaria. He asserts that the IMF introduced the plan to offer a measure of credibility and stability to the Bulgarian economy before the inflation crisis spun out of control. In this plan, the Bulgarian currency, the *lev*, would have been tied to the U.S. dollar. At the time, the socialist-led government was not interested in economic reforms, much less a tightened monetary policy. There were serious discussions among members of the Bulgarian National Bank's board of governors and advisors in 1995 in which Roumen Avramov, a board member, proposed a currency board, also tied to the U.S. dollar.<sup>64</sup> Kostov, Stanchev (a UDF

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<sup>64</sup> According to Georgy Ganev, who has a copy of the board minutes from this meeting in 1995, there is a blank line for the word "currency board" when Avramov spoke in Bulgarian, using the English translation. There was no Bulgarian equivalent, and like the secretary of the minutes, many of the board had no idea

National Assembly member in 1990-91), Avramov, and Martin Zaimov (trade minister 1996-97, private banker and appointed deputy central bank governor in 1997) all endorsed the plan. Therefore, when the UDF leadership anticipated its win in the early elections of 1997, the party had a macro-economic policy plan in place and began early negotiations (before the election) with the IMF to secure a package that would satisfy the country's lenders. The currency board plan that emerged, however, was not tied to the U.S. dollar, but to the German mark. The reason is purely political and the result of private discussions and concessions between the emerging liberal advisory network and its partners in the IMF and the international private banking community. This role of the IMF and any directives its staff may have made at this critical time for Bulgaria underline the delicate bargaining position of a country in crisis with a major source of finance. There is strong evidence for arguments highlighting the powerful role of the IMF in the origination and execution of macroeconomic policy.

According to Kalin Hristov, who worked directly for BNB Governor Zaimov, the politics of the currency board plan were related to the wars in the neighboring (and disintegrating) former Yugoslavia, the panic caused by the Mexican (then Asian, then Brazilian) currency crisis, and the internal politics of the IMF. In interviews with Hristov and Nenovsky, they claim the currency board tie to the German mark in 1997 diverged from established plans to tie to the U.S. dollar because of an outright request by the First Deputy Managing Director of the IMF, Stanley Fischer, in a memo to the BNB Board of Governors.<sup>65</sup> According to these sources, it was Fischer's personal instruction to the

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what Avramov meant to propose; the concept was so new and outside of the perceived realm of possibilities. Interview with Georgy Ganev, 5 October 2005, Centre for Liberal Strategies, Sofia.

<sup>65</sup> I cannot independently verify the existence or text of this memo, but three sources in separate interviews gave consistent reports of it. I also do not support the suspicion of impropriety on the part of Fischer,

Bulgarian government to tie the value of the *lev* to the *mark*, then place its reserves in German currency, and deposit much of those reserves in a German branch of Citibank. Fischer's purported argument in favor of the *mark* was that the currency would be a safe European currency, with accessible exchange mechanisms in proximity, which most economists consulted for this research agreed to be a rational assessment at the time. The young central bankers suspect impropriety by Fischer because he recommended the mark and Citibank perhaps because he was later appointed to a leadership role at the global firm, which he joined in 2001. There may also be suspicion on the part of these young central bankers because in earlier currency board discussions among their mentors (e.g., Avramov), the plan was to choose the U.S. dollar as an anchor currency. Their suspicion of outsiders' motivations may be a protection mechanism for the beliefs and advice of their own liberal advisory network leaders.

The underlying sentiment from many of the central bankers and UDF politicians interviewed for this research is that the UDF government and its advisors opted for "voluntary colonization,"<sup>66</sup> a concession of monetary sovereignty and an effort to align the political economy of Bulgaria with that of the liberal international finance community. The currency board idea may have been an original Bulgarian one, but the execution clearly included the input of the IMF and external advisers.

The currency board plan, and its necessary reorganization of the Bulgarian National Bank, allowed the Bulgarian liberal network, foreign governments, and

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though I do see how the very detailed nature of the IMF recommendations to the central bank struck a nerve among these well-educated central bankers as meddling and an overreach into the sovereignty of Bulgarian economic policymaking.

<sup>66</sup> Kalin Hristov used this term to describe the UDF-led effort to adopt the currency board and to follow the instructions of the IMF in its economic reform agenda after 1997. Interview with Hristov at the Bulgarian National Bank, 27 September 2005.

international organizations to influence economic institution building. Zaimov, on the advice of Avramov, based the reorganization of the BNB on the Bank of England<sup>67</sup> currency board structure used during colonialism. Nenovsky defended this central bank design in the academic literature and within the bank's research department at the time.<sup>68</sup> Zaimov and Avramov had experience working and studying at the Bank of England, and deemed it the most liberal model of a central bank, most appropriately for its historical structure dealing with a shared currency or pegged currency in its colonies.<sup>69</sup> The bank was then divided into three divisions: supervision, research/data collection, and emission (currency board maintenance).

The UDF objective of the currency board, according to Kostov, was to satisfy the IMF and create an immediate impact on the Bulgarian economy internally by slashing inflationary pressures and externally by creating an economic policy that would attract foreign investors. Moving UDF insider and pro-market Martin Zaimov from trade minister to governor of the central bank signaled a shift in leadership at the BNB. The BNB was radically reorganized under the currency board plan, as its mandate to emit and

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<sup>67</sup> The design of currency boards originated in Britain in the early 1800s among a group of economists known as the "Currency School." The Bank of England converted to a currency board through the Bank Act of 1844. The goal of creating a currency board was to provide the colonies with a stable and convertible currency without the cost of producing and transferring notes and coins. Also, by using a currency board arrangement instead of the pound Sterling, the reserves held could be deposited to earn interest in London. The first successful attempt to establish a currency board in the British colonies occurred in Mauritius in 1849. The West African currency board was established in 1912 for the British colonies of Nigeria, Sierra Leone, Ghana, and Gambia. The English currency board system was most used in the late 1940s, when about fifty countries had currency boards. Colonies favored the arrangements since the system controlled inflation and provided full convertibility into their anchor currencies. See John Williamson (1995) *What Role for Currency Boards?* Washington: Institute for International Economics; also see, Kurt Schuler (1992) "Currency Boards" *doctoral dissertation*, Department of Economics, George Mason University.

<sup>68</sup> Nenovsky explained this design plan in our interview, implying that the experience and familiarity of the plan's architects with the English model made it a natural choice. See Nikolay Nenovsky (1998) "Is Money Supply in Bulgaria Controllable?" (in Bulgarian) *Economic Thought*, Vol. 43, no. 1, pp. 27–43; see also, Nenovsky (1999) "Une Économie en Transition a-t-elle Vraiment Besoin d'une Banque Centrale? La Caisse d'Émission en Bulgarie." *Revue d'études comparatives Est-Ouest*, Vol. 30, no. 4, pp. 65–96.

<sup>69</sup> Kalin Hristov and Nikolay Nenovsky attested to the Bank of England model for the Bulgarian National Bank restructuring in 1997.

defend the national currency ceased. Zaimov then appointed a number of younger associates, like Hristov and Manchev, who carried on the liberal principles of the economic restructuring of 1997 through 2005.

The role of the IMF in the currency board plan is established, but there were other international actors involved in the reorganization of the central bank and policies toward private banking after the financial crisis of 1997. The role of the United States government, particularly through the US Agency for International Development (USAID), in highlighting (and diminishing) certain central bank functions and supervisory powers has not been fully documented to date. The connections between USAID technicians, their in-country investment managers, and local Bulgarian liberals in the central bank and the private sector are critical to understand the direction and approach of bank regulation following the crisis. This research uncovers these relationships, which are social ties in a well-established liberal network, for the first time in the academic literature. More traditional explanations would focus on the power dynamics between states and international institutions, which is clearly in play. In this research, the added value is the microscopic approach to individual ties within the Bulgarian state apparatus, specifically the Bulgarian National Bank, and in the US Agency for International Development, and with members of the IMF country delegation and senior management.

The United States took an increasing interest in Bulgarian politics and economic liberalization after 1995, when more significant economic aid flowed to the country. According to one USAID official in the Sofia American Embassy, the directives to the office from the U.S. State department have fluctuated with the neighboring conflict and

the gradual increase of European Union influence. In an interview with Rayna Dimitrova,<sup>70</sup> Senior Financial Sector Analyst at USAID, she explained that the economic aid program (in fact, all USAID activity in Bulgaria) was scheduled to end in 1998, but in 1997 Bulgaria received a ten year extension of aid packages, including a major initiative on “Financial Integrity” and an “International Banking Institute,” meant to be a training center for employees of the BNB after 1997. According to Dimitrova, the shift in US policy occurred because of changing US interest in the Balkans and in a larger private investment initiative led by USAID in the former socialist countries of Eastern Europe.

Bulgaria was one of twelve countries to receive a private investment fund with SEED capital (over 200 million dollars) from the US State Department. The Bulgarian American Enterprise Fund had a mandate to fund at least 20 million dollars in new business ventures inside Bulgaria. USAID funded the Bulgarian American Enterprise Fund directly with 58 million dollars.<sup>71</sup> In an interview with the director of the fund, Thomas Higgins, he acknowledged that the fund could not find adequate investments and instead began a program to act as a mortgage lender to private Bulgarian citizens.<sup>72</sup> In 1997 it was still illegal for a foreign bank or foreign entity to operate as a mortgage lender. Higgins worked with colleagues at the IME and CLS to propose legislation to the National Assembly to allow the fund to operate as a foreign investor and as a private

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<sup>70</sup> Interview with Rayna Dimitrova at the U.S. Embassy in Sofia, October 2005. Dimitrova worked for the Bulgarian National Bank from 1991-1997, then took a position with USAID to work specifically with banking issues.

<sup>71</sup> See <http://bulgaria.usaid.gov/103/page.html> for detailed information on USAID initiatives in Bulgaria, documenting the recommitment to Bulgaria in 1997 and then the change of aid policy from 2002-2007 in light of the EU accession process. The USAID program in Bulgaria is scheduled to end in fall 2008.

<sup>72</sup> Interview with Thomas Higgins at the Sheraton Hotel, Sofia, October 2005.

bank.<sup>73</sup> Higgins described this moment in Bulgarian economic history, from 1997-2002, as a cultural and business environment of the “Wild West.”

Rules about investment and banking practices were left unresolved and most entrepreneurs, UDF officials, and private consultants working toward the liberalization goal encouraged an attitude and approach of laissez-faire capitalism: Let businessmen and investors make their attempts at calculating the value of Bulgarian enterprises, and the market would establish and stabilize itself. In their combined work experience and training abroad, central bankers and liberal advisory network members had solid knowledge of best practices, of the inevitable formation of credit bureaus and mechanisms to report on bad loans and lending practices of banks. However, these liberal advisors and foreign investors and foreign government representatives specifically chose to leave these mechanisms out of their recommendations for the short term. This logic, according to Higgins, was very profitable for some and many of his own partners were, as he characterized them, “mafiosos.” The market would settle and rules would be established in the long run, but for the short run (at least a five-year period) the banking sector and investment climate should be unregulated. USAID, the Bulgarian-American Enterprise Fund, and their local partners, the IME and CLS, among others, all opted *not* to recommend the creation of a credit bureau or a deposit insurance fund until two full years after the currency board was established.

Kalin Hristov of the BNB had a similar assessment of the actors in the banking sector, calling it “vibrant” from 1997-2005, emphasizing the sixty murders of

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<sup>73</sup> In fact, it was IME director, Krassen Stanchev, who introduced Higgins as a interview contact, as a colleague and supporter of IME research initiatives in Bulgaria. The two had worked together on policy recommendations and identifying areas for US investment in Bulgaria for the fund.

businessmen and bankers occurring between 2002 and 2005 alone. It is important to note that Higgin's operation, the largest private investment vehicle in the country at the time, was wholly subsidized by the U.S. government (USAID) and in open dialogue and consultation with established members of the liberal advisory network in Bulgaria. These funds were part of the SEED funding to Eastern Europe from the U.S. government. In 1989, the U.S. Congress passed the Support for East European Democracies Act (SEED), authorizing financial support to facilitate development of democratic institutions, political pluralism, and free market economies in the Balkan region. Since 1990, Bulgaria has received over \$600 million in SEED assistance. In 2007, after its EU accession, Bulgaria was not eligible for continued funding.

USAID used its financial influence through its private equity investment arm, the Bulgarian American Enterprise Fund, to bend and change the BNB's standing rules on the supervision of non-bank enterprises and foreign banks operating in Bulgaria. USAID also influenced the BNB reorganization and supervision capacity after 1997 in several ways. First, it created a training institute that allowed American experts and partner local Bulgarian liberal policy consultants access to the BNB's offices and staff. Second, USAID facilitated incentives from NATO and the US government to introduce the European peg in Bulgaria in 1999. Third, USAID discouraged the development of a credit bureau or regime to verify the liquidity and stability of banks and non-bank financial institutions.

In 1998-99, USAID began a program to improve the technical capacity at the BNB with the addition of new computer equipment and tracking programming to store

information about the financial system. The donation and aid package were a reward and incentive package negotiated between the UDF-Kostov government and the bank's board of governors, aimed at tying the Bulgarian currency to the European and preparing for a European Union accession bid in exchange for favorable treatment of US interests, including the planning of a major US military base, in Bulgaria. According to well-placed BNB employees and members of the Board of Directors in 1998-99, in exchange for US support of Bulgaria's candidacy to the European Union, Bulgaria would allow fly-over rights to NATO expeditions bombing neighboring Serbia, and be open to the planning of a more extensive US military presence in Bulgaria. The UDF government and its leadership in the Bulgarian National Bank then made plans to peg the currency to the *euro* instead of the German *mark* in a move to prepare the country for membership in the European Union.

The external pressures to reorganize the bank and its supervision capacities were clearly strong, as evidenced above. The liberal network was ideologically aligned to the USAID programs (allowing foreign banks to operate freely and foreign investment to enter) and had its own organic support (and design) for the IMF currency board plan. Kostov played an important role in appointing UDF supporters who would heed pressures from external powers (IMF, NATO), but also spearheaded support for less government intervention in the private bank market. Meetings facilitated between private research institutions like the Institute for Market Economics and the Centre for Liberal Strategies and foreign politicians and donors helped to generate press support for the liberalization process.

Choices made from 1997-99 in an effort to distance Bulgaria from its past banking and currency crises made private bank operations in Bulgaria profitable and easily accessible to the general population. These institutional choices also unleashed a growth in private banking without much government supervision that has created conditions similar to those before the twin crises. Instead of state-owned enterprises over-borrowing and weakening bank balance sheets, after the monetary policy reform individuals are borrowing more than they can repay and banks are not accountable directly to the government, but to the independent central bank and its board of governors.

***Consequences of the Liberal Advisory Network: Political and Economic Outcomes of Central Bank Restructuring***

There are five key outcomes of the central bank restructuring necessitated by the currency board plan and the liberal network's management of macro-economic policy after 1997. These are detailed below, but, in short, they relate to the following issues:

- 1) supervision of private banks was lax and lacked technical controls and communication protocols,
- 2) little political will existed to create and manage a credit bureau,
- 3) a deposit insurance fund for banks was absent until 2002,
- 4) bank lending increased, while the risk ratio of bank lending decreased dramatically,
- 5) the role of government and National Assembly oversight in economic policy decreased through 2002.

In a report<sup>74</sup> on adherence to Basel standards in 2000, the IMF found that the Bulgarian National Bank still had no comprehensive database of bank-to-bank lending, nor of connected lending,<sup>75</sup> or large loans between banks and private businesses, or insurance/non-bank financial entities. This was cause for concern as the Bulgarian economy suffered greatly due to connected lending between state-owned enterprises (SOEs) and state banks in the early 1990s. In fact, the collapse of the banking system and the crisis that brought about the currency board reform began with the connected lending practices of the SOEs and state banks. To leave these practices unresolved or unregulated by the central bank was malfeasance on the part of the external advisors and local regulators. The IMF also found that the BNB had “no explicit rules and no capital requirements for important market risks” (recommendation no. 25) including a bank’s trading book (its own investments in securities). This is precisely the problem that caused the downfall of the American credit market in 2007-08 when banks traded complex securities (derivatives and swaps on mortgage-backed securities) on their own balance sheets with depositors’ and investors’ funds. American banks did have internal safeguards to measure market risk, including computer systems to stop traders from

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<sup>74</sup> International Monetary Fund (March 2000) “IMF Review of BNB Basel Standards as of 2000,” Report on the Observance of Standards and Codes (ROSC). Internet Access: <http://www.imf.org/external/np/rosc/bgr/banki.htm>

<sup>75</sup> Connected lending is a term to describe how banks and firms are related through parent companies or holding companies, as well as through more informal obligations such as shared board members and influential shareholders. Connected lending was a cause of the Asian financial crisis in 1997, particularly in Thailand, according to many scholars. On the effect of connected lending in the Asian crisis, see Chutatong Charumilind, Raja Kali, and Yupana Wiwattanakantang (2006) “Connected Lending: Thailand before the Financial Crisis,” *The Journal of Business*, Vol. 79, no. 1, pp. 181-218. On bank and board membership connections and the general problem of connected lending, see Randall S. Kroszner and Philip E. Strahan (2001) “Throwing Good Money after Bad? Board Connections and Conflicts in Bank Lending,” University of Chicago, *Law & Economics*, Olin Working Paper No. 139.

taking over-leveraged positions, yet these banks still lost billions of dollars. The Bulgarian system had no rules at all through 2002.

The IMF also reprimanded the BNB for failing to monitor management practices of private banks. The IMF recommended the BNB establish communication mechanisms and reporting practices for the appointment of private bank board members and that the BNB monitor some standard of professional qualifications. The IMF wrote, “the fit and proper tests of management and Board members should focus more on the actual understanding of a bank’s activities, in addition to the formal criteria. Rules for the creation of audit committees in banks should be introduced” (IMF 2000: 26). Included in this recommendation was the advice to lower the threshold for reporting cash transactions to help monitor money-laundering. (For example, all cash deposits and transfers over 10,000 *euro* should be reported to the central bank.)

There is some correlation to management appointments and the monitoring of laundering activities, and the IMF made no mistake in putting the two recommendations together. As discussed earlier, the increased activity of the banking sector, particularly in cash transactions and deposits, coincided with reports of organized crime linked to private bank operations. The IMF found Bulgaria to be “materially non-compliant” on issues of consolidated supervision of the Basel standards. The finding essentially underscored the BNB’s inability to collect data from private banks on their balance sheets in a regular quarterly or even annual schedule, and underscored the BNB’s incapacity for off-site and on-site supervision of private bank activities. In regards to basic bank supervision, private banks from 1997-2002 may have had some legal obligation, according to the 1997 *Law on Banks*, to report incidence of financial duress, regular

balances, and changes in management, yet banks were under no practical pressure or external supervision to do so.

A credit bureau or credit register is a basic tool of financial markets to verify bank and borrower solvency, past histories of debt obligations and compliance. In the case of Bulgaria, the IMF proposed a credit register in 1999 with support from the World Bank for the purpose of reporting bank histories. The credit activities of private business have not been regularly monitored in the country to date. According to Rayna Dimitrova of USAID,<sup>76</sup> there was no recommendation by USAID in its workshops and training schedules with the BNB to implement a register and no support from local consultants (IME, specifically in this issue) to do so, even though it was clear to Dimitrova and her counterparts of the value of such a mechanism. The USAID program did not recommend (or fund) a credit bureau mechanism because, according to Dimitrova, it was considered “too interventionist” in the market. The advice was essentially that credit checking mechanisms are useful, but should be initiated by local business people. In conversations with Nicolai Nenovsky and other BNB management, the issue of verification of bank credit histories was not an important one. By 2004, a register was in place, managed by the BNB with limited technical capacity of reported bank balances. According to Nenovsky, the BNB register was an organic effort led by BNB management, in consultation with private bankers on the board of directors.<sup>77</sup>

A deposit insurance fund is a mechanism in which private banks voluntarily submit a portion of their capital (as agreed upon by the board of directors of the independent central bank, in which the private banking community has representation) to

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<sup>76</sup> Interview with Rayna Dimitrova, 24 October 2005, US Embassy, Sofia.

