

## Chapter 2

# Financial Globalization and the Effects of Monetary Policy

Zelha Altinkaya

**Abstract** The 2008 global financial crises had a deep impact all over the world. The experience of the global financial crises dates back to last century. Firstly, national economies turned to global economies due to rapid development in technology; increase in trade of commodities and capital flows after the industrial revolution. However, failure of the gold standard system was the main reason for the first global crisis in the late eighteenth and early nineteenth century. Initially, the crisis emerged in the financial markets and spread to the commodity markets, and later to international trade. The Great Depression of 1929 would be described by sharp decreases in production, high unemployment, inflation and interest rates. Similarly, the 2008 global crisis emerged on financial markets. The monetary policies followed by developing countries influenced all the markets in not only developed but also developing countries. This paper aims to discuss the impact of globalization and monetary policies on different markets and different parts of the economies. In the first part of the paper, the main instruments of monetary policies will be explained. The question of how global factors will become an important part of domestic nations will be one of the main issues in this part. The role of central banks and their policies on developed countries is another issue. In the second part, the main focus will be on foreign exchange rate volatility. Here, especially 2008 financial crisis will be analyzed in perspective of Euro area countries. The main arguments for recovery of financial crisis another issue discussed.

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Z. Altinkaya (✉)  
Istanbul Aydın University, 34295 Istanbul, Turkey  
e-mail: zaltinkaya@aydin.edu.tr

## 2.1 Introduction

The financial crisis, which began in 2007, was considered to be the most severe crisis of global economy since the Great Depression. Unfortunately, it led to a deep and long lasting global economic recession. After the deep contraction in the world economy, all countries were looking for a solution. The institutions and the countries had difficulty finding extraordinary policies to stabilize their economies and the World Economy due to the reason that since Advanced Market Economies did not face such a deep crises since the Great Depression. In this chapter, after reviewing the concept of globalization and its relation to financial institutions in Emerging Markets Economies financial systems are generally underdeveloped. The financial depth at markets are very low; they are very sensitive monetary shocks; credit interest rates are very high in comparison to advanced market economies. The currency would not fully convertible: one would have needed a license to buy foreign exchange and while this would not have prevented all capital flight, it would have prevented rapid flight in a crisis (Krugman, 2000:27). In these countries traditional Keynesian interest rate channel is weak and does not operate effectively (Mukherjee and Bhattacharya, 2011). In general, high inflation, high volatility of exchange, large current account deficits have been discussed in the literature so far. On the other hand, FED and the European Central Bank are two key financial institutions at two Advanced Market Economies. Fed is an independent financial institution; head of FED is the strongest person in the USA. Similarly, the European Central Bank is the important party at Euro Crisis in addition to Global. In this chapter, after reviewing the concept of globalization and its relation to financial institutions in financial markets, the monetary policy applied during the crises and its effects will be analysed.

## 2.2 Globalization, Financial Institutions and Monetary Policies

Globalization is an old phenomenon and would be considered as free flows of commodities, labor and capital in a very simple manner. Although, capital flows were limited to a few countries and a few sectors at the beginning, capital flows have been a central issue for centuries. Similarly, the collapse of the World Economy is not a new phenomenon. The world economy contracted in 1914, just before World War I. It was the end of the gold standard era, free trade and free capital mobility for a period of time. Economic globalization starting after industrial revolution and with the support of Adam Smith and his followers and philosophers since early the 18th century, had raised the prosperity in advanced countries and many other poor countries. The liberal economists argued that markets should be free and governments should not intervene in markets although they considered a role for government restricted only to national defense and

justice. Although, world trade had expanded approximately 1 per cent year during the seventeenth and eighteenth centuries it raised 4 per cent during nineteenth century due to rapid changes and globalization (Rodrik 2011: 24). Three important changes have been defined within this period: the use of steam in transportation and industry and the invention of the telegraph made revolutionary changes on the global economy. Especially, the widespread adoption of the gold standard allowed capital to easily move internationally. It was the realization of Adam Smith and his follower's philosophy and making the world prosper (Rodrik 2011: 22).

The rapid growth in external liabilities of the United States and its implications for a possible reversal in the current strength of the dollar has been a main theme of discussion in economic policy. The discussion on the relation between international payments and real exchange rates has a long and distinguished intellectual history. In the late 1920s, the discussion was on the impact of the German war, in the 1970s, on the implications of oil price shocks, in the early 1980s, the consequences of the debt crisis, and in the mid and late 1980s with the debate on causes and consequences of the large fluctuations in the value of the dollar consequences of the large swings in the value of the dollar. The international system was dominated by Bretton Woods's system of fixed but adjustable exchange rates, limited capital mobility and autonomous monetary policies.

Schmukler (2003) summarized the capital flows and reaction of the markets in three steps: deregulation, privatization and advances in technology made foreign direct investment (FDI) and equity investment in emerging markets. Early 1990s were the boom years for foreign direct investments and portfolio flows to emerging markets in East Asia and the other leading emerging markets. After the Latin American Crisis, the 1997 East Asia Crisis was the second most important crisis in the emerging markets in the last few decades after collapse of Bretton Woods's system in 1973. Friedman, Minsky, Schwarts considered banking panics as a major reason of first contraction on globalization (Mishkin 1992: 2).

However, many economists viewed financial crises as the case where sharp declines in asset prices, failures of large financial and non-financial firms, deflations or disinflations, disruptions in foreign exchange markets or some combinations of all these at the same time. They also strongly suggested much more government intervention when a financial crisis occurs (Mishkin 2012).

After 2003, all governments were following the policies necessary for participating in the globalized world while raising the volume of capital mobility and trade that helped rapid growth in financial markets. Although, globalization made the world wealthier, Stiglitz defined the recent conceptualism of globalization as overselling, just before the 2007 global crises Stiglitz (2005) used globalization *to refer not only to closer integration of the countries and people of the world that has resulted from lowering of transportation and communication costs and man-made barriers but also to the particular policies, like "Washington Consensus"*.

