A Macroeconomic Perspective on Crisis Recovery

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1. Introduction

The aim of this paper is to analyze the various strategies each country has applied in order to recover from the acute financial crisis that started in 2008 and seems to have no end. In order to offer a valuable analysis we have studied the numerous and various articles that have been written on the matter, such as Bergsten’s and Arvind’s “America Cannot Resolve Global Imbalances on its Own”, Blanchard's and Milesi-Ferretti’s “Global Imbalances – In Midstream?”, Deo’s “The Risk with Eastern Europe”, International Monetary Fund Economic and Financial Surveys such as “World Economic Outlook April 2010” and “Global Financial Stability Report, Meeting New Challenges to Stability and Building a Safer System” etc. According to these studies, US officials seem to agree that the US must become an export-oriented rather than a consumption-based economy and must rely on real engineering rather than financial wizardry.

The logic of this new US position is not just economic. It is also strategic. US influence can be compromised if it is dependent on foreign investors to bail out its financial sector (as in the early part of this crisis) or to finance its fiscal profligacy (as China and other surplus countries have been doing for a long time). The US undoubtedly also recognizes that it might not be able to finance large external deficits in the future at an acceptable price so to some extent it is making a virtue of necessity. This long-run vision for US growth entails greater exports and probably a smaller current account deficit. The vision will require an end to the remaining overvaluation of the dollar. In the short run, US recovery from the recession requires that the fiscal and monetary stimulus programs be effective. In turn, that calls for domestic and foreign investors to absorb smoothly and trustingly the voluminous amounts of IOUs being offered by the US government. Hence it is essential to avoid perceptions that the dollar is about to fall, at least by very much, and that the US authorities are pushing it down [1]. To sum up the main ideas present in the studies that analyze the financial crisis in Asia, the impact of the global financial crisis on emerging Asia has been mixed. Whereas the broader aggregates for emerging Asia that include China, India, and Indonesia show a relatively small growth slowdown during the crisis, Hong Kong, Korea, Singapore, and Taiwan experienced very sharp growth slowdowns compared with those in Central and Eastern Europe. Emerging Asia’s exports, imports, sovereign bond spreads, equity prices, and financial stress indices are similar to those in the other emerging-market regions.

In terms of international reserves, exchange rates, credit flows, market interest rates, and public-sector support to the financial sector, emerging Asia looks, at least so far, to have been much less adversely affected than other regions/groups. Within emerging Asia, Korea is the most sensitive to financial stress in the advanced economies, while the NIEs as a group appear most sensitive to a growth slowdown in the United States [2]. The global financial crisis was a result of failures in both the market and state—markets created financial turmoil and regulatory agencies failed to detect risks and correct imbalances. [3] Overall, global GDP is expected to expand by 3.3 percent in 2010 and 2011, rising somewhat thereafter to 3.5 percent in 2012.

Reflecting much higher productivity and population growth, the economies of the developing world are expected to grow by about 6 percent in all three years, while high-income-country growth is limited to 2.3
percent in 2010 and 2.4 and 2.7 percent in 2011 and 2012 respectively. Because of these large growth differentials, developing countries will be a major source of global growth. Close to half of the increase in global demand in each of 2010 through 2012 will come from developing countries, and their rapidly rising imports will be responsible for more than 40 percent of the increase in global exports [4].

A study from the Peterson Institute for International Economics concluded that in 2009 the dollar had again become seriously overvalued, principally though not exclusively, against the Chinese renminbi and some other Asian currencies [5]. Redirecting resources away from finance and consumption towards exports and investment will require relative price shifts, for which the dollar has to move down. So a stronger rate for the dollar now and a more sustainable rate once the recovery has taken hold can reconcile the short-run imperative and the medium-term goal [1]. If the US will not run large and persistent current account deficits, countries such as China, and probably Germany and Japan, will not be able to run large and persistent current account surpluses. They will not be able to rely on export-led growth. They will have to find ways to expand domestic demand on a lasting and substantial basis.

