Financial Instability and Economic Growth in Transition Economies

Savvas Zachariadis

Abstract The paper focuses on the fiscal and financial position of European post-socialist countries prior to the Global Financial Crisis (GFC) of 2007–2009 and afterwards. It highlights the impact of the transmission of crisis and the changes that have been ensued in terms of the pattern of economic growth. For this reason, it reviews the relation of higher GDP growth rates and the deepening of financial development, a model that had been adopted by the majority of countries until the outbreak of the crisis. More precisely, emphasis shall be given to Bulgaria, Romania, and the Baltic States due to the fact that these countries had experienced the most intense effects. Furthermore, we incorporate Minsky's financial theory in order to identify the resemblances of the theory with their domestic financial systems and to reveal the weaknesses and vulnerabilities of their fiscal and financial stance. The scope is to indicate that the pursuit of a rapid accelerating GDP growth rates based solely on the financialisation of the economy does not constitute a panacea policy for total economy. Thus, we display relative macroeconomic data in relation with growth GDP rates ex ante and ex post the crisis. Hence, we address the issue that the advent of Global Financial Crisis has induced the countries under examination to moderate their economic policy of credit expansion and high indebtedness towards more balanced and steady growth pattern at the expense though of lower annual GDP rates.

Keywords Growth · Global crisis · Minsky · Financial · Instability · Capital flows

JEL Classification F43 · G01 · F36

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1 Introduction

The rapid growth model grounded on capital inflows has been inextricable intertwined with the financial deepening process. Romania, Bulgaria and the Baltic Stateshave experienced rapid growth models until the outbreak of the crisis in 2008 when a plunge was ensued. Large capital inflows in association with greater financial integration, and domestic ownership of financial institutions consist of main features of the economies. However, during the period of accelerating growth until 2008, financial vulnerabilities were built up as well. Minsky in his theory has delineated the credit cycle process that bears resemblance with the course economies have traversed. By 2011 and onwards, economies have recovered but GDP growth rates have been relatively modest. Thus, the paper highlights the contradiction between these fiscal and financial positions.

2 The Impact of Financial System in Economic Growth

According to the dominant paradigm in economic theory, an efficient financial system can stimulate rapid economic growth. In general, financial intermediaries encourage the efficient allocation of capital to investment production and eliminate the liquidity risk. Thus, the financial system sways investment, saving, and ergo economic growth. Schumpeter (1911) mentioned the positive impact of financial development in economic growth, since banks provide financial assistance to entrepreneurs' investment projects. The same conclusion had been deducted later on (Gurley and Shaw 1955; Goldsmith 1969). King and Levine (1993) refer that an efficient financial system constitutes a key factor of economic growth. According to Beck et al. (2000) the development of an efficient financial system is an important determinant of economic growth. Levine (2005) suggests that financial markets can boost economic growth by providing payment services, liquidity, information, thus facilitating the trade of goods and services, by moving deposit capital to productive and tradable sector. Cojocaru et al. (2012) redounded that credit to the private sector is a positive factor in promoting economic growth except for periods of hyperinflation. As far as economies in transition are concern, they abutted that financial efficiency positively influences economic growth (Cojocaru et al. 2015).

Financial development boosts growth via the channels of capital accumulation, human capital, and total factor productivity. Each of these functions certainly depends upon regulatory and legal framework that is applied to each country. La Porta et al. (1997) consider the regulatory framework and institutional structure of each country as a crucial element of the positive impact of financial system on growth. The terms reform and liberalization were quite popular at the beginning of the 1990s in Bulgaria, Romania and the Baltic States. In this way, the policies that have been followed accommodated the development of a liberal financial sector under the standards of

foreign advanced countries. These policies involved legal and regulatory structures that encouraged the new financial system to grow.

3 Financial Development and Economic Growth in Romania, Bulgaria, and Baltic States

The reform of the financial sector initiated in early 1990s and was accompanied with the transition process towards market economy. There has been a serious challenge to transform from a heavily regulated economy to an open and liberalized market. It was not the same case for all post-socialists countries but heavy regulation had been applied in Bulgaria, Romania and the Soviet Union (including Baltic States).[1] The countries were committed to strive towards structural reforms as a perquisite to join EU, where their accession in 2004 and 2007[2] had been a contributor factor to pursue convergence with rest of EU countries. Romania and Bulgaria have traversed similar route towards European integration and accession. Accordingly, Latvia, Lithuania and Estonia had indicated impressive expansion, even referred as the Baltic tigers.

The countries started to alter their financial systems in accordance with international financial systems. The banking sector had been the driving force of financial sector. The new legal framework allowed the operation and development of private banks, which were entitled to trade, invest, cooperate, and generally to provide the financial services a regular commercial bank offers. Therefore, new private banks were permitted to operate internationally, attracting the interest of foreign financial institutions and investors. Within a decade, foreign banks[3] took control of the majority of domestic banks (Fig. 1), whereas Estonia displayed the highest share verging on 100%. The above fact had been catalyst for the expansion of banking sector.

The contribution of foreign banks to the development of their financial systems was notable. They totted the missing know-how methods, financial products, innovations, and newest technology to fit in the domestic banking system. The new foreign-owned banking environment enhanced the efficiency of domestic financial system, credit, competition, attracting foreign capital inflows and investments, and hence boosting economic growth.

Therefore, economic growth has been accelerated from the beginning of 2000s and was mainly driven by credit growth and large capital inflows. The Baltic States performed an unprecedented GDP growth, exceeding even 10% (Fig. 2). Over the years 2000–2007, Latvia had recorded the highest GDP growth with average rate of

[1]During the Communist period not only all countries shared the same degree of centralization. For instance in Hungary, Poland and the former Yugoslavia some independence was given in firms but for Bulgaria, Romania and the Baltic countries, as members of the Soviet Union, the status quo was quite different.