On the other hand, Greenspan (Greenspan, 2007:12) the former chairman of the Fed, for a long time argued not only about the technological, and economic developments but also geo-political changes starting with the collapse of the Soviet Socialist States Union, unification of Germany, the end of the Cold War that

reduced real long term interest rates all over the world produced new bubbles in different countries like home price. While many people accused him as being the prime responsible person for the global crises; *however, it was the heavy securitization of the US subprime mortgage market from 2003 to 2006 that spawned the toxic assets that triggered the disruption* (Greenspan 2007: 12). He considers the bankruptcy of Lehman Brothers was the starting point of the infectious global financial crisis. Following the crisis, the economy contracted more than the Great Depression of the 1930s.

The collapse of private counterpart credit surveillance, fine-tuned over so many decades, along with the failure of the global regulatory system calls for the thorough review by governments and private risk managers now underway (Amartya et al. 2012).

Greenspan's analysis of the crisis was very critical on explaining the causes of the crisis which is a non-monetary issue but the Third World nations, especially China, replicated the successful export-oriented economic model of the Asian Tigers that were fairly well educated with a low cost workforce joined with the developed world's technology and protected by increasingly widespread adherence to the rule of law, unleashed explosive economic growth. The International Monetary Fund estimated that in 2005 a labor force of more than 800 million was engaged in export oriented competitive markets. Additionally, hundreds of millions became subject to domestic competitive forces, especially in the former Soviet Union (Greenspan 2010).

The first signs of crises came in early 2007 when loan originators and financial institutions in the US subprime market incurred heavy losses from derivatives of securitized subprime mortgages. However, these first signs were limited to problems in the subprime mortgage market until late 2007. The Lehman Brothers bankruptcy was the trigger of the financial crisis, and shortly after AIG, American International Group, and the Reserve Primary Fund collapsed on September 16, 2008. When the mortgage institutions and banks and other financial institutions experienced bankruptcy in the UK and other European countries due to the subprime mortgage market, the financial crisis became global.

The World Economy was shrunk more than what had been at the time great depression of 1930s. *The collapse of private counterpart credit surveillance, fine-tuned over so many decades, along with the failure of the global regulatory system calls for the thorough review by governments and private risk managers now underway* (Amartya et al. 2012).

## 2.3 Effects of Monetary Policies

When the monetary policy has been applied to raise the output level and reduce the inflation rate, the transmission mechanism would support the policy to achieve the targets. First, Keynes discussed the transmission mechanism. The effects of monetary policy would differ depending on the instrument. The short term interest

rate is the key monetary policy instrument under inflation targeting. However, new instruments have been added to the monetary policies. Their effects through transmission mechanism also changed depending on the latest developments of globalization. Traditional interest rate channel, the credit or loan supply channel; the exchange rate channel and the asset price channel.

The issue of exchange rate levels and their relationship with other major economic variables such as growth, income, current account balances, consumption and trade have led to a great deal of discussion since the beginning of the mid 2000s, in particular when global imbalances started to widen. After Bretton Woods systems, volatility of exchange rates increased during 1970's. This strongly affected economies on the World. Misalignment of exchange rates away from levels that reflected inflation or cost differentials would destabilize international trade flows due to incorrect price signals to the markets. In general, this would resource misallocation costs on an economy Aubain and Ruta (2011:5).

During the crisis, all advanced market economies continued to follow expansionary monetary policies and other instruments very effectively. The Federal Reserve has been following the view that monetary policy can be effective in restoring aggregate demand for the last 30 years or more. Not only the US but all advanced market economies continued to follow expansionary monetary policies and other instruments very effectively. The USA took extraordinary actions in response to the financial crisis to help stabilize the US economy and the financial system. Americans started saving more in response to recessionary fears (FED, 2012). A dozen megabanks control 70 percent of the asset in the US banking industry. It was highly concentrated. It was necessary to keep the banks to survive since these were "too big to fail" (Fisher, 2013). These megabanks, 0.2 percent of banks were treated differently from the other 99.0 percent.

Although the Troubled Asset Relief Plan (TARP) was initially intended to purchase subprime mortgage assets to help prop up financial institution's balance sheet, it soon became clear that agreeing on prices for those assets was not viable. Later, the US Treasury used TARP funds to inject capital into financial institutions and supported their balance sheets more directly. In October of 2008, the Federal Deposit Insurance Corporation (FDIC) announced the Temporary Liquidity Guarantee Program guaranteeing newly issued senior unsecured bank debt, such as federal funds and commercial paper as well as noninterest bearing accounts. Its purpose was to "strengthen confidence and encourage liquidity in the banking system (FDIC 2008)". Although these programs were initially intended to last less than a year", they were extended several times. During the crisis, all advanced market economies continued to follow expansionary monetary policies and other instruments very effectively. The Federal Reserve has been following the view that monetary policy can be effective in restoring aggregate demand for the last 30 years or more. Not only the US but all advanced market economies continued to follow expansionary monetary policies and other instruments very effectively. Spreading bank failures in Europe in the Fall of 2008 led to similar bailouts of financial institutions: the UK Treasury set up a bailout plan that guaranteed 250 billion pounds of bank liabilities, added 100 billion pounds to the facility that

swaps these assets for government bonds and allowed the UK government to buy up to 50 billion pounds of equity stakes in British banks. \$10 trillion worth of bailout packages across 20 countries including both guaranteeing the debt of the banks was direct injection of capital. There was a high degree of international coordination in these policies. Comprehensive bailouts which helped recapitalize the financial sector did help lower interbank risk premiums, but bailouts of individual banks on an ad hoc basis were received by the markets. This increased interbank risk premiums (Ait Shalaia, 2010). When governments support ad hoc bailouts in credit markets, it would suggest that the credit markets may be worse off than they appear. In contrast, following a comprehensive plan to recapitalize the financial system helps to restore confidence and to unfreeze the credit markets. Furthermore, they found out that there were strong spillovers from actions taken in one country to another, suggesting the benefits of a coordinated policy response between countries to cope with a global financial crisis (Mishkin 2010: 19).