The recovery from the Global Financial Crisis can be considered to be far better than previously expected, but in spite of the optimistic trend, it is still uneven, describing accentuated discrepancies between the different regions of the world. Among the developed economies, the United States is apparently performing better than Japan and Europe. Among emerging and developing ones, the best economic evolution is by far attributed to Asia, while several emerging European and Commonwealth economies are still far behind. In fact, emerging Europe is expected to pass through an extremely delicate period, with unemployment rates soaring, significantly more than in the rest of the world. Unfortunately, no one can tell for sure when exactly this uneven recovery is going to start distributing itself evenly around the world.

One of the immediate key tasks which need to be accomplished is represented by the reduction in sovereign vulnerabilities. In many advanced economies, there is a pressing need to design and implement viable medium-term fiscal consolidation strategies. These should include clear time frames to bring down gross debt/GDP ratios over the medium term, as well as contingency measures if the deterioration in public finances proves out to be even greater than expected. If macroeconomic developments proceed as expected, most advanced economies are expected to embark on fiscal consolidation in 2011.

For a long time, the United States has, drawing support from transnational corporations and financial operations, ate away at what is the most valuable part of the world and at its own ability to create real values, and this led to the shrinkage of its manufacturing sector gradually. Currently, the U.S. unemployment remains high, consumer debts have climbed and the mode of tired real estate market practices are hard to break. And the short-term policies to look for and cultivate new growth areas and competitive advantages cannot be effective. In short, U.S. economy has significantly increased the risk of a renewed recession and it may still maintain a lower growth rate in the next two or three years. In such circumstances, the United States tends to choose to go on using monetary policy to stimulate economy. The Fed on last Wednesday not only launched a new round of "quantitative easing" policy but also reduced its policy interest rate to close to zero. Moreover, The Fed will continue to assess the effects of financial and other developments on economic prospects and will provide "essential" support to ease economic woes. The Fed's resolve to rescue economy by means of money printing seems to be firm, but this may just be futile nevertheless.

Financial instability spread globally from the United States, not due to the large and abrupt exchange rate movement that were feared, but because of international financial linkages among highly leveraged institutions as well as the global nature of the housing bust. The fragility of the international financial system was not well appreciated before the crisis. The magnitude of global imbalances up to 2008 both reflected that underlying fragility and allowed the system to become ever more fragile over time [6].

In an environment with weakening effects of economic growth on the momentum, the hope of using monetary policy to create prosperity will not necessarily stave off specters of economic downturn and deflation, but will plant the hidden danger of inflation, asset bubbles and trade retaliation in the future, and erode the global confidence in the US dollar.

From the current point of view, the economic recovery has made decision makers and economist in Europe suggest cuts in the stimulus policy or plan, either through tightening up lending or slowing government investment. But the United States does not seem to opt for "tightening their belts." The policies of the United States and Europe are quite different in their orientations and, in essence reflect their different social realities and problem-solving ideas [7]. In the first part of this article we argue that coherent macroeconomic and fiscal-consolidation strategies are greatly required using the main arguments used in the contemporary economic literature and the main ideas from International Monetary Fund and World Bank articles. The second part of the article, by analyzing world economic markers, the evolution of the main currencies and the individual growth rate of global imbalances we conclude that the crisis recovery is robust, but still uneven. Meanwhile, given the still weak recovery, the fiscal stimulus should be thoroughly implemented, except in the economies facing large risk increases, where it is more urgent to consolidate the overall macroeconomic frame. Moreover, reforms that do not affect demand in the short term, such as rising retiring age or lowering public costs are to be implemented without delay. Other policy challenges relate to
the unwinding of monetary accommodation across the world and redirecting capital flows towards the emerging economies.

The literature on the benefits and costs of financial globalization for developing countries has exploded in recent years, but along many disparate channels with a variety of apparently conflicting results. A number of recent papers in the finance literature report that equity market liberalizations do significantly boost growth. Similarly, evidence based on microeconomic (firm- or industry-level) data shows some benefits of financial integration and the distortionary effects of capital controls, but the macroeconomic evidence remains inconclusive. At the same time, some studies argue that financial globalization enhances macroeconomic stability in developing countries, but others argue the opposite[8]. While the crises discussed in previous empirical literature tend to be those associated with foreign currency debt or balance of payments problems, the global crisis of 2008-2009 offers a chance to check if the severity of an emerging market economy’s credit crunch is systematically linked to the volume and the composition of its pre-crisis international capital inflows, since the crisis may have triggered a reversal of global capital flows[9].

