

What have we learned from the global financial crisis so far: some lessons and some dilemmas

Abstract

Perhaps now is the time to draw some initial conclusions about the global crisis. This article tries to summarise the main lessons and dilemmas from the global crisis in advanced and transition economies. Our focus here is both on the causes of the crisis and on future prevention, bearing in mind that this is neither the first nor the last financial crisis the world has seen. The article has four parts. The first part deals with the nature and the causes of the current crisis; the second discusses policy responses in advanced economies and the main dilemmas faced by policy-makers and economists; the third analyses the reasons for the very different macroeconomic developments among the economies of central and eastern Europe; and the fourth is focused on the political dimensions of the crisis.

Keywords: *global financial crisis, recession, fiscal stimulus, advanced economies, central and east European economies*

Introduction

In 2008, the global financial system experienced its worst crisis since the Great Depression of the 1930s. The two main consequences of the global financial crisis are a lack of trust in financial institutions; and the first truly global recession since World War II (Roubini, 2009). It is well-known that a lack of trust can have paralysing effects on financing and investment.

Similar to the case of the Great Depression, we will be debating the causes and consequences of the 2007-10 financial crises for decades. It will take time and much research to resolve all the important issues. Even now, economists still have different interpretations and views on certain aspects of the Great Depression. Evaluations will continue to evolve along with events, but decisions have to be made and it is not too early to begin drawing some provisional lessons.

This article offers some initial lessons on the financial crisis, but it also focuses on those issues which are the subject of intensive debate and disagreements among economists.

Causes and nature of the global financial crisis

The current crisis erupted in America in summer 2007, but during 2008 there was much talk about the rest of the world being able to 'decouple' from the US recession and financial crisis. For example, in September 2008 German finance minister Peter Steinbrück declared:

The financial crisis is above all an American problem. The other G7 finance ministers in continental Europe share this opinion.¹

Nevertheless, in spite of these arguments, the crisis had, within a few months, engulfed the entire world. Many commentators were surprised by these developments but, from the historical perspective, this was nothing unusual. The Great Depression of 1929 also, in some sense, originated in the USA, but it was just as global as the current crisis (which has several names: the Great Recession; the Great Credit Crisis; and the Second Great Contraction).

How did the world's economy get into such a mess? All crises have multiple causes, but the two fundamental factors behind the current crisis have probably been: an irrational willingness to take risk; and the failure of financial regulators to strengthen control over financial institutions.²

The first factor, greater risk-taking, was driven by the 'global savings glut', to use the phrase coined by Ben Bernanke in the period before he became Chair of the American central bank, the US Federal Reserve (Bernanke, 2005). Banks and other financial institutions simply bet against the possibility of bad times and, in the short run, those bets paid off very well. However, in the long run they suffered heavy losses. In essence, the banks were betting against extreme volatility which, sooner or later, does arrive.

The second factor has been the weak and inadequate regulation of financial institutions. Blind faith in the self-correcting power of free markets has been proven to be wrong. Alan Greenspan said in Congress:

Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief.

The end result was that both markets and governments failed – at the same time and on similar issues. *Ex post*, it is easy to argue that regulation should have done more but, in most countries, governments were happy about rising real estate and asset prices and did not try to slow down those basic trends.

The nature of the current global recession shows it to be a different kind of recession than the ones we have grown used to since World War II and which are included in the textbooks (DeLong, 2009). There are two reasons why the escalation of the financial crisis in September 2008 provoked an unprecedented contraction of activity and trade (IMF, 2009a).

First, the IMF authors find that recessions created by the bursting of financial bubbles are different to recessions produced by other causes (for example, supply shocks)

- 1 Noah Barkin (2008) *U.S. Will Lose Financial Superpower Status* Reuters, 25 September <http://uk.reuters.com/article/2008/09/25/financial-germany-steinbrueck-idUKL-NE48O02G20080925>.
- 2 One explanation of the recent crisis is that the fundamental cause is greed and corruption on financial markets. It is easy to agree with Tyler Cowen (2008) that greed does not play an independent role because greed, as he says, like gravity, is pretty much always there.

in that they are both more severe and last longer. The likely reason is that pre-crisis growth in the former case is based on an illusion of rising wealth and is more artificial.