Policy responses in the recent crises were initially similar to those in past crises, but over time they have differed. Past crisis responses typically involved three phases, first repression to deal with severe liquidity stress and to stabilize financial market. Credit Easing was preferred to stimulate spending. Different central banks often seem to believe different things about how these processes might work is not encouraging. The European Central Bank sees it “non-standard” policy measures, not as monetary policy at all, but as a means of restoring market functioning so that standard measures can be transmitted to the real economy more effectively. The reduced term might reduce the supply of loans for longer term investments. If creditors have higher marginal propensities to spend than debtors then spending overall might be reduced. A similar conclusion is suggested if consumers would be careful for purchasing an annuity on retirement (White 2012). Secondly, resolution and balance sheet restructuring involved removing some financial institutions from the system and recapitalizing feasible ones, restructuring to restore the financial soundness and profitability of institutions and asset management to rehabilitate non-performing loans. The reduced term might reduce the supply of loans for longer term investments. If creditors have higher marginal propensities to spend than debtors then spending overall might be reduced (White 2012).

The effects of monetary policy in the recent crisis have been analysed since the early 2008. Peersman (2011) examined the macroeconomic effects of traditional interest rate innovations and unconventional monetary policy actions on the Euro area economy. Peersman focused on three different types of disturbances at the supply side of the credit market: innovations to the supply of credit by banks independently a monetary policy action; shocks to the supply of credit due to a shift in the policy rate and the credit supply shocks caused by non-standard monetary policy actions that are orthogonal to the policy rate (Peersman, 2011). Peersman found out more than one instruments of the monetary policy can be used to influence the economy. In particular, a policy action which raises the monetary base or the size of the central bank balance sheet for a given policy rate, has a “hump shaped effect” on economic activity and a permanent impact on consumer prices (Peersman, 2011). Whereas a rise in the balance sheet of the Eurosystem is

passed on the bank lending via a decline in interest rate spreads of banks, the spreads increase significantly after a fall in the policy rate. Furthermore, the so called credit multiplier declines considerably after a balance sheet shock. In contrast, the fluctuation in the volume of credit after an interest rate innovation is mainly created by a rising multiplier. Secondly, on unconventional policy shocks, the parameters did not change dramatically as a consequence of the crisis. One unconventional policy shock may occur in credit supply market. Spread declines in the money market. Peers calls this disturbance as a “signaling” shock by which could for instance to be the consequence of lending at longer maturities by the ECB or a consequence of lending at longer maturities by the ECB or a change in the communication about the future stance of monetary policy. The second non-standard policy is identified as a disturbance to the money supply of credit caused by a shock in the volume of central bank money that is orthogonal to both the policy rate and the money market term spread. There is still a hump shaped impact on economic activity which is more sluggish than the response to an interest rate innovation. A Credit supply shock which is caused by a decline in the money market term spread that is orthogonal to the policy rate tends to be followed by a temporary increase in economic activity and a more permanent effect on the level of consumer prices. The dynamic are strikingly similar as for a traditional interest rate innovation Surprisingly, the monetary base does not react and the policy rate effectively declines after a few months.

### ***2.3.1 Effects of Monetary Policies on Interest Rates***

Just before 2007, the Advanced Market Economies were following very strong monetary policies. Expansionary monetary policies during the recent crises were critical in supporting banks and markets. (Stiglitz 2010) argued US monetary policy was largely responsible for Latin America’s lost decade, as the unprecedented increase in interest rates brought on the debt crisis of the early 1980s. Several central banks committed themselves to maintain low interest rates by taking advantage of their currency reserves. Those moves were contrary to the efforts of central banks in many past crises in which nominal rates were kept high or sometimes even raised to support currencies. In the recent crises, the low policy rates and ample liquidity allowed banks often to preserve their intermediation margins in spite of higher costs of other funding. Moreover, accommodative monetary policy also helped support overall asset values, reduced the risk of an adverse debt-deflation spiral, and limited nonperforming loans, at least initially, thus protecting some of the banks’ profit streams and balance sheets despite losses on trade securities (Table 1). Monetary policy was relaxed significantly early on by quickly adjusting short-term interest rates to historical lower levels. Here, are the rates applied in some of the countries between 2003 and 2008.

It was 2.33 % in 2003. However, the rate increased to 4.28 % in 2007. In the European Union, the UK followed high interest rate policy in the period between

**Table 1** Short Term Interest Rates

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Turkey	38.52	23.84	15.87	17.93	18.25	18.84	10.98	7.81	8.74	8	7.25	8.25
U. S.	1.17	1.58	3.53	5.17	5.28	3.2	0.94	0.53	0.42	0.43	0.38	0.46
Euro 15	2.36	2.13	2.2	3.09	4.28	4.63	1.24	0.81	1.39	0.59	0.17	0.13
Germany	2.33	2.11	2.18	3.08	4.28	4.63	1.23	0.81	1.39	0.58	0.17	0.14
Greece	2.33	2.11	2.18	3.08	4.28	4.63	1.23	0.81	1.39	0.59	0.17	0.12
U.K.	3.67	4.57	4.7	4.8	5.96	5.49	1.2	0.69	0.89	0.91	0.67	0.59
Spain	2.33	2.11	2.18	3.08	4.28	4.63	1.23	0.81	1.39	0.59	0.17	0.12
Japan	0.04	0.03	0.03	0.25	0.66	0.74	0.35	0.16	0.12	0.16	0.28	0.24
Switzerland	0.33	0.48	0.81	1.56	2.57	2.48	0.36	0.19	0.12	0.07	0.05	0.05

Source OECD Statistics, 2013 [http://stats.oecd.org/Index.aspx?DataSetCode=EO92\\_INTERNET](http://stats.oecd.org/Index.aspx?DataSetCode=EO92_INTERNET)

2003 and 2007. However, after 2008, the UK also decreased the rate to 1.2 % in 2009 following expansionary monetary policy. All the other countries followed low interest rates policy during the crisis period. Turkish economy was at extraordinary conditions, the interest rate was 38.52 % at 2003 and 17.93 % at 2006. By 2009, the interest rate decreased to 10.98 % in 2009.