2. Coherent macroeconomic and fiscal-consolidation strategies are greatly required

While the global economy is still recovering from the consequences of the most severe crisis since the Great Depression, the recovery has gained significant traction, yet although it is proceeding better than expected, it also significantly varies in speed – being more sluggish in the advanced economies and more solid in the emerging and developing ones. The average growth rate estimated for certain economies in 2010-2011 is even believed to reach 10%, whereas other are bound to experience negative trends. Nonetheless, activity remains strongly dependent on highly accommodative macroeconomic policies and is subject to downside risks, as fiscal fragilities have come to the fore.

The economic recovery was aided by the improved conditions on the financial markets, normalization of international trade, the correlation of capital flows and last but not least, the growth-oriented national policies. It is to be mentioned that, generally, the economies that are faced with plummeting output during financial crises are the ones to experience slow (if not the slowest) recoveries and vice-versa – those that are in the lead of recovery are very likely to remain there.

Moreover, economies that are faced with financial shocks and were already experiencing internal imbalances (notable current account deficits) are also likely to head towards a slow recovery. Last but not least, as stated above, emerging economies are expected to perform better than advanced economies in terms of economic growth and according to the forecasts so far, the crisis recovery will be stronger in Asia and weaker in emerging Europe. However, in order for an effective recovery to actually take place, radical measures need to be taken, a task that could not be more difficult given the fact that the aforementioned measures are to be correlated internationally.

In most of the advanced economies, but also a small number of emerging ones, the demand needs to be rethought and redirected, as it has so far been focused on the public sector and its consumers. It should be further channeled on the private sector, a change which requires the consolidation of public finances and the reorganization of the fiscal sector. Both emerging and developed economies are now faced with improving their economic growth based on internal sources, as the demand level on international markets is not likely to reach the pre-crisis levels very soon.

A rapid crisis recovery is strictly dependent on applying policies based on unilateral circumstances. Nonetheless, the time variation of their unilateral application may result in unwanted externalities, and these externalities are to be taken into consideration when defining the policies. The fiscal policy-driven externalities usually have a significant impact on advanced economies – the national economies’ contractions having negative implications on the exports to other countries, while extended deficits, correlated with the lack of medium-term fiscal consolidation strategies have an extremely corrosive effect on exchange rates. More importantly, the absence of foreign investment flows or the exchange rate deterioration in some of the great emerging economies may seriously destabilize the financial climate of other economies (either advanced or emerging ones), while the extremely reduced exchanged rates of certain advanced economies might lead to an entire wave of investment withdrawals, with a significant destabilizing potential affecting the concerned economies. Managing flexible exchange rates in the context of an open capital account has been an especially thorny issue for developing economies[10].

The crisis recovery policies must aim at the imperfections of the macroeconomic policies applied so far, which, in the last ten years, have led to significant global imbalances, as the current account variations were only considered to be dangerous only if they generated internal or systemic distortions or if they generated global shortages (the uneven depreciation of an international reserve currency)[11].

The imperfection in the fiscal systems of advanced economies has encouraged credit granting and, as a consequence, savings have plummeted, while the market imbalances and certain government programs affected them even worse. The insufficient fiscal consolidation during economic growth periods have further increased these effects, just as the massive emerging Asia government reserves did.

Given that emerging Asia is investing aggressively overseas, what this suggests is that relatively more investments are being made outside emerging Asia[12].
Regarding the economies that need to rebalance their private capital flows (the United States), an acceleration of the financial system reformation is required, as to be able to recreate the appropriate frame of economic recovery. Such a frame would encourage a permissive monetary policy, thus not having a strong effect on the inflation rate or the stability of internal and international markets. These measures are mostly significant for the United States, as they play a systemic role on the international financial markets.