<sup>77</sup> Interview with Nikolay Nenovsky, 10 November 2005, Bulgarian National Bank, Sofia.

a pool in the event that if one bank is in crisis, the group's combined capital will be available. In the United States, the Federal Deposit Insurance Corporation, founded in the 1930's after the failure of American banks in the depression, guarantees deposits by individuals up to \$100,000 at any member bank. In Bulgaria, a deposit insurance fund was established in name in 1999, but was not active until 2002. In a seminar at the Bank for International Settlements in 2000, Militia Mladenov, Chairman of the Management Board of the Bulgarian Deposit Insurance Fund, gave a paper detailing the problems of the nascent fund and proposing ways the Bulgarian government might intervene with legislation to protect depositors from the risk of failing banks.<sup>78</sup> Mladenov explains that the 1999 *Law on Banks* left control of the administration of failed banks to the courts, instead of the central bank or the deposit insurance fund (governed by the central bank). In this case, the deposit insurance fund, and, by extension, the BNB, had no oversight of how to manage a failed bank's assets, or how to mandate its trustees to provide accounting records and make bank assets available for distribution to depositors. The lengthiness of court adjudication and the unfamiliarity of the court with complex accounting reporting made the failure of banks a disaster for depositors and the insurance fund impractical. Two major banks failed between 1999 and 2002 and the deposit scheme experienced severe delays.<sup>79</sup>

One obstacle was the insurance fund's lack of independence, as its budget is controlled by the BNB and its management (from 1999-2002) led by a former Bulbank chief executive. The ties between the former state bank Bulbank (also the largest private bank) and the management of the BNB doomed the deposit insurance fund in its

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<sup>78</sup> See Mileti Mladenov (2000) "A Case for New Bank Bankruptcy Legislation in Bulgaria," Geneva: Financial Stability Institute, Bank for International Settlements.

<sup>79</sup> Interview with Rayna Dimitrova, *ibid.*

inception, as other banks were skeptical there could be a fair allocation of resources. In 2003, the courts were still attempting to locate physical capital and assets of the failed banks to auction to repay depositors.<sup>80</sup> Because of Mladenov's efforts and recommendations by the Bank of International Settlements, draft legislation for a revision of bankruptcy law for private banks was passed in 2002. The independence of the Deposit Insurance Fund, however, remains in question as its budget (and management) is tied to that of the Bulgarian National Bank.

After 1997 and the reorganization of the Bulgarian National Bank, private banks gained new leverage and freedoms to expand their lending practices and increase risk in their portfolios. Even though the BNB made public affirmations of the core Basel principles, the appropriateness of these principles to a fragile bank market are questionable.<sup>81</sup> According to the US Department of Commerce, the average capital adequacy ratio (capital base to risky credit exposure) declined from 43 percent in 1998 to 23 percent in 2003. The ratio reached 13.9 percent by 2007. This means that banks had less capital or reserves to defend their positions in more risky investments. The Basel standards only require a 12 percent ratio, which the BNB adopted by 1999. However, the distribution of assets in the country was concentrated in only three banks (Bulbank, State Savings Bank or DSK, and United Bulgarian Bank—all former state banks, and many linked to members of the board of governors of the BNB). By 1999, foreigners held 85 percent of total capital in domestic banks. Further impacting the looseness of Bulgarian

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<sup>80</sup> See Mladenov; also substantiated in interviews with BNB officials and local private bankers.

<sup>81</sup> For a discussion of the different bank environments in developing economies versus industrial economies and developed bank sectors and how the same capital requirements may not be "one size fits all," see Andrew Cornford (2000) "The Basel Committee's Proposals for Revised Capital Standards: Rationale, Design and Possible Incidence," UNCTAD and the Harvard Center for International Development, G-24 Discussion Paper Series.

private bank regulation, the BNB had no authority to regulate or receive information on foreign bank assets in the country. This means that transfers between foreign banks and domestic banks were not always reported, and that foreign investment made up an overwhelming portion of the protected capital (by the weak Deposit Insurance Fund) in domestic banks.<sup>82</sup>

One of the main political outcomes of the bank restructuring and restricted macro-economic policy was the reduction of influence and administration of the National Assembly in central bank business. The board of governors of the BNB reports to the National Assembly, and board members are routinely appointed by the prime minister. However, subsequent changes in governments have not impacted the management orientation of the BNB, nor have the major liberal network members of the BNB left since 1997. Zaimov remains connected to the board, as does Avramov, Nenovsky, and general managers like Hristov, despite three changes of government and the election of a socialist government in 2005.

A second important change in the political landscape was the bid and process of European Union accession begun in 2000. With more scrutiny towards economic policy and a concern to be outwardly liberal and welcoming to foreign banks and investment, successive governments had little interest in provoking the BNB, private banks or foreign investors with meddling in new economic regulations. Added to that, the hands-off approach by the technical advisors and local consultants gave a freer hand to BNB managers to leave private banks to their own cognizance.

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<sup>82</sup> See US Department of State (2008) *Doing Business in Bulgaria Report*. Washington, D.C.: US Department of State. For Internet access: [www.buyusa.gov/bulgaria/en/80.html](http://www.buyusa.gov/bulgaria/en/80.html).

When the UDF lost power in 2001 to the newly organized party National Movement of Simeon II, named for the former monarch Simeon Saxe-Coburg Gotha, the BNB leadership remained in place and even more liberal-minded Bulgarians with finance experience abroad returned to help further the liberalization goals begun in 1997 with the UDF election. The only major legislation on banking and finance from 2001-2005 was the 2002 bankruptcy reform discussed previously. Private banks enjoyed an extended period of growth and foreign investment.

The underside of this extended period of lax regulation of the bank sector includes the unexpected, or little discussed, rise in household loans (as banks increased lending to individuals with flat or decreasing incomes), increase in activity in the informal sector and gray economy, as well as unimpressive results in combating poverty, health, and education standards for marginal communities. The Consumer Lending Act of 2007 required banks to publicly announce their interest rates and terms for personal loans, which previously could fluctuate or easily confuse some first-time borrowers.

Legislation on personal and commercial debt has clearly favored the bank sector. The little publicized amended Article 42 of the 1997 Banking Act (amended in August 2006) allows banks to seize a debtor's property and demand repayment of the full sum of a loan even if only one installment of a loan is in arrears. The Association of Commercial Banks requested the legislation with approval of the Bulgarian National Bank.<sup>83</sup> According to Creditex, a private market research firm in Sofia, bad loans were expected to make up 9

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<sup>83</sup> *Sofia Echo*, "Bulgaria's banks get stronger powers against defaulting debtors," 16 October 2006. Internet Access: [http://www.sofiaecho.com/article/bulgaria-s-banks-get-stronger-powers-against-defaulting-debtors/id\\_18121/catid\\_23/search\\_1](http://www.sofiaecho.com/article/bulgaria-s-banks-get-stronger-powers-against-defaulting-debtors/id_18121/catid_23/search_1)

percent of the credit market by the end of 2007, clearly putting some private bank balance sheets in dangerous positions.<sup>84</sup>

The World Bank finds that poverty levels remained at double the levels of 1995 well into 2002, and persist without much positive change in groups of Roma and the unemployed to the present. Registered unemployment rose steadily from 1997 to 2002 and has ranked the highest in the region at 17.5 percent in 2002. The country continues to have large current account deficits. The deficit was \$1.7 billion in 1996 and stood at \$15.8 billion in 2006.<sup>85</sup> Inflation has steadily increased to levels not seen since the recovery period of the economic crisis (May 1998). Year-on-year inflation in Bulgaria rose to 14.2 per cent in March 2008, according to the National Statistical Institute.<sup>86</sup> Income levels have not converged to EU standards, and remain the lowest in the union. Salaries in Bulgaria remained the lowest in the EU, even compared with neighboring Romania. According to the National Statistics Institute, average monthly household salaries in Sofia surpassed 500 *leva* for the first time in 17 years, but in rural areas, average incomes were much lower. Per capita income in July 2007 was 254.51 *leva*, though spending was 322.35 *leva*.<sup>87</sup> Personal indebtedness and the rising costs of basic living necessities (due also to EU accession and general global trends in food and fuel prices) have made life for the average citizen after the monetary reforms of 1997 still very difficult.

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<sup>84</sup> *Sofia Echo*, "Economy Briefs," 30 July 2007.

<sup>85</sup> See the World Bank for statistics cited, "At a Glance," available on-line: [http://www.worldbank.bg/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/BULGARIAEXTN/0,,menuPK:305464~pagePK:141132~piPK:141109~theSitePK:305439\\_00.html](http://www.worldbank.bg/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/BULGARIAEXTN/0,,menuPK:305464~pagePK:141132~piPK:141109~theSitePK:305439_00.html)

<sup>86</sup> See *Sofia Echo*, "Year-on-year inflation in Bulgaria grows to 14.2% in March" 14 April 2008. Internet Access: [http://www.sofiaecho.com/article/year-on-year-inflation-in-bulgaria-grows-to-14-2-in-march/id\\_28760/catid\\_68](http://www.sofiaecho.com/article/year-on-year-inflation-in-bulgaria-grows-to-14-2-in-march/id_28760/catid_68)

<sup>87</sup> See Petar Kostadinov, *Sofia Echo*, "2007 In Review: Life on the street," 4 January 2008. Internet Access: [http://www.sofiaecho.com/article/2007-in-review-life-on-the-street/id\\_26890/catid\\_5/search\\_1](http://www.sofiaecho.com/article/2007-in-review-life-on-the-street/id_26890/catid_5/search_1)

### ***Conclusion***

The currency board plan of 1997 and the subsequent liberalization of the private bank sector, particularly from 1997-2002, did little to secure the financial stability of Bulgarian citizens. Access to credit did increase, as did access to foreign investment. Inflation has stabilized, but did rise between 1997 and 2002 and did not remain at single digit levels as expected. In fairness, part of the inflationary trend after 2002 was due to the EU accession process and global commodity trends. However, the changing nature of the Bulgarian financial architecture clearly veered toward openness without government intervention or supervision. The liberal advisory network is an alternative means to analyze this laissez-faire approach. The people who have controlled monetary and bank policy since 1997 have created a network of ideas and positions of power and decision-making that have remained intact for a decade, despite changes in government and the weakening of the first major party supporting economic liberalism, the UDF.

The role and power of this liberal advisory network can be evaluated as strong according to five key indicators proposed in this research. First, the liberal advisory network in Bulgaria enjoyed ideational support and patronage through a number of organizations, including educational experience abroad and research opportunities with liberal Western central banks. A key factor of support for the liberal policies advocated in the network was the general policy environment in Eastern Europe in the early to mid-1990s, which clearly favored pro-market approaches to government concerns. Liberalism in its newness had a certain “halo” effect which attracted students and policymakers alike. The popularity of study-groups, such as the Hayek Society, and informal gatherings to discuss liberal policy and theory opened a social space for liberal ideas

about economic policy which symbolized a new political freedom and a vibrant (and young) intelligentsia absent in Bulgaria's socialist experience.

The liberal advisory network's ties to international organizations such as the IMF were more combative, which may have provided more negotiation power to the Bulgarian economic policy team after stabilization in 1997. In principle, the IMF had an important role in the formulation of the emergency government economic policies of early 1997. Ties between IMF country representatives and Bulgarian central bankers, however, were not close or mentoring relationships, as was the case in Ecuador (to be discussed). More important sources on international influence were from private organizations such as the Soros Foundation, American university partnerships, and financial entities established with American government funds (e.g., the Bulgarian American Enterprise Fund).

In the domestic sphere, the Bulgarian liberal advisory network enjoyed significant political power because of the institutional design of the parliamentary system. The demands of consensus-building effectively gave the central bank a more autonomous (and technocratic) work zone, without singular executive or legislative intervention. Moreover, the ability of liberal network members to move between nascent liberal political parties, including the UDF and the movement led by the former king, Simeon Saxe-Coburg Gotha, kept the expertise of liberal network members more valuable than single-party alliances.

The mobility of the Bulgarian liberal advisory network is key to understanding how this group has navigated political party changes, foreign sources of support and influence, as well as a shifting national political identity from a socialist to a wholly

democratic and liberal society. Class and social structure identities all became more fluid in the 1990s for Bulgarians, and the liberal advisory network is evidence of the movement of academics and young technocrats to high positions in economic policy formation and execution. In sum, the liberal advisory network in Bulgarian enjoyed a privilege of material resource support and ideational support that allowed it to actively formulate policy according to a strict theoretical ideal, which was at the expense of creating government safeguards for bank depositors and borrowers.

## **Chapter 4 - Ad Hoc Economic Institution-building, Dollarization, and Bank Reforms in Ecuador**

### ***Introduction***

Ecuador experienced the worst financial crisis in the country's history between 1998 and 2000. Joined with political instability, a series of bank failures and rising inflation drove the country's financial system to collapse in late 1999. As an effort to contain the currency crisis, the president announced he would adopt the U.S. dollar as national currency on January 9, 2000. Dollarization created a constitutional crisis, as the president who proposed the policy, Jamil Mahuad, was forced out of office in a non-violent coup on January 21, 2000. Necessary reform of the bank sector then stalled while ad hoc efforts to create new institutions to deal with bank fragility and failure were unsuccessful and chaotic with severe long-term consequences for citizens.

This chapter explains the causes of the financial crisis in 1998-2000, and the government's attempts at economic policy response in both the redesign of the central bank and supporting institutions, and in efforts to regulate the private bank sector. The chapter describes how a weak liberal advisory network developed through liberalization processes beginning in the early 1990s and how during the crisis this network diffused economic policy innovation and increased bank regulation. The chapter puts forward the argument that the weak structure of economic advisory networks limited ideas, access, and support from foreign governments and domestic and international financial institutions to manage the 1998-2000 financial crisis. Furthermore, the structure and landscape of national political competition privileged the position of the president. As a result, all major economic reform has been mandated by the president and a few key advisors—a tradition initiated in the Duran administration (1992-1996).

This pattern of policy origination through the presidency discouraged young economists and bankers to build policy and ideological consensus, opting instead to prioritize connections that might yield political appointments and career opportunities. Economic advisory networks struggled with poor access to foreign donors and alternative sites to build their credibility as the premier source of economic policymaking in Ecuador, as they lacked material resources and alternative employment opportunities in think tanks and broad academic settings. The presidential position remains key to understanding economic policy change in Ecuador, as do social structures of class and concentrated wealth which continue to guide the political process. These explanations are enhanced by an understanding of the intricacies of economic policy innovation and attempts at bank sector reform, particularly how long term institutional affiliations and ties between individuals, both domestic and international, can influence policy choice and outcome.

In contrast to the experience of a strong liberal advisory network in Bulgaria, the weak and sparse network in Ecuador relied more on individual relationships between mentors and mentees of the central bank in moments of economic policy crisis. While Bulgaria's liberal advisory network enjoys support from private donors and governments abroad to fully develop an ideological stance and institutional presence in public debate (an effect of the intense financial and ideological interest in Eastern Europe from the United States and Western Europe after 1989), Ecuador's network is prone to internal competition for limited resources and employment opportunities.

The chapter proceeds as follows: it begins with an explanation of how the bank sector developed and flourished with liberalization efforts of the 1990s, only to collapse

in financial crisis by 2000. It traces the development of liberal economic policies in Ecuador through several administrations. It also explains how presidential politics in Ecuador can singularly influence economic decision-making, while also diminishing the role of party identification and strong ideological commitments to economic policies. With evidence from field interviews, the chapter underlines the importance of individual ties (at the expense of network expansion and the formation of dense ties between private and public finance institutions) in the management of the financial architecture of Ecuador. Problematically, the individual ties that inform economic policymaking can supersede institutional affiliations and any broader policy goals of the network.

As in the analysis of Bulgaria in the last chapter, this chapter addresses a failure of state authority in the regulation of finance and banking, providing two key sequential experiences as evidence. In the first, the president (with an advisor) opts for dollarization out of desperation, acting in secrecy and alone without congressional support or formal support from international financial institutions and foreign governments, namely the United States. In the second, after the crisis when subsequent administrations have the opportunity to rebuild the financial sector with better regulation, efforts are ad hoc and easily skirted by aggressive and politically active owners in the private bank sector. The state fails to reign in bank behavior, not for lack of action, but for lack of communication and cooperation between state economic institutions (central bank, supervisory agency, and deposit guarantee agency) and the private bank sector.

The state's failure to direct monetary and bank policy with authority and competency is related to the weakness of a financial advisory network, which was not able to facilitate policy dialogue both within and between the state and private bank

sectors. The political advisory network in Ecuador is not stridently liberal in orientation or focused on advocating liberal economic policy; rather, the network is focused on maintaining ties to the advisory process and the locus of power in the presidency, regardless of the president's party affiliation. The sections that follow elaborate how the economic advisory network forms in the context of liberalization in Ecuador, why these network ties are weak and "short", and how the relative strength of the presidency allows certain reforms to occur.

### ***Background***

In just one decade, from 1985-1995, Ecuador experienced a major boom in financial services and economic growth. Yet by the end of the 1990s, Ecuador experienced its worst economic crisis—a severe statement for a country familiar with economic and political volatility.<sup>88</sup> The underlying cause of the economic crisis was a total collapse of the national banking system, together with a currency crisis and a credit crunch. That is to say, Ecuador had more than a "twin crisis" of a bank and currency disaster, but also experienced a tightening of international and domestic credit lines, which made an already difficult fiscal situation for the government near dire. The crisis closed sixteen banks in the country, where only forty banks operated before the crisis in 1997. Nearing

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<sup>88</sup> Ecuador has experienced a number of political crises, including a military dictatorship from 1972-1979, as well as multiple constitutional crises (1997-1998 being the most recent in which a National Assembly formed expressly to rewrite the constitution giving more power to the president over congress). President Rafael Correa proposed Ecuador's 20<sup>th</sup> constitution in July 2008, to be the third in the last three decades. See, "Ecuador: The Good Life," *The Economist*, 31 July 2008. Economic stability has been difficult; following the dictatorship, Ecuador suffered an inflationary crisis and currency run in 1982, as the economy has been consistently vulnerable to the global price of its export commodities, specifically oil. Between 1997 and 2008, there have been eight presidents; three were removed from office by coup or social protest.

hyperinflation, the Mahuad administration adopted the U.S. dollar as the country's official currency in January 2000.<sup>89</sup>

The economy did stabilize, but very slowly. In 2002, financial activity was still below its pre-crisis level. The toll on everyday citizens was extreme. Per capita gross domestic product in 1999 was equal to 1977 levels.<sup>90</sup> Economists estimated the cost of the crisis at over 20 percent of gross domestic product (GDP) (Jacome 2004: 5). Bank deposits were frozen unilaterally for over one year (2000-2001), and the failure of many banks left depositors waiting for years to reclaim<sup>91</sup> a portion of their savings, if any at all. The crisis created the largest wave of emigration in Ecuador's history, as 1.5 million people (entire families or heads of families) fled, many to Spain and the United States looking for work between 2000 and 2004 (Gallina 2007: 4). This chapter details the social and political consequences of the crisis, but first examines the roots of the financial crisis, Ecuador's foray into liberalization trends of the 1990s, and the development of an economic policy advisory network based on social ties between officials in government and in the private bank sector. The chapter explains the limits of state authority in monetary and bank reform and the failure of the state to create synergy between economic policy and the interests of the local private and public bank sectors. In this

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<sup>89</sup> Hyper-inflation is generally defined as two months or more of inflation at 50 percent or higher. In Ecuador, annual inflation increased approximately 30 percent between 1996 and 1997. By 1999, annual inflation stood at 61 percent. During 1998-1999, the effective exchange rate of the *sucre* to the U.S. dollar depreciated 50 percent. See International Monetary Fund (2000) "Selected Issues and Statistical Annex," IMF Staff Country Report, No. 00/125. Washington: International Monetary Fund, for detailed information on the changes in inflation during the 1998-2000 crisis, debt pricings of Ecuadorian bonds, and a descriptive analysis of the crisis.

<sup>90</sup> For more data on the financial impact of the crisis see: D. Hoelscher and M. Quintyn (2003) "Managing Banking Crises," Occasional Paper No. 224. Washington: International Monetary Fund. For a specific discussion of the Ecuadorian crisis, see Luis Jacome (2004) "The Late 1990s Financial Crisis in Ecuador: Institutional Weaknesses, Fiscal Rigidities, and Financial Dollarization at Work," IMF Working Paper, WP/04/12. Washington: International Monetary Fund.