As it can be seen from Table 1, the short term interest rates 1.17 % in 2003. It was increased to 5.28 % in 2007. This is very high increase within very short period of time. In Greece, Germany, Spain the rate were the same and above the interest rates in the US.

Although, at 2003, Japan, the Switzerland and the all other advanced economies countries had the lowest interest rates, during the period between 2004 and 2007, the short term interest rates increased substantially. It was the highest rate in the US just before 2007. Greece was following almost the same rate with Germany. Turkey had very high interest rates during this period due to the 2001 financial crisis. It would be recognized that the largest decrease on interest rate was on Turkish economy. However, at the beginning of the crisis, the US and Euro 15 countries had very high short term interest rates.

The low rate of interest would have different results in the economy: Even if the ultra- low interest rate and non- standard measures are considered as stimulator for spending, this would push another series of bubbles, the World experienced during the last financial crisis. This would be very helpful for recapitalizing banks. However, very low rates of interest would be considered as penalty for insurance companies, pension funds and other forms of saving. This could contribute to more risk taking and eventually more financial instability. Third, the crisis is already estimated by the OECD have lowered the level of potential in the AME's by an average of three percentage points. *By lowering saving and encouraging the survival of "zombie" companies and "zombie banks" potential could be lowered even further* (White 2012: 13).

By the end of 2012, The Fed was still very sensitive to monetary policy. However, economists criticized the Fed's policy on asset purchasing and accommodative monetary policy, which encouraged capital flows to emerging markets



economies. Bernanke also acknowledged that capital flows were causing undesirable currency appreciation and too much liquidity to asset bubbles and inflation, and/or economic disruptions as capital flows quickly move to the other countries. The interest rate was differentiated from the inflows of emerging markets. Accommodative policies in advanced economies impose net costs on emerging market economies (Bernanke 2012b).

### ***2.3.2 Effects of Monetary Policies on Inflation***

The 1950s and 1960s were the years, the majority of macroeconomists discussed the role of monetary factors affecting the macroeconomic fluctuations. Keynes emphasized shortfalls in aggregate demand as the source of the Great Depression and the role of fiscal factors as possible remedies. In 1960s, Friedman argued the growth of money supply as a remedy for Depression. Money supply was a key determinant of aggregate economic activity and particularly inflation. Friedman predicted expansionary monetary policy in the 1960s would lead to high inflation. In 1960s and in 1970s, a high inflation environment leads to over investment in financial sector, which expands to help individuals and businesses escape some of the cost of inflation (English, 1996). Inflation leads to uncertainty, either. Inflation rates were similar to each other in European Union counties during 2003–2008 period. In the USA, it was 3.6% in 2008. However, in Japan it was the lowest with 1.5% and in Turkey it was the highest rate of inflation with 19.2% in 2008. Easy monetary policy might cause a sharp increase in inflation. This was a real threat in many emerging market economies in 2011, but it could also be a problem in advanced market economies as well. For those, like the Fed, who focus on the domestic output “gap” as the driver of inflation, such an outcome seems almost impossible. Yet, an “irrational” increase in inflationary expectations cannot be ruled out. One possible trigger might be a sharp decline in the value of the dollar whose inflationary effects would be compounded if the prices of imported goods were rising (White 2012) (Table 2).

Expansionary monetary policy has been expected to a sharp increase in inflation. This was a real threat in many emerging market economies in 2011, but could it also be a problem in advanced market economies as well. For those, like the Fed, who focus on the domestic output “gap” as the driver of inflation, such an outcome seems almost impossible. Yet, an “irrational” increase in inflationary expectations cannot be ruled out. One possible trigger might be a sharp decline in the value of the dollar, whose inflationary effects would be compounded if the prices of imported goods were rising (White 2012). During the crisis the inflation rate declined to 3.6% in the UK, 3.3 % in the US, 3.8 % in the Euro 15 area. By 2012, these rates declined 1.9% in the U.K. and 1.8% in the U.S. However, in Italy and Israel, the rates were still high. Especially, it increased to 22.9% in Greece by 2012.

**Table 2** Inflation Rates

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Turkey	46.5	25.2	16.5	17.9	18.3	19.2	11.6	8.4	8.8	8.7	8.5	9.8
U.K.	4.5	4.9	4.4	4.5	5	4.6	3.6	3.6	3.1	1.9	2.1	2.7
U. S.	4	4.3	4.3	4.8	4.6	3.7	3.3	3.2	2.8	1.8	2	2.6
Euro 15	4.2	4.1	3.4	3.8	4.3	4.3	3.8	3.5	4.2	3.8	3.5	3.7
Germany	4.1	4	3.4	3.8	4.2	4	3.2	2.7	2.6	1.5	1.7	2.3
Greece	4.3	4.3	3.6	4.1	4.5	4.8	5.2	9.1	15.7	22.9	16.5	14.3
Israel	8.9	7.6	6.4	6.3	5.6	5.9	5.1	4.7	5	4.4	4.3	4.5
Italy	4.3	4.3	3.6	4	4.5	4.7	4.3	4	5.4	5.5	4.9	4.9
Japan	1	1.5	1.4	1.7	1.7	1.5	1.3	1.1	1.1	0.8	1.1	1.6
Spain	4.1	4.1	3.4	3.8	4.3	4.4	4	4.2	5.4	5.9	5.7	5.5
Switzerland	2.7	2.7	2.1	2.5	2.9	2.9	2.2	1.6	1.5	0.6	0.8	1.3

Source OECD Statistics, 2013 [http://stats.oecd.org/Index.aspx?DataSetCode=EO92\\_INTERNET-Inflation Rates](http://stats.oecd.org/Index.aspx?DataSetCode=EO92_INTERNET-Inflation Rates)