Second, synchronised crises (in which several major economies are simultaneously hit) are also more difficult to get out of. No country can rely on other economies to pull it out of the crisis via their demand for its exports.

The current crisis is, obviously, both finance-driven and synchronised:

So we are in the worst of all possible worlds. (Rodrik, 2009)

The crisis in advanced economies

Main lessons of the crisis

There is already a large volume of literature which has been developed around the lessons of the crisis for advanced countries. We draw three relevant lessons from the recent financial collapse and then briefly elaborate them.

The first lesson is that economic prosperity depends on financial stability, both in the short- and in the long-run. We have seen during the crisis that unregulated markets do not necessarily produce optimal outcomes, so governments need to strengthen their supervision and regulation of financial markets and repair their broken financial systems. That is the only way to restore confidence in financial (banking) systems, in order to stimulate frozen credit activity.

This lesson applies not only to policy-makers but to economists as well. The recent financial crisis has damaged the reputation of macroeconomics, and not only for its inability to see the crisis coming. Much more important has been the profession's blindness to the very possibility of catastrophic failures in a market economy.

Paul Krugman suggests that economists have to do two things in this situation. First, they have to face up to the inconvenient reality that financial markets fall so far short of perfection that they are subject to extraordinary delusions and the madness of crowds. Second, they'll have to do their best to incorporate the realities of finance into macroeconomics. He admits that even:

... Standard New Keynesian models left no room for a crisis like the one we're having, because those models generally accepted the efficient-market view of the financial sector. (Krugman, 2009)

The second policy lesson is that aggressive monetary and fiscal easing are necessary to compensate the falls in private demand during severe financial crises. Led by the Federal Reserve, central banks in the developed world have embarked on extraordinarily aggressive policies to combat recession and promote recovery.

For example, monetary policy in USA has been eased by pushing the target federal funds rate to below 25 base points in December 2008 from 5.25 % in September 2007. Despite the substantial decline in the federal funds rate and in interest rates on Treasury securities, credit costs for businesses and households have actually risen (Mishkin, 2009).

Given the limitations of monetary policy (nominal interest rates cannot fall below zero), many developed and emerging market countries have implemented fiscal stimulus packages since late-2008 as a means of offsetting the slowdown in domestic private demand and boosting spending by households and investment by firms. The U.S. again moved first, applying the largest stimulus of any country in 2008 (Table 1). By 2009, however, the stimulus applied by G20 emerging market members matched that of the United States (Eichengreen, 2010).

Table 1 – G20 countries: discretionary measures, 2008-10

	2008	2009	2010
G20 PPP – GDP weighted average	0.5	1.8	1.3
Advanced countries	0.6	1.6	1.2
of which:			
US	1.1	2.0	1.8
EU G20	0.1	1.0	0.8
Japan	0.4	1.4	0.4
Emerging and developing G20	0.4	2.0	1.4
of which:			
China	0.4	3.2	2.7
G20 discretionary impulse ²	0.5	1.2	-0.5

¹ Figures reflect the budgetary cost of crisis-related discretionary measures in each year compared to 2007 (baseline), based on measures announced through to early March. They do not include (i) 'below-the-line' operations that involve the acquisition of assets (including financial sector support); and (ii) measures that were already planned for; Spring 2010 adjustments in Europe to previous plans.

