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ABSTRACT

HOW THE GOBAL FINANCIAL CRISIS AFFECTS EASTERN EUROPE: FINANCIAL REFORMS , PRIVATE SECTOR IMBALANCES AND RISK FACTORS.

Former 'command' economies have evolved along the path of reform processes that have entailed increasingly monetized systems, with a larger domestic banking and financial sector relative to GDP.

This goal, deemed crucial for a rapid transition to the market, has been achieved in the context of low government debt/GDP ratios and relatively low levels of fiscal imbalances. In fact, the surging integration of these countries in the global economy , in a period of high rates of international capital flows, has been characterized by an observed dominance of private capital in such movements, both in the West and in the East. This has taken - among others - the form of Western (especially European) banks' penetration in Eastern financial markets, together with increasing foreign private direct investment.

This state of affairs is now attracting increased attention in the face of the current global financial crisis.

The paper reviews the literature on financial crises that puts a special stress on bank fragility in developing economies (starting with the path-breaking analysis of the Chilean crisis by Diaz-Alexandro ) and the more recent studies of the effects of external financial liberalization on economies in transition. In the context of over a decade of private sector and financial reforms, a distinction is made between countries that have, or have not, gained direct access to the European market.

The differing features of reform and integration in the global economy, resulting in differing levels of domestic financial development and private sector imbalances, are used to make a tentative assessment of the vulnerabiliy of a set of former 'command' economies to sudden reversals of foreign capital inflows, which now appear very likely in view of the global financial and economic crisis.