[2]Romania and Bulgaria have joined EU during the second enlargement wave in 2007.

[3]Mainly by Austrian, Belgian, German and Italian banks.

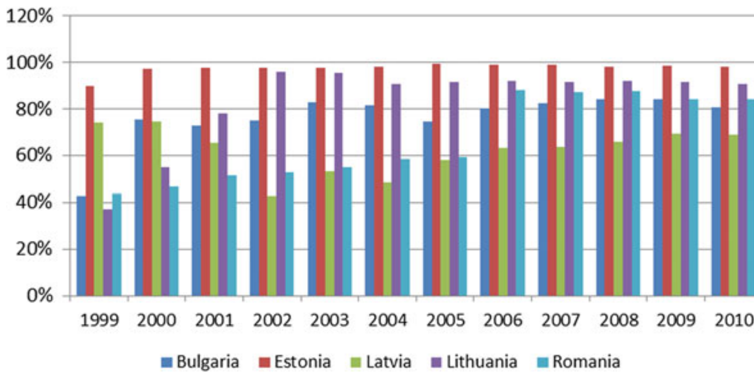

Fig. 1 Foreign ownership* share %. *Source* EBRD Banking Survey. *Foreign ownership defined as banks with assets of foreign ownership >50%

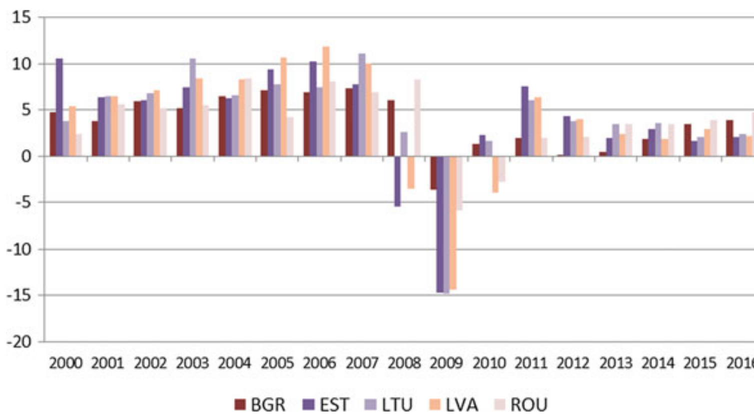

Fig. 2 GDP growth rates. *Source* World Bank

8.5%, Estonia with 8%, and Lithuania around 7.5%. It should be noticed that Bulgaria and the Baltic States had fixed exchange rate parity to euro and that accommodated the impressive increase in GDP. Bulgaria and Romania had presented an average GDP growth of 5.9% and 6% respectively from 2000 to 2008. During the period of the transmission of crisis (second half of 2009), all countries had displayed negative or very low GDP rates. From 2011, all of them have positive rates but they have never reached the levels of pre-crisis period.

GDP per capita augmented even to 10%, particular in Baltic States and then plunged approximately to −14% (Lithuania) in 2009. Although Romania remained in floating rate regime, still, there was a 10% increment in 2008 (Fig. 3).

During the transition process, it is normal to present higher rates of growth as a result of the convergence process. Besides, neoclassical theory states that growth is higher for emerging economies, but also the faster a country grows, the further

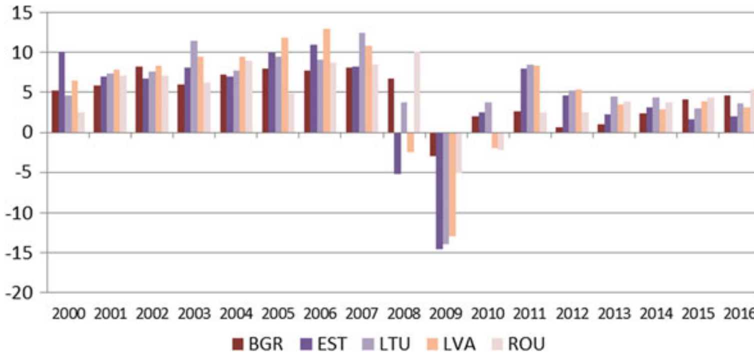

Fig. 3 GDP per capita growth. *Source* World Bank

away deviates from its steady state. Except for financial development, similarly the international trade, technological transfer, privatizations, higher competition, skilled labor force, deregulation, all of them have contributed to enhanced economic activity.

The gross fixed capital formation (GFCF) had reached an average of 30% but after the crisis it has been stabilized in an average rate of 20% (Fig. 4). However, private consumption had the major impact in growth between 2000 and 2008, as it is depicted in Fig. 5. Public and private consumption still comprises the highest GDP percentage for all countries exceeding an average rate of 75%.

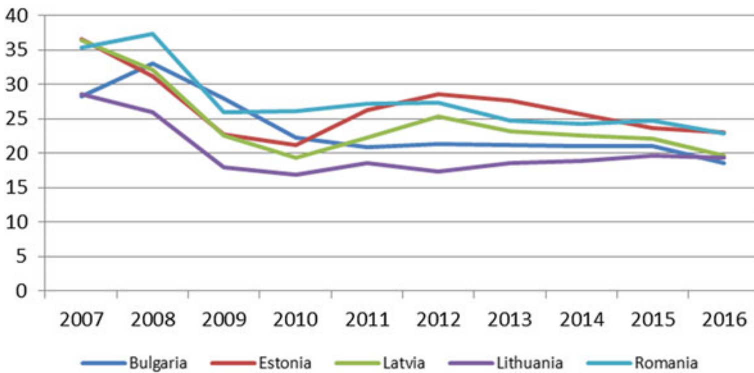

Fig. 4 Gross fixed capital formation (investment at current prices) % of GDP. *Source* World Bank