Source

### 2.3.3 Effects of Monetary Policies on Growth

After rapid growth at world economy during 2003–2007 period, the growth rate increased to 5.1 % in 2007. The USA had experienced recovery and expansion since 2009, although, this expansion was slow. The effects of deleveraging by households, a weak US housing market, tight credit conditions in some sectors, and spillovers from the situation in Europe, fiscal contraction at all levels of government and concerns about the medium term US fiscal outlook were considered as the main barriers preventing fluent performance of the US economy (Bernanke 2012a, b). Therefore, households and businesses are still very careful about spending. The economic growth has been insufficient to stimulate employment (Table 3). The World economy declined -1.1% at 2009. Euro 15 economies had their worst performance during 2009. Only, China and Indian economies did not suffer from the financial crises. The USA had experienced recovery and expansion since 2009, although, this expansion was slow. The effects of stimulus for consumption by households, still weak US housing market, tight credit conditions in “some sectors, and spillovers from the situation in Europe, fiscal contraction at all levels of government and concerns about the medium term US fiscal outlook were considered as the main barriers preventing fluent performance of the US economy (Bernanke, 2012a October 14). During this period, Turkey followed very stable and rapid growth. However, 2009 was shrinking year for Turkish economy (Table 3).

**Table 3** Growth Rates During the Period Between 2003 and 2014

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
World	3,4	4,6	4,3	5,0	5,1	2,5	-1,1	4,9	3,7	2,9	3,43	4,23
Euro 15	0,7	2,0	1,8	3,4	3,0	0,3	-4,3	1,9	1,5	-0,4	-0,09	1,30
OECD	2,1	3,1	2,7	3,2	2,8	0,2	-3,6	3,0	1,8	1,4	1,4	2,3
China	10,0	10,1	11,3	12,7	14,2	9,6	9,2	10,4	9,3	7,5	8,5	8,8
India	7,0	8,2	9,2	9,3	10,0	6,0	5,2	10,5	7,8	4,5	5,9	7,03
D.A.E	4,7	7,0	5,6	6,1	6,5	2,4	-1,2	9,2	3,9	3,3	4,4	4,7
O.O. P.	7,6	10,1	6,9	7,0	6,2	5,1	0,9	4,6	3,6	4,5	5,8	6,
Turkey	5,3	9,4	8,4	6,9	4,7	0,7	-4,8	9,2	8,5	2,9	4,1	5,1
U.K.	3,8	2,9	2,8	2,6	3,6	-1,0	-4,0	1,8	0,9	-0,1	0,89	1,55
U. S.	2,5	3,5	3,1	2,7	1,9	-0,3	-3,1	2,4	1,8	2,2	2,1	2,8

Source OECD Statistics, 2013 [http://stats.oecd.org/Index.aspx?DataSetCode=EO92\\_INTERNET-Growth Rates](http://stats.oecd.org/Index.aspx?DataSetCode=EO92_INTERNET-Growth Rates)

### 2.3.4 Effects of Monetary Policies on Unemployment

The unemployment rate, one of the important indicators, was so high during the period between 2003 and 2008. Spain had one of the high unemployment rate of 11.04 % in 2003 (Table 4). In USA it was 5.99 % in 2003. it was lower during 2006–2007 period. At 2003, it was also high in Turkey among the leading economies by 10.82% due to the earthquake in 1999 and 2001 financial crisis. The great number of people were unemployed in this time period. Until 2008, Turkey had this level of unemployment. However, in Germany, Greece, Italy, Japan, Spain has much lower rate of unemployment 2007 in comparison to 2003.

In the USA, the unemployment rate was still around 7.8 % by the beginning of 2013, quite above what had been expected in the long run. On the other hand, consumer price inflation was below what had been expected. At the beginning of 2013, the FED presented the economic view of the USA as follows:

At 2009, the officially announced unemployment rate increase to 13.75 % at Turkey and 18.01% at Spain. However, in addition to Global Crisis, the crisis in the Euro area, especially at Greece and Spain, caused very high unemployment rates during the period 2009 and 2011. The unemployment rate was still 7.8% at the USA at the beginning of 2013, quite much above what had been expected in the long run. On the other hand, consumer price inflation on was below what has been expected.

The economy is recovering, but progress on maximum employment has been slow and the unemployment rate remains elevated. At the same time, inflation has remained subdued. The Energy prices and other commodities have temporarily been affected by inflation.

The US Federal Open Market Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens to support continued progress toward maximum employment and price stability.

**Table 4** Unemployment Rate During the Period Between 2003 and 2008

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Germany	9.13	9.83	10.69	9.69	8.31	7.19	7.43	6.76	5.75	5.29	5.52	5.57
Greece	9.71	10.49	9.85	8.89	8.28	7.65	9.46	12.53	17.65	23.57	26.65	27.24
Italy	8.44	8	7.71	6.78	6.11	6.77	7.8	8.41	8.44	10.56	11.42	11.76
Japan	5.25	4.72	4.42	4.13	3.85	3.98	5.07	5.06	4.59	4.4	4.36	4.29
Spain	11.04	10.55	9.16	8.51	8.26	11.34	18.01	20.06	21.64	25.05	26.89	26.78
Switzerland	4.03	4.32	4.33	3.94	3.58	3.34	4.26	4.45	3.95	3.86	4.11	4
Turkey	10.82	10.59	10.4	10.01	10.06	10.74	13.75	11.66	9.61	9.01	9.32	8.65
U.K.	5.02	4.77	4.85	5.45	5.36	5.71	7.63	7.86	8.08	8.03	8.28	8.04
U.S.	5.99	5.52	5.08	4.62	4.62	5.8	9.28	9.63	8.95	8.09	7.81	7.51
Euro 15	8.69	8.94	8.94	8.23	7.41	7.44	9.37	9.89	9.98	11.12	11.91	12
OECD	6.97	6.86	6.63	6.1	5.66	5.98	8.16	8.32	7.95	7.97	8.15	8

Source Economic Outlook, No.92 December 2012 OECD Annual Projections

The Federal Open Market Committee (December, 2012) indicated that it currently anticipates that a target range for the federal funds rate of 0 to 1/4 per cent will be appropriate as long as the unemployment rate remains above 6-1/2 per cent, inflation between one and two years forward is projected to be no more than half a percentage point above the Committee's 2 per cent longer-run goal, and longer-term inflation expectations continue to be well anchored.

