



## Individual Advanced Research Opportunities Program

### Research Report

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Please respond to the following questions, using the form below as a template. Research Report, along with your Final Report, is due within 30 days of the end of your grant. Please e-mail your Final and Research reports to [iaro@irex.org](mailto:iaro@irex.org).

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1. Title of Research Proposal:

The Social and Political Consequences of Restricted Monetary Policy in Bulgaria

Part of a dissertation project currently titled:

“The Politics and Process of Economic Reforms in Ecuador and Bulgaria After Monetary Stabilization” – a Comparative Case Study of Banking Reforms and their Relation to the Informal Economy in Post-socialist and Developing Political Economies

2. Topic of Research

The dissertation compares how two states, diverse in political history and cultural legacies, Ecuador and Bulgaria, have elected similar economic policies with similar political and social ramifications. In each country, hyper-inflation and a weak banking system caused an economic crisis that toppled the ruling government and led to a severe and rare economic policy choice, a “restricted” monetary policy—to dollarize in

Ecuador, and to create a currency board in Bulgaria. While lowering inflation and encouraging foreign investment, the policies did not resolve the problem of the informal economy, nor did the policies create an environment in which citizens trust their government's ability to provide economic stability and to create institutions responsible for furthering broader development goals. The research seeks to explain how the credibility of the reform process, the networks involved and past experiences with crisis perpetuate the informal or "grey" market, and why international understandings of economic stability may differ from domestic perceptions.

In a broader sense, the dissertation asks why some countries across regions are better able to implement a liberal economic reform agenda; and secondly, why do we see similar results in certain reforms across post-socialist and developing economies? It evaluates the process of the post-socialist transition when economies are decidedly "open", yet particularly vulnerable to the shocks of the international economy, and the political pressures to ameliorate the effects of 15 years (or more) of liberalization on marginal groups and the working poor in both the developing and post-socialist world.

### 3. Relevance and Contribution to Field

#### Contribution to the Field

This research is based firmly in the field of comparative political economy, within Political Science. The dissertation seeks to address a major question in development studies across political and economic histories—why are some countries better able to implement a market-friendly economic reform agenda than others? And, why do we see similar results in economic reform policies across post-socialist and developing economies? The methodology and the literatures it engages are, however, more interdisciplinary. My dissertation is in conversation with literature and research in economic sociology, particularly those studies that question the "logic of the market" and emphasize the importance of economies based in social networks and social relationships, what Polanyi called "social embeddedness of economic relations." (Polanyi, Granovetter, Fligstein) The research also considers anthropological studies of value in major economic and social transitions. (Woodruff, Verdery, Stark and Bruzt; Eyal, Szelenyi and Townsley) And, of course, the study uses a subject of macro-economics, monetary policy, to reveal the political and social influences, what some political economists and institutional economists call "informal institutions" of both the policy choice and the policy outcome. (North, Knight, Levi, Weingast, Helmke and Levitsky)

This research is particularly relevant to post-socialist and East European studies because it evaluates the process of the post-socialist transition in a moment when economies are decidedly "open," yet particularly vulnerable to the shocks of the international economy, and the political pressures to ameliorate the devastating effects of fifteen years of liberalization on marginal groups, ethnic minorities and the working middle class. In comparison, it also establishes similarities in policy advice and outcomes in developing economies, using an example from Latin America, indicating the importance of understanding efforts at establishing liberal markets and mechanisms for generating stable economic growth. The working title, "After the Money Doctors Leave" suggests that there is a period of policymaking and domestic "coming to terms"

with the advice of international financial advisors that follows a severe change in economic policy, such as a dollarization or currency board plan.

The topic also delves into the problems of measurement in analyzing economic growth and “development” in transition environments. Benchmarks are likely to be set by international financial institutions (IFI’s), yet the interaction of the IFI’s and governments, and importantly, their business and banking elite, are often off of the internal critique radar of the IFI’s and the international investor community. The shortcoming is that institutional advice, such as when to suggest a credit bureau, or why certain currencies and certain private banks are recommended as safe-holders of government (and public) funds often goes without question or analysis.