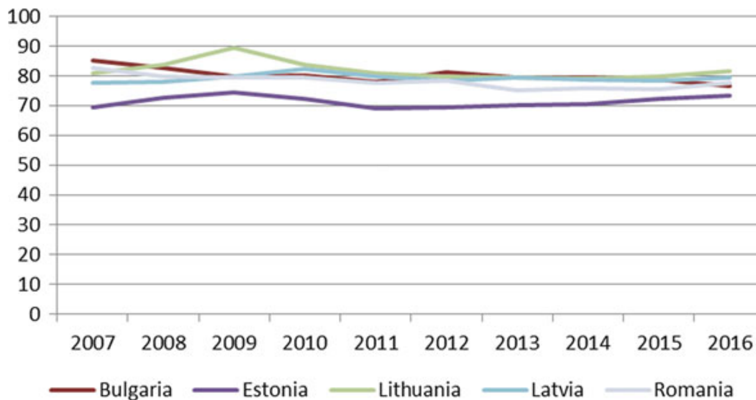

Fig. 5 Final consumption expenditure (% of GDP). *Source* World Bank

4 Credit Expansion and High Indebtedness

In Baltic countries, Romania and Bulgaria, the growth model was associated with greater external indebtedness. Becker et al. (2010) state lending had been the determinant factor of the enhanced domestic consumption until the onset of crisis. Capital inflows and credit expansion include foreign direct investment (FDI), cross-border borrowing by banks and non-financial corporations, speculative capital short-term flows for portfolio positions, where the latter is characterized as volatile flows for financial stability (Leigh et al. 2007). By contrast, FDI consists of investment that establishes a lasting interest in domestic economies. Bulgaria and Estonia have represented the largest flows of FDI until 2008, but hence the average rates have not surpassed 5% (Fig. 6). Bulgaria and Romania have been rather attractive for foreign investors who were interesting in labor intensive production.

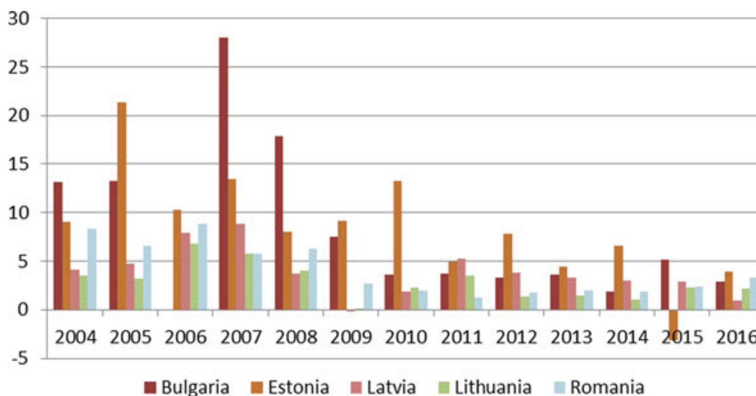

Fig. 6 Foreign direct investment (flows) % of GDP. *Source* Eurostat

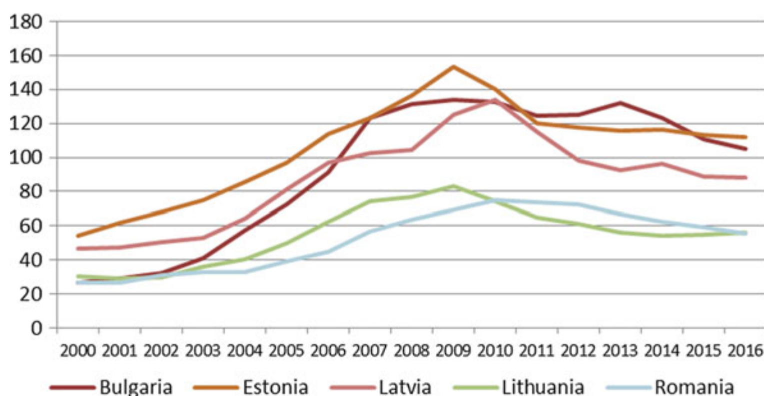

Fig. 7 Private sector debt % of GDP. *Source* Eurostat

Furthermore, agents and corporates were engaged in debt by acquiring the innovative financial products. Private sector lending has been one of main determinants of GDP growth. The debt of private sector[4] (firms and households) to GDP exploded (Fig. 7), which implies that domestic demand has been mainly financed externally in form of loans. By 2000, all countries indicated a private sector debt below 50% but until 2008 it soared up to 100% of GDP (Latvia, Bulgaria, and Estonia).

Additionally, the new banking sector inspired confidence to households inducing them to be engaged in more credit. Therefore, households were associated with indebtedness, especially in the forms of credit cards and mortgage loans[5] (Fig. 8). Estonia and Latvia presented household debts over 50% from 2008 to 2010. Households expected wage increases in near future as a result of income convergence policies but that also entails the deepening of current account deficit. The combination of low interest rates and higher income levels assisted households to increase their expenditure levels and validate their debts.

5 Vulnerabilities

Vulnerabilities involve the other side of the coin of rapid accelerating growth since they have been simultaneously enhanced. The financial system of Baltic States, Romania and Bulgaria could be regarded as bank-based oriented. That repeated cycle of credit growth expansion had led to economic growth, but was based on credit and capital inflows rather than in productivity. That process enables the augment of

[4]The private sector debt is the stock of liabilities held by non-financial corporations and households and non-profit institutions serving households. The instruments that are taken into account to compile private sector debt are loans and debt securities.