### 2.3.5 *Effects of Monetary Policies on Current Account Balance*

The Current Account Balance is one of the important indicators for the performance of the economy. As it was designed earlier, Bretton Woods, the USA is the country with current account deficit while the other countries had balanced had the largest current account deficit before 2007, especially, at 2006. However, when it became non manageable by 2007. The current account deficit decreased considerably in 2009 and still it is at manageable level (Table 5).

At the beginning of the global crisis, at Euro 15 area, global crisis, the current account deficit was not so high. However, the Euro crisis, affected all European Union countries more after 2007. At 2012, it was more than ever before. At the beginning of 2013, the Euro area still covers high risk issues in capital flows. European banks were at the center of the euro area crisis. Especially, confidence in Euro Area is still problem. This would remain problem since the low bank capitalization continues in many countries despite an EU requirement that banks reach in 2012 a ratio of a minimum 9% of the best quality "Core Tier-1" capital to risk-weighted assets, in excess of the current international requirements.

Lagarde (2013) argues in the Euro Area, "firewalls operational" need to be made. This includes fiscal adjustment at the country level and supporting demand,

**Table 5** Current Account Balance of the Countries During 2003-2008 Period

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Turkey	-7,5	-14,4	-22	-32	-38,4	-41,5	-13,4	-46,6	-76,9	-57,7	-64,6	-73,3
U.K.	-31,7	-46,9	-47	-72	-64,1	-25,9	-27,2	-57,7	-46,5	-81,1	-88,1	-82,0
U.S.	-519	-628,6	-746	-800,6	-710,3	-677,1	-381,9	-441,9	-465,9	-470,3	-481,8	-539,7
Euro15	41,8	111,1	40	37,8	25,8	-96,2	38,2	54,9	65,5	173,3	234,0	268,9
OECD	-311	-315,1	-497	-578,3	-523,9	-667,4	-175,7	-189,2	-316,5	-300,2	-295,7	-300,1
World	-67,1	-1,2	25	194,18	283,2	209,2	213,5	303,1	329,3	278,7	345,5	395,8
N.OECD	4,1	11,7	13,9	13,6	1,5	-28,2	-24,3	-47,2	-52,4	-57,4	-63,8	-71,5
Brazil	43	68,9	132,	231,8	353,2	420,6	243,2	237,7	201,8	237,7	265,0	220,2
China	10,3	1,8	-9,7	-9,6	-7,5	-25,8	-31,3	-51,6	-64,0	-68,6	-62,8	-72,7

Source: OECD Statistics, 2013 [http://stats.oecd.org/Index.aspx?DataSetCode=EO92\\_INTERNET](http://stats.oecd.org/Index.aspx?DataSetCode=EO92_INTERNET)- Current Account Deficit Economic Outlook, No.92  
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especially with further monetary easing. The capacity of European banks to absorb losses need to be raised by increasing their capital relative to assets. There could be large capital needs in the major euro area countries. Moving towards a stronger banking system would help to rebuild confidence and get credit flowing again. Greenspan also asked for emergent adoption of Basel Criteria 3 (Greenspan, 2013) Recent studies show the view that advanced economy monetary policies are not the dominant factor behind emerging market capital flows. Even as monetary policies in advanced economies have continued to ease and longer term interest rates in those economies have continues to decline.

Lagarde (2013) considers the recovery of the global economy for the year of 2013 weak and uncertainty is still high. The IMF forecasts global growth of only 3½ percent this year, which is not much higher than last year. Short-term pressures might have eased, but the longer-term pressures are still present. She argues that the main policy action will be based on putting uncertainty at rest. (Lagarde 2013) also argues in the Euro area, resting risk means “making firewalls operational”; pushing ahead with a banking union, continuing with the difficult but necessary fiscal adjustment at the country level; supporting demand, especially with further monetary easing.

Lagarde (2013) believes the United States should pull together in the national interest and avoid further avoidable policy mistakes, such as failing to agree on increasing the debt ceiling and for the United States and Japan, reaching agreement on medium-term debt reduction.

For the emerging and developing economies, they are faring better despite their concerns about continued turmoil and lack of decisive action in the advanced economies, conditions differ greatly. Some are more vulnerable than others, but they need to rebuild the policy space that has been used up in alleviating the crisis in recent times.

After the November 6, 2012 election, America faces “a fiscal cliff” with automatic tax increases and spending cuts at the start of 2013 that will most likely drive the economy into recession unless a bipartisan agreement on an alternative fiscal path is reached.

Lagarde (2013) also argues increasing the capacity of European banks to absorb losses, by increasing their capital relative to assets, needs to be addressed in the coming years. If the euro area’s largest banks were to move to a 5 % standard, the current capital shortage is estimated at around EUR 400bn (4¼ per cent of euro area GDP). This is not just a problem for banks in the “periphery—there could be large capital needs in the major euro area countries. Future capital needs could be lessened if banks were required to separate commercial banking and market activities, reducing the total assets of the banking business. Moving towards a stronger banking system would help to rebuild confidence and get credit flowing again.

European banks are at the center of the euro area crisis. Especially confidence in the Euro Area is still a problem despite the actions to strengthen banks and build a banking union. This is likely to remain a problem until underlying concerns over low capitalization of some banks are addressed.

Low bank capitalization persists in many countries despite an EU requirement that banks reach in 2012 a ratio of a minimum 9 % of the best quality “Core Tier-1” capital to risk-weighted assets, in excess of the current international requirements.