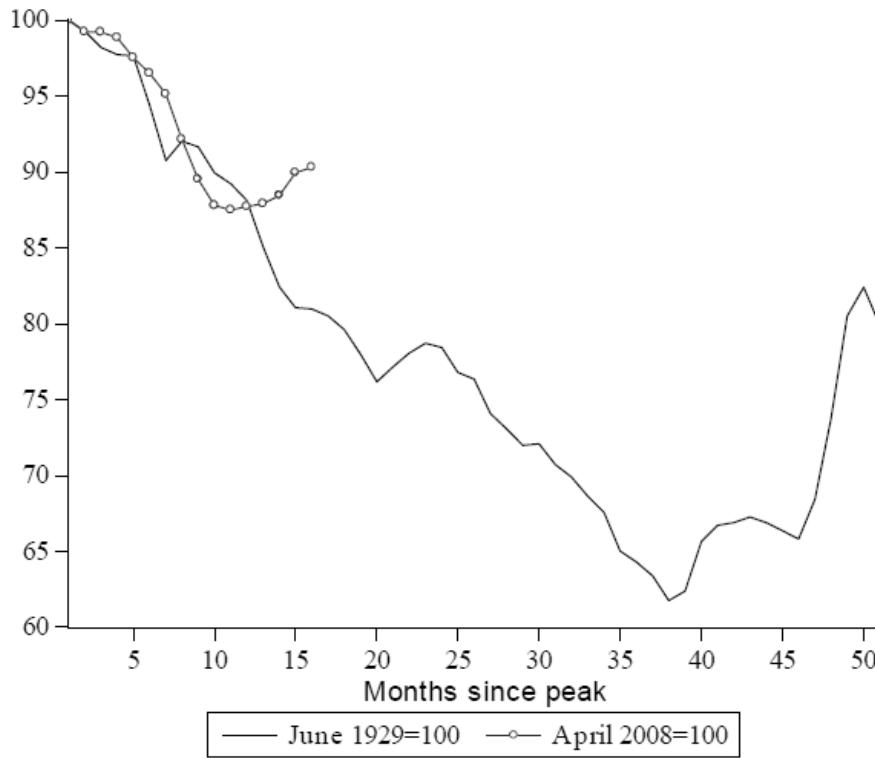
² Change on the previous year.

Source: Eichengreen (2010).

This approach is in contrast with the Great Depression, when the policy response was limited and hesitant, especially regarding fiscal policy (Almunia *et al.* 2009). Therefore, the stimulus measures are widely credited with preventing the Great Recession from turning into another Great Depression.

Figure 1 compares the movements in global industrial output during the two crises. It demonstrates well that, in the first year of the crisis, global industrial production fell about as fast as during the first year of the Great Depression (Almunia *et al.* 2009). After that, it has shown clear signs of recovery. This represents a sharp divergence from the experience of the Great Depression, when the decline in industrial production continued fully for three years.

Figure 1 – World industrial output, now vs. then



Source: Almunia et al. (2009)

The third lesson is that global crises require an international response. The experience of the current crisis also underscores the importance of having sufficient international co-ordination both among macroeconomic policy-makers and financial stability regulators. In the midst of the financial storm, the International Monetary Fund has called for fiscal stimulus in as many countries as possible, including advanced and emerging market economies (IMF, 2008).

Economic models show that worldwide expansionary fiscal policy, combined with an accommodating monetary policy, can have significant multiplier effects on the world economy (see, for example: IMF, 2009). In the domain of regulation, the need for co-ordination is also obvious, bearing in mind that much of banking supervision remains national even though cross-border banking and financial flows have expanded in scale.

Dilemmas (unresolved issues)

When first the recession hit, and the need for government action became apparent, debates began over the steps governments should take to try to turn things around. The debates are far from over and they have attended virtually every element of the policy measures. Somewhat surprisingly, there has been rather heated opposition to the very principle of fiscal stimulus.³ The most important areas of disagreement are as follows.

Tax cuts versus government spending

One point of contention has been whether tax cuts or increases in government spending would have the largest impact on the economy. In the focus of this debate has been the estimated value of the multiplier of public spending, and its impact upon the growth of aggregate demand and GDP. A study by Obama administration economists, Christina Romer and Jared Bernstein (2009), predicted that the stimulus plan debated in Congress will raise gross domestic product by \$1.57 for every \$1 spent. This study confirms the New Keynesian view that government spending can expand the economy under conditions such as we are experiencing today.

In contrast, the neo-classical school is quite vocal in pointing out the low value of the multiplier, which can even go below 1, thus stressing arguments over the inefficiency of government fiscal stimulus.⁴

Austerity versus stimulus

The ‘austerity debate’ is extremely relevant in 2010, in the aftermath of the crisis. At the highest corporate and government levels, there is confusion about how to heal national and global economies. The US and Japan are leaning towards further stimulus, while the EU and UK are pursuing austerity.

Academic economists also sharply disagree on that issue. Some prominent economists (for example, Alberto Alesina, Gregory Mankiw and Kenneth Rogoff) believe that cutting deficits and reducing debt is essential to inspire confidence in financial markets and to ensure that long-term economic growth is not damaged (Alesina and Ardagna, 2009). Others (for example: Paul Krugman, Joseph Stiglitz and Christina Romer) argue that austerity measures will not only fail to restore nations to fiscal health but may make their economies even weaker, throwing them into double-dip recessions or even outright depression.