[5]The mortgage lending growth was also related to rapid growth in house prices resulting in an overvaluation of house prices.

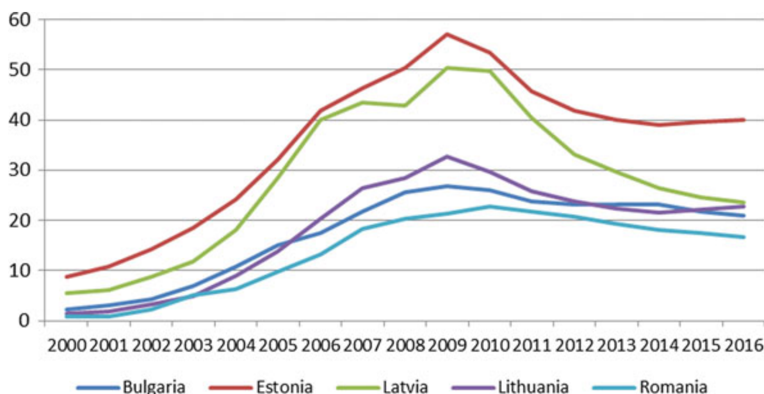

Fig. 8 Household debt % GDP. *Source* Eurostat

growth rate in a rapid pace favoring short term financing but at the expense of long-term investment projects, resulted in large external imbalances. Government deficits were growing until 2009, deteriorating countries' fiscal stance (Fig. 9).

The mixture of large capital inflows, credit expansions and loans led to aggravation of their current and financial account balance for almost all countries and higher inflation (Figs. 10, 11 and 12). The negative current account in Bulgaria and Latvia had overpassed 25% and 20% respectively in 2007.

Figure 12 summarizes the net borrowing position all countries had adopted prior to crisis. It indicates the sum of total current and capital accounts' balances in the balance of payments. It had been negative from 2000 to 2008 showing that countries were in borrowing need with limited financial capacity.

The pegged exchange rate has attracted large inflows of short-term lending from European banks but that deteriorated trade balance and the balance of payments.