<sup>91</sup> Part of the state's solution to the bank crisis, to be discussed here in this chapter, was the creation of an agency to guaranty deposits of failed banks and to sell assets of failed banks to pay back depositors. The agency has not been successful and many citizens have waited years to recover their savings.

case, reform does take place, new supervision and guarantee agencies are created, yet they cannot resolve lasting problems of fragility.

### ***Banking and Monetary Systems in Ecuador: Roots of Liberalization***

Liberalization began in earnest in the early 1990s in Ecuador. Though capital controls had been lifted since the 1982, beginning with the Osvaldo Hurtado administration, domestic financial markets remained restricted by the central bank's control of interest rates and exchange rates.<sup>92</sup> The state also directed credit to private enterprise through a national development bank. Sixto Duran Ballen, leader of the Conservative Party of Ecuador (PCE) and president from 1992-1996, made the most substantial efforts to "modernize" and align Ecuador's monetary and banking policies with those recommended by the International Monetary Fund (IMF) and Ecuador's key strategic, commercial and donor ally, the United States. One of Ballen's first policy changes in late 1992 was to encourage the Central Bank of Ecuador (BCE) to eliminate the foreign exchange controls which supported a dual (official and private exchange businesses, or *casas de cambio*) exchange market throughout the 1970s and 1980s. Full unification of the foreign exchange market was achieved in the second half of 1993, in the context of a heavily managed float. Ballen also oversaw the first major legislation to liberalize the banking sector, the 1994 *Ley General de Instituciones del Sistema Financiero* (LGISF), or General Law on Institutions of the Financial System.

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<sup>92</sup> For a discussion of Ecuador's first administrations to attempt liberalization policies, see Jeanne A.K. Hey and Thomas Klak (1999) "From Protectionism Towards Neoliberalism: Ecuador Across Four Administrations (1981-1996)," *Studies in Comparative International Development*, Volume 34, no. 3, pp. 66-97.

The general law on the financial system of 1994 had some precedent in the efforts of two previous liberal administrations after the end of military rule<sup>93</sup> (1972-79). In Ecuador, basic stabilization measures began in the administration of Osvaldo Hurtado (1981-1984). The administration of Leon Febres Cordero (1984-1988) followed a monetarist<sup>94</sup> model and began to reduce some of the social spending programs initiated under the military government, particularly import substitution policies aimed at promoting the agricultural sector. In contrast with liberalization efforts in the Southern Cone (Chile, Argentina), elite technocrats of elected civilian governments led Ecuador's first experiments with neoliberalism. These first groups of economic advisors were the original liberal advisory network of Ecuador.<sup>95</sup> They arrived at a moment following military rule, with new ideas and new strategies to transform the Ecuadorian economy.

In their study of the origins of neoliberalism in the Central Andes, Conaghan, et. al. use a class-based argument to understand the transformation in economic policy and advising beginning with the Hurtado and Cordero administrations. They argue that the new popularity of neoliberalism, as an ideology and economic policy, reflected a growing frustration with the developmentalist state (or a statist approach used by the military in social spending and encroachment on private business) by the local bourgeoisie in Ecuador in the early 1980s. They argue, "(N)eoliberalism was consciously chosen by

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<sup>93</sup> For many people in Ecuador, military rule is known colloquially and nostalgically as the *dictablanda*, or bland dictatorship, because of the social reform efforts and lack of brutality of the military-led governments. There were two distinct military administrations, one between 1972 -1976, led by Rodriguez Lara, and the second from 1976-1979, a triumvirate of three commanders of armed services who sought to lead a transition back to civilian rule. See Anita Isaacs (1993) *Military Rule and Transition in Ecuador, 1972-1992*. Pittsburgh: Pittsburgh University Press.

<sup>94</sup> A monetarist policy implies focusing on the supply of money, following the argument that excessive expansion of the money supply causes inflation, thereby giving the central bank a key role in emission and maintaining price stability.

<sup>95</sup> See Catherine Conaghan, James M. Malloy, and Luis A. Abugattas (1990) "Business and the 'Boys': The Politics of Neoliberalism in the Central Andes," *Latin American Research Review*, Vol. 25, no. 2, pp. 3-30, for a class-based assessment of the first neoliberal networks (and their political motivations) in the region.

policymakers with an eye toward specific power relations in their respective societies,” (Conaghan, et. al. 1990: 4). They contend that local business elites used neoliberalism to further their economic interests and to keep the working classes (and indigenous population) from threatening the power relationships between white or “Spanish” landowners and indigenous workers. This class-based argument offers an important perspective on the rigid class identities and social inequalities that plague Ecuador and can influence the economic reform process. Distinct from traditional interest group arguments, the business elite in Ecuador is also a class-based elite, and the source of wealth in the small country. This wealth stems from land-holdings (a remnant of poor post-colonial land redistribution) and agricultural conglomerates that dominate domestic bank ownership. The addition of a network approach allows us to further investigate and map ties between a business and banking elite and the technocrats and politicians who originate and execute monetary and bank supervision policy.

Conaghan, et. al. identify some of the key players in the neoliberal advisory network beginning with the Febres Cordero administration (Conaghan, et. al. 1990: 12). Cordero began his political career as an outspoken representative of industrial interests during the Lara military regime (1972-1976). Born into a prominent family of Guayaquil, Cordero had a successful career as the general manager of the Noboa Group, the largest and wealthiest Ecuadorian family conglomerate with assets in commodities (bananas, among others), banking and industrial investments. He also was the president of the Camara de Industrias (chamber of commerce) of Guayaquil in the 1970s. With the end of military rule in 1979, Cordero joined the center-right Social Christian Party and was

elected to congress. He soon began to assemble a team of economic advisors and prepare to run for president in the 1984 elections.

The economic team Cordero assembled became leaders and symbols of neoliberal economic policy for the next three decades. Conaghan, et. al. detail the social history that created the trio of advisors (Alberto Dahik, Julio Emanuel, Francisco Swett) and note their shared experience training abroad in economics and public policy in American universities (Princeton University, University of South Carolina). This training incubated their commitment to a pro-business economic policy that embraced neoliberal economics, without immediately threatening the protection and subsidies enjoyed by industry in Ecuador. While the Conaghan, et. al. analysis concludes in the late 1980s, the “boys” or technocrats they describe is a reference to the noted “Chicago boys,” Latin American economists who trained at the University of Chicago with Milton Friedman in the 1960s and returned to Chile to implement his theories under the Pinochet dictatorship (1973-1990).

The Ecuadorian “boys,” or American-trained neoliberal economists, have had a lasting impression on Ecuador’s business and banking community. Conaghan, et. al. refer to the shock therapy, or simultaneous implementation of several liberalization policies, as a “slow shock therapy” approach in Ecuador. This seemingly contradictory phrase is meant to convey that Dahik, Emanuel, and Swett tried to tailor the use of mass liberalization of prices and reduction of state subsidies to the Ecuadorian market with more tolerance for industry subsidies. In an effort to rally the agricultural industry base (to which many banks were tied through conglomerate entities), shock therapy in Ecuador allowed many subsidies to continue to coastal export industries, such as banana,

cacao, and shrimp operations. This tailored shock therapy approach, particularly during the Febres Cordero administration, would cement Ecuador's trajectory towards an open economy, while sustaining the power and wealth positions of the country's main industrialists, who in many cases were also the country's bank owners.

In interviews conducted for this dissertation with bankers and business people in Quito, a common introduction, at least regarding one's economic ideology, was to say, "*Soy por Cordero*," or in opposition, "*No soy una Roldista*," which means: "I'm for Cordero," or "I'm no socialist or social spender." (A *Roldista* refers to the administration of Jaime Roldos, the first elected president after the military rule who favored social spending and statist policies.)<sup>96</sup> This personal identification with a former president and his economic team twenty years after the Cordero administration still signifies a pro-business, pro-economic liberal stance. It also underlines the longevity of personal political loyalties in Ecuador. Many parties are dedicated to individual politicians and these same politicians tend to have long careers in government and in constant campaigning.

In Ecuador, this identification with an economic team and specific moment of liberalization is stronger than a party identification. This weakness of party affiliation is an on-going problem in Ecuadorian politics and is part of the reason why individual politicians are able to direct economic policy from the presidential position without party cohesion and larger institutional backing, to be discussed more fully in this chapter. One

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<sup>96</sup> Jaime Roldos was killed in an airplane crash over the Ecuadorian jungle in 1981 during his tenure as president. There is some popular discussion and intrigue into the cause of the crash. Many Ecuadorians loyal to his party speculate that Roldos was the victim of an assassination because of his socialist policies and his rejection of international oil exploration efforts by American interests. Roldos founded a political party, People, Change and Democracy Party or *Partido Pueblo, Cambio y Democracia*, but after his death, the still active left-center party is known as the Roldista party.

outcome of this pattern of the one man party identity in Ecuador is the lack of party policy development and opportunities for networks to advocate and work along-side party members towards policy objectives. The personalistic nature of political reciprocity means technocrats are indebted to individual politicians for positions, rather than larger ideological movements that might gain material support in research institutes or private foundations outside of government. The lack of cohesive party development is a major problem for Ecuador and an important factor in considering the process of economic policy reform.

In more general terms, the social networks and powerful business interests supporting liberalization, or a hands-off approach of the state in the economy, are more deeply rooted in Ecuador's agricultural economy with landed elites in the two major commercial centers, the highland capital city of Quito—associated with state bureaucracy and large multiple crop farms—and the coastal city of Guayaquil, where the major international agricultural commodities of Ecuador—cacao and banana—have been based for over a century.

Many analysts use this regional distinction as the starting point for understanding *all* Ecuadorian politics as oppositional between highland elite statist and coastal commercialists.<sup>97</sup> As late as 2000, the IMF and its directors<sup>98</sup> have used this argument to

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<sup>97</sup> For the seminal work on social and political history of Ecuador, see Rafael Quintero Lopez and Erika Silva Charvet (1995) *Ecuador, Una Nacion en Ciernes*. Quito: Editorial Universitaria. Lopez and Charvet assert and develop the regional competition thesis, though their work also delves into more detailed analysis of social problems involving indigenous labor and land reform. See also general studies of Ecuador's political development: Rodrigo Rangles Lara (1995), *Venturas y Desventuras del Poder*. Quito: Carvajal, and Jose Sanchez-Parga (1995) *Lo Publico y la Ciudadania en la Construcción de la Democracia*. Quito: Instituto Latinoamericano de Investigaciones Sociales.

<sup>98</sup> See Stanley Fischer, "Ecuador and the International Monetary Fund," edited text of a speech given at the Hoover Institution, Conference on Monetary Unions, 19 May 2000. Fischer argues, "Ecuador's economic history has not been a happy one. A lack of national cohesion has dogged the country ever since it opted for

help explain Ecuador's problems in implementing economic policy. But in actuality, both regional elites have favored liberalization at the expense of state spending on social issues and a care-taking role for indigenous and working class citizens through the 20<sup>th</sup> and 21<sup>st</sup> centuries. Liisa North and Carlos Larrea detail the development of the economic liberal interest groups in both cities.<sup>99</sup> They argue that state industrial development policy in the agricultural export sector privileged certain conglomerate businesses and the family networks who owned them, setting in place a power structure of connected industrial groups that have dominated both business and politics in Ecuador since the 1930s with distinct regional bases (North and Larrea 1997: 915).

In this study, understanding the long-standing practice of connected lending in terms of conglomerate financial groups that have assets in agricultural business and in banking is vital to tracing the risk practices of banks involved in the 1999 financial crisis. These conglomerates and their power structures are also important to recognize their influence in politics, as political candidates depend on these elites in both Quito and Guayaquil for fundraising and endorsements. The regional competition thesis, however, has little use in explaining the failure of economic policy, as business interests and banks in both areas contributed to the financial crisis.

### ***Liberalization Takes Hold: Economic Policy and Growth in the 1990s***

The *Ley General de las Instituciones del Sistema Financiero* (LGISF) of 1994 was the

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independence from Simon Bolivar's Grancolombian Federation in 1830. From the start there was fierce rivalry between the residents of the highlands, centered on the capital Quito, and those on the Coast, centered in Guayaquil." Internet access: [http://media.hoover.org/documents/0817928421\\_1.pdf](http://media.hoover.org/documents/0817928421_1.pdf)

<sup>99</sup> See Liisa North and Carlos Larrea (1997) "Ecuador: Adjustment Policy Impacts on Truncated Development and Democratisation," *Third World Quarterly*, Vol. 18, no. 5, pp. 913-934. For a detailed examination and argument contending a few leading industrial groups and family networks form the power structure of Ecuadorian politics, see Luis Fierro (1991) *Los Grupos Financieros en el Ecuador*. Quito: CEDEP, and earlier work by David P. Hansen (1971) "Political Decision Making in Ecuador: The Influence of Business Groups," doctoral dissertation, Department of Political Science, University of Florida.

culmination of a push since 1984 to use bank and business-friendly regulation to build a new more expansive (and competitive) financial sector in Ecuador's economy. Banking to this point had been a subsidiary business to the interests of major commodity exporters. Groups like the Noboa family of Guayaquil were those with assets able to fund bank operations, which they also used to expand their existing industries. The Cordero economic team's approach to neoliberalism had been to continue some protections and subsidies of key export industries, while freeing businesses to grow without state supervision. The tone of the LGISF reflects this philosophy towards the expanded commercial bank sector—hands off by the state, but also with some support and incentives to local entrepreneurs to enter the sector.

According to Ecuadorian economist Augusto de la Torre, the LGISF broadened the scope of operations a bank could perform directly or through its subsidiaries, allowing banks to create new hybrid forms of investment funds and conglomerates that expanded the kinds of financial services existent in the country (de la Torre, Garcia-Saltos, and Mascaro 2001: 4). Augusto de la Torre is also a key figure in the development of the dollarization plan, as well as the antecedent economic liberalization programs of the 1990s. He was president of Ecuador's central bank in the Duran administration (1993-1996). He figures as a leader of the nascent liberal advisory network in Ecuador and as a private advisor—outside of his former official capacity at the IMF and current position at the World Bank—to the Mahuad administration, to be detailed in this chapter. From 1986-1992 he was an economist with the International Monetary Fund and during 1991-1992 was the IMF's resident representative in Venezuela. De la Torre has worked for the World Bank since October 1997. Currently, he is the Chief Economist for Latin America

and the Caribbean. Prior to that, he held the posts of Senior Advisor in charge of the Financial Systems Department and Senior Financial Sector Advisor for Latin America and the Caribbean. Somewhat problematically, he is *the* authority on the currency and bank crisis of Ecuador in the academic literature in English, and the most often cited authority in the literature originating in Ecuador, while he clearly had a personal involvement in the 1994 economic reform legislation and the monitoring of the expansion of credit in the bank sector through 1996 as head of the Banco Central.

One outcome of the LGISF was the state sanctioned approval for banks to operate under one corporate umbrella with multiple kinds of subsidiary organizations, particularly offshore operations not subject to the same laws as the bank branches based in Quito. For customers and borrowers, these banks seemed to be one and the same. A depositor could open a dollar-based account in Quito, while the bank branch in Quito would simply note the deposit to its sister bank (often with the same name) operating offshore. The financial conglomerates had complex property structures that typically included, in addition to the onshore bank, an offshore bank, a fund management company, a securities trading/brokerage house, a credit card company, leasing and factoring businesses, and often an insurance company.

Offshore banks had operated in Ecuador since the 1980s, but the expansion of bank businesses occurred after the LGISF in 1994 when banks could maintain their offshore operations and expand their onshore presence, technically on the same (conglomerate) business balance sheet. The purpose of the LGISF was to consolidate supervision of these investment businesses. The rationale, according to de la Torre and

other local economists and policy advisors<sup>100</sup> consulted for this research, was to acknowledge the lag between bank action and government supervision, but also to encourage banks to increase the kinds of financial products and services they offered. The LGISF intended to make bank operations and expansions subject to less government “red tape” and intervention, but the law did not challenge or define clear boundaries of bank profit-making and lending. As a result, in 1998, four years after the law was passed, the limited institutional structures of bank supervision the LGISF planned still were not in place (de la Torre, et. al. 2001: 5). Duran Ballen’s 1994 LGISF broadened the investment and banking environment, but did little to create institutional supports to monitor it, except on paper.

The offshore phenomenon of Ecuadorian banking reflects the problems the LGISF created in “letting the genie out of the bottle,” so to speak, in that bank products grew to proportions that the state and bank supervisors were incapable of monitoring and predicting. Offshore banks in Ecuador were licensed by Caribbean governments, but were authorized to operate on Ecuadorian territory by the Ecuadorian Superintendent of Banks. Every offshore bank was part of an onshore financial conglomerate and therefore connected to the domestic economy. For Ecuadorian citizens, there was no distinction between onshore and offshore banks. By the mid-1990s the offshore banking sector was about 70 percent the size of the onshore system (de la Torre, et. al. 2001: 4). The LGISF in 1994 explicitly confirmed the freedom of onshore banks to take dollar deposits and make dollar loans (previously illegal and the purview of the offshore operations), essentially making the legal distinction between on and offshore banks moot. The bank

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<sup>100</sup> Interviews with Professor Eduardo Valencia, Universidad Catolica, December 2006; Professor Marco Romero, Universidad Andina, December 2006.

lobby, however, kept the offshore category legal and part of the 1994 reform for the purpose of keeping the offshore banks' foreign licenses. The foreign licenses, which the LGISF legitimated, functioned to offer secrecy on depositors' identity and other protection services against political risk, a service valuable to Ecuadorian citizens accustomed to devaluations and frequent change of governments. As Gabriel Martinez explains from a source of his own interview research on the 1994 legislation, "Its framers, according to a former Banking Superintendent, intended it to be based on liberty for everything except wrongdoing."<sup>101</sup>

Theoretically, the extreme liberal approach matched the ideological demands of Ecuador's lenders, specifically the IMF, but the approach also retained the status quo of power bases in the country in which bank-industry conglomerates held onto their wealth and increased their ability to move funds between operations without government supervision. Liberalism in action may have encouraged corrupt and wealth-extracting practices in the bank sector. Corruption as a single explanation for the failure of the bank system and currency crisis is not accurate, however. It is a feature of larger institutional processes at work, many with roots in social structures dating back five hundred years, and others in the new international demands of liberal finance begun in the 1980s. One part of these multiple institutional processes is the interaction of formal and informal rule-makers in economic policy, which this dissertation seeks to uncover more fully.

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<sup>101</sup> See Gabriel Martinez (2006) "The Political Economy of the Ecuadorian Financial Crisis," *Cambridge Journal of Economics*, Vol. 30, no. 4, pp. 567-585. Martinez uses interview data to explore an economic analysis of the factor of moral hazard in the bank crisis. He finds broad support for 'endogenous' explanations of financial crises and little backing for explanations such as accidents or policy mistakes. Interviewees argued that after the the stabilization program in 1992, bankers became euphoric and accumulated debt to finance imprudent levels of expansion; that incentives for moral hazard led to financial corruption and excessive risk taking; and that weak regulation after financial liberalization encouraged financial fragility.

This legal duality between on and offshore banks, which the LGISF legitimated, essentially created loopholes for the financial service industry to hide operations (and losses) in offshore subsidiaries. A second effect of the LGISF was the free entry and exit of institutions to the financial market, an attempt to level the playing field between domestic and foreign banks. As a result, the number of financial institutions increased from 31 in 1993 to 44 in 1996 (Jacome 2004: 18). As Luis Jacome, an IMF economist, argues, the LGISF legislation did stimulate growth of the financial services sector, but it failed to attract foreign banks, a problem that would later heighten the credit crisis when domestic banks failed in 1998-1999 and had no outside, or foreign commercial credit lines as rescue.<sup>102</sup> The failure to attract stronger foreign banks, suggests Jacome, was not the legislation itself, but rather the limited attractiveness of Ecuador's small market.

Both Jacome and de la Torre argue that the failure of the LGISF to regulate and predict the dangerous behavior of the offshore branches of conglomerate financial services in Ecuador was due to a failure in bank supervision, or more directly, in the state institutions of the Superintendent of Banks and the central bank. A different approach would be to consider the role of the IMF (the institutional base of both of these analysts) in pressuring the liberalization efforts in 1994, but neglecting to share support and experience of the Fund in building supervisory institutions. The blame, according to Jacome and de la Torre, falls on the Superintendent of Banks, i.e., the state, rather than liberalization as a politicized process.