The developments in the Euro area where covering high risk issues led to corresponding swings in capital flows. Recent studies do not support the view that advanced economic monetary policies are the dominant factor behind emerging market capital flows. Even as monetary policies in advanced economies have continued to ease and longer term interest rates in those economies have continued to decline, the effects of capital inflows, whatever their causes are, on emerging market economies are not pre-determined but instead depend greatly on the choices made by policy makers in those economies. In some emerging markets, policy makers have chosen to systematically resist currency appreciation as a means of promoting exports and domestic growth. However, the perceived benefits of currency management come with costs, including reduced monetary independence and the consequent susceptibility to imported inflation. The perceived advantages of undervaluation and the problem of unwanted capital inflows must be understood as a package you cannot have one without the other.

The Japanese disaster faced in 2011 was affected more than financial crisis. However, the 2012 was the recovery year for the Japanese economy; Japan has been still suffering from weak demand.

Classens et al. (2012) analyzed the timing of interventions by depicting the evolution of liquidity support and the timing of guarantees and recapitalizations by governments around the onset of crises. Also, they compared the frequency of policies used at the end of 2009. As in past crises, liquidity supports and guarantees were deployed in the early stages, although more extensively relative to GDP. However, they argued that policy approaches became less forceful currently than the previous crises. Especially, progress with comprehensive operational and asset restructuring has been slow. However, Iceland, Ireland and Ukraine, the sequence and type of response more closely resembled those of past crises, including due diligence of the viability of financial institutions and quality of assets, public recapitalization, removal of nonperforming assets, operational restructuring and the adoption of IMF programs. The details of policy mixes varied due to the differences in the causes and severity of countries, whether they also involved in a currency or sovereign debt crisis, types of defunct assets involved and political economy considerations. In Iceland and Ukraine, foreign exchange exposures were large wholesale funding runs and withdrawal of foreign capital led to crises and created pressures on currencies, which then reduced the repayment capacity of borrowers. In Ireland, problems were predominantly real estate related and affected largely commercial banks.

In the United States, assuming the “fiscal cliff” is avoided; GDP growth is projected to be at 2 % in 2013 before rising to 2.8 % in 2014. In Japan, GDP is expected to expand by 0.7 % in 2013 and 0.8 % in 2014, respectively. The euro area will remain in a recession until early 2013, leading to a mild contraction in GDP of 0.1 % next year, before growth picks up to 1.3 % in 2014 (OECD 2013) .

The US and the other advanced countries suffered a lot from the effects of the 2008 financial crisis; therefore, they had low investment returns. Emerging market economies including the Turkish economy performed better than advanced countries, so capital inflows entered these countries.

### ***2.3.6 Effects of Monetary Policies on Export***

One other important indicator is export. In general, here focus would be on the influences of monetary policy on export via change on volatility of foreign exchange. Real Exchange rates and changes on exchange rate are one of the important factors determining the level export. Real exchange rates are not only determining the relative prices of tradable to non-tradable but also potentially strong impact on the incentive to allocate resources. Real exchange rates are also a measure of real competitiveness, as they capture the relative prices, costs and productivity of one particular country vis- a vis the rest of the world.

An alternative strategy- one consistent with classical principles of international adjustments is to refrain from intervening in foreign exchange markets, thereby allowing the currency to rise and helping insulate the financial system from external pressures. Under a flexible exchange rate regime, a fully independent monetary policy, together with fiscal policy as needed would be available to help contract any adverse effects of currency appreciation on growth. (Bernanke 2012b).

In several models, the effect of volatility of exchange rates on trade depends heavily on the level of risk aversion of traders. Risk neutral traders are unlikely to be affected by exchange rate uncertainty but risk adverse ones will albeit in different degrees. Paradoxically for very risk adverse traders, exporting more could be response to increased volatility in order to compensate for the expected fall in revenue per exported unit. Some models emphasize the effects of exchange rate variability more on the composition than on the gross volume of trade. Kumar (1992) indicated that while the relationship between exchange rate fluctuations and gross levels of trade is ambiguous, fluctuations have a positive impact on intra-industry trade. The logic of the argument is that the exchange rate risk act as a “tax” on the comparative advantage of the exporting sector relative to the domestic sector. If comparative advantage is reduced, economies of trading countries will become less specialized an intra-industry trade will increase at the expense of inter-industry trade. Due to change in monetary policy, export increased in all countries after 2009. In some emerging markets, policy makers have chosen to systematically resist currency appreciation as a means of promoting exports and domestic growth. However, the perceived benefits of currency management come with costs, including reduced monetary independence and the consequent susceptibility to imported inflation.



In the following tables, it would be seen that the USA was the largest exporter country of the world at 2003 (Table 6). However, Germany and China had very good performance following the USA just prior to 2007.

The USA, had the highest export volume at 2008 however, 2009 was the worst performance of USA export. Expansionary monetary policy was so much beneficial to the export of the USA economy. The export increased up to 1.8 billion USA \$. However, the good performance of export did not change Lagarde's view.

Among all these transmission channels, the early (1970s and 1980s) theoretical analyses and models of the relationship between exchange rates and international trade focused primarily on the commercial risk involved in conducting international transactions and the uncertainty generated by short term or long term volatility (Aubain and Ruta, 2011), (Lagarde 2013) considers recovery of global economy for the year of 2013 weak and high uncertainty. IMF forecasts global growth of only 3½ percent this year, not much higher than last year. The short-term pressures might have alleviated, but the longer-term pressures are still with us. She argues main policy action will be based on putting uncertainty rest. (Lagarde 2013) also argues in the Euro Area, resting risk means "making firewalls operational"; pushing ahead with banking union, continuing with the difficult but necessary fiscal adjustment at the country level; supporting demand, especially with further monetary easing. The effects of capital inflows, whatever the cause, on emerging market economies are not pre-determined but instead depend greatly on the choices made by policy makers in those economies.

## 2.4 The Fundamental Challenge in Financial Crisis

The fundamental challenge in the financial crisis 2008 is the difficulty of attaining effective global policy coordination on key matters, particularly in the absence of sufficiently powerful multilateral institutions with a meaningful degree of autonomy from nation states. Without deep coordination on a broad range of interconnected issues, there is little hope not only for resolving the pressing global problems of the day, such as a self-destructive international financial architecture and the unfolding environmental catastrophe, but even for defending some modest democratic and developmental gains of the past two decades (Onis 2010) .