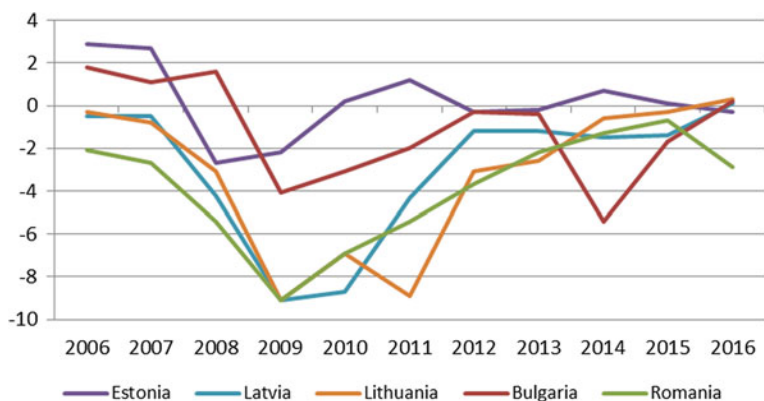

Fig. 9 Government deficit/surplus % of GDP. *Source* Eurostat

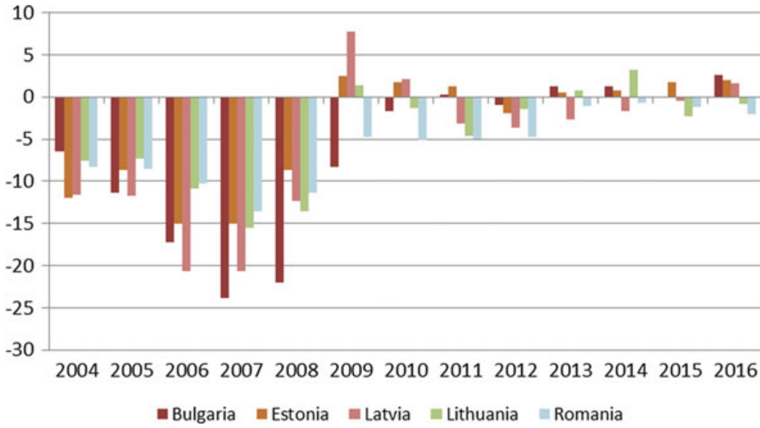

Fig. 10 Current account balance % GDP. *Source* Eurostat

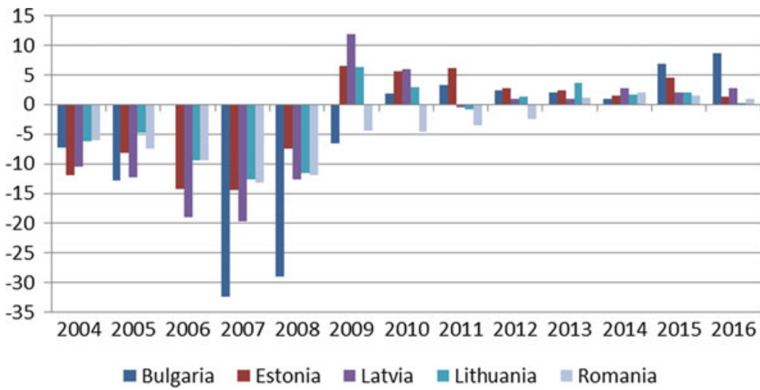

Fig. 11 Financial account balance % GDP. *Source* Eurostat

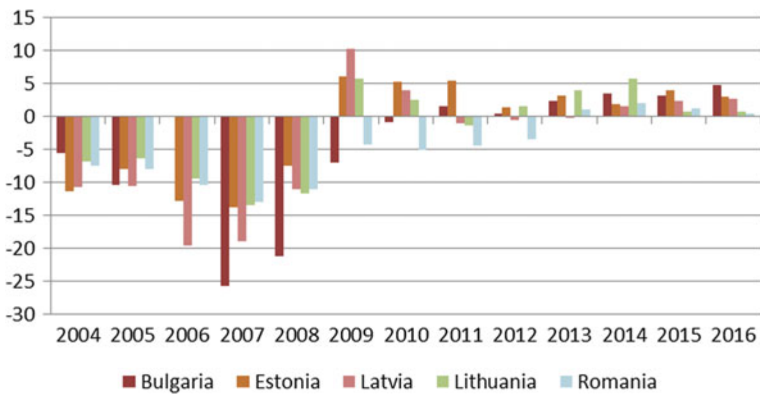

Fig. 12 Net lending/borrowing (current and capital account). *Source* Eurostat

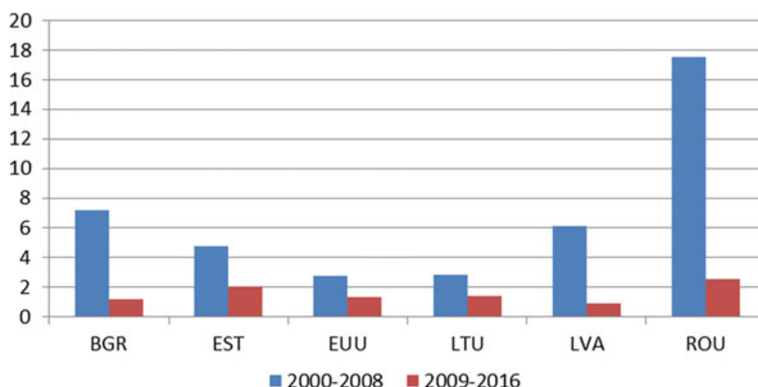

Fig. 13 Inflation, consumer prices %. *Source* World Bank

Bulgaria and the Baltic States with fixed exchange rates denoted higher credit expansions with relatively low interest rates. However, fixed rates would not facilitate these countries to deal with crisis by applying their monetary tools.

After the initial phase of credit expansion, banks become overconfident in terms of creditworthiness and optimism neglecting the implications of a distortion. As we have already mentioned, local banks were local subsidiaries and as a result there was increased reliance for loanable funds. Consequently, demand becomes dependent to domestic banking, which in turn was exposed to external factor. At banking sector vulnerabilities, the rising loan-to-deposit ratio (Fig. 14), especially for Baltic States, indicates that deposit growth could not keep the pace with credit growth.

Banks consist of the driving force of domestic economic activity. Notwithstanding, financial stability is not assured by financial development via foreign banks whilst their presence does not guarantee liquidity in times of distortions (Winkler 2009).[6] Therefore, liquidity may be withdrawn by subsidiaries from these emerging markets to meet their home banks' needs (Mihaljek 2009).

The domination of domestic banking by foreign banks automatically made them susceptible to any exogenous financial distortion and hence contagion effects. De Haas and Van Horen (2012) have shown that large international banks in financial crises can create cross border contagion effects across countries, potentially leading to reduction in their output. Even if there is insolvency avoidance or deposits guarantees policies, these cannot be sufficient enough in cases of contagion crisis in international level. The reason is the liquidity shortage and hence vast amount of funds will be required, since all products and financial transactions are internationally traded and cleared.

[6] An empirical example also stems from Peak and Rosengren (1997) who note that when Japanese banks experienced losses due to a decline in the stock market, their subsidiaries in U.S. have reduced lending more than the parent bank in home market. Also, when a foreign subsidiary bank in Croatia suffered large currency losses in 2002 the parent bank did not act as lender of last resort.