Monetary policy and asset bubbles

There is also little consensus on whether central banks helped to create asset bubbles and the banking crisis.

3 An example is the famous CATO Institute sponsored advertisement, signed by 200 economists and published in *The New York Times* and *The Wall Street Journal* on 9 January 2009, against the proposed Stimulus Plan of President Obama. Among the signatories were James Buchanan, Edward Prescott and Vernon Smith.

4 See, among others, Barro (2009) and Becker and Murphy (2009).

Federal Reserve Chairman Ben Bernanke, a monetary economist of the highest calibre, denies it, while John Taylor, an equally respected monetary economist, insists on it. (Rajan, 2010)

In his academic works, Bernanke has always argued that central banks cannot do much to control bubbles: they can only react to the macro effects of the bubble (on inflation and growth) without trying to burst the bubble pre-emptively (Bernanke and Gertler, 2001). On the contrary, Roubini believes that, when used appropriately, monetary policy is one of the most effective ways to deal with such bubbles (Roubini and Mihm, 2010).

International policy co-ordination

The world is on the brink of confrontation over exchange rates ('currency wars') as a result of the inability of world leaders to address global current account imbalances. These 'wars' remind us that mechanisms for international policy co-ordination remain inadequate. What is needed is a grand international agreement aimed at working out imbalances in a co-operative manner that allows everyone time to adapt and to share the burdens of adjustment. However, the increasingly contentious state of affairs in global economic relations is not likely to produce such a consensus anytime soon.

The impact of the crisis on central and eastern European economies

Similar to other emerging economies, the central and eastern European region was surprisingly resilient to the global crisis for a period of over one year. However, it was strongly affected by the 'sudden stop' in capital inflows and the collapse of global demand that followed the bankruptcy of Lehman Brothers in September 2008. The severity with which the crisis hit many central and east European countries took many people by surprise. The economic downturn in 2009 turned out to be more pronounced in countries in the region (which saw a decline in GDP of -3.6 %) than in other emerging regions, including Latin America (where the rate of decline in GDP was about half that of central and eastern Europe, at -1.8 %).

Emerging and developing countries together recorded a positive GDP growth of 2.4 % in 2009.

Main lessons from the crisis

Actually, there was a significant differentiation between countries in central and eastern Europe regarding the decline in output in 2009. The deepest (two-digit) contraction was experienced by the three Baltic states, while Poland was the only EU-12 country to record positive GDP growth in 2009 (Table 2). Albania and Kosovo also registered positive growth rates, while the decline in Macedonia was a marginal one (-0.7 %).

Central and eastern Europe is not a homogeneous and clearly definable economic area, but many policy lessons can be drawn from their experience of the crisis. We will briefly analyse four of them.

First, the crisis underscores the importance of counter-cyclical fiscal policy. Developing countries in 2009 were, for the first time, able to run counter-cyclical fiscal

policies, but only those who had saved during the boom years. On a global scale, China's fiscal expansion was the most important, but not the only example. A relatively sound fiscal position allowed most Latin American governments to respond to the economic and financial crisis with a moderately counter-cyclical fiscal policy, in sharp contrast to the past. The average scale of fiscal packages there (1.3 % of GDP) was above the level of those provided in central and eastern European countries (Sonsoles *et al.* 2010).

Table 2 – Annual growth in real GDP (%), 2003-2010, EU and EU candidates)