My research has traced the process of the advisement of the currency board (and dollarization plan, in Ecuador) and the reorganization of the banking sector (central bank and its supervisory capacity, plus the new institutions created to assist in the development of a private banking system), as well as correlating these institutional changes to public perceptions of credibility in the government’s economic policy, and general indicators of stability and trust in different kinds of public and private institutions. My argument is unique, or at least uncommon, because it builds on studies in institutional economics, development policy and new understandings of informal institutions (norms, networks and rules of behavior) that are changing the way many scholars are approaching inequality and governance in a “globalized” international political economy.

#### 4. Approach and research methodology; list of research sites

##### Research Design and Methodology

The central research question is, “What explains the persistence of the informal economy after a restricted monetary policy is in place?” The economic reforms are expected to transition both post-socialist and developing economies into “formalized” or “rule of law” capitalist systems. One of the challenges in promoting and establishing liberal or capitalist political economies is the process of “institutionalization”, which is generally focused on rule of law and protection of property rights. In this research, the analysis looks at the challenges of and responses to the policies mandating the value, exchange and emission of money as key components of this institutionalization process in emerging liberal markets. The case selection is based on the two largest cases of restricted monetary policy, in terms of population size and size of the economy (GDP). The cross-regional approach purposively links problems of post-socialist and developing political economies.

Explanations (hypotheses) for the persistence of the informal economy after restricted monetary policies include: 1) The sequence of banking reforms that followed the restricted monetary policy delayed establishing credibility and confidence in domestic capital markets, privileging government debt and public enterprises that were “late” to privatize. 2) The way in which rules were created about how money would be lent, how borrowers would be compared, and when the state might intervene in exchange relationships signaled an “insider” process to economic actors, thereby legitimating further informal (or non-legal based) exchange. 3) Network relationships between international financial institutions and government decision-makers (e.g.,

finance ministers and central bankers) and between private banks and government decision-makers often determined the scope and speed of banking regulation reforms that delayed building credibility among domestic constituents. 4) Established norms and practices of informal exchange (barter, cash economy, family and social networks) formed during periods of economic crisis and political instability were reinforced by the non-credible nature of reforms regulating money following the currency board/dollarization stabilization plans.

The testing methods and sample populations include: extensive elite-level interviews with advisors in the US Department of Treasury, the International Monetary Fund, central bankers, private bankers, lawmakers and economic policy technocrats; thick description of a selection of social network cases; quantitative survey data on credibility from the International Finance Corporation and national statistic institutes. I am using measurements from existing surveys on the informal economy in Bulgaria (conducted by: IME, Center for Social Practices, Center for Liberal Strategies, Institute of Sociology in Sofia University), which have detailed both small business and household confidence in economic policymaking, including a specific measure of confidence in the currency board. I will use these sociological studies, data on cash to deposit ratios, indicators of available finance (mortgages and personal loans) combined with my interview materials to: 1) build a picture of how society responds to economic policy reforms and 2) describe why confidence and trust in a reform process can perpetuate or diminish informal economic practices.

## 5. Research findings and preliminary conclusions

### Project Description

The dissertation seeks to compare how two very different states, in terms of political history and cultural legacies, have elected similar economic policies with similar political and social ramifications. In each country, hyper-inflation and a weak banking system caused an economic crisis that toppled the ruling government and led to a very severe and rare economic policy choice, a “restricted” monetary policy—to dollarize in Ecuador, and to create a currency board in Bulgaria. These monetary policies were both recommended by the International Monetary Fund and, in some part, by the US Treasury Department and/or the US Agency for International Development. The policies, enacted in 1997 in Bulgaria and early 2000 in Ecuador, achieved their goals of lowering inflation and creating a favorable environment for foreign investors. Monetary stabilization created credibility among outsiders and the international finance community. The policies did not, however, resolve domestic problems like the informal economy (what some call the grey economy or black market, the under-reporting of tax and social security obligations to the state, a social preference for cash exchange and a low cash to deposit ratio within the banking system.) The policies and the subsequent banking reforms and new financial rules do not seem to generate confidence and credibility among insiders—everyday citizens, small business owners and entrepreneurs—evidenced by the importance of informal economic practices, survey data of public trust in economic policymaking, and interview data among both policymakers, public finance experts and private business people.