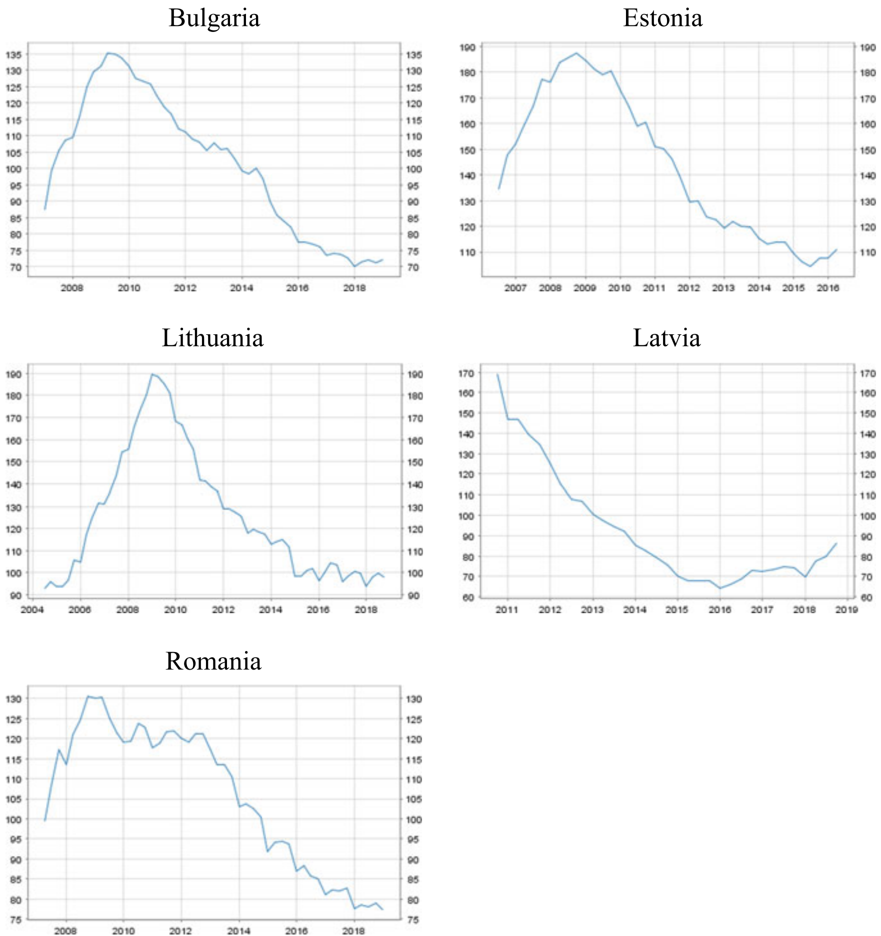

Fig. 14 Loans to deposits ratio. *Source* ECB

6 The Global Financial Crisis and Channels of Transmission

The global financial crisis was spread via international trade and financial linkages.[7] The Minskyan financial cycle was apparent in the US subprime crisis where the boom phase commenced with an enhanced securitization of mortgages, mainly debts as a result of the introduction of financial innovations and the bubbles in real estate sector.

[7]A decrease in the price of a basic world-wide traded good, such as wheat or cotton, it is possible to influence markets, economies and domestic financial systems even if the initial shift in price has emerged somewhere else. That is because the determinant factor is the amount of the leverage of speculators and the vulnerability of these markets.

Even though the crisis originated from an advanced country, it provoked a cessation of external capital flows. International investors started to withdraw in their attempt to move towards safer positions. Whenever a financial disruptive takes place, the implications are not limited in the financial sector but it could carry away other sectors of real economy.

Contagion and spread effects have appeared to Bulgaria, Romania, and the Baltic States due to high trade and financial interdependence. The global financial crisis has influenced countries by means of various channels of transmission. The transmission channels are divided in direct, indirect, and second round effects. The direct channel operates via changes in assets' prices of financial institutions portfolios. The indirect financial channels, as well as second round effects, are arising whenever investors' confidence to domestic economy has been aggravated and is empirically denoted by retracting movements through capital flows, foreign exchange markets, real estate, money and debt markets. The transmitted channels transpired via foreign direct investments, international trade and monetary policy. The channel of international trade was evident because of the large degree of openness, due to trade integration with the EU, in the last two decades in terms of goods and services in their trade balance. In the exporting sector, the countries were rather competitive in terms of labor intensive products and raw materials. Thus, the domestic demand channel has had full impact because of the decline of external demand from the main export markets of goods and services produced in the region. The contraction of FDI has led to the deterioration of financial conditions in domestic credit. The interplay among monetary authorities and the adoption of identical monetary policy amounted to another reason which principally addressed to Bulgaria and the Baltic States with pegged to euro regimes.

Consequently, financial institutions in Bulgaria, Romania, and the Baltic States were deleveraged and a contraction initiated as a result of the decline in foreign demand. The Baltic States, mostly, were subject to sudden capital inflows stops. Bulgaria and Romania, whose GDP growth was supplied largely by foreign capital inflows, felt sharply their reduction, because they counted on foreign capitals to finance credit expansion. Hence consumption and investment could not be easily refinanced, and unemployment (Fig. 15) had sharply increased.

The impact of global financial crisis has moderated credit and lending rates but has also deteriorated validate conditions. In Baltic States and Romania the credit growth fell by an average of more than 35% between the last quarter of 2008 and third quarter of 2009 (ECB 2010, p. 88). The high cost of financing of the economy and the further impairment in the economic perspective has forced banks to limit lending. In addition, labor market pressures render borrowers' ability to fulfill their payment commitments even more difficult. In Romania with floating rates, the depreciation in nominal exchange rates, in accordance with foreign currency, has also conduced to a rise of non-performing loans in total loans (Fig. 16). This increment was likewise noticeable in Latvia and Lithuania, where non-performing loans in total loans exceeded 20% in 2009.

A noticeable reason for contagion through expectations involves investors' psychology. The attitudes, perceptions, conventions are influenced by others actions,

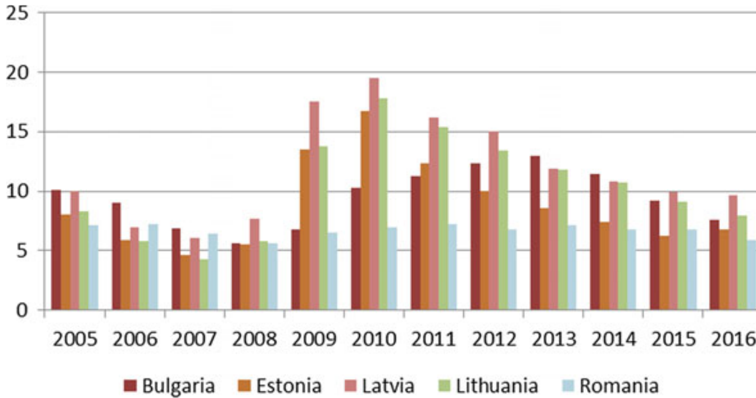

Fig. 15 Unemployment rates. *Source* Eurostat

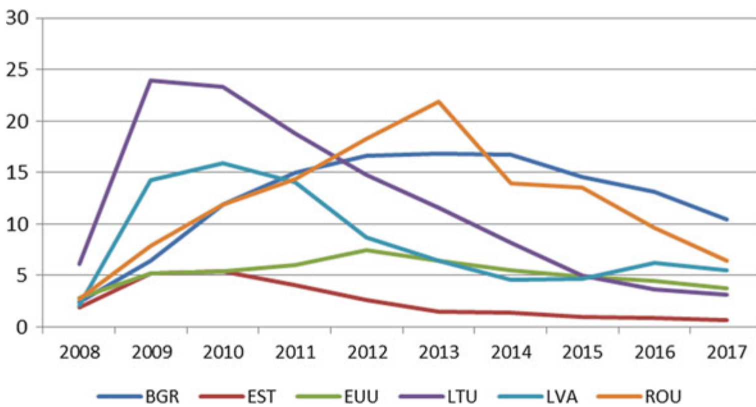

Fig. 16 Bank non-performing loans to total gross loans (% GDP). *Source* World Bank