In contrast to this standard explanation, this dissertation finds fault with the pressure to liberalize that came from the IMF and the United States to the Duran Ballen

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<sup>102</sup> See Luis I. Jacome (2004) "The Late 1990s Financial Crisis in Ecuador: Institutional Weaknesses, Fiscal Rigidities and Financial Dollarization at Work," IMF Working Paper WP/0412. Washington, D.C.: International Monetary Fund.

administration in drafting the 1994 LGISF, which clearly minimized a distinction between onshore and offshore banks. Like the Cordero administration before him, Ballen made both debt negotiations with the foreign governments (through the American Brady Bonds initiative, discussed below) and good relations with the IMF (for a renewed standby agreement) top priorities in his administration. The drafting process of the legislation included consultations with IMF staff representatives in Ecuador, financial sector representatives of the USAID office in the American embassy in Quito, and with owners of Ecuador's largest private banks. The message, according to de la Torre (regarding private bank owners) and interview sources, in the consultations was clear: Keep the bank sector free of restrictions and encourage foreign banks to enter. The domestic banks and their owners had one demand: leave the off-shore system intact.

The duality of the off-shore and on-shore system caused serious problems for Ecuador, yet any state would have trouble regulating an industry that was allowed, even encouraged, to keep a major part of their operations secretive and outside of state supervision. Furthermore, the responsibility for financial sector reform is idealized as a kind of *institutional readiness*, rather than a practical assessment of the politics between the executive initiating the reform legislation and the state institutions existent to enforce the law. That is, it should have been obvious in 1994 that opening the bank sector to operate in various investment and insurance instruments, while maintaining operations offshore, would create supervision problems as well as incentives for moral hazard among bankers.<sup>103</sup>

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<sup>103</sup> This 20/20 hindsight is now accepted among many Ecuadorian economists, but very few opposed the legislation when it was introduced. De la Torre, for example, was president of the central bank in 1994 and there is no evidence from interviews with his closest staff members that there was any public opposition to the reform from the central bank or its economists.

Duran Ballen and his economic advisors drafted the LGISF with the assumption that opening Ecuador's financial sector to foreign banks, allowing the currency to float (though a managed float), and encouraging the financial sector to experiment with new products (trusts, bonds, security exchanges, parallel dollar and *sucre* based accounts) would help Ecuador in its debt negotiations and economic relations, particularly with the United States. In 1994, Ecuador renegotiated much of its public debt with \$6 billion in Brady Bonds. Brady bonds are named after former U.S. Treasury Secretary Nicholas Brady, who led the effort to help Latin American countries reestablish credit by securitizing--in the form of dollar bonds--the bad bank debt that accumulated during the 1982 Latin American debt crisis, itself a problem of easy lending (from banks flush with dollar deposits from the oil producing countries in the late 1970s) and then difficult repayment as inflation increased for developing economies.

According to the National Law Center for International Trade, in 1995, the United States was the destination of almost 43 percent of Ecuador's exports and the origin of almost 36 percent of its imports. Ecuadorian exports to the United States in 1995, which amounted to \$1.9 billion, included oil (38 percent), fish (25 percent), and fruit, mostly bananas (14 percent).<sup>104</sup> Ecuador's imports from the United States, which amounted to \$1.5 billion in 1995, included equipment for civil engineering, aircraft, and telecommunications as well as consumer goods and autos. US investment amounted to \$728 million in 1994, with 76 percent concentrated in the oil industry.

A key weakness in the LGISF legislation was its institutional design (and division) of state supervision agencies. The institution responsible for monitoring bank

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<sup>104</sup> Data accessed from the National Law Center for International Trade on-line:  
<http://www.natlaw.com/pubs/specbs3.htm>

activities is the Superintendent of Banks, not the central bank, as is the case in most liberal political economies. In Ecuador, separating the supervision role from the central bank created a problem in monitoring risk, liquidity, solvency, and dealing with bank failure. The LGISF granted the Superintendent the responsibility to monitor compliance, rather than risk practices of banks.<sup>105</sup> This division created three kinds of problems: 1) The Superintendent could not obtain accurate information on banks' loan practices, not to mention their accounting of offshore accounts, which could legally be kept secret. 2) The LGISF did not provide instruments for bank resolution in the event that a banking crisis emerged. 3) The central bank was denied access to key information on bank liquidity, which the Superintendent then controlled. Transferring deposits from a failing bank to a sound bank was not allowed, making contagion to other financial institutions likely. The LGISF made the central bank responsible for dealing with bank failures, mostly in the form of bailouts, yet the central bank did not have the legal authority to verify bank solvency or the information to monitor bank loan practices, which was the purview of the Superintendent. These problems are path-dependent, as the two institutions have parallel purposes and shared responsibilities, but few mechanisms exist for communication or incentives to streamline the institutions. A traditional institutional approach is instructive to understand why the institutions persist at cross-purposes, and a more detailed network approach can uncover the social relationships within these institutions.

This institutional division of responsibilities compounded the basic problem of lack of information on offshore accounts by making a large portion of domestic bank

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<sup>105</sup> For more detailed discussions of the limitations of Ecuador's bank supervision and its role in the 1999 crisis, see Luis Jacome (ibid), and Laura Maria Patino (2001) "Lessons of the 1999 Financial Crisis in Ecuador," *Journal of International Banking Regulation*, Vol. 3, no. 1, pp. 37-70.

activity unverifiable while also tying the hands of state institutions to deal with anticipating bank crises. A secondary, but equally problematic, weakness of the institutional division of the Superintendent and the central bank was its social division of technocrats. The division of responsibilities and the frustration between the two institutions sharing the little bank data available created institutional rivalries between staff and turf battles between appointed heads of both institutions.

Many researchers and managers at the central bank found the staff at the Superintendent's office unqualified to monitor bank activity, as their educational qualifications differed greatly. Heads of the central bank are generally political appointments with experience in the bank. Heads of the Superintendent have been drawn from the private sector of bank owners and managers and are rarely individuals with public service records. In fact, the staff at each institution tended to come from two distinct learning and social environments. Traditionally, economic analysts at the central bank are graduates of the economics department of the Universidad Católica in Quito, where the training focuses on development economics with a market-friendly approach. Recruiting for the Superintendent of Banks is usually drawn from mid-level bank associates (management trainees) in private banks, many with graduate business degrees (MBAs) from local and American universities. These social factors will be discussed more thoroughly below.

The LGSIF was the institutionalization of several trends in the Ecuadorian economy through the early 1990s. There was relatively strong growth and optimism within the bank sector that encouraged short-sighted bank and monetary policy. The Ecuadorian financial sector grew substantially in the mid-1990s, particularly during the

Duran administration (1992-1996). In early 1993, interest rates began to fluctuate freely and the private bank sector enjoyed a reduction in rates from the central bank, roughly from short-term rates of over 50 percent to approximately 30 percent, which banks then used to expand their credit operations.<sup>106</sup> It had been common in Ecuador to divide loans into very short repayment cycles, with the majority of lending maturing before 91 days because of the fluctuation in the value of the *sucre*. Banks were able to extend repayment cycles and offer various loan products. A real expansion in credit occurred.

Real GDP growth averaged just over 3.5 percent between 1990 and 1997, fueled by an increase in exports that doubled over the same period. Ecuador had put in place a series of structural reforms during the early 1990s, which were aimed at underpinning short-term macroeconomic policies.<sup>107</sup> These structural adjustment programs begun in 1992 under the Duran administration included a 35 percent devaluation of the *sucre*, as well as a 125 percent increase in the government-determined price of gasoline.

Another constant indicator in Ecuador's economic policy is the global price of crude oil, as Ecuador is an oil exporter and its financial health is dependent on the price of oil. In the early 1990s, the price of oil dropped from around \$30 per barrel to \$16 a barrel, increasing pressure on Ecuador to adopt fiscal policies to save its losses in export revenue (Marchan, *manuscript*: 10-11). In spite of this loss in oil revenue, Ecuador seemed to be gaining ground, at least in terms of growth in domestic capital markets, as

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<sup>106</sup> Data from the annual reports of the central bank of Ecuador, *Memoria del Banco Central del Ecuador por 1996*, cited by Carlos Marchan (*manuscript*) *La Banca Central en el Entorno de la Crisis Financiera del Ecuador: Factores que la Originan y Son Causa de su Profundizacion (1995-1999)*. Quito: Banco Central del Ecuador.

<sup>107</sup> See Luis Jacome (*ibid*), for a detailed explanation of the macro-economic policies begun in 1992 through the crisis, see Carlos Marchan (*manuscript*) *La Banca Central en el Entorno de la Crisis Financiera del Ecuador: Factores que la Originan y Son Causa de su Profundizacion (1995-1999)*. Quito: Banco Central del Ecuador.

lending increased and foreign direct investment increased, at least up to 1994. As Carlos Marchan shows in his analysis of Ecuador's economic history of the 1990s, using data directly from the central bank, foreign direct investment increased from \$178 million in 1992 to \$479 million in 1993, and again to \$531 million in 1994.<sup>108</sup> This increase in investment in a country otherwise struggling with fiscal shortfalls was a product of a global upward trend in investments in emerging markets, rather than an indication of the specific merit or promise of the Ecuadorian economy. As a result, there was (relative) macroeconomic stability during the 1993-95 period as average annual inflation came close to 40 percent during those years, having bottomed out at 22 percent in 1995, only to climb back to 30 percent by the end of 1997 (Jacome 2004: 8). The growth, however, was unsustainable not just for the sector's institutional weaknesses, but for a series of exogenous factors to be discussed below.

### ***Signs of Structural Weakness and Just Bad Luck***

The Ballen administration was successful in implementing its liberal agenda with the LGISF and fiscal policy—including difficult structural adjustment programs—in attempts to secure better international credit and good standing among donors and trade partners. These policies alone would have social ramifications, but combined with a series of four exogenous factors including horrible weather, a global financial downturn in lending to developing economies, volatility in the price of oil, and political instability (constitutionally and in foreign relations), overall political and economic development stalled, paving the way for deepening crisis by 1999. Accompanying these exogenous

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<sup>108</sup> See Carlos Marchan (ibid) and annual review of the Banco Central del Ecuador (1996) *Memoria Anual del Banco Central del Ecuador por 1996*, which includes the table discussed here with FDI data for the years 1992-1994.

factors, the structural weaknesses of the LGISF began to reveal problems within the domestic bank market.

First, *El Niño*, a periodic tropical weather pattern of the Pacific active in 1997, increased water temperatures which devastated the shrimp industry and caused flooding, destroying most roads along the coast of Ecuador. Most of the flooded cities had problems with water supply, sewage (and cholera outbreaks), and damage to their infrastructures. Even though the affected urban population was larger, the rural population suffered most as the flooding isolated many communities for months without road access to cities for supplies and medical attention. In these communities, harvests and agricultural products were lost, raising market prices. Cost effects of the weather system totaling over \$2.6 billion are detailed below with data from a United Nations Environmental Program project.<sup>109</sup>

**Table 4.1: Impact of El Niño (millions of US \$)<sup>110</sup>**

<b>Sector &amp; Subsector</b>	<b>Direct Damages</b>	<b>Indirect Damages</b>	<b>External Effects</b>	<b>Total Damages</b>
Social (a)	63.1	129.1	29.2	192.2
Infrastructure (b)	123.3	707.0	80.2	830.3
Economic (c)	582.9	709.0	545.4	1291.9
Expenses on mitigation, prevention and emergency		333.1		333.1
<b>Total</b>	<b>769.3</b>	<b>1878.2</b>	<b>654.8</b>	<b>2647.5</b>

(a) Social sector includes housing, health and education.

(b) Infrastructure sector includes water and sewage, energy and electricity, transportation and telecommunications, urban infrastructure.

(c) Economic sector includes agriculture, livestock and fisheries, industry, commerce and tourism.

Source: UNEP, "Ecuador Country Case Study: Impacts and Responses to the 1997-1998 Event," Available on-line: <http://www.ccb.ucar.edu/un/ecuador.html>.

<sup>109</sup> For the final project report, see UNEP (2000) "Reducing the Impact of Environmental Emergencies through Early Warning and Preparedness," UNEP/NCAR/UNU/WMO/ISDR Assessment. Geneva: United Nations. Internet access: <http://www.ccb.ucar.edu/un/enFinal.pdf>

<sup>110</sup> The table is reprinted from the UNEP Ecuador country report, however, for original data on the financial effects of the weather crisis, see: Comisión Económica para América Latina y el Caribe (CEPAL) (1998) *Evaluación de los efectos socio-económicos del fenómeno de El Niño en 1997-1998*. Quito: CEPAL, pp.37-41.

Second, global markets turned pessimistic on lending to so-called emerging markets after the devaluation of the Mexican peso and American bail-out of Mexican debt in 1995. The “Tequila effect” spread to other developing economies, including Ecuador.<sup>111</sup> As James Mahon contends, over the past decade every economic slump in Latin America can be linked to a financial crisis in another emerging market. The general trend of the 1990s to the present has been the decline of access to capital markets in Latin America, with a net outward transfer of resources from 1999 onward (Mahon 2003:59). Essentially, it has become more difficult for Latin American governments to borrow money, though private investment (through privatizations of state enterprise and acquisitions of public and private assets) has increased in the region as a whole in the last decade.

Luis Jacome further details the impending crisis of access to credit for Ecuador in the late 1990s. Ecuador had limited access to international capital markets after its first debt default in 1983 and was able to access international capital markets only once<sup>112</sup> in close to twenty-five years, in 1997 (Jacome 2004:14). Besides the multilateral institutions (IMF, World Bank, Inter-American Development Bank), the only remaining source of government financing was local banks, which bought government securities denominated in or indexed to foreign currency. As a result, domestic debt climbed from 2 to close to 20 percent of GDP between 1990 and 1998, and helped increase public debt to more than 90 percent of GDP in 1998 (Jacome 2004: 15).

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<sup>111</sup> See James Mahon Jr. (2003) “Goodbye to the Washington Consensus?” *Current History*, Vol. 102, issue 661, pp. 58-64, for a discussion of the broad dimensions of multilateral and private lending in so-called emerging markets after market corrections, such as the 1995 Mexican crisis, the 1999 Russian crisis and Argentina’s devaluation crisis of 2001-02.

<sup>112</sup> This does not include the refinancing of Brady Bonds in 1994, in which no new capital was allotted, only debt rescheduled.

In spite of this difficulty for the government to access credit lines, investment opportunities in Ecuador abounded, and the inflow of private capital encouraged banks to expand their commercial lending and investments in local enterprises—what economists call a “credit boom.” As de la Torre, et. al. detail:

Private capital inflows (including foreign direct investment—FDI) surged from an average of US\$200 million per year during 1989-92 (about 2 percent of GDP) to US\$730 million in 1993 and US\$780 million in 1994 (about 5 percent of GDP). Private capital inflows led to an abundance of loanable funds, relaxing the credit constraints to which households and enterprises had been subject in prior years...*Be it as it may, Ecuador clearly confirms the oft-found empirical regularity that a credit boom precedes a banking crisis.* (de la Torre, et. al. 2001: 10-11, emphasis added)

As American homeowners and investors recently experienced, easy lending or “credit booms” are often followed by severe consequences in the bank sector. In Ecuador, the housing market was not the victim of a credit boom, but small businesses and individuals, as well as entire banks and their customer deposit bases suffered. Because Ecuador had few foreign banks operating, access to consumer credit quickly tightened beginning in 1996 and became nearly impossible for small business owners and middle class workers to secure loans from local banks after 1998.

In 1995-96, the end of the credit boom created a situation of capital flight in which many financial societies closed (approximately 17 institutions, mostly trusts and investment funds allowed to operate after the LGISF in 1994) and seven banks were forced to seek liquidity injections, or direct bail-outs from the central bank (de la Torre, et. al. 2001:15). These initial bank failures were the first signals of structural weakness stemming from institutional changes in bank sector regulation. The reaction of the central bank also set a precedent for remaining banks to expect to be rescued—a problem which grew in proportion by 1999.

Third, the government's dependence on oil revenues proved a real weakness to its fiscal position as oil prices fluctuated between a range of US\$16-17 per barrel in 1991-92 to about US\$11 in late-1993 and early-1994 (de la Torre, et. al. 2001: 10). Oil income represented 30 to 35 percent of total public sector income. The decrease in oil revenues increased pressure on the government to reduce public spending, partly by increasing prices on previously subsidized goods, including gas for cooking. In addition, there was external pressure from the IMF to negotiate a stand-by loan with requisite fiscal austerity measures; negotiations were on-going from 1994-1996. Fiscal restraint, however, proved difficult in the late 1990s, as turnover and constitutional crisis<sup>113</sup> in the presidential position unfolded.

Fourth, ensuing political instability, including a costly border dispute with Peru, turned public (and government) attention away from financial regulation and the sector's fragility.<sup>114</sup> The military conflict took place during the Duran administration in 1995.

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<sup>113</sup> In the wake of the failed presidency of Abdala Bucaram (1996-1997), members of Congress and politicians of the center and center-right parties (particularly the Partido Social Cristiano) successfully campaigned for new elections to a one-time National Assembly to reform the constitution. The previous constitution of 1978 had a provision for the vice-president to assume office in the event of a temporary incapacity (mental or physical) of the president, but not a permanent incapacity (which Congress determined Bucaram to have). The Congress used this omission to elect an interim president from its own ranks (Fabian Alarcon) in 1997. National Assembly representatives were elected from established districts and members met in the Universidad Andina auditorium from late 1997 to June 1998 to form a new constitution. Elder statesman and former president of Ecuador Osvaldo Hurtado (1981-1984) led the National Assembly. A national referendum on June 5, 1998, approved the new document. The major changes in the 1998 constitution concerned indigenous rights to community land and intellectual property, as well as recognition of various indigenous communities (not as a pluri-national system as some delegates proposed) and indigenous language recognition. The 1998 constitution also included an article allowing Congress to replace a president with the vice-president for "abandoning his post" (*abandono del cargo*), which the Congress used in 2000 against President Jamil Mahuad and in 2005 against President Lucio Gutierrez. For more detail, see Pablo Andrade (2005) "Democracia Liberal e Inestabilidad Politica en Ecuador," *Oasis*, Issue 11, pp. 167-189.

<sup>114</sup> For more detail, see Gabriel Marcella and Richard Downes (1999) *Security Cooperation in the Western Hemisphere: Resolving the Ecuador-Peru Conflict*. Miami: North-South Center Press. In the mountains of the Cordillera del Condor, a stretch of border remained unclearly marked where deposits of gold, uranium, and oil reportedly lay. Peru claimed that the approximately 1,000 mile border between the two countries had been set by the 1942 Rio de Janeiro Protocol, which had confirmed its victory over Ecuador in a ten day war in 1941 over territory. But Ecuador declared the protocol null in 1960, before the last 48 miles of

However, the border dispute remained unresolved until 1998. During this same period, after Duran left office in 1996, the country had three presidents (and corresponding changes of staff in the central bank board of governors and ministry of finance) in the span of two years between the start of 1997 and year-end of 1998. There are no official data on the financial cost of the conflict with Peru. According to Miguel Davila,<sup>115</sup> former director of the Banco Central (1999-2000) and staff member of the research directorate for twenty years, the costs were kept secret by the Duran administration (particularly, the military), but most internal central bank estimates varied between 600 and 700 million dollars. The only effort by the government to adjust for the loss was an increase on the vehicle tax, further debilitating the fiscal situation for the next administration of Abdala Bucaram.

The populist and flamboyant Abdala Bucaram took office in late 1996. Though much of his campaign included promises of free housing to the poor and rock concerts in which he performed, Bucaram also proposed ambitious monetary reforms as part of the introduction of a currency board by July 1997. His personal style and unpredictability, however, made negotiation of the currency board plan impossible with the congress and the business community. Bucaram lacked support from the business elite, as he did not depend on them for campaign financing. Moreover, the business community feared that economic proposals from Bucaram would create instability in credit markets. Members

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the border had been marked. In a move to assert Peru's claim to the 48 mile stretch, President Alberto Fujimori sent troops and warplanes into the region on January 25, 1995. Ecuador's president Sixto Duran Ballen attempted to negotiate a peace, but both sides escalated the conflict with naval and air shows of force. Casualties in the hundreds and at least 100 dead were reported on both sides. A cease-fire and truce took effect on March 1, 1995, after tense peace talks. On October 26, 1998, under Ecuadorian president Jamil Mahuad's initiative, the two countries signed a peace treaty defining the border, creating a committee to resolve boundary issues peacefully, and agreeing to terms for bilateral trade and navigation rights.