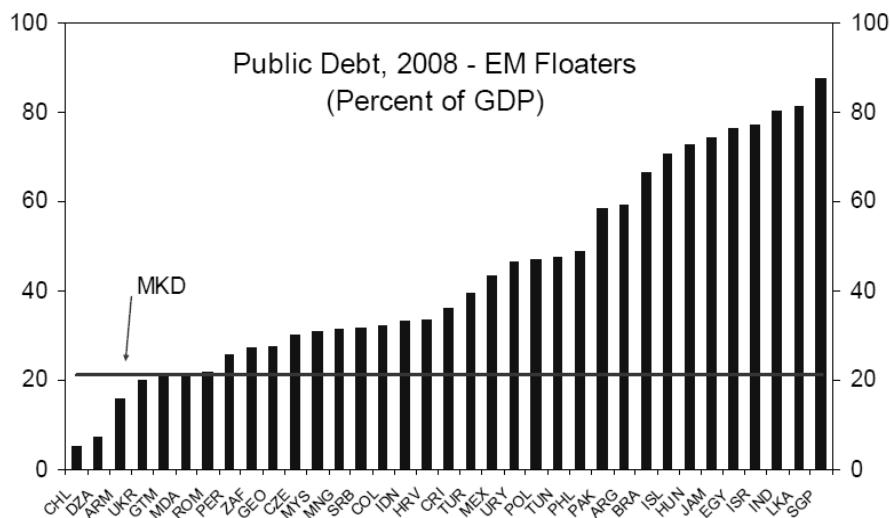
Country	2003	2004	2005	2006	2007	2008	2009	2010
EU-12								
Bulgaria	5.0	6.6	6.2	6.3	6.2	6.0	-5.0	0.2
Cyprus	1.9	4.2	3.9	4.1	5.1	3.6	-1.7	-0.7
Czech Republic	3.6	4.5	6.3	6.8	6.1	2.5	-4.3	1.7
Estonia	7.6	7.2	9.4	10.0	7.2	-3.6	-14.1	0.8
Hungary	4.3	4.9	3.5	4.0	1.0	0.6	-6.3	-0.2
Latvia	7.2	8.7	10.6	12.2	10.0	-4.6	-18.0	-4.0
Lithuania	10.2	7.4	7.8	7.8	9.8	2.8	-15.0	-1.6
Malta	-0.3	0.7	3.9	3.6	3.8	2.1	-1.9	0.5
Poland	3.9	5.3	3.6	6.2	6.8	5.0	1.7	2.7
Romania	5.3	8.5	4.1	7.9	6.3	7.4	-7.1	0.8
Slovakia	4.8	5.0	6.7	8.5	10.6	6.2	-4.7	4.1
Slovenia	2.8	4.3	4.5	5.8	6.8	3.5	-7.3	1.1
EU candidates								
Albania	5.8	5.7	5.8	5.4	6.0	7.8	2.8	2.3
Bosnia and Herzegovina	3.5	6.3	4.3	6.2	6.5	5.4	-3.4	0.5
Croatia	5.0	4.3	4.2	4.7	5.5	2.4	-5.8	0.2
Kosovo	5.4	2.6	3.8	3.8	4.0	5.4	4.0	4.8
Macedonia	2.8	4.1	4.1	3.9	5.9	4.8	-0.7	2.0
Montenegro	2.5	4.4	4.2	8.6	10.7	6.9	-7.0	-1.7
Serbia	2.4	8.3	5.6	5.2	6.9	5.5	-2.9	2.0
Turkey	5.3	9.4	8.4	6.9	4.7	0.7	-4.7	5.2

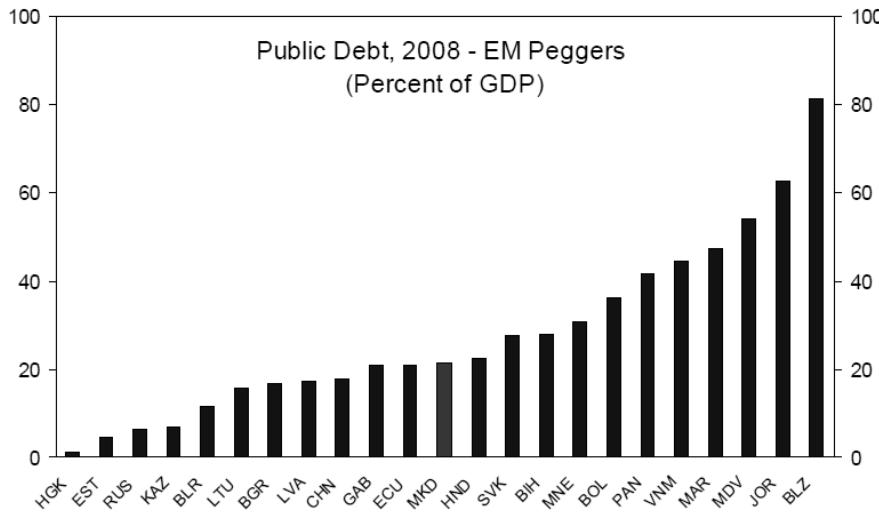
Source: International Monetary Fund World Economic Outlook Database April 2010.