I call this disparity in international institutional advice and domestic social and economic behavior a difference in international and domestic credibility. In my research, I am conceptualizing domestic credibility as a complex measure of how individual citizens trust the state and its ability to regulate the economy, how money is transferred and safeguarded, and the frequency of legislative efforts at curtailing unregulated or grey economy growth. Credibility in the institution of money (and the rules and rule-makers that uphold the value of money) is a critical challenge to both developing and post-socialist economies as both are subject to pressures from external economic shocks, the advice and credit of both public and private financial institutions, and to their domestic political communities. This credibility is established by the political process of regulating the value, emission and exchange of money, the frequency of cash exchange, credit-lending patterns (in personal versus corporate financing), tax reporting, and the practice of decision-making and exchange based on networks and personal relationships, rather than regulated or state-verified interactions. In short, what creates credibility domestically, and why might informal economic institutions prevail after international credibility is established through lowered inflation and market-friendly policies for foreign investors? What process of rulemaking and economic institution building after stabilization might coordinate the credibility problem among domestic constituents and international interests? And why might these two sets of interests be opposed?

My research looks at how certain legislative reforms, particularly in banking regulations and central bank supervisions, have evaded or chosen not to address the issue of the informal economy based on a rationale of the free market. Legislation covering the regulation of banks to give personal loans for mortgages and small businesses, to major corporate lending have favored a logic of market competition, rather than tackling a concern for some of the informal institutions (norms, social practices of trust and value exchange) that prolong the practices of the informal economy. In addition, the research suggests that ways of economic decision-making in both political economies are informed by a series of social networks and trust networks that operate from the highest levels of government ministries, international financial institutions and corporate businesses to the lowest levels of women's cooperatives and family enterprises. Domestic institutions, in this research exemplified in banking and credit regulatory systems, are "un-credible" and social networks tend to facilitate business and everyday exchange in ways that perpetuate the existence of the informal economy, further hindering the state's ability to collect taxes, plan for social expenditure, and shield citizens from external economic shocks.

Findings from five months of interviewing and field research in Sofia reveal a slow reform of banking institutions with intensive mediation and intervention by the US Agency for International Development (USAID), the US State Department, as well as surprising actions on the part of IMF advisors. My research suggests that the period following the policy implementation continues to rely on outsider interventions, and that many non-financial related policy issues can influence the unexpected and mundane world of bank supervision and technical assistance programs to the financial sector. I expect to find similar relationships between international financial advisors and banking/political elites in the Ecuadorian case. I have further developed quantitative indicators of domestic and international credibility using the surveys from the World

Bank the International Finance Corporation (IFC), as well as survey results from independent research organizations based in the case countries, and multi-national surveys. My dissertation will elaborate the findings of these combined survey measures and identify a new mixed qualitative and quantitative approach to understanding the politics of economic reforms in crisis environments—a measure that will be applicable to both developing and post-socialist political economies.

The goal of the research and the analysis within the dissertation is to document how reform advice processes often neglect a systematic understanding of the sequencing of banking and financial institution reforms in the context of their sociological effects. The research also strongly suggests that political maneuvering on a grand scale, in terms of war time negotiations and military planning to elite corruption within international financial institutions, often determine specific economic policy choices, and new institutional design in these fast-changing markets and states. Interviews conducted at the highest levels of central banking, private banking, the International Monetary Fund, the US Agency for International Development and among academic experts legitimate these findings. Subsequent research, for a shorter period, is planned for early spring of 2006 based in Quito, Ecuador.

#### 6. Future research agendas

After completing the research component in Ecuador and writing the dissertation, I hope to do follow-up research in both countries to complete a book based on the dissertation. I would also like to work with scholars studying similar cases within both regions and perhaps try a collaborative writing project, I would be particularly interested in working in a cross-disciplinary project involving sociologists studying the effects of trust and networks and economists studying the role of “Money Doctors” in reform environments across the post-socialist and developing economy landscapes.

#### 7. Policy recommendations

At this point, it is too early to make concrete policy recommendations, but I think it is clear that economic reform advising needs to evaluate the evidence of growing informal economies where severe or restricted monetary policies are in place, and why there might be a disconnect between international and domestic measures of credibility. I look forward to learning more and being able to write with more confidence about what kinds of policy options and government to IFI agreements might be more comprehensive and capable of promoting sound growth policies.