Apart from the fiscal consolidation, the progress made by the reformation of the fiscal sector must become a top priority both for emerging and developed economies, as the global crisis the world is facing has spread exclusively due to the imperfections of the financial markets. Given the integrated nature of the national financial markets and institutions, their reformation requires an international synchronization.

In short term, major work is still needed to repair the extended damage brought along by the crisis:

- Bank recapitalization: more capital is required to absorb the deterioration in credit quality and to support healthy credit growth in the future, when regulatory standards are expected to tighten.
- Bank resolution and restructuration: this will facilitate the return to health of the banking system and help avoid further turbulence from weaker institutions as extraordinary policy support is withdrawn.
- Reviving markets for securitized assets: these remain impaired and dependent on official support, yet they have become a normal part of the bank lending process in many advanced economies.

Looking further ahead, much work remains to be done in order to reestablish market discipline. This can only be achieved through strict actions on a number of fronts: better and more adaptable prudential policies and frameworks, including bank resolution regimes which provide authorities with broad powers to intervene in financial institutions; higher capital requirements; new funding instruments (such as convertible bonds); incentives to keep financial institutions smaller and more manageable; requirements for institution-specific resolution plans; fees to cover bailout costs and, if ever needed, direct restrictions on the size and scope of financial activities.

At the international level, in spite of the notable improvements made over the years, the global crisis has revealed important flaws in the supervision of the markets, the process of burden sharing and in the procedures regarding the resolution of failing institutions. All these aspects need to be resolved in the short run. Another issue threatening economic recovery is the unemployment rate. In the advanced economies, forecasts estimate that the latter will reach 8.5% in 2011, and only afterwards to decline slowly.

However, the problem is far greater that the statistics show. A large part of the employed population is engaged in temporary activities or part-time jobs, and a considerable part of the unemployed population, although able to work, has given up on the idea of ever getting a job, therefore it is no longer included in the statistics. The decrease in the production output had a different influence on unemployment in each of the developed countries. For example, in the United States, the unemployment rate grew by almost 4%, but in Germany, the impact was more limited, due to reduced work schedules, Germany's case not being a singular one, too [11].

Considering the slow growth in world output and the still ongoing effects of the financial crisis, it is estimated that the unemployment rate will still be high in 2011. Consequently, this raises the question of temporary unemployment, which is becoming long-term unemployment, a situation that could negatively influence the output growth. Therefore, the implementation of certain significant macroeconomic measures, the restructuring the banking system, and last but not least, reviewing policies regarding labor market are greatly required.

Worker retraining programs can help reintegrate the unemployed into the labor market. Salary flexibility is important in terms of facilitating reallocation of labor in economies that have suffered strong sectorial shocks. Also, salary adjustment is required to mitigate the effects that the lower salaries had on life standards. Another measure, such as granting tax breaks to companies or firms that hire the unemployed may prove useful while macroeconomic uncertainty still dominates the global economic climate.
The way these measures are implemented has a significant importance, because, in the past, similar programs haven’t brought the expected results – in some cases, the vast majority of these facilities was drawn to jobs that would have been created anyway sooner or later. But even so, such programs are useful even if, inevitably, the effect and effectiveness diminishes in time.

The economies that have faced high unemployment rates induced by the crisis are advised to review their labor protection legislation, and thus to differentiate the two types of labor market – temporary and permanent. The review may consist in tightening the law on temporary jobs and improving the restrictive provisions regarding permanent jobs.

In most developing economies, the unemployment growth was more balanced than in the advanced economies. However, in some emerging economies, statistical data do not entirely reflect reality, and condition of the labor market is generally much worse. The necessity of reducing the adverse effects of unemployment rate spikes becomes an imperative in the whole world economy.

While virtually all countries have seen significant economic downturns in the recent global recession, the causes have not been exactly the same. Similarly, while it is now forecast that most countries will enjoy reasonably robust and mutually reinforcing recoveries, the forces underlying these recoveries will differ somewhat across countries [13].

3. The crisis recovery is robust, but still uneven

Fortunately for the current state of the global economy, signs of crisis recovery are already beginning to show, but we can talk about an even recovery for all the areas of the world. [14] It is expected that, by the end of 2010, the world production will increase by 4.25%, an obvious improvement compared to 1% in October 2009 [15], financial markets recovering a lot of both traders’ and consumers’ confidence (Image 2).