The US and the other advanced countries suffered greatly from the effects of the 2008 financial crisis; therefore, they had low investment returns. Emerging markets, including Turkish economies performed better than advanced countries, so capital inflows increased in these countries. After the Second World War, as it is the case in the political area, the US was one of the main countries influencing international monetary flows. All those accusations of manipulation and currency wars were in effect referring to the demand of solving the trilemma by the USA. They argued that the USA should give up having an independent monetary policy and the FED should give up on trying to stabilize the US economy so that emerging markets are not faced with the uncomfortable trade-off between massive

**Table 6** Volume of Export at the Period Between 2003 and 2014

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Turkey	88	98	106	113	121	124	118	122	130	150	159	170
China	545	678	837	1036	1,242	1,347	1211	1544	1682	1774	1.95	2.161
U. K.	541	567	618	694	676	685	628	668	699	697	714	740
U.S.	1.116	1.223	1.306	1.422	1.555	1.65	1.499	1.666	1.777	1.842	1.918	2.036
Germany	962	1.055	1.139	1.294	1.4	1.431	1.249	1.416	1.5282	1.596	1.648	1.744
Euro- 15	3.395	3.644	3.841	4.193	4.472	4.511	3.953	4.387	4.671	4.802	4.959	5.235
World	10.785	11.92	12.878	14.148	15.237	15.723	14.127	15.951	16.903	17.412	18.232	19.483

Source OECD Statistics, 2013 [http://stats.oecd.org/Index.aspx?DataSetCode=EO92\\_INTERNET-Export](http://stats.oecd.org/Index.aspx?DataSetCode=EO92_INTERNET-Export) Economic Outlook, No.92 December 2012 OECD Annual Projections

appreciation and imported inflation. Krugman (2011) also argued that any kind of misbehavior due to the issue of monetary policy by the US does not exist in emerging markets. He also argued if there are trade-offs in the markets, these would occur at any currency regime and it's not the responsibility of the Fed to save the other decision makers and their choices.

## 2.5 Conclusion

Although, just at the beginning of 2007, the IMF was stating that the overall US economy is doing well and indicators are very encouraging, and the need for large bank buffers appeared increasingly less important in the Great moderation period. The whole picture started to change at the end of 2007. The credit cycles were not fluid. Financial markets evolved substantially in recent decades. In retrospect, the growth of securitization was so high that even the loans converted into securities and sold to investors in global capital markets. Serious deficiencies with these securitizations, the associated derivative instruments and the structure that evolved to hold securitized debt were at the heart of the financial crisis. The US monetary policy was largely responsible for the bubble whose breaking led to global recession (Stiglitz 2010)..

Recent global crises would be considered as evidence for the case that credit booms have been associated with the financial crises. More credit means increased access to finance and greater support for investment and economic growth, many governments and the central banks which are considered as independent authorities to implement monetary policy independently, followed interest rates and had come largely to disregard monetary aggregates.

There was a long standing view that it was better to deal with the bust than try to prevent the boom. Till, Lehman Brothers in the USA and Northern Rock in the UK, nobody was worried about the international monetary market. The US was following a very careful monetary policy. Although, the interest rates were not so high as it was at emerging markets, the capital flows were looking for safe places and high returns in global markets.

Although the crisis was a global financial crisis, the precautionary measures were also taken in financial markets via monetary policies. Before the financial crisis, the Fed was following very low interest rates, still it supports zero rates. The chairman of the Fed states they won't change their policy till the output level reaches the level required to achieve normal unemployment rates. The Fed policy mainly states the target for the USA economy. However, the USA, the leader of the World Economy since 1944, has been explicitly requested for leadership to the World economy again. While Krugman (2011) did not accept this designed role once more and stated explicitly and reminded Mundellinan "impossible trinity" *which say you cannot simultaneously have free movement of capital, a stable exchange rate and independent monetary policy as an answer to the Putin's statement on current international monetary system as follows*

We are hooligans, Brazil accuses us of currency war and the Chinese are wellbeing their using charming selves. But, what's going on in international currency scene (Krugman 2011).

Krugman and Dixit are not confirming the old role of the USA. Dixit (2012) firstly stated the uncertainty surrounded by the United States and Europe and argued *dysfunctional politics and continued adverse demographic trends would trap former economic giants into relative mediocrity in the world. Their situation will be eerily reminiscent of many Latin American countries in the bad old 1970s and 1980s*. From time to time they may enjoy a little growth but much of the time their economies will stagnate while new dynamic economies of Asia and parts of South America and Africa grow faster. Europe and America will remain burdened by debt and suffer periodic bouts of inflation and currency crises. International Monetary Fund officials from its shining new headquarters in Singapore will send missions to Washington (Dixit 2012: 3).

Stiglitz (2012a) argued the US needs a financial system that serves all of society, rather than operating as if it were an end in itself. Globalization made all countries more interdependent, in turn requiring greater global cooperation. Stiglitz also argued the new task for the USA in a new world order, it should have more of a role on leadership in reforming the global financial system by advocating for stronger international regulation, a global reserve system and better ways to restructure sovereign debt, in addressing global warming in democratizing the international economic institutions and in providing assistance to poorer countries (Stiglitz 2012b).

The collapse of the US subprime mortgage market by mid-2007, provides an interesting story of how determined projects of profitably marginalized the masses into a free market society through the elaborate financial risk, which failed spectacularly. Aggravated by the other factors such as faulty monetary policy decisions, the unraveling of this project with tragic human costs has brought to the surface the fallacy of two fundamental assumptions underlying the liberal market model. The presumed efficiency of self-regulating markets proved to be an illusion (Onis 2010).

The global markets suffer from weak governance due to a lack of global antitrust authority. Although, countries are looking for authorities to manage the world economy, the Advanced Market Economies, especially the USA is not willing to play a role as she did before.

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