<sup>115</sup> Interview with Miguel Davila, 9 March 2006, Quito. Davila began his career as a researcher at the Banco Central in 1979 and left in 2000 as its president. He also served as an economic advisor to President Sixto Duran Ballen (1995-1996) and later to President Jamil Mahuad (1998-2000).

of congress were hesitant to associate with economic policy proposals by Bucaram, particularly so early in his tenure. It was not his currency board idea that lacked merit, but the source of the proposal—a president who instilled little confidence outside of his working class support base. Bucaram used an appeal to the poor and working class to garner votes, but his economic team included young liberals who would later work for the pro-business candidate Jamil Mahuad.<sup>116</sup>

Bucaram was declared “mentally unfit” to hold office by Congress (using its constitutional authority) in February 1997. As interim president, the leader of the congress, Fabian Alarcon, assumed office for only 18 months in an effort to restore calm and credibility. Alarcon made no major economic policy reform initiatives. Alarcon did preside over a period of major political institutional change, as a new constitution was formed in 1997-1998. Alarcon did not lead Congress or work to draft the institution, rather a separate National Assembly formed by popular representation (using existing districting) to reform the constitution with the principle aim of reducing congressional power.

Though the public supported the ousting of Bucaram, the ease with which the congress could replace him increased concerns of repeated political turnover and instability. Former president Osvaldo Hurtado served as president of the National Assembly, which met in the auditorium of the Universidad Andina on a near daily basis until the new document was approved on June 5, 1998. At this same time, presidential elections were held to replace interim president Alarcon. Jamil Mahuad, a liberal-minded and Harvard-educated public policy analyst, assumed the presidency in August 1998.

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<sup>116</sup> For example, one of the key interview contacts for this research, Ramiro Galarza, a self-professed economic liberal, led Bucaram’s economic policy team.

Mahuad chose to delay attention to the financial sector at the beginning of his term and instead concentrated on an immediate foreign policy goal to secure a peace agreement with Peru. The peace deal secured high approval ratings for Mahuad, but was not able to transfer that public good will to his eventual handling of the bank and currency crisis to follow.

These exogenous events and the removal of Bucaram (and ensuing constitutional changes) left the country eager for stability and nostalgic for the respectability of older statesmen like Duran and Cordero. These men symbolized times of economic opportunity, openness, and competitiveness in the region; and quite simply, they personified a vision of national pride. From 1998-2000, Ecuador again confronted crisis, in its financial system and in its presidential leadership, with such devastating consequences that many chose to leave the country rather than wait for the next president to restore calm and prosperity.

### ***Social Networks in Economic Affairs and Their Institutional Bases***

This section explains the social and institutional bases of power and liberalism in Ecuador and how these at times formed advisory networks. Liberal advisory networks are one kind of social network and therefore may function in coordination or in competition with other decision-making processes. This chapter argues that although social networks are dense in Ecuador, economic advisory networks are weak. Subsequently, economic policy is often a product of executive mandate informed at best by consultations with individual or privileged advisors. The chapter provides evidence for this argument by detailing two supporting elements of policy-making at work in the 1998-2000 economic crisis:

- 1) Social networks informed the often differing economic orientation of staff at the central bank and the bank superintendent, further dividing these competing institutions and impeding the development of a cohesive liberal advisory network; and
- 2) Wealthy elite and individual advisors in the banking sector and business community could wield more influence in economic policymaking than liberal advisory networks.

To make these points, the section traces the Mahuad presidency, his alliance with liberals of the banking community and the challenges facing his administration at the outset of the currency and bank crisis in 1998. Original interview data detail sources of social networks and the limits of advisory networks.

In Ecuador, social networks also can function as political networks. The bases of power and wealth remain held in few hands—the result of colonialism, uneven land<sup>117</sup> distribution, and race and class inequalities reaching back to the 16<sup>th</sup> century.<sup>118</sup> According to the U.S. Agency for International Development (USAID), income distribution in Ecuador is among the worst in the region, with roughly 80 percent of the income share of GDP accruing to approximately 20 percent of the population.<sup>119</sup> Wealth

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<sup>117</sup> Sharecropping systems (*huasipungos*) operated as feudal systems in Ecuador well into the 1960s when the first agrarian reform passed in 1964 limiting the size of individual family holdings to 800 hectares in the highlands near Quito and 2,5000 hectares along the tropical coast. Law revisions in the 1970s required that all land with absentee landlords be sold to tenants, and squatters allowed title to land they had worked for more than three years. The requirement to sell land to tenant farmers was not enforced by the state, nor was expropriation encouraged. Moreover, few families could afford to buy the land at market prices, as required by the reform law. In 1982, 80 percent of farms consisted of less than ten hectares, yet these small farms accounted for only 15 percent of total farmland. The coastal agribusinesses of banana and cacao production accounted for most of available arable land. See Peter Lanjouw (1999) “Rural Nonagricultural Employment and Poverty in Ecuador,” *Economic Development and Cultural Change*, Vol. 48, pp. 91-122.

<sup>118</sup> See an examination of traditional political power bases by Osvaldo Hurtado, vice president under the first democratically elected government in 1979, and then president from 1981-1984: Osvaldo Hurtado (1981) *Political Power in Ecuador*. Albuquerque: University of New Mexico Press, (translation by Nick Mills, Jr.) Hurtado was also president of the National Assembly in the critical period 1997-98 in which a new constitution was formed.

<sup>119</sup> See USAID (2001), “Ecuador Overview,” *Fiscal Year 2001 Program*, available on-line: <http://www.usaid.gov/pubs/bj2001/lac/ec>.

is highly concentrated<sup>120</sup> and often passes through family ties and family businesses. Many of these wealthy families become involved in politics as candidates, and the remaining are sought after by politicians to fund campaigns. Likewise, the pool of presidential candidates is small and tends to re-circulate. There are multiple political parties in Ecuador and run-offs are common. Candidate rivalries are often long-standing and repeated over sequential elections. For example, Bucaram and Mahuad competed for the presidency in 1988—both failed.<sup>121</sup> Then both ran subsequent successful campaigns a decade later (1996 and 1998, respectively).

It was the populist Bucaram administration that first proposed some highly technical monetary policy in 1996, specifically inviting the well-known liberal economic advisor Domingo Cavallo to assist in a policy proposal for a currency board in Ecuador to be modeled on the Argentine plan.<sup>122</sup> Bucaram failed in this endeavor because he was not able to secure support of the business and bank community. Despite his scandalous public performances in rock concerts and mass rallies in which he promised free housing

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<sup>120</sup> Ecuador had a Gini co-efficient of 53.6 in 2003; see, United Nations (2007) *Human Development Report*. New York: UNDP.

<sup>121</sup> Abdala Bucaram reformed and led the *Partido Roldodista Ecuatoriano* (PRE), the former *Pueblo, Cambio y Democracia* (PCD) party led by Jaime Roldos, president (1979-81). Bucaram is a member of a powerful Guayaquil political family. His uncle, Assad Bucaram, was elected mayor of Guayaquil in 1962 and was a forceful critic of the military government of the 1970s. Abdala Bucaram's sister, Martha, married Jaime Roldos and was killed with him in a plane crash in 1981. Bucaram took control of his brother-in-law's populist party, then renamed the Roldista Party, and used it to pursue his own political aspirations for the presidency. Bucaram was elected mayor of Guayaquil in 1984. He left Ecuador for Panama in September 1985 to avoid embezzlement charges, but remained head of the party. He was granted amnesty by congress in 1986 and ran for president in 1988 and again in 1992, winning 17 and 22 percent of the votes, respectively. He again was charged with corruption and fled to Panama after the elections in 1988. He was cleared again, one year later. His party, however, fared better and increased its representation in congress to 13 deputies by 1992. Once elected president in 1996, he used his short time in office (six months) to appoint family members to cabinet posts and, according to the Supreme Court of Ecuador in its March 7, 1997 ruling against him, engage in corruption. Before the court could enforce its arrest order, Bucaram secured political asylum for himself and his family in Panama.

<sup>122</sup> For an account of Bucaram's invitation to Cavallo and his attempted currency board plan, see Stanley Fischer (2000) "Ecuador and the IMF," text edited from a speech at the Hoover Institution, 19 May 2000. Palo Alto, California. Available on-line:

<http://internationalmonetaryfund.com/external/np/speeches/2000/051900/htm>.

and toys, Bucaram was able to attract many of the same young liberal technocrats of the central bank and private banks to work on his economic policy team.<sup>123</sup> These same advisors would later work for Bucaram's successor, the pro-liberal Jamil Mahuad.

The currency board proposal—though Congress never considered it formally—indicates the ideologically loose politics of economic advising in Ecuador. This looseness in the formation of economic policy is evident in two respects: 1) Political parties are not firmly attached to economic policies. As political parties often are associated with individual candidates (e.g., Bucaram is the face and persona of the Roldista party), party platforms are flexible, particularly in the economic sphere, as they are subject to the will of the candidate. 2) The opportunity to work on a president's economic team does not signal an enduring commitment to his party or his broader public policy positions. This flexibility is a problem of weak political identification at the party level and a scarcity of opportunity for qualified economists. This scarcity impacts the development of a liberal advisory network because employment opportunities become more valuable than maintaining ideological positions and affiliations. Moreover, the lack of party cohesion and resources leaves little space or financial support for partisan think tanks and publications.<sup>124</sup>

As Bucaram was a source of embarrassment to the business community, the Mahuad administration appealed more to business owners and the socially-conservative wealthy elite. Through his party affiliation (Christian Democratic Union, an off-shoot of the more conservative center-right Social Christian Party), his American education

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<sup>123</sup> Two interview sources for this research fall into this category of shared research and advising experience for both the Bucaram and Mahuad administrations, which were at opposite ideological poles of the political spectrum.

<sup>124</sup> The single academic press in Ecuador is the Abya-Yala press in Quito, and there is one main economic policy publication, Ecuador DEBATE, published bi-monthly under auspices of the Universidad Católica.

credentials, and his circle of advisors, his candidacy and administration had a public association with the Hurtado-Cordero era of new liberals in the mid-1980s and the stability and pro-business reputation of Sixto Duran Ballen.

Jamil Mahuad has had a long resume of political service and campaigning in Ecuador. Mahuad was a member of Osvaldo Hurtado's cabinet as Secretary of State for Labor and Human Resources (1983-1984). Hurtado had been known, un-popularly, for his ability to stick to difficult stabilization programs of the IMF. Mahuad led a ministry that suffered many job cuts at the time and dealt with opposition from unions opposing reforms.<sup>125</sup> He represented the province surrounding Quito, Pichincha, in the congress from 1986-1988 and again from 1990-1992. Mahuad was also mayor of Quito (a position former president Sixto Duran Ballen also held in the 1970s) from 1992-1996. Mahuad presented himself as a new kind of politician in Ecuador after the ousting of the Bucaram, with an image of respectability that many Ecuadorians of the upper and business classes felt proud of and felt anxious to rebuild the country's international profile (both diplomatically and commercially) after over two years of turmoil.

***Advisor Today, Banker Tomorrow: Working in the Revolving Door***

In a series of interviews with long-time contacts and new contacts in 2006, those young liberals who were graduate students and aspiring bank executives a decade earlier gave detailed accounts of their experiences in the financial crisis and how the crisis changed or confirmed their political views and career paths.<sup>126</sup> Two important patterns

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<sup>125</sup> The Centro de Investigacion de Relaciones Internacionales y Desarrollo (Center for Research in International Relations and Development) in Barcelona maintains detailed histories of Ecuador's presidents and their policies, source available on-line: [http://www.cidob.org/es/documentacion/biografias\\_lideeres\\_politicos/america\\_del\\_sur/ecuador/jamil\\_mahuad\\_witt](http://www.cidob.org/es/documentacion/biografias_lideeres_politicos/america_del_sur/ecuador/jamil_mahuad_witt)

<sup>126</sup> Karen Manjarres, Xavier Valencia, and Hector Barrahoa assisted in constructing the chain of contacts involved in this research. Interviews were conducted with nine former central bankers, four individuals

emerged: 1) Former students of the economics department at the Universidad Católica have a long tradition of starting their careers at the Banco Central del Ecuador and use this institutional connection to further their training in economics and policy leadership in government positions, forming a network based on mentoring social ties. 2) The scarcity of highly-trained economic analysts facilitated career movement (and a revolving door of employment) between private and banks and bank supervision agencies, creating a problem of moral hazard for many involved in the identification and state-led remediation of troubled banks.

The outcome of these patterns is the development of at least two separate social networks and a lack of leadership and cohesion in a single liberal advisory network when the bank sector collapses in 1998-2000. Core staff and former staff of the central bank maintained strong mentor relationships which facilitated policy formulations between key advisors in the Mahuad cabinet and with an informal (and unofficial, if not, unauthorized) advisor in the World Bank. The Superintendent of Banks relied on a revolving door practice between private banks and the state agency to staff its purchase and assumption operations (the take-over of failing private banks by the state). In many cases, the managers of failed banks took positions to administer the failure of competitor banks. The state agency to supervise failed banks was led and managed by private bankers themselves often on brief rotations in the public sector. This revolving door between the state supervision agency and private banks created disincentives to properly monitor and administer the private bank system, while also discouraging information exchange among competitors and the state. These staffing traditions and practices created disinformation

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with experience at the Superintendent of Banks, three with the Agencia de Garantías de Depósitos (AGD), including its director (2003-2004), Wilma Salgado. Salgado is also on the faculty of international economic relations at the Universidad Andina in Quito.

problems and isolated attempts at problem-solving in the bank sector to the executive branch.

As a result, the creation of the deposit guarantee agency (AGD) in 1998 and the dollarization policy in January 2000 came directly from the president's office, with no sustained dialogue between the central bank, the executive economic policy staff or the private sector. The long-term effect is that no single group of central bankers and private bankers maintain a forum or sustained ties in order to discuss policy ideas and innovations; rather, the direction of economic policy is largely at the discretion of the sitting president, making competition for political appointments intense. The following section examines a series of interview subjects involved in the institutional triangle between the AGD, the Superintendent of Banks, and the central bank.

Diego Diaz, a young liberal in his early 40s, is a first example of a Universidad Católica economics graduate who has used social ties to advance his career in disparate political circles. He has worked for populist and liberal presidents and sees his ideological commitments to liberal markets second to the opportunity to work in positions of economic leadership in his country. Diaz joined the Banco Central after graduation and took advantage of its generous graduate fellowship program to pursue a master's degree in economics at the University of Chicago. The Banco Central has a well-known fellowship program for its promising research staff, paying all tuition and a generous living stipend for study at any university, national or abroad. Diaz was promoted to investment director of the central bank (1996-1999), in which he was responsible for investing the foreign reserves of Ecuador in international markets. He worked directly for Miguel Davila, director of the central bank (1999-2000) and architect

of the dollarization plan, who became a mentor to Diaz. Davila worked for the central bank for over twenty years (1979-2000) and also used its fellowship program to earn a master's in economics from the University of Chicago in the early 1980s. Diaz described<sup>127</sup> his experience at the central bank as operating in a highly political, yet very closed, even “cloistered” environment.

Diaz worked for President Abdala Bucaram in 1996 and described the economic policy process, particularly the innovation of the currency board proposal, as an experiment rather than a policy plan. The failure of the policy to attract support in Congress or among the business community, according to Diaz, was the lack of understanding among politicians, and the inability to present the plan publicly for debate. The president did not see it as necessary, and there were not independent research organizations—apart from universities—in which to debate. Inviting Domingo Cavallo to advise the president created some press coverage, though Diaz contends the local chamber of commerce in Quito and the bank association were not interested in associating with the Bucaram administration to open a dialogue. Diaz gave the impression that his work with Bucaram was an opportunity to “practice” economic policymaking for a future appointment as finance minister or the like, rather than any interest in furthering a policy agenda. He also described his long term professional contacts as ones based in his experience at the central bank, through individual mentorship, rather than policy adherents.

Central bankers in Ecuador tend to stay with their jobs for a decade or more. They are treated with educational privileges and job security in ways that other public employees do not expect or enjoy. It is a social environment in which mentoring is a key

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<sup>127</sup> Interview with Diego Diaz, 8 March 2006, Quito.

factor in promotion, and tends to operate regardless of the party politics of the executive branch. However, the directorship at the bank is a presidential appointment, and a director draws on his mentees for support in that role. Relationships in that instance are more valuable than party identification or political alliances. Gender and class identifications are also important; this research was not able to identify a female economist at the Banco Central who studied abroad on fellowship or are connected by mentorship relationships with the interview subjects in this research. Likewise, social status or class identifying signals shared by these young liberals reach back beyond the Universidad Católica to certain Quito neighborhoods and private secondary schools.

Diaz, for example, worked as an economic advisor to the Bucaram administration, yet had little allegiance for the politics of the PRE or Bucaram. His loyalties were tied to Miguel Davila, who helped Diaz secure a private bank job in 1999 when the state, under the auspices of the newly formed Agencia para la Garantia de Depositos<sup>128</sup> (AGD), or Agency for the Guarantee of Deposits, took over operations of Banco Popular. (The Mahuad administration's decision to create the AGD will be discussed later in this chapter.) The new agency created yet another institutional apparatus to monitor bank activity and was clearly short-staffed from the outset, relying on young staffers from the Banco Central to handle the devolution of the largest financial institutions in the country, with assets abroad and various legal battles on-going.

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<sup>128</sup> The government of Colombia was also pursuing legal action in 1999 against Banco Popular to recover \$64 million in tax and customs revenues alleged to have vanished from an off-shore arm (based in the Bahamas) of the bank, as part of a larger scheme that siphoned millions from Colombian depositors and taxing authorities. See, "White & Case: Colombian Government Sues Ecuadorean Bank in Miami to Recover \$64 Million in Public Monies That Vanished," *Business Wire*, September 9, 1999. Available online: [http://findarticles.com/p/articles/mi\\_m0EIN/is\\_1999\\_Sept\\_9/ai\\_55707259](http://findarticles.com/p/articles/mi_m0EIN/is_1999_Sept_9/ai_55707259).

Diaz was named managing director of Banco Popular International, the subgroup responsible for investigating and salvaging the bank's international investment portfolio. This was a massive task, as the bank filed with the U.S. Federal Reserve Board (for its American locale in Miami) for closure on June 4, 1999.<sup>129</sup> Just six months earlier in January 1999, the bank was in a merger process as the largest financial institution in Ecuador, with assets totaling more than \$2.7 billion.<sup>130</sup> Diaz chose to stay in Ecuador during the crisis and helped to manage the fall-out of the largest failing bank in 1999. He remained in Ecuador after dollarization and now works for a Chilean petroleum company. Other young staffers of the Banco Central in the mid and late 1990s chose to leave Ecuador.

Xavier Valencia, a Católica graduate and son of the economics department chair Eduardo Valencia, used his Banco Central fellowship to study economics at the University of Notre Dame and then secure a position with Goldman Sachs in its commodities trading division. He has made a successful ten-year career in New York and has no plans to return to Ecuador in the near future. His father, Eduardo Valencia, however, has been an active opponent of dollarization<sup>131</sup> and an authority in economic policy and advisor<sup>132</sup> to the current left-leaning president, Rafael Correa (2007-present).

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<sup>129</sup> See, Federal Reserve Board, Atlanta, docket number 99-013-WARB-FB, available on-line:

<http://www.federalreserve.gov/boarddocs/press/Enforcement/1999/19990625/Attachment.pdf>

<sup>130</sup> See, "Ecuadorian Banks Merge to Form Banco Pacifico Popular," *Global Finance*, January 1999.

Available on-line: [http://findarticles.com/p/articles/mi\\_qa3715/is\\_199901/ai\\_n8840880](http://findarticles.com/p/articles/mi_qa3715/is_199901/ai_n8840880).