Real GWP growth reached 3.25% in the second trimester of 2009, and then reaching 4.5% in the last trimester. In world key-economies (both developed and emerging), the domestic demand has improved, and the external demand was stimulated by international trade recovery. Global activity is also recovering, at a faster pace in the emerging economies and at a slower one in the developed ones [16].

The recovery of the United States, although slower than in the European Union or in Japan, promises to be stronger than in the other two countries, a situation quite surprising if we take into account the fact that the United States have been the epicenter of the current crisis. The U.S. economic recovery, compared with the European Union and Japan, reflects a number of differences between the three power centers: in the United States, the fiscal stimulation has been achieved on a considerable larger scale, the non-financial corporate sector is less dependent on bank lending (which is still a problem), the securities markets have recovered relatively quickly, and the Federal Reserve System reacted promptly in implementing policies to counter the crisis.

At the same time, the Japanese yen’s strong appreciation has adversely affected exports rebalancing in Japan and deflation has led to increased interest on loans. Euro zone trade relations with European emerging countries and CIS (Commonwealth of Independent States), as well as the irregular appreciation of the euro have affected E.U. exports. [17] Moreover, some Euro zone economies have been badly hit by the financial and real estate crisis.

However, both the activity in emerging economies, as well as that in the advanced ones improved considerably. In the Asian emerging economies, production already exceeds the rates reached before the crisis (figure 2). In the third quarter of 2009, even some Latin American countries have started to show signs of recovery, although the production level in this area cannot be compared with the one in Asia, some Latin American economies still facing the crisis effects. Emerging Europe and CIS are other regions where sustained
economic recovery has not taken place yet, while Middle-Eastern economies are benefiting from the oil demand growth and its rising price. The situation in sub-Saharan Africa is different. Most middle-income economies and oil exporters, subject to production contraction and some abrupt decelerations in 2009 are beginning to benefit from the international trade and commodities prices rebalancing.

Figure 3. The evolution of the main currencies (2000 = 100)

Cross-country financial flows seem to recover after the 2008 shock. Key-factors behind the recovery include increases in capital flows to emerging economies and their willingness to retake financial risks. The financial flows state has influenced exchange rates, leading to a depreciation of the U.S. dollar and an appreciation the floating exchange rates of other emerging and advanced economies, but if we consider the levels attained before the crisis, the changes are still reduced (figure 3).

As for the major economies, China's current account surplus fell from 9.5% of the GDP in 2008 to 5.1% of the GDP in 2009 [18], reflecting a contraction in the world output and international trade, but also an accelerated growth in public spending. During the same period, the current account deficit of the United States declined from 5% to 3% [19] of the GDP, a state induced by the collapse of savings and investments households. Both economies have benefited from lower oil prices, which in turn led to reduced Middle Eastern economies surpluses.

Image 4. Global imbalances (individual growth rate)

However, the International Monetary Fund outlooks seem to suggest an increase in current account deficits throughout the period of rebalancing the international trade (figure 4).

Regarding the global economic recovery, there are two factors that will continue to support it during 2010, with financial incentives gradually decreasing in intensity. The first factor is the state of financial markets - funding (credits) is hoped to become available once more so the households rebalancing their incomes could start consuming again. The second one consists of the revival of the industrial production. In anticipation of a major contraction in consumption, the fear of the onset of a new crisis similar to the one in 1929-1933 has led to production restrictions, but at present, the expected growth in consumption can lead to a revival in production. At the same time, public deficits are expected be reduced. This will result in economic downturn by reducing income and therefore also reducing consumption, a situation correlated with an increase in savings. Nevertheless, it is difficult to determine how much this measure is going to affect the economic growth. In the emerging economies’ case, it is expected that, as a result of forecasts announcing the growth of demand, investments will play a significant role in economic recovery.
Countries such as Brazil, China, India [20] or Indonesia are already showing signs of crisis recovery, in spite of the slow recovery of the advanced economies, which have withdrawn their capital flows and therefore, their investments. This recovery of the emerging economies is due to the fact that some of them have not suffered financial systemic shocks, nor accelerated increases of the unemployment rate.