The scope of fiscal policy in some countries of central and eastern Europe has often been constrained by a requirement for belt-tightening to restore order to the balance of payments (i.e. Hungary, Romania, Ukraine and the Baltic states). In such cases, the net impact of fiscal measures was neutral, or even deficit reducing, i.e. pro-cyclical. Fiscal deficits in most countries were quite modest during the boom years, but it is now obvious *ex post* that they should have been more conservative. The Czech Republic and Poland decided on fiscal stimulus packages of around 1 % of GDP in 2009, which is broadly in line with the average for the EU and euro area.

Macedonia, due to the low level of its public debt (Figure 2), was able to afford fiscal stimulus, but faced high financing costs (on both the domestic and the international markets). The fiscal stimulus in Macedonia was a combination of tax cuts and fiscal expansion.

Figure 2 – Macedonian public debt in comparison with emerging market economies

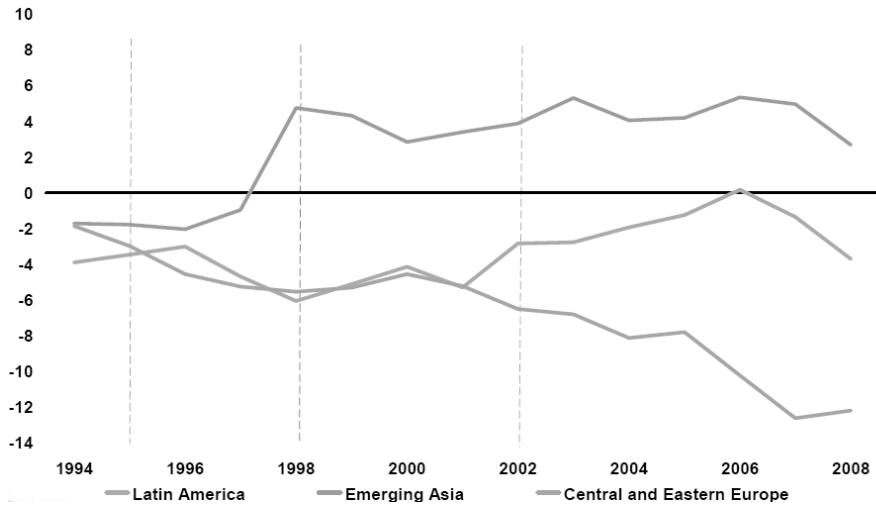




Source: IMF (2010).

Second, the crisis reminds us that large current account deficits may be dangerous, especially if they are financed in risky ways. Many emerging market economies have learned the lessons of the 1994-2002 crises (often called the ‘capital account crises’); this time, many of them, especially from emerging Asia, used capital inflows to accumulate foreign exchange reserves rather than to finance current account deficits (see Figure 3).

Figure 3 – Current account deficits in emerging market countries (% of GDP, unweighted averages)



Source: EBRD.

On the contrary, some central and eastern European countries entered the global crisis in a position of unique vulnerability among global emerging-market regions as a result of their large current account deficits and, hence, their heavy reliance on external financing. The EU's five Balkan and Baltic members all registered double-digit current deficits as a proportion of GDP in 2007, led by Latvia and Bulgaria with deficits equal to 22.4 % and 22 % of GDP, respectively. Those countries which had financed their current deficits with short-term debt and debt in foreign currencies had the most trouble (Hungary, Latvia, Ukraine, etc.).

The third policy lesson is that the structurally under-developed and not highly leveraged banking systems of central and eastern European countries have led to them being relatively well-positioned during the crisis. This 'blessing of under-development' may be illustrated with several figures regarding the Macedonian banking system.

First, bank credit penetration in Macedonia was 36 % of GDP in 2007, compared to 132 % of GDP in developed markets.

Second, the banking business model in Macedonia remains relatively conservative: credit expansion is largely funded by local deposits; and the loan-to-deposit ratio is 88 %, which is much lower than in developed markets (135 %).

Third, mortgage credit penetration is very low: only 3 % of GDP vs. 10 % of GDP in some transition countries (Poland, the Czech Republic) and 59 % of GDP in the developed world.