<sup>131</sup> Some of his work against the dollarization program includes: Eduardo Valencia (2001) "Propuesta para superar la crisis dolarizada," *Economía y Humanismo*, Number 10, Quito: Pontificia Universidad Católica del Ecuador, also, (2004) "Dolarización, inflación y recesión en el Ecuador," *Economía y Humanismo*, Number 15, Quito: Pontificia Universidad Católica del Ecuador, and most recently, (2005) "Dolarización o el caso de una estabilidad inestable," *Economía y Humanismo*, Number 16, Quito: Pontificia Universidad Católica del Ecuador.

<sup>132</sup> In early 2008, Professor Valencia was appointed head of the National Finance Corporation in the Rafael Correa administration.

In many respects, party affiliation and liberal ideology are flexible in Ecuador. Social ties—through the Universidad Católica, the Banco Central, and its network of current and former employees—are more durable than party allegiances. Professor Valencia confirmed in an interview the tradition of his department’s students at the Banco Central.<sup>133</sup> In interviews with Professor Marco Romero, director of the international economic relations program at the Universidad Andina, he also discussed his experience as a young technocrat-economist at the Banco Central (1974-1995).<sup>134</sup> Romero also earned his doctorate while on a Banco Central fellowship in Mexico. His personal politics, like many of the professors of the Universidad Andina, are more leftist in orientation, and he explained the Católica-Banco Central connection as more of a human capital issue in Ecuador, where the “best and brightest” of a select class of Quito’s young students from the 1970s through the 1990s vied for positions at the Católica and then at the Banco Central.

Miguel Davila (president of the Banco Central, 1999-2000) also confirmed this tradition in his own experience.<sup>135</sup> He said in an interview that the Católica-Banco Central connection was an important one, but that advisors in economic policy in Ecuador were chosen on the basis of “*amistades*” or friendships. He went on to comment that his friendships with President Mahuad and Augusto de la Torre (Davila’s mentor at the Banco Central) were prime motivations to take on advisory roles, rather than a shared ideological or party commitment. Those relationships, forged through years of school and work together in the directorate of the central bank, form a small pool of talent—at

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<sup>133</sup> Interview with Professor Eduardo Valencia at the Universidad Católica, Quito, 13 March 2006.

<sup>134</sup> Interviews with Professor Romero on two occasions at the Universidad Andina, Quito in December 2006, in addition to numerous email exchanges in that year. This conversation took place on 14 December 2006.

<sup>135</sup> Interview with Miguel Davila at his consulting firm in Quito, 9 March 2006.

least in technical economics—which the country has continually drawn from for cabinet posts in recent administrations. These men are members of a social network of the technical elite, rather than a political elite, with a strict ideological orientation and shared goals for the Ecuadorian economy. Their social network is small and opportunities are limited. Therefore, when a presidential appointment or advisory role is offered, the party affiliation or economic orientation of the candidate is less important than the opportunity to serve in a position of power and prestige in government.

Davila was appointed director of the Banco Central in December 1999, as part of President Mahuad's plan to announce dollarization in January 2000 (discussed below). Davila discussed the difficulty the administration faced in 1998 and 1999 in recruiting and retaining qualified staff to the newly formed AGD, the bank supervision office and the central bank. The AGD drew from ranks of the central bank's research and analysis division, while the bank supervision office was suddenly much busier placing analysts to do forensic accounting on bank balance sheets as more banks required investigation. As a manager, Davila knew the three institutions were competing for talent and that their resources were severely limited. He knew because he had little support in his own role and depended on long-standing relationships he cultivated with junior staff to work on his team. He also acknowledged the increasing division and tension between the central bank and the bank supervision operation as more banks acknowledged liquidity problems through 1999. The central bank sought more information and authority to intervene in troubled banks, yet the bank superintendent began investigations at its own pace and reported findings to the central bank only when state funds were required. The central bank, on the other hand, faced all of the public pressure to calm wary depositors and to

control the mounting inflation problem. Davila saw the supervisory institution as prone to bank demands and manipulation of information, as well as under-staffed and often under-trained to perform its job adequately.

In interviews with contacts in private finance—those who did not work at the Banco Central—their experiences reveal other social networks active in Ecuador's bank sector. As discussed earlier in this chapter, private bank operations expanded in the mid-1990s, creating new kinds of opportunities for many young graduates in Ecuador at the time. Many of these banks (all domestic, as there was nearly no international bank presence in Ecuador at this time, with only small private client branches from Citibank and Lloyd's as the primary foreign operators) recruited graduates of the six-year undergraduate law program at the Universidad Católica and other local universities for their management training positions and loan officer positions.

Hector Barrahona began working for Banco Aserval, a boutique investment bank, in 1996.<sup>136</sup> He graduated from the law program at the Universidad Católica that year. Banco Aserval suffered in the economic crisis of 1999 when it was temporarily closed and then reopened as a subsidiary of the Banco del Pichincha in 2001. By that point, Pichincha—formerly the third largest bank in the country—was state-controlled. Barrahona was developing a specialization in trusts, one of the many newer financial products banks offered after the 1994 LGISF reform. When he lost his job at Banco Aserval in 1999, he was hired by a former boss who also left Aserval to head a division of the Superintendent of Banks to liquidate assets of the Banco del Progreso, the first bank to fail in 1998.

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<sup>136</sup> There were multiple informal interviews with Hector Barrahona in Quito in March and December 2006.

Barrahona described work at the Superintendent of Banks in 1999-2000 as a period of institutional confusion and self-protection. Part of his job was to identify banks in danger of failing, yet he acknowledged that there was pressure from his superiors to delay reporting “bad news” to the central bank, which would be responsible for bailing out the bank or closing it and sending its depositors to seek assets at the newly created AGD. Barrahona worked closely with heads of private banks and knew his career depended on their support; yet, he was bound to report their problems of liquidity. He also knew that reporting problems to the central bank would only increase the broader financial crisis in the country, as in 1999 the exchange rate spiked with any news of yet another bank failure. Barrahona found himself in the middle of a classic moral hazard position—his personal career depended on the goodwill of the bankers, and his personal assets also fluctuated with information he might provide on bank problems. The outcome, in his experience, was to shield information between the superintendent (his employer), his private bank contacts (his future employers), and the central bank, which likely further contributed in some way to the uncertainty in the market related to banks’ financial standings.

Barrahona’s banking career became a career in bank failures, assessing the value of failed bank assets and finding buyers for those assets. Because the banks that failed in 1998-2000 were largely held by individuals or families, the business of liquidating assets meant Barrahona spent much of that period working out of a private home, formerly the property of a bank owner. This experience, as he recalls, led him to distrust both individual bank owners and the central bank (and its directorate) that helped to replenish the funds of banks as they were failing. Barrahona now runs his own financial services

firm which sets up private trusts for investors and wealthy families. His political views are economically liberal, yet he has no party loyalties and expects very little of public institutions.

Like Barraahona, Ramiro Galarza learned from the banking crisis when he returned to Ecuador from his graduate studies in the United States.<sup>137</sup> He saw that risk-assessment and political flexibility could be useful career tools in Quito's finance sector. With a master's degree in economics from the University of Chicago and experience as an analyst in a New York investment bank, Galarza returned to Ecuador in the midst of the crisis. Again, Galarza's experience reiterates the issue of human capacity and the enormous responsibility and opportunity afforded to young, liberal, educated men in this moment of financial crisis. Barely thirty years old, Galarza was undersecretary of finance in 2001 in the administration of Gustavo Noboa (2001-2003). Noboa was the vice president who assumed office when President Mahuad was ousted in January 2000. In 2002, Galarza was appointed to the directorship (the panel of advisors reporting directly to the president) of the Banco Central. In 2004, he joined the administration of President Lucio Gutierrez<sup>138</sup> (2003-2005) as vice-minister of finance. This broad experience—and high-level experience—demonstrates two important points: first, political appointments do not require political loyalty; and second, that young liberals with even limited foreign banking experience and economics training were in high demand and limited supply. Galarza worked in two opposing administrations in three high-level positions in the

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<sup>137</sup> Interview with Ramiro Galarza, 14 December 2006, Quito.

<sup>138</sup> Lucio Gutierrez, a former colonel of the Ecuadorian army, was a member of the military junta that replaced Jamil Mahuad in a day of massive street protests on January 21, 2000. The junta handed power to then Vice President Gustavo Noboa and Gutierrez was jailed for six months, though he was never charged or prosecuted for his role in the non-violent coup. He ran for president in 2002 and was elected on a new party ticket named for the January 21, 2000 protest movement, the *Partido de la Sociedad Patriota*, Patriotic Society Party (PSP).

course of three years. Galarza now owns his own financial services consulting firm, providing international banks (mostly bond traders) with data and opinions on the bank sector in Ecuador.

These personal experiences reveal several limitations of Ecuador's financial community in dealing with crisis. First, there was a problem with human capital allocation and leadership: too many government and private institutions competed for a limited number of skilled economists and financial analysts. Second, ties between the central bank and one university system created limited networking opportunities for aspiring technocrats and furthered institutional divisions between the three key financial supervisory agencies: the AGD, the central bank, and the Superintendent of banks. Furthermore, the political environment of high turnover in the executive branch encouraged technocratic approaches to economic policy appointments, while discouraging the development of party links to economic policy proponents. Choices for young economists or finance experts with some domestic or foreign training in economics were limited to work for the central bank (given the right university affiliation), the executive branch (given a social tie to a political appointee), or a local private bank (accepting the job security risk). Research organizations,<sup>139</sup> consultancies, and ratings agencies or independent credit bureaus are scarce or non-existent. There is no surprise then that the Mahuad administration also had few resources, in terms of an organized and articulate liberal advisory network, to look towards for advice in dealing

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<sup>139</sup> Even academic positions seem limited to small circles of educated elites with social or family ties. For example, one of the stronger programs in economic development studies and political science in Ecuador is the Facultad Latinoamericana de Ciencias Sociales in Quito (FLACSO). The directors of these two programs are Carlos de la Torre and Hugo Jacome, family members of the prominent Ecuadorian economists Augusto de la Torre of the World Bank and Luis Jacome of the IMF, respectively. Interview with Hugo Jacome in Quito, 14 March 2006.

with the banking crisis that ensued at the outset of his short tenure as president. Instead, President Mahuad relied on social ties and his close network of political appointees to manage the crisis.

***Ad Hoc Economic Policy: Crisis Management Among Friends***

Just a few weeks into his presidency, Jamil Mahuad was faced with the first evidence of an impending bank crisis. In February 1998, Banco de Prestamos asked the central bank for assistance (a bail-out) to meet its credit obligations. By the end of 1998, four major banks failed. As Jose Antonio Lucero explains, between August 1998 and December 1999, the Mahuad government (through the central bank) transferred \$6 billion to the bank sector—roughly the same amount<sup>140</sup> the state spent on education in the preceding 13 years, on health for the last 39 years, and on agricultural development for the last 42 years (Lucero 2001: 62). When Banco de Prestamos was closed, there was no federal deposit guarantee system for depositors and only small savings holders received payments after several weeks (but partial payments at best, as the devaluation of the *sucre* automatically deteriorated their account's value). The collapse of Filanbanco in August 1998, whose depositors' assets totaled 14 percent of cash holdings in the onshore system, increased pressure on the value on the *sucre*, and pressure on the central bank's liquidity support (Jacome 2001: 22). According to Jacome, total emergency loans from the central bank to 11 private banks in liquidity crisis reached close to 30 percent of the monetary base by the end of September 1998 (Jacome, *ibid*). The central bank reacted to its own diminishing funds by devaluing the currency. It began a slide downward that

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<sup>140</sup> For the original compilation of these data, see Wilma Salgado (2000) "La crisis económica y el 'gran salto al vacío' de la dolarización," *Ecuador Debate*, Issue 49, pp. 7–24, cited in: Jose Antonio Lucero (2001) "Crisis and Contention in Ecuador," *Journal of Democracy*, Vol. 12, no. 2, pp. 59-73.

became difficult to contain. It was a twin crisis in that private banks were weak and seeking capital infusions, while the central bank could not keep up with demand and risked its own solvency by lending massive sums to banks at risk. The Mahuad administration tried to relieve fiscal pressure by raising domestic gasoline prices.

The gasoline price hike was the first of a series of executive decisions made in haste and in consultation with a few insiders of the Mahuad administration, including Miguel Davila. In fall 1998, it became clear that the Banco Central and the Superintendent of Banks were not able to contain the rising inflation, the demand for currency, and the administrative role of assuming management responsibilities for four major banks in the country. The Mahuad government then decided to create a new state institution to shore up public confidence in the bank system, the Agencia de Garantia de Depositos (AGD).<sup>141</sup>

The logic for the creation of the institution was flawed from the outset. As Halac and Schmukler of the World Bank argue, guaranteed transfers from the state to private banks in financial crisis generally increases the risk of moral hazard in bank operations and benefits bank owners and large depositors, while negatively affecting the poor, who are either not repaid their deposits in failed banks or most directly affected by the other variables (reduced government subsidies, rising unemployment, inflation of basic consumer goods) or both (Halac and Schmukler 2003). They find that in Ecuador, the

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<sup>141</sup> For an economist's perspective on the problem of state transfers of capital to the private bank sector, see Marina Halac and Sergio L. Schmukler (2003) "Distributional Effects of Crises: The Role of Financial Transfers," Research Paper, WPS3173, The World Bank, as part of background research for the World Bank Latin American and the Caribbean Flagship Report 2003 "Inequality and the State in Latin America." Halac and Schmukler clearly detail the evidence financial transfers from the state to private banks also affect income distribution and poverty levels after financial crisis. They show that borrowers with close ties to banks (and bank owners with connected lending to conglomerate family businesses—of which there were many in Ecuador) benefited from crises and their resolution through state transfer channels. They examine three cases: Ecuador, Chile and Mexico.

AGD has paid \$850 million directly to depositors and still has yet to return deposits for \$757 million (in addition to nearly \$1.4 billion the AGD spent in bank capitalization) while recovered assets of failed banks taken into AGD custody amounted only to \$43 million as of May 2003 (Halac and Schmukler 2003: 11).

The AGD then worked in the same sphere as the central bank and the bank superintendent, whose roles and authority were already over-lapping. Staffing the new institution with qualified experts proved difficult as the office of the bank superintendent was already drawing on bankers from closing banks to perform audits and crisis management at their former competitors. As Diego Diaz explained, there was a situation of personal moral hazard in the bank community, as those with knowledge of the crisis moved to protect their individual assets, while delaying public announcements of bank liquidity problems. Diaz and his co-workers at the central bank expected more banks to fail and knew the resources of the government were diminishing and a massive bail-out would only increase inflationary pressure on the *sucre* and leave the state with little to manage its outstanding obligations.

Those like Diaz in the central bank also saw the AGD as a political band-aid to a deeper institutional crisis. Diaz blamed the superintendent's role in assessing bank solvency as the primary barrier to transparency in the bank sector. The AGD simply functioned "to quiet the poor and working class with savings deposits," as major depositors and bank owners had early opportunity to transfer holdings to dollar accounts abroad or offshore at the outset of the crisis. Diaz also confirmed the problem of communication between institutions (AGD, Superintendent of Banks, Central Bank) as an increasing sense of panic among those working in the sector. Technocrats in these

institutions sought to confirm relationships with mentors (to try and protect themselves and secure future employment), rather than sharing information across institutional boundaries.

The AGD depended on the central bank to fund its recapitalization programs of failing banks, yet the central bank was also responsible to close banks that were insolvent. To further divide responsibilities, the bank superintendent office was responsible for determining which banks were in danger of reaching the point of needing state intervention. The AGD operated for “purchase and assumption,” which essentially meant writing a government check to a failing bank. Quispe-Agnoli and Whisler of the Federal Reserve Bank of Atlanta argue that the AGD failed in its purpose and was poorly designed and inadequately funded from the outset, which was compounded by its abuse by banks with on and offshore operations (Quispe-Agnoli and Whisler 2006: 15). Banks with offshore operations transferred capital to those accounts while reporting deeper losses to the central bank, while dollar based accounts offshore were quickly transferred or disappeared from balance sheets.<sup>142</sup>

There is some evidence from interviews with former AGD director Wilma Salgado and limited press reports<sup>143</sup> that the Mahuad government developed the draft AGD law with informal advice from the World Bank. The government also included in the draft law the creation of a 1 percent tax on financial transactions, replacing the income tax (which had poor collection and auditing capacity) with the aim of improving deteriorating state finances. Congress approved the AGD law in early December 1998. Exacting a 1 percent tax on all financial transactions from January 1999 onwards was

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<sup>142</sup> See Myriam Quispe-Agnoli and Elena Whisler (2006) “Official Dollarization and the Banking System in Ecuador and El Salvador,” *Economic Review*, Issue 3, Federal Reserve Bank of Atlanta.

<sup>143</sup> See Darien Gap (2001) “AGD Still Owes Depositors \$815 million,” *Americas Insider*, 15 March 2001.

devastating for the financial system as it was imposed in the middle of a liquidity crunch, which actually accelerated the collapse of many financial institutions, including Banco del Progreso, the largest bank of the system (Jacome 2004:23).

The last ditch effort to control the contagion of the bank crisis and head off the increasing inflation (the *sucre* depreciated over 50 percent between January and February 1999 alone) was to force all banks to close for a one week holiday, 8-12 March 1999 (Jacome 2004: 24). During this week, Mahuad and Davila met with the central bank directorate and determined the only means left of stopping the inflationary panic (people were lining the streets in front of banks and ATMs to withdraw money and hoard foreign currency in their homes) was to freeze all deposits, which occurred on 15 March. Time deposits and repurchase agreements were locked for at least one year. Saving deposits in excess of 500 U.S. dollars and one half of all checking account balances were frozen for six months. This action turned public opinion firmly against Mahuad, who was also facing pressure from the IMF to control the country's fiscal situation in return for a stabilization package. Private banks worked against the state, securing liquidity funds from the central bank (or the AGD, if they were proven insolvent) and exchanging the government funds for dollars, thus driving demand for dollars up and *sucre*s down. The central bank kept printing money. By the end of 1999, the *sucre* had lost 80 percent of its dollar value in the 16 months of Mahuad's presidency.<sup>144</sup>

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<sup>144</sup> For this inflation citation and a description of the crisis from the point of view of Ecuador's creditors, see: Stanley Fischer (2000) "Ecuador and the IMF," text edited from a speech at the Hoover Institution, 19 May 2000. Palo Alto, California. Available on-line: <http://internationalmonetaryfund.com/external/np/speeches/2000/051900/htm>. Fischer argues that the Mahuad administration had many opportunities in 1998 and 1999 to restructure an agreement with the IMF, but chose on at least two occasions not to do so—either because of social protest to increased fiscal reform, or because the Mahuad administration saw the IMF's assessment of their interventions in the bank sector as unfair or harsh.

The social consequences of President Mahuad's efforts to change fiscal policy in response to the monetary crisis were disastrous. Internal debt rose 39 percent, as the central bank sought loans from the remaining solvent national banks at unfavorable interest rates and often in dollar denominations (making them more costly as the *sucre* depreciated). Interest payments on the debt soared from 1 percent of GDP in 1998 to 5 percent in 1999. To offset the increase in interest expenditures and debt, social spending was cut, which fell in real terms by 50 percent in 1999 (Lucero 2001: 63). As the public sector contracted, the private sector contracted as well and unemployment doubled. As Lucero indicates, in 2001, the poorest sectors of society suffered the heaviest burden, as the Gini coefficient rose to .58, making Ecuador the third most unequal society in Latin America (after Brazil and Paraguay) (Lucero, *ibid*).

***Dollarization: An Act of Desperation, in Isolation***

As a last straw, Mahuad and his closest economic advisor--Miguel Davila--considered dollarization. In an extensive interview with Davila, he explained that Mahuad first approached him in August 1999 asking for a draft proposal to dollarize the economy.<sup>145</sup> It was to be a private research task, not part of Davila's work at the Banco Central or with his contacts in the administration. Davila turned to his old mentor at the Banco Central—Augusto de la Torre, then employed at the World Bank as the senior financial sector advisor for Latin America and the Caribbean. Davila took a personal leave of one week—a “vacation”—to Washington, D.C. in September 1999 to meet with de la Torre. They met after work hours on several evenings at a local pub, to frame a plan for Ecuador's dollarization. At this same time, negotiations were ongoing for an IMF package to provide \$400 million in direct aid and to release loans from other multilaterals

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<sup>145</sup> Interview with Miguel Davila, 9 March 2006, Quito.

worth twice that. Meanwhile, Ecuador defaulted on its Brady Bond payments in August 1999.<sup>146</sup> International credit lines, already bleak, proved impossible to secure.