Overall, it appears that the world economy will enter a recovery phase, but the recovery will be uneven (figure 2). Global growth is estimated to reach 4.25% in 2010 and 2011. Economic growth in advanced economies is approximated at 2.25% in 2010 and 2.5% in 2011, after a 3% drop in production in 2009. [15] In developed economies, the economic growth is expected to reach 6.25% during the 2010-2011 period, after a modest rate of 2.5% in 2009. Therefore, the return of developed economies will be quite sluggish, as compared to previous statements (recessions of the mid-1970s, early 1980s and 1990) and the situation of emerging economies. Some European Union countries that have suffered major financial imbalances during the crisis will be forced to survive a very difficult period, not falling into forecasts of economic growth, while countries such as Australia or the newly industrialized Asia (which have been less strained by the global crisis) are most likely to have the most favorable evolution.

Conclusion

There is no single solution to the effects of the financial crisis on middle-income countries, but introducing fundamental labor markets reforms to create high-paying jobs will be the key to restarting economic growth. Labor reform is always politically contentious, but the current crisis, by illustrating the dangers of ignoring necessary long-term reforms, has made it easier to reach consensus on the need for action. If policy makers undertake the right reforms, middle-income countries could achieve higher growth, better standards of living, and more effective government.

Critical reforms include improving access to education and on-the-job training, reducing the costs of hiring and firing workers, and increasing the number of women in the workforce. Unemployment is likely to remain high in middle-income countries as the crisis continues, threatening the stability of governments across Latin America, East Asia, and Eastern Europe. Governments must resist the temptation to take populist shortcuts that make it appear that they are dealing with the crisis when they are not, and should instead be clear and consistent in their pursuit of reform. Sustainable growth requires a balance between exports and domestic demand. East Asian economies that relied heavily on exports for growth have been hit harder by the crisis than Latin American countries that emphasized domestic demand. Diversified trade offers some protection against economic shocks. Middle-income countries should diversify not only their exports but also the markets to which they export.

The economic crisis has shown that even when a crisis originates in industrialized countries, developing countries pay the highest price and underlines why developing countries have a crucial interest in the financial soundness of large economies like the United States. This helps explain why the G20, rather than the G8, is leading the effort to design a regime to govern international finance. Or that Brazil, Russia, India, and China (the BRICs) organized their first summit to discuss, among other things, the role of the dollar as its reserve currency.

The crisis recovery policies must aim at the imperfections of the macroeconomic policies applied so far, which, in the last ten years, have led to significant global imbalances, as the current account variations were only considered to be dangerous only if they generated internal or systemic distortions or if they generated global shortages (the uneven depreciation of an international reserve currency).

Looking further ahead, much work remains to be done in order to reestablish market discipline. This can only be achieved through strict actions on a number of fronts: better and more adaptable prudential policies and frameworks, including bank resolution regimes which provide authorities with broad powers to intervene in financial institutions; higher capital requirements; new funding instruments (such as convertible bonds); incentives to keep financial institutions smaller and more manageable; requirements for institution-specific resolution plans; fees to cover bailout costs and, if ever needed, direct restrictions on the size and scope of financial activities.

The health of the global financial system has improved since 2009. However, risks remain elevated due to the still-fragile nature of the recovery and the ongoing repair of balance sheets. Concerns about sovereign risks could also undermine stability gains and take the credit crisis into a new phase, as nations begin to reach the limits of public sector support for the financial system and the real economy [21].

The current crisis has exposed the rather obvious flaw in the British Treasury’s reasoning (to be fair, the flaw did not really need the current crisis to expose it – it was a rather glaring fault in the first place). A government that is required to use fiscal stimulus in a fiscal crisis to counter a procyclical monetary policy will swiftly end up with a massive budget crisis. National fiscal policy cannot deal with anything other than the most fleeting of asymmetric shocks [22]. The current assumption is that the post-crisis political economy will reflect the rising influence of China and India, and of other large emerging economies. Supposedly, the United States, the epicenter of the financial crisis, will see its economic power and influence diminish. [23]
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