in particular from those first suffered from a financial event. When psychology is modified and internationally spread, then contagion effects will probably take place to other economies as well. For instance, when agents consider the price of an asset as overpriced and wish to sell it, this attitude may be easily spread causing a massive liquidity need. This overoptimistic or pessimistic psychological behavior is not only transparent from borrowers' size but from lending size as well.

7 Alternative Theories of Financial Expansion and Minsky's Theory of Financial Instability

The prevailed economic theory implies that countries with more integrated financial sectors can stimulate economic growth and also are more resilient in times of crisis. However, many authors were quite reserved with this view. Arestis and Demetriades (1997) support that financial expansion and liberalization could result in a decline to savings deposits, as a consequence to an increase in interest rates driven by larger demand in capital markets. In addition, asymmetric information could cause addable problems with negative effects on savings formation, and hence, on economic growth. Prasad et al. (2003) argue that there is no clear evidence that financial integration augments economic growth in developing countries, but rather it intensifies consumption volatility. In case of transition economies, they suggest that the targets of financial supervisory, transparency, and corruption control, must be included in their agenda.

Counter to the widely held belief, Kroszner et al. (2007) refer that financial distortions have also a strong influence on real economy to the degree that amplifies the deepening of financial sector. Wagner (2010) cites that the unrelenting financial integration and diversification involve larger systemic risk. Wray (2011) states that financial liberalization and expansion may initially yield prosperity and economic growth but it could render the financial system unstable and susceptible to international financial events such as the global financial crisis of 2008. Following this view, we may now refer to Minsky's theory of financial instability.

Minsky has been an influential economist who focused on financial instability, with the interaction of finance and macroeconomics. Many of his insights could be used as a helpful tool to comprehend the financial boom and bust that had been occurred in Baltic States, Bulgaria and Romania. He made his contribution with his famous Financial Instability Hypothesis (FIH) (Minsky 1992) and his book of Stabilizing an Unstable Economy. Minsky noticed cycles as the outcome of an endogenous process in an inherently unstable economic system, where self-interest behavior prevails in complicated financial relations. He argued that "in order to understand short-term dynamics of cycles and the longer-term evolution of economies, it is necessary to understand the financing relations that rule, and how the profit seeking activities of businessmen, bankers, and portfolio managers lead to the evolution of financial structures" (Minsky 1993, p. 106).

According to Minsky's Financial Instability Hypothesis the financial system is unstable and becomes even more fragile in prosperity times. There are units of hedge, speculative, Ponzi.[8] When hedge finance is dominant, positive expectations implicitly emerge inducing all participants in financial system to be engaged in more debt. The fundamental assertion of the FIH is that "the financial structure evolves from

[8]Speculative borrowers can only validate the interest payment but not the principal and thus must roll over the financing with another loan. Ponzi units cannot meet either the principal or the interest and the options left, expect for new borrowing, is to sell assets or dividends, lowering in that way the margin of safety.

being robust to be fragile over a period in which the economy does well" (Minsky 1991, p. 16). The financial instability hypothesis suggests that the economy could easily shift from hedge to speculative in times of euphoria. This phenomenon takes place in forms of risk aversion, reductions in margins of safety, as long as short term credit is easily accessed and there is a strong incentive of refinancing interest and positions, rather than the option of getting rid of debt burden. As economy expands, enterprises are willing to increase their debt levels since higher profits are coming in. Such success encourages other agents to imitate similar behavior. All the above characteristics could be traced in Baltic States, but in Romania and Bulgaria as well from 2000 to 2008. Minsky rejected the notion that financial issues are independent from the rest of the economy. When a financial incident occurs that entails to implications to real economy, which have been identified in terms of consumption, employment, investment and output, where all countries have presented a large decline.

The exchange of present capital to future, whereas present capital is used for current investment in production and future capital represents profits accrued to repay past loans. Thus, what matters in the real economy is the amount of all liabilities, loans and credit structure, and certainly asset holdings not only for the actual period but most importantly for a longer period. The latter phenomenon is significant since the shift of economy towards fragility and imbalance does not occur all of sudden but is the result of accumulated events, which had been taken place from 2000 to 2008 particular for Baltic States. Financial institutions supply the economy with credit, spending power, and thus, aggregate demand (Minsky 1986).

Minskian instability is established today in the behavior of the players. The danger of financial instability risk comes from the creditors' side and not from debtors. It is the fear of Minskian approach that creditors cannot cope without the expected payments. It is the leverage of the creditor, not the leverage of the debtor that creates the crisis and contagion (Mayer 1999). That attitude was visible by capital outflows and deleverages process that had been observed in the countries from 2009 to 2011.

The forthcoming disruptive period or crisis as a result of the financial instability is apparent whenever borrowers can no longer finance their debts through normal channels and Ponzi units grow (i.e. increase of non-performing loans). That is where "Minsky moment"[9] appears, when everyone has become fully aware that indebtedness had reached its peak and repayments cannot be easily met. Apparently, Bulgaria, Romania and Baltic States have all experienced, to some extent, that moment in 2008. The access to finance became more expensive or attainable, putting pressure to firms, households and governments. The slowdown of capital inflows was operating adversely due to highly reliance on external funding.