Davila returned to Ecuador with a sketch of a plan. He drafted the proposed legislation to dollarize the economy on his personal laptop, with minimal support from his own research assistants. Mahuad approved the plan and prepared to make a public approach to the congress to seek support. His efforts with congress would be tenuous, as Mahuad's approval ratings in the fall of 1999 were 7 percent.<sup>147</sup> In December 1999, Mahuad appointed Miguel Davila as president of the Banco Central. The dollarization plan still was not public.

Mahuad finally formally announced the dollarization plan to congress on 9 January 2000. Street protests and organized union strikes had been common since February of 1999, as people expressed their distrust and anger with the bank closures, the deposit freeze and the government's fiscal austerity measures. On 12 January 2000 civil society groups declared a day of civil disobedience, organized largely by the indigenous movement and its umbrella organization CONAI (Comision Nacional de Asuntos Indigenas-National Commission for Indigenous Affairs). The military, led by Colonel Lucio Gutierrez, joined the protests and did not defend the president's palace from the crowds. It was a matter of hours before it was clear that Mahuad would have to step aside, and power was quickly restored to the vice president, Gustavo Noboa.

According to Professor Marco Romero, Mahuad's finance minister did approach the U.S. Treasury Secretary for input in a possible dollarization plan in a meeting in

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<sup>146</sup> For a discussion in the American press about the importance of Ecuador's default, its simultaneous IMF negotiations, and the implications to other countries holding Brady Bonds, see: Michael Weinstein, "Economic Scene: Why all the fuss over pint-sized Ecuador? Brady Bonds," *The New York Times*, 2 September 1999.

<sup>147</sup> Cedatos-Centro de datos y estudios de Quito.

November 1999.<sup>148</sup> Romero contends that finance minister Guillermo Lasso asked Treasury Secretary Lawrence Summers for assistance, since Ecuador had recently made concessions to allow the U.S. military to operate a base on the coast in Manta, as part of its Plan Colombia. Romero reports that Lasso was quickly rebuked—that from the U.S. government point of view the two issues were unrelated and not under the Treasury department purview. The Treasury department reaction is not surprising (or unjustified), but Lasso’s blunt request for assistance, as one of a handful of cabinet members briefed on the plan—if accurate as Romero contends—displays how desperate and isolated the Mahuad administration was in the fall of 1999.

Of course, the official stance of the U.S. Treasury differs with regard to any involvement or discussion of dollarization with the Mahuad government before January 2000. In an interview with the (then) Deputy Assistant Secretary for international affairs in the U.S. Department of the Treasury, Nancy Lee, she was very clear in stating the department had no knowledge and no input in Ecuador’s dollarization draft legislation or planning.<sup>149</sup> The official reaction was one of surprise, from both the IMF and the U.S. Treasury Department in regards to Ecuador’s decision to dollarize.

In an interview with Bernai Velarde,<sup>150</sup> the USAID senior financial sector representative in Ecuador (1999-2006), he confirmed there was no mediation or intervention by USAID in the bank crisis in 1998-1999 as an advisor to a dollarization plan or transition. He described the agency’s role in the period as facilitating discussions and “knowledge tours” for the private banking community to know and learn more of the

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<sup>148</sup> Interview with Marco Romero, Universidad Andina, Quito, 14 December 2006. Romero has embarked on a research project investigating the international politics of negotiating Ecuadorian military and political support for the U.S. Plan Colombia.

<sup>149</sup> Interview with Nancy Lee, June 2005.

<sup>150</sup> Interview with Bernai Velarde, 12 December 2006.

U.S. system, particularly the Federal Deposit Insurance Company (FDIC). Yet, USAID in Ecuador proposed no new legislation or institutional or financial support for a deposit guarantee program. USAID did not budget any technical assistance to the central bank or the superintendent of banks in Ecuador between 1997 and 2000. In 1999, there was support for micro-enterprise, for pollution control, and poverty reduction programs, but nothing to the financial sector.<sup>151</sup> Velarde's explanation of the crisis was to blame a "culture of corruption" as the failure of the bank system. He claimed his role in conducting seminars and tours for the bank community in the U.S. was to confirm an ideological connection to an "Adam Smith view of state-market relations."

Velarde's simplistic (and unsympathetic) explanation for the complicated financial crisis lent credibility to the argument here that established liberal networks in Ecuador could not exist because they have not found roots in foreign institutional support, in private research organizations, nor in idea-based exchanges with scholars and bankers in non-work settings. Not until 2001 did USAID-Ecuador begin negotiating a package with the Inter-American Development Bank and the World Bank to provide \$10 million in technical assistance to the AGD to help restructure the banking system.<sup>152</sup> In interviews with the former AGD director, Wilma Salgado, she confirmed there was no immediate involvement with USAID, nor did the funds directly address the communication and coordination problems between the state institutions. The funds are restricted to the purchase of computers and equipment, rather than in capacity training or

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<sup>151</sup> See the USAID Congressional Presentation of budget allocations for fiscal years 1997-1999, available on-line: <http://www.usaid.gov/pubs/cp99/lac/ec.htm>

<sup>152</sup> See USAID, "Fiscal Year 2001 Program: Activity and Budget Information," United States Agency for International Development, Washington, D.C. Available on-line: <http://www.usaid.gov/pubs/bj2001/lac/ec/>.

external audit staff to intervene in the private bank sector—the two priority needs of the AGD institution.

***After Dollarization: A Few New Rules, Same Politics***

Mahuad was briskly ushered to the Peruvian embassy for asylum<sup>153</sup> after three military colonels (including future president Lucio Gutierrez, 2003-2005) assumed power on 21 January 2000. The military break-off group and its indigenous supporters and protestors returned power to Vice President Gustavo Noboa on 22 January 2000.<sup>154</sup> Noboa began immediate plans to carry on with dollarization and formerly submit legislation to congress for approval. Noboa received support from the conservative Partido Social Cristiano (PSC) in congress and assurances from the business community that the plan would be supported. Miguel Davila remained president of the central bank and in charge of implementing the dollarization plan. Noboa also faced the completion of the IMF negotiations begun under Mahuad, including a stand-by agreement in April 2000 to make over \$2 billion of credit available over a three-year period. Noboa faced the same limitations of Mahuad in attempts to reform an economy in difficult conditions:<sup>155</sup> the recession of 1999 resulted in a 7 percent contraction of GDP, while the official unemployment rate was 17 percent, and 62 percent of the population was considered

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<sup>153</sup> Just weeks later, Mahuad moved to the United States, to take a position as visiting professor at the Harvard Kennedy School of Government, where he has remained through 2008.

<sup>154</sup> This dissertation does not go into detail of the rich and complicated politics of indigenous communities in Ecuador. Many analysts describe the protests of January 2000 as led by a wholly (and cohesive) indigenous movement, though there were clearly other factions of society involved. For the most detailed local scholarly account of the protests involving indigenous communities against dollarization, see Kintto Lucas (2000) *La Rebellion de los Indios*. Quito: Abya-Yala.

<sup>155</sup> For a compilation of data and arguments against dollarization, with evidence of its effects through 2005, see Alberta Acosta and Fander Falconi, eds. (2005) *Asedios a lo Imposible: Propuestas Economicas en Construccion*. Quito: FLACSO. Data cited here is included in an essay by Acosta and Falconi, “Otra politica economica: deseable y posible,” in Alberta Acosta and Fander Falconi, eds. (2005) *Asedios a lo Imposible: Propuestas Economicas en Construccion*, pp. 17-38. Quito: FLACSO. Included in this edited volume is also an essay by Rafael Correa, president of Ecuador (2007-present), with his early economic policy proposals to de-link from the Washington-based multilaterals for aid, to change the structure of state oil exploration agreements with multinationals, and to reduce poverty.

beneath the poverty line (living on less than \$1 per day), the *sucre* had devalued 80 percent (of its dollar value) and annual inflation stood at 60 percent—the highest in the Americas (Acosta and Falconi 2005: 19).

On March 13, 2000, Congress approved the *Economic Transformation Law* (commonly known as the “Trolebus” law, as it also funded the popular trolley bus of Quito) for full dollarization effective September 2000. The law included changes in the role of the central bank, the development of a liquidity fund, and the modernization and tightening of banking supervision and regulation. Under the new law, the central bank is authorized to conduct liquidity operations with banks. Previously the central bank only provided funds for liquidity needs, it did not coordinate with private bank staff to assess liquidity needs—that was the role of the Superintendent of Banks. However, the authorization to assess liquidity was not removed from the Superintendent of Banks, making both institutions more at odds with each other to assess the health of the private bank system. Private bankers, in turn, now have more opportunities to exploit the tensions between the two state institutions. Additionally, the Trolebus law established a separate Liquidity Support Fund to supplement the central bank’s capacity during liquidity problems (Beckerman and Solimano 2002). Banks are required to allocate 1 percent of their deposit base to the fund. However, the liquidity fund (as of 2006) remained grossly under-capitalized and untested (Quispe-Agnoli and Whisler 2006).

As Quispe-Agnoli and Whisler document, Ecuador has moved towards more stringent capital adequacy regulations, which are closer to (but still below) Basel I standards. In addition, Noboa, with the advice of his economic team at the central bank (Davila), made efforts to amend the 1994 LGISF in 2001, with a specific prohibition

against related-party (or “connected”) lending. The prohibition has resulted in no legal ramifications for banks to date. According to the analysts Quispe-Agnoli and Whisler of the Atlanta Federal Reserve Bank, “while regulations were updated, actual implementation and enforcement continue to be poor” (Quispe-Agnoli and Whisler 2006:19). Bank accounting standards continue to deviate from international norms while some regulations continue to be lenient, including rules for loan write-offs.

The institutional consequences of the government’s efforts in the bank sector have led to confusion and continued parallel responsibilities and limited staffing. The upgrading of the Banco Central’s responsibilities in determining liquidity needs did not go along with a dismantling of responsibilities in the Superintendent of Banks. Nor has there been a clear decision on how to close or transform the operations of the deposit guarantee agency (AGD) created by Mahuad in 1998. It continues to pay out depositors and seek to liquidate bank assets from accounting in 1999.

The AGD has been embroiled in controversy, particularly in 2004, when its director, Wilma Salgado, was quickly sacked by left-leaning President Gutierrez as a concession to gain support in Congress from representatives of the conservative Partido Social Cristiano (PSC). Salgado was viewed as a threat to liberal interests in the bank community and became an easy target for political trade-off for the leftist Gutierrez, who had appointed her in 2003 as an effort to put an anti-banking face on an institution seen as privy to bankers’ interests by the public. To make matters worse, she became the center of a legal scandal for her decision to publish the names of all debtors from the crisis (of bank owners and connected operations with outstanding debts to failed banks under the administration of the AGD) in a national newspaper. She was accused of

impinging on constitutional rights to privacy and of abusing her position as director of the agency.<sup>156</sup> She went into hiding as warrants were issued for her arrest.<sup>157</sup> Freedom House, in its 2005 democratic governance country study on Ecuador, called her dismissal a conflict between “political forces” (bank owners and the presidency) which thwarted the effectiveness of governmentally controlled agencies (Freedom House 2005).

The Superintendent of Banks continues to function with close ties to managers at private banks and to lack both resources and technical staff to conduct major examinations of private bank accounting. According to Ramiro Galarza, the bank sector is again expanding and that liquidity is not a major concern. His consulting firm, RLGA Consulting, published an update in May 2008 arguing that deposits are growing twice as quickly as the loan portfolio (on average) in the local bank sector and that the largest banks are seeing profits rise as much as 25 percent in the last year. His evidence contends the sector is making efforts to extend loans in safe quantities relative to bank deposits, and that the largest banks are doing well; while he also acknowledges smaller banks are facing a decline in profits of at least 15 percent this year.<sup>158</sup> A closer examination reveals that only the two largest banks are profiting at such levels and that the majority of banks in the country are struggling. The increase in loans could also be due to the surge in consumer credit products offered through credit cards, car loans, and mortgages that Ecuadorian banks did not offer on a large-scale basis before 2001.

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<sup>156</sup> For an international account of the persecution of Wilma Salgado, in the context of the politicized nature and difficulty of enforce banking (and other) law in Ecuador, see Andres Mejia Acosta (2005) *Countries at the Crossroads: A Survey of Democratic Governance*, Country Report for Ecuador. New York: Freedom House. In interviews with her husband, Professor Marco Romero, and her attorney in Quito in December 2006, Salgado was still living in a secret location but agreed to meet and communicate by mail.

<sup>157</sup> As evidenced here, political longevity in Ecuador is common--even after arrest warrants are issued. Wilma Salgado was recently asked to join the left-leaning administration of Rafael Correa in July 2008 as finance minister. At the time of writing, it is not clear if the charges against her will be dropped.

<sup>158</sup> Email communication from Ramiro Galarza, 28 May 2008.

Galarza's firm also argues that the global price of oil is, for now, acting in Ecuador's favor, helping to keep government revenues higher, despite problems in debt repayments. Eduardo Valencia reiterates this connection, and contends that the relative safety of the bank system and the fiscal situation of Ecuador from 2001-2006 is due to the role of remittances and the rising price of oil, more than any implicit stabilizing qualities of the dollarization policy.<sup>159</sup>

A major change in Ecuadorian politics since dollarization has been the limited success of leftist candidates, though their economic policies have largely been in line with their predecessors' policies. In 2003, former military officer and coup leader of the 2000 protests against Mahuad, Lucio Gutierrez, became president on the ticket of a newly formed party named for the anti-dollarization protests. Gutierrez appointed a number of left-leaning intellectuals to his administration, including Universidad Andina economist Wilma Salgado as head of the AGD. Gutierrez, however, felt pressure from various bank owners and members of the politically conservative and economic liberal party the PSC (Partido Social Cristiano) to remove Salgado from office a year later for her outspoken criticisms of bank owners and their protection of personal assets during the 1998-2000 crisis.

Gutierrez was removed from office by Congress on April 20, 2005, by congressional vote (without debate) on grounds of "abandoning his post"—though Gutierrez was sitting in his office at the time. Mounting public tension regarding Gutierrez's abuse of presidential power, including the appointment of sympathetic

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<sup>159</sup> Interview with Eduardo Valencia, 13 March 2006. Also see, Eduardo Valencia (2005) "Dolarización o el caso de una estabilidad inestable," *Economía y Humanismo*, No. 16, Quito: Pontificia Universidad Católica del Ecuador.

justices to the Supreme Court, made the former colonel unpopular.<sup>160</sup> His economic policies during his two year tenure did not change the institutional structure set up by President Mahuad to deal with banking and monetary policy—though he campaigned on an outright rejection of dollarization and battling the “corruption” of the bank sector.<sup>161</sup> Gutierrez was succeeded by his vice president, Alfredo Palacio.

Two years later, in January 2007, leftist economist (and former finance minister under the Palacio administration) Rafael Correa assumed the presidency on a platform of redistribution of resources to the poor, nationalizing oil resources and production, and critiquing the Washington Consensus and the Andean Free Trade agreement.<sup>162</sup> To that point, Correa’s experience in government was limited to his 100 day tenure as finance minister under Palacios. Prior to that post he was a professor of economics at the Universidad San Francisco, a private liberal arts college in the suburbs of Quito.

Correa is the only president yet (eight years after dollarization) to confront (but not dismantle) the effects of new bank supervisory institutions and monetary policies of the Mahuad administration. Correa’s administration operates in a permanent campaign mode, by-passing legislative debate and consensus building.<sup>163</sup> His efforts to de-

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<sup>160</sup> For a discussion of the largely middle-class protests that turned popular opinion against Gutierrez, see Michael Shifter (2004) “Bonfire of the Andes,” *Foreign Affairs*, Vol. 83, issue 5.

<sup>161</sup> For a discussion of Gutierrez and his leftist aspirations turned to status-quo politics, see an argument by Peter Hakim that Latin America is not shifting towards a populist or leftist orientation in general trends or in specific cases like the Gutierrez administration: Peter Hakim (2003) “Dispirited Politics,” *Journal of Democracy*, Vol. 14, number 2, pp. 108-122. For an argument to the contrary, see Jorge Castañeda (2006) “Latin America’s Left Turn,” *Foreign Affairs*, Vol. 85, issue 3, pp. 28–42. There has been a certain amount of fear-mongering in the American press of the leftist turn in Latin American politics, given the statist politics and anti-American rhetoric of President Hugo Chavez of Venezuela.

<sup>162</sup> For details of Correa’s campaign agenda, see *The Economist*, 18 January 2007, “Ecuador’s New President.”

<sup>163</sup> See Catherine Conaghan and Carlos de la Torre (2008) “The Permanent Campaign of Rafael Correa: Making Ecuador’s Plebiscitary Presidency,” *The International Journal of Press/Politics*, Vol. 13, pp. 267-285. Conaghan and de la Torre argue that Correa has used an on-going campaign approach to mount popular support for his policies without traditional backing from a single party. In fact, he created a new

legitimize Congress through a new National Assembly and form (yet another) constitution<sup>164</sup> are a series of confrontations with established avenues of political competition. He seeks to reconfigure political institutions in order to lengthen his tenure, though he has done nothing substantial to date to change existing institutions in the bank sector or to challenge the dollarization policy.

Since the Mahuad administration and the 1998 constitution, presidents have had more ability to manipulate Congress<sup>165</sup> by by-passing legislative authority. Moreover, Correa and Gutierrez made it very clear that party representation and support in Congress and in campaign backing are not necessary to win the presidency, as both men created new parties<sup>166</sup> to support their presidential bids. The electoral system allows small parties to present candidates in congressional and/or presidential elections (which are simultaneous, held every four years). The use of referendums and calls for extra-congressional bodies, such as the National Assemblies convened in 1998 and 2007, have allowed the president to re-direct debate and set the political agenda according to his concerns.

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party in order to run for president and has used popular referendum to side-line (and delegitimize) opposition in Congress.

<sup>164</sup> In a national referendum, Ecuador will vote on September 28, 2008 to approve Correa's new constitution, drafted by the National Assembly he called for during his campaign.

<sup>165</sup> The number of deputies in Congress has fluctuated in recent years, expanded by the 1998 constitutional reforms from 82 to 121 members, and again in 1999, to 123 members, following the creation of a new province, Orellana. An electoral reform passed in 2000 reduced the number of deputies in Congress to 100, starting from the congressional election in 2002. Representation is geographically based and deputies are elected from open lists drawn up by party leaders, giving party leaders main responsibility for and access to potential candidates. Parties that do not reach a threshold of 5 percent of the popular vote in two consecutive national elections lose their party registration, barring them from contesting future elections. However, congressional fragmentation remains a problem. Independents have been allowed to run for congressional seats and other official positions since 1996. The presidential party ticket does not require supporting congressional candidates, as Correa made the explicit decision not to list candidates for congress along-side his presidential bid. For more information, see Columbia International Affairs On-line (CIAO): <http://www.ciaonet.org/atlas/EC/index.html>

<sup>166</sup> Correa formed the *Allianza PAIS* (Alliance of the Alternative and Sovereign Homeland) party in 2006 before his run for the presidency. Gutierrez formed the Patriotic Society 21<sup>st</sup> of January (*Partido Sociedad Patriótica 21 de Enero*) party to commemorate the protests that removed Jamil Mahuad from office in 2000.

Moreover, Gutierrez and Correa both maintained a distant relationship with the finance sector, offering no substantial changes to existing institutional structures, nor threats to the operation of a liberal finance regime. In fact, Correa's own finance team through the summer of 2008 included some of the same members of Mahuad's bank supervision heads. However, Correa has made more efforts to include left-leaning academics in his economic policy team, including Professor Eduardo Valencia, Professor Susana Cabeza de Vaca<sup>167</sup> (formerly the director of the U.S. Fulbright program in Ecuador, 1997-2007), and Professor Wilma Salgado. These are left-leaning, but establishment academics from the three major universities in Quito: the Universidad Católica, the Universidad San Francisco, and the Universidad Andina, respectively. Inviting Salgado to join as minister of finance may be a signal that Correa is willing to give more leverage to the AGD and bank supervision agency to delve into unresolved bank debts from the 1998-2000 crisis, but this remains to be seen.