Our fourth policy lesson here concerns the role of capital inflows after the crisis. We can see that growth in transition – unlike in other regions – has been associated with capital imports (Figure 3). It is very likely that, after the crisis, capital inflows will be rolled back or, at least, will grow more slowly than in the past. Therefore, central and east European countries will need to rely more than before upon their own resources for development funds. This will require significant policy changes which will be a major challenge, especially for the economies of south-eastern Europe which suffer from structural weaknesses in their tradable sectors.

Political dimensions of the financial crisis

One of the key messages of many scholars and analysts is that the political dimensions of the financial and economic crisis should not be neglected. The prolonged recession, and an insufficient response to social demands, could produce problems regarding social unrest and weakening governance. Furthermore, it may even challenge the political stability of some states, or even regions – especially when the impact of the economic crisis is unequally shared within a society.

In general, reactions at the individual, collective and national levels are ones of egoism and xenophobia (anti-immigrant sentiment); on the one hand, a low level of confidence in the political elites and political institutions but, on the other, large (and unrealistic) expectations for a quick response to the consequences of the crisis, very often rationalised amidst a request for strong leadership. Such a social and political context encourages radical political forces and a populism among political actors, creating the conditions for political manipulation.⁵ Nations with a weak democratic tradition are less capable of an effective (democratic) response to economic downturns.

For the present, it is difficult to be conclusive as regards the real impact of the current crisis on politics and on the democracy-building process. Nevertheless, we can focus our attention on the political dimensions of the economic crisis as seen from a European perspective. The political aspects are very interesting both for advanced and for less developed countries. It was stated by Ricardo Lagos, President of the Club de Madrid⁶ (Club de Madrid, 2009), that Europe is – politically – embroiled in the financial crisis at three different levels.

First, the crisis has influenced the dynamics of integration within Europe itself. Within Europe, the crisis has provoked tension between the economic and the political spheres. On the one hand, some have observed a re-nationalisation of economic policy-making (the rescue packages and broader stimulus measures introduced at national level); while, on the other, some have drawn the conclusion that effective solutions to

- 5 The political consequences of the current economic crisis have been discussed at the General Assembly of the UN at the conference *World Financial and Economic Crisis and Its Impact on Development* (see more: International IDEA, 2009); and at the Parliamentary Assembly of the Council of Europe in 2009 and 2010 (see doc. 12282 and 12299).
- 6 The Club de Madrid is an independent organisation dedicated to strengthening democratic values and leadership around the world. The world's largest forum of former presidents and prime ministers (with seventy members from fifty states), it provides strategic support and technical advice to leaders and institutions working to further democratic development.

the crisis require deeper co-ordination between governments. The lesson of European integration is that economic divergence can easily spill over into political divergence: the crisis cannot be resolved while the political dimensions of integration remain parked.

Second, the crisis has produced a general tendency toward protectionism, threatening to pull the EU back from liberal policy in its external economic relations (as a result, open trade is seen by the EU population as much more of a risk than an opportunity).

The third issue concerns Europe's geopolitical vision, which could be summarised in the context of the less cosmopolitan political dimension of the EU's foreign policies. Climate change, security and human rights are still not a priority of EU commitments. This is a trend that must be addressed. At the same time, preferences for strong leadership could seriously damage the development of democracy within and beyond Europe, with potentially serious implications for economic stability and development. The latter is especially important for the consolidation of democracy in post-communist societies.

The key message from all the debates about the political consequences of the economic crisis is: there is no trade-off between the effective management of the crisis and deepening the quality of the democracy.

Conclusion

The global economic crisis has offered many lessons but has also opened even more dilemmas for policy-makers and economists. Two of the lessons we draw are common to both advanced and transition economies.

First, the crisis underscores the importance of maintaining a counter-cyclical fiscal policy. The lack of fiscal space is not only a problem for policy-makers in central and eastern Europe – too many advanced economies entered the crisis with large budget deficits and elevated debts.

Second, the crisis warns us that large current account imbalances could be dangerous, especially if they are financed in risky ways. This lesson applies not only to Latvia, but to the United States as well.

The main policy dilemmas for policy-makers in high-income countries are how to regulate their financial systems and when to start reducing their budget deficits. The major challenge for central and east European countries, on the other hand, is how to design their macroeconomic and structural policies in a situation in which they will have to finance more of their growth at home.

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