[9] Lahart (2007), 'In time of tumult, obscure economist gains currency', p. 1. The Wall Street Journal, August 8. The term Minsky moment was adopted by Paul McCulley, the managing director of Pacific Investment Management Company in 1998 during the Russian crisis (Lahart 2007). Hence, the term became popular even from newspapers to describe financial crises such as the sub-prime crises.

8 Cope with Crisis

In order to cope with crisis, measures had been taken in terms of monetary and fiscal policy. It should be noted that remedy is not similar for all countries. Fiscal expansion is feasible in advanced economy, by issuing government bonds and treasuries. Thus, agents could turn to state safety, contributing indirectly to fiscal expansion. By contrast, in developing countries, such as the Bulgaria, Romania and the Baltic states, the capital outflows render the remedy more complex. Most of the emerging economies do not have the option to expand their fiscal policy either of their large government debts/deficits, or-and from markets' unwillingness to lend them. Unfortunately, in developing countries, financial crises have the additional effects of exchange rate devaluations due to balance of payments adjustment and also a fiscal contraction. The above combination makes difficult for developing countries the application of fiscal expansion as counteractive policy. Latvia and Romania have requested and received financial assistance from IMF, EU, and other international financial institutions.

In monetary policy, interest rates were reduced to stimulate domestic demand. As far as exchange rates are concern, the central bank of Romania intervened through open market operations to defend national currency. The rest of countries with fixed exchange rates, central banks intervened in foreign exchange markets to avoid downward exchange rate trends. Perhaps exchange rate flexibility could reduce currency mismatches and help agent to consider more prudently the market prices risks.

9 Conclusion

Bulgaria, Romania and the Baltic States have almost adopted similar growth pattern, whereby strong capital inflows accompanied by credit expansion fuelled domestic demand and overheated the economies. Although the countries have been exporters of labor intensive products, the evidence imply that the accelerating economic growth prior to crisis was chiefly grounded on private domestic demand. The governments of Baltic States, Romania and Bulgaria have shown full confidence in the financial model.

The pattern had performed outstandingly prior to crisis. However, the impact of financial crisis has highlighted the accumulated vulnerabilities of financial instability and rapid economic growth. The global financial crisis has revealed the weaknesses not only in terms of their financial systems but also of growth based models. The financial systems were deregulated as a result of the transition period and the need to attract foreign capital. Interest rates differentials and plenty of investment opportunities have managed to accumulate foreign investors. As soon as the GFC started to unfold, contagion effects took place by means of trade and financial transmission channels, reducing capital inflows, external financing, exports, tax revenues, domestic demand, credit provisions, and also exchange rates.

Even though the presence of large foreign banks in their domestic banking systems could undoubtedly provide numerous advantages, there are also issues that need to be taken into serious consideration. The banks are subsidiaries and operate on the interests of parent banks and there is no guarantee that they will safeguard domestic financial systems or maintain credit and liquidity levels in times of financial distortions. Furthermore, they increase the possibility of spillovers effects since they automatically integrate domestic financial systems to the international level. Banking sector restructuration was further needed in accordance with adequate deposit guarantee laws and accounting methods to inspire confidence of the financial sector.

The Keynesian view suggests that in times of contraction fiscal policy should be expanded in order to sustain demand. However, public finance of Bulgaria, Romania, and the Baltic States could not afford that policy, bearing in mind the limitation of government revenues because of the restrained economic activity. In addition, financing from domestic or international markets was not an option due to the prohibitive costs of borrowing. The fact that governments had produced expansionary fiscal policies during the upward phase of credit cycle (2000–2008) has left them with rather less reserves to cope with downward phase. Advanced countries are better shielded against a financial crisis by means of greater reserves, a developed private and financial sector, greater share in international trade, and a fiscal budget ready to expand to maintain aggregate demand. The above fiscal and monetary tools of advanced countries do not apply in most developing and transition economies.

Considering the rapid economic growth countries had experienced prior to crisis, we notice that it was grounded on financial development, which has also emerged vulnerabilities. Thus, that model of economic growth was linked to financial instability that Minsky had described thirty years ago. It is the Minskyan credit cycle where higher GDP growth rates have brought confidence and optimism and an increment to most macroeconomic variables. Gazing deeper, notwithstanding, serious dynamic unstable financial indications had been nurtured. As Minsky (1986) cleverly pointed out, it is the illusionary stabilization of an unstable system. That signifies a fictitious GDP growth and stability that had actually yielded instability.

The emergence of crisis has nominated a lower but steadier growth pattern. That pattern involved emphasis in productivity and trade, deviating from high indebtedness and credit expansion. This debate arises not for the scope to disconnect economic growth to financial development but rather to pursue stability. That is a perquisite to minimize or even avoid contagion effects to real economy in periods of adverse financial movements. Although financial globalization and liberalization was accepted by most of transition economies, the Global Financial Crisis has inducted a premonitory heed as far as the boundaries of financialisation to real economy and economic growth must be.

Finally, a rapid accelerating GDP growth model based solely on the financialisation of economy does not constitute a panacea policy since it unperceivably destabilizes the system, particular during the boom period. Bearing in mind that economic growth is desirable for each economy we observe a tradeoff between two policies. Firstly, a rapid acceleration GDP growth that could be achieved via capital inflows

and credit expansion and a modest growth pattern based primary on domestic potentials. If one economy selects the first policy then instability is likely to rise, rendering the economy prone to international distortions. The benefits are clear, but likewise the risks. The second option reassures a sound and shielded economy, nevertheless, many years are required to attain real convergence. So how could a developing economy rapidly grow without being susceptible to financial instability? That would be an issue for further research.

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