### ***Conclusion***

Social networks in Ecuador are an essential part of the political culture and play a major role in the creation of economic policy as well as concerted efforts to undermine it. These social networks are based on class identities, educational institutions, ethnic identities, and family ties. However, *liberal* advisory networks are more limited to the private sector and lack deep connections outside of the central bank to academic institutions, research organizations, foreign donors and international organizations. The

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<sup>167</sup> Interview with Susana Cabeza de Vaca in Quito in April 2006 and December 2006. She was not an opponent of dollarization, as was Correa when the policy was proposed, but she was a former colleague of Correa's at the beginning of his academic career. Before she took the position as director of the Fulbright program in Ecuador, she was dean at the Universidad San Francisco, a private university outside of Quito, where Correa was a junior faculty member in the Economics department in the mid-1990s. Cabeza de Vaca is also not an economist, but trained in education policy. She holds a position on Correa's economic policy team as Minister of Production, a vague cabinet-level post that concerns general productivity of the economy's private sector.

liberal advisory network was shallow or thin, which created communication barriers, problems of trust and accountability between the state and private sector, and a lack of exposure to best practices in international banking and financial institutions.

Measuring the strength of the liberal advisory network in Ecuador according to the five key indicators identified in this dissertation, the network appears much weaker than its counterpart in Bulgaria. First, the lack of strong academic and ideological bases of support restrained the network from developing alternative bases of operation outside of state bureaucracies. The single university program at the Universidad Catolica served as the traditional training ground for central bank economists, though it could offer little in terms of research organizations, publications, or think tanks to provide alternative employment. This weakness in academic institutional support is a result of a larger problem of weak ties to foreign donors and aid which might have built organizations and alternative institutions for economic analysis, as was the case in Bulgaria. Economic liberalization in Ecuador was not prioritized among foreign government aid programs (such as USAID). Ecuador's liberal advisory network did rely on personal member ties to international financial institutions, specifically the tie to Augusto de la Torre, in the formulation of its dollarization plan. Problematically, de la Torre was also the architect of the liberalization legislation in 1994 which legitimized many of the problems in Ecuador's on and off-shore banking regulation. The small size of Ecuador's network and its limited access to resources and people to advocate innovative economic policy proposals affected the network's growth and visibility. The increasing reliance on presidential decree to formulate economic policy also side-lined and politicized innovation that might have originated in the private sphere of research institutes and

academic settings—both natural homes to the development of a vibrant economic policy advisory network. Lastly, stubborn social structures of class and elite bases of wealth and industrial holdings—specifically the ties between industry and banks—make changes to bank supervision difficult.

This chapter has argued that the volatile nature of presidential turnover in Ecuador has allowed executive officers to mandate reform in the bank sector. The financial sector lacks expansive and deep-rooted liberal networks between central bankers, politicians and their counterparts in private banks and international financial institutions. The weakness of connections, in both ideological commitments to enforcing a liberal market and in professional informal exchange, marred communication and enforcement of the reforms. The institutional changes that the executive branch made during and after the financial crisis between 1998-2000 were weakened without the human resources and cooperation from private bankers and central bankers to perform proper supervision. Furthermore, these institutional changes, particularly the creation of the AGD, were “sticky” and difficult to undo, such that even left-leaning presidents Gutierrez and Correa made campaign pledges to dismantle a failing system, but made no substantial policy changes or staff changes to that effect.

The outcome in Ecuador is a deep division between the state and the bank sector socially, in terms of trust and human capacity. The outcomes for the Ecuadorian population are further instability in the bank system, which is loosely regulated, and divided by a triumvirate of institutions with over-lapping responsibilities and poor enforcement results. In addition, unreported and unregulated “offshore” banks are still

legal. Many owners of failed banks have left the country or are involved in various legal battles in Ecuador and in the United States.

The chapter has attempted to demonstrate that the weak structure of the liberal advisory networks secured limited intervention and support from foreign governments and financial institutions while staffing a one-stop shop of liberalization policies in the office of the president. The political landscape in Ecuador, with a history of strong executive intervention and limited organized policy dissent from legislative groups or policy organizations, helped make executive mandate reforms possible. However, this shallow policy incubation had the effect of lacking institutional follow-through and broad-based financial sector support. The liberal advisory network, while essential in creating policy solutions at the service of the president, had little power and resources to maintain influence outside of executive favor. The lack of foreign support, in government-based aid programs such as USAID, and in private initiatives and foundation support for idea-based research organizations and policy publications, limited network reach. Only with the election of a left-leaning president in 2005, did the possibility of bank sector reform seem likely, though it still encountered the long-standing obstacles to reform from elite bases of power in the industrial-linked bank sector.

## Chapter 5 - Conclusion

### *Bank Failures Big and Small: Why Study Monetary and Bank Crises*

Inflation, bank failure, and monetary policy crises do not occur only in small, developing, and transitioning political economies. Monetary policy and bank supervision are critical issues for rich and poor countries alike. These issues are especially important in the wake of a new global recession as a result of the credit expansion in mortgage lending in the United States (and Western Europe), which led to a severe credit crunch, or contraction of the credit market to both individual and corporate borrowers, and to a series of high-profile bank failures in 2008. Followed by increasing inflation<sup>168</sup> in the United States and globally, fueled by food commodity prices and oil, the experiences of Bulgaria and Ecuador with twin bank and currency crises underline the severe consequences many rich governments also must consider. One major difference, of course, is scale; yet, the policy options and the mechanisms of policy choice and implementation are very similar.

The last wave of bank failures in the United States occurred during the 1989-1990 recession in which 532 banks failed. Prior to that, over 2,300 banks failed in the savings and loan crisis spanning 1986-1995.<sup>169</sup> The 2008 global financial crisis began in the U.S.

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<sup>168</sup> See the International Monetary Fund (2008) *World Economic Outlook Update: Global Slowdown and Rising Inflation*. Washington: International Monetary Fund. The IMF predicts global economic growth to decelerate significantly in 2008 and early 2009, with rising inflationary pressure, particularly in the developing world. The IMF advises that “emerging economies” should conduct tighter monetary policy and greater “fiscal restraint” while “advanced economies” are not under the same inflationary pressure. This is long-standing, and many would argue, double-sided policy advice. Poor countries face higher inflation and more severe consequences of inflation because much of their goods are imported from developed, rich economies. Poor people in poor countries bear the brunt of the burden of rising global prices, without dependable state resources and services for health and food relief. The IMF report is available on-line: <http://www.imf.org/external/pubs/ft/weo/2008/update/02/index.htm>.

<sup>169</sup> For a comprehensive list of U.S. bank failures since 1934, see Federal Deposit Insurance Corporation, *Historical Statistics on Banking*, available on-line: <http://www4.fdic.gov/HSOB/SelectRpt.asp?EntryType=30>. Also see, Jill Konieczko, “The Biggest U.S. Bank Failures,” *U.S. News and World Report*, 15 July 2008.

with a credit boom, a surge in lending to finance home sales. Between 1997 and 2006, American home prices increased by 124 percent.<sup>170</sup> The surge in home prices and the accompanying looseness of mortgage lending was not isolated to American banks; European home prices also soared. In Britain, in this same period, home values rose by 194 percent, in Ireland by 253 percent, and in Spain by 180 percent.<sup>171</sup> Banks tried to take advantage of this demand by loosening restrictions on mortgages and creating mortgage products that would allow more people (and less qualified people) to borrow. Many homeowners sought second mortgages on the increased appraised value of their homes, which helped fuel increased consumer spending. U.S. household debt as a percentage of income rose to 130 percent in 2007, from under 100 percent in 2001, and only 80 percent in 1992.<sup>172</sup>

The contraction of credit is both an issue of trust between banks and a more empirical problem of liquidity, as banks see the value of their own investments fall, and are unable to sell these assets to meet outstanding obligations. The IMF gave an early estimate of the cost of the American mortgage crisis (badly named, as it is more of a banking and bank supervision crisis than a crisis related only to home financings) at \$1 trillion.<sup>173</sup> The full impact, at the time of this writing, is not known.

A global banking crisis begs questions of accountability. Should the IMF have warned of a global financial contagion of the American mortgage crisis? Could the

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<sup>170</sup> See *The Economist*, "CSI: Credit Crunch," 18 October 2007.

<sup>171</sup> *Ibid*, *The Economist*.

<sup>172</sup> See *The Economist*, "America's Economy: Getting Worried Downtown," 15 November 2007.

<sup>173</sup> See reporting by Bloomberg News, "Credit Crisis Could Cost Nearly \$1 Trillion, IMF Predicts," *International Herald Tribune*, 8 April 2008. Also see, International Monetary Fund (2008) "Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness," IMF: Washington, available on-line: <http://www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm>. Managing Director of the IMF, Dominique Strauss-Kahn conceded that the fund "was not as vocal as it could have been" about the risks of a sub-prime financial crisis.

regulatory institutions of the American bank sector, including the Securities Exchange Commission, the Federal Reserve Bank, and the Office of Thrift Supervision do more to assess the risk of products (e.g., mortgage backed securities, special investment vehicles, bundled mortgages, etc.) banks held and sold? What kinds of social ties and network ties allow state bank supervisors, credit rating agencies, and private bankers to overlook these risks? These questions will fuel debate and policy changes for many years as scholars and financiers examine the vulnerabilities of the American financial system.

The relevance to this dissertation is the emerging evidence that even wealthy countries with complex and seemingly competent economic institutions also face problems in how formal and informal institutions interact. The findings here are an attempt to demonstrate that the policy response to financial crisis is subject to the interaction of formal and informal institutions, using evidence based on interviews from the twin financial crises (monetary and banking) in Bulgaria in 1996-1997 and in Ecuador in 1998-2000. This approach is an effort to explore how liberal advisory networks can alter the policymaking process in significant ways, using a more nuanced sociological lens trained on the sets of human relationships across national and international borders that define the governance of a national financial architecture.

The theoretical ambition of the dissertation is to complement existing approaches in the institutional literature on economic crisis, transition, and reform to more closely examine social ties between actors at the national and international level, specifically using the concept of advisory networks. The concept of networks helps to complement and drill down to a deeper level of specificity those theoretical explanations that focus on broader concepts like elite interest groups and corruption. By examining individual ties

and relationships, over the course of a liberalization process in many cases spanning two decades or more, the research and empirical evidence of these liberal advisory networks reveals new information on financial crisis decision-making and new ways of analyzing macroeconomic policymaking and bank sector reform. The dissertation makes an effort to establish measures of network strength based on findings from the case studies. The research identifies several key factors to a liberal advisory network's ability to influence monetary policy choice and subsequent reform in the bank sector. These factors are:

- 1) Academic links and bases of liberal ideological support, including opportunities for graduate study abroad in English, American, or Western European economics training, apprenticeships in foreign central banks embracing a liberal market ideology, and private study groups and “societies”, such as the Hayek Society in Bulgaria;
- 2) Network member ties to international financial institutions and international private banks and the use of unofficial policy drafting and advocacy;
- 3) The availability of foreign sources of aid to network members and initiatives, including government aid to central banks and training, and private aid to research initiatives by local network think tanks;
- 4) Network position in a domestic political environment as a prominent source of policy innovation, origination, and execution in contrast to existing political institutions such as the legislature, executive, and interest groups;
- 5) Network members' ability to transcend class and party identities and develop a professional identity and expertise based on an ideological commitment to liberal policy.

### *Summary of the Findings*

The dissertation has argued that informal rule-making institutions, namely advisory networks in the domestic and international finance sector, can influence the scope, timing, and legitimacy of extreme monetary policy and bank sector reforms attempted by formal rule-making institutions. The structure of advisory networks, including the network's position vis-à-vis other domestic political institutions, specifies the influence of informal institutions in the formulation and execution of monetary and bank policy. To measure and compare the structure of liberal advisory networks in each case, the dissertation explains their social origins, details membership identification processes, traces member ties between national and international institutions, and tracks tangible resources in aid and financing that the network is able to secure for its policy initiatives.

In Bulgaria, the social origins of the liberal advisory network can be found in the early pro-democracy movement among intellectuals and children of the *nomenclatura*—those with opportunities to study and live abroad under the socialist regime who find themselves in unique positions to reshape the political and economic landscape after 1990. The open field of the post-socialist landscape of the early 1990s allowed former professors and students to create new political identities and new organizations (specifically the proliferation of non-governmental organizations and consultancies) dedicated to the reform of the state and economy. These new organizations linked financial and social resources of the new liberal advisory network, channeling foreign aid money and ideas into the national political agenda.

In Ecuador, the social origins of the liberal advisory network are more complex. Centuries of entrenched wealth and power disparity between the landed-elite, white or *mestizo* population and the indigenous population make social identities more rigid.

Access points to educational opportunities and careers in economic policy are limited to a handful of students in limited institutions. Moreover, foreign interest in partnering with local expertise through consultancies and non-governmental organizations is scarce, as are the accompanying grant funds and resources.

The outcomes of both the dollarization and currency board programs in Ecuador and Bulgaria, respectively, are persistent weaknesses in the banking system—the financial architecture—in which supervision of bank behavior is lax or unregulated. Liberal advisory networks rely on dense networks formed over time and through existing academic and international institutions to manipulate or deter policy changes to the financial architecture. The more international in scope and well-funded these networks are, the stronger the network, as evidenced in Bulgaria. Stronger networks can isolate economic policymaking (specifically, monetary and bank reforms) away from legislatures and subsequent executives.

In Ecuador, the liberal advisory network lacked the same connections to international private banks and pro-liberal non-governmental organizations (NGO) and donors that sustained and legitimated the liberal advisory network in Bulgaria. The Bulgarian liberal advisory network was able to isolate bank reform and monetary policy reform from a subsequent socialist government. In contrast, the weaker and disorganized Ecuadorian liberal advisory network made little effort to influence policy goals or dialogue (and rather sought to maintain the status quo) when two leftist presidents with redistributive agendas took office in 2003 (Lucio Gutierrez) and 2007 (Raul Correa), respectively. Local liberal networks in Bulgaria enjoyed more international support (in the form of prestige and financing) from foundations and development agencies, making

their tenure as liberalization policy experts more durable and influential inside government.

In Ecuador, ties to outside liberal organizations in the form of academic institutions, development agencies and private foundations were few as the region lacked the urgency and priority in funding that post-socialist states received through the 1990s. Furthermore, the international banking industry has not established a significant retail or investment banking presence in the country. As a result, the Ecuadorian liberal network has relied on more personal contacts of nationals working within multilateral organizations (the International Monetary Fund and World Bank, specifically) and local businessmen and bankers.

In both cases, efforts to assimilate banking standards to the Basel accords (outlined in Chapter 2) have been led by the private sector and managed by private bankers who operated as key members of the liberal advisory network in each country. This expertise and proximity to the international benchmark--both as an institution and area of knowledge--allowed private bankers to implement (and impede) rules about banking supervision on their own timing and to their demands.

The dissertation finds then that countries with weak executives and formal rule-makers are often unwilling or unable to independently enact monetary and bank policy reforms because of the influence of powerful informal rule-makers. Conversely, those executives who are able to single-handedly create institutions to supervise bank action and change monetary policy are unsuccessful in their reforms without the support of a liberal advisory network across public and private banking spheres. The resulting instability in the finance systems in both instances is a problem of state consolidation of

authority in economic policy—the ability to enforce liberalism—rather than a disinterest in or failed effort to implement a liberal economic agenda.

In the cases, there are several key findings in common. First, the liberalization process—particularly the legislation to structure an open market—unfolds through the early 1990s in both countries. In Ecuador and Bulgaria, the beginnings of private bank-state relationships are roots of later bank crises. In Bulgaria, the tradition of state-owned enterprises and state banks with easy access to government capital via the central bank encouraged imprudent bank lending and bail-outs. In Ecuador, efforts to liberalize the economy were led by a series of pro-liberal presidents who used their authority to sustain unregulated bank practices (off-shore systems) and to bail-out private banks with government money when crisis loomed. The creation of the AGD went a step further to assure banks (rather than depositors) that their behavior would have little consequence or state intervention.

In Bulgaria, one finds a case of exceptional influence of policy advisors on the reform and rule-making of the bank sector. In the instance of crisis, a liberal advisory network and a pro-Western, pro-market prime minister came to power with lasting effects. The liberalization of the bank sector that goes along with the currency board plan is supported even after the liberal-minded prime minister left office and a socialist government took control. This lasting hesitation to legislate and extend supervisory governmental control over the bank sector is due to the kinds of ties between central bankers (as policy technocrats) and private bankers. Their ties enable them to dominate the political issue of reforming and supervising the bank sector, making these private citizens and public servants a key political force. Their political strength endures

successive governments because this advisory network is also tied to outside sources of financial and ideological support.

In contrast, in Ecuador policy advisors within a pro-liberal government had strong influence as individuals with personal contacts during the currency crisis and in conceiving the dollarization plan. However, when the pro-liberal administration fails, these policy advisors cannot rely on strong ties with external sources of support, nor does the private bank sector keep close alliances with the reformed central bank. The liberal advisory network is weak and shallow. What few advisors remain move to the private sector, or find work in subsequent governments of more statist or leftist political orientation. Economic policies, particularly regarding the reorganization of the central bank and the two other bank supervisory agencies (the AGD and the *Superintendencia de Bancos*) have been slow to change, even as two successive left-leaning administrations (Gutierrez in 2003, Correa in 2007) assumed office. Correa has made the most substantial efforts to reorganize the central bank and assume control of monetary authority in the executive office. How those policy changes will unfold remains to be seen.

In both cases, the private sector and the public bank sector are striving to meet an unenforceable international standard, the Basel Accords. The ephemeral nature of the international benchmark is part of the problem in creating verifiable checks on the private bank sector. Ecuador and Bulgaria have not had the global support of norms and formal institutions on which to model their bank sectors. Furthermore, the Basel standards are widely considered to be weak and unable to contain financial crisis even in well-developed capitalist economies.

***Theoretical and Empirical Contributions to the Literature***

In this dissertation, the opposition of formal versus informal institutions helps reveal, both descriptively and analytically, different kinds of state-bank relationships in the regulation of a liberal market economy. The analytical focus has been to develop a concept of informal institutions, namely networks, because they are an understudied measure of economic behavior and economic institution-building. In both country cases, networks—a principal kind of informal institution—play a central role in the decision to shift monetary policy to dollarization and a currency board, respectively. Networks also influence how state authority in the regulation of the bank sector proceeds after monetary stabilization. Networks are means of communication, of legitimating ideas and policies, of transferring human capital between the public and private sectors, and of initiating or delaying institutional change. The personal level of interview data reveals the specific ties (or nodes) between network members and places these ties at moments of economic institutional change and crisis. Furthermore, the detailing of individual ties maps a policy process with a level of specificity that a large-N study or aggregate country data cannot convey.

The case study chapters of the dissertation detail how networks (one kind of informal institution) are also vital to economic policymaking and planning at the national and international level. Social ties and advisory networks are important, though often unexamined, mechanisms of economic institutional change. In explaining the choice to pursue a restricted monetary policy and to attempt to restructure banking systems, the dissertation explains how liberal advisory networks can alter the policymaking landscape in significant ways. These informal institutions can resolve problems of continuity in policymaking between administrations and generate relationships between national and

international finance institutions that prioritize and convey economic ideas and produce policy options (and repress others). The absence of a strong advisory network can weaken a policy process as well, creating policy inertia or a path dependency, such as the stalemated purpose of the AGD in Ecuador.

At the least, a final goal of the dissertation is that it might convey the importance of expanding the research agenda in monetary and bank reform policies to include a closer examination of advisory and social networks as possible and capable sources of significant influence in the policy process. In addition to existing explanations in the literature on macroeconomic policy choice and reform of economic institutions after crisis, a focus on advisory networks and informal social ties can expand the research agenda in case studies to include a ground-level understanding of a policy process. The microscopic approach to individual ties, their bases in social structures, and the specific interaction between actors in domestic and international institutions, all provide a full and rich description of the kinds of negotiations and the immediacy of decision-making in moments of macroeconomic crisis and bank sector reform.

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