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1. The spread of the global financial crisis to Eastern Europe: Evidence from leading indicators and the impact of exchange rate regimes.. 1

The spread of the global financial crisis to Eastern Europe: Evidence from leading indicators and the impact of exchange rate regimes

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Abstract: This study expands on the literature on the global financial crisis of 2007-2008 and investigates whether leading indicators used successfully in previous studies can explain the incidence of the 2008-09 global financial crisis on Eastern European countries. We also investigate whether the exchange rate regimes adopted affected how strongly the crisis was transmitted to the real economy of the CEE's. The global financial crisis of 2007 has affected economies across the globe. While some experts have pointed out that the crisis affected countries globally with severe consequences but the spread was slow and unlike other crises in the past (Willett et al, 2009), others (Berglof et al 2009) argue that decoupling has taken place. Past studies have found reserves to be a leading indicator of the current crisis (Frankel and Saravelos, 2009) while others find no evidence (Rose and Spiegel, 2009a, b). We dwell on this conflict. Past exchange rate overvaluation, stock market indices, industrial production and the exchange market pressure index were the most useful crisis incidence measures in this study.
Using cross sectional data, we find that bank liquid reserves to bank asset ratio and rise in credit, both proxies for banking system vulnerability and public and publicly guaranteed debt were consistently statistically significant indicators of the financial crisis for the Eastern European sample. Three key findings emerge from our study measuring the impact of exchange rate regimes. First, countries running floating exchange rate regimes in the CEE's were more likely to withstand the shock from the crisis than those running fixed exchange rate regimes, a result similar to Dietrich et al, 2011. Secondly, richer countries prior to the crisis were more likely to perform worse during the crisis than poor countries, a result that mirrors those of Frankel and Saravelos (2010). Thirdly, the measure of current account, the ratio of current account to GDP was important in explaining the amount of transmission to the CEE's. Countries with higher ratios of this measure before the crisis performed more poorly during the crisis than those with lower ratios.

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