FINANCIAL MARKETS AND REGULATION: A POTENTIAL DISCREPANCY IN A MONETARY HISTORY OF MARKET TURBULENCE.

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JEL code: G210 - Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

Abstract

The last financial crisis, has really become something very peculiar and different from any previous classic cyclical turmoil, as outlined in our classic economy models: Austrians, Keynesians and post Keynesians and cannot be seen as a pure temporary financial crisis, needing a central authority to become a regulator of last resort or a set of new rules framing financial products and trading rules to pursue general stability.

Recently, the overlapping global economy has shadowed all local markets and productions as the low fare Eastern Countries industrial chains have crowded out globally all western industrial areas.

The inflationary factor linked to the world financial and monetary expansion has not actually been offset by the productivity and technological innovation but, mostly, because of the Eastern low cost and competing growing quality standards and overcoming productions pouring toward western markets.

Within these angles the proper financial market regulation must consider a preliminary adjustment of world wide monetary policies, labour costs, welfare State policies.

Outside the free market price fixing mechanism there is only room for market abuse and manipulation. The present crisis is so far imputable to the asymmetries between the welfare state legislative framework and the free Asian markets and to the unsolved related monetary issues.

Keywords: financial, crisis, markets, asymmetries, China.

Foreword

Assuming a common general suggestion the present financial and banking market crisis may be seen as an effect of a deregulation of global financial markets, a loosening control over banks and a wide abuse of management compensation trough widespread stock options programs and leveraged buy outs by management misbehaviours.

On the other side, the market collapses in year 2007 and 2008 and the derivative toxic financial bubble and stigma may be seen as the outcome of all worsening economic scenarios or the unpredicted final effect of very deep far rooted queue of mistakes, like a *tsunami* in a inexperienced world of self erupting global bubbles.

My opinion is that what happened at the end of the last decade is not related to some specific deregulation or financial institution or authority misconducts, neither to dangerous financial innovation, on the contrary, what started in August 2007 is an unavoidable course linked to at least thirty years of monetary instability, contradictory remedies and uncontrolled public spending in a world of euphoria, growth and prosperity, without any care about the potential consequences of a loose monetary *deficit spending*.

Financial markets and regulation: a potential discrepancy in a monetary history of market turbulence.

Foreword

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1. Economic integrations, competition and cooperation

Present Financial Crisis, origins effects in a local versus global Framework

In the 2008 fall the *Development Committee* of the World Bank meeting, chaired by the Italian Central Bank President Draghi, lately *Financial Stability Board*, trying to work out some measures aimed to save the collapsing Western Economy, adopted the mission statement:

"*We are concerned by the impact of the turmoil in world financial markets and the continued high prices of fuel and food. We welcomed member countries' commitment to take comprehensive and cooperative measures to restore financial stability and the orderly functioning of credit markets*."

The aging *turmoil in most world financial markets,* called also euphemistically *banking crisis*, has gradually been revealing itself as something definitely new and very different from any previous historical recession or depression as known and as described and studied in our classic and modern economy models, classics, Keynesians[1] and post Keynesians ones[2] and, according to my analysis, this is not at all a financial or banking crisis in its deep nature.

The present crisis stems from a worldwide historical scenario and may be connected, in its mostly relevant fundamentals to some unsolved monetary issues as expressed by Robert Mundel in his delivery speech at the Nobel price assignment in year 1999[3] and from some recent social miscalculation starting with the collapse of the Berlin wall and the global openings afterwards.

We must remember the 1921 Genoa economic conference, addressed to the regeneration of a *gold standard*, project firmly supported by Ralph Hawtrey but strongly opposed by the young John Maynard Keynes, basically unsuccessful, which failure, according to Mundell, lead to the second world war as a main underlying factor to autarchy, custom barriers and nationalism.

The 20th Century's unsolved financial turmoil starts at the FED foundation in 1913 and deepens in the first and second world wars, two global wars in a single Century, according to Mundell[4], likely consequences of those unsolved monetary issues.

The nineteenth century began with a long lasting efficient international monetary system in 1815, result of the Vienna conference and the aftermath of the British Empire after the defeat of Napoleon, when a world order was globally revised.

Such system was strongly based on the *gold standard* which was dissolved trough the first World War monetary strategies, and its abortive restoration efforts during the last century twenties and thirties, that generated the great depression, national autarchies, the collapse of the world trade and, as a likely *consequence of the peace*[5], the second World War.

The new arrangements and the multilateral clearing systems that followed the monetary system collapse, triggered by Nixon in 1971, relied finally more on the dollar policies of the Federal Reserve System than on the simple discipline of gold itself. When the link to gold was ultimately severed, the Federal Reserve System was implicated in the greatest inflation the United States had ever known, at least since the days of the Revolutionary War. Even so, as the century ends, a relearning process has created an entirely new framework of issues and questions about reinstalling some of the advantages of the payment and monetary system with which the century had began.

Last century can be divided into three different periods:

- the first part, 1900-33, is the story of the international gold standard, its breakdown during the war, failed restoration in the 1920's and its demise in the early 1930's;
- the second part, 1934-71, begins in the great depression with the devaluation of the dollar and the establishment of the $35 gold price in 1933 which ends when the United States took the dollar off gold convertibility for private holders;
- the third part of the century, 1972-1999, starts with the collapse into flexible exchange rates and with the subsequent outbreak of massive inflation and stagnation in the 1970's, the huge interest rates and the new supply-side economics in the 1980's, finally the return to monetary stability, mostly based on the oil standard and the issuance of the Euro in the 1990's.

At Bretton Woods in the New Hampshire, the gold reserve problem was eluded by the implementation, supported by Harry Dexter White, from the U.S. Treasury department, of the platform for the *gold-exchange standard*, a necessary compromise between gold supporters and gold contrarians, which lived up to its dismissal by the President Richard Nixon in August 1971. In that year the *gold standard* was unquestionably abandoned and we entered the present cycle of ever growing financial and monetary crisis leading to the *oil standard* and to the taking over most of the monetary policies by the Central Banks the world around.

2. <u>The present crisis, specific causes and determinants.</u>

The core factors affecting the present financial crisis, after the 1987 exceptional stock market crash, which lead to the Greenspan appointment at the FED, a strong supporter of the loose monetary policy, may be presently linked to the following three recent major real causes:

– the second world wide trade liberalization, generally called the *second globalization*, understood as an effect of the end of the cold war;

– the existing asymmetries in local social, work, taxing and regulatory frameworks and fundamentally asymmetric welfare standards, fiscal accounting rules, financial reporting and auditing practices;

– the mass progressive reallocation of industrial finishing production on a world basis from regional local markets to the Eastern and far Eastern countries, pursuing the final target of a critical industrial size trough mass production, lowering costs in a global world competition definitely prevailing over a single market trading approach.

Just to remind some of this special burdens affecting fair competition on a global basis, we outline Western unparalleled:

– labor protection stringent procedures, permanent compulsory training, updating and new reporting duties;

– privacy strict protective widespread procedures;

– financial transactions monitoring and reporting costly procedures;

– filings against illegal recycling activities;

– financial auditing and filing requirements;

– labor and enrolling preferred compulsory paths;

– unions strict political and social monitoring attitudes;

– periodical labor negotiations;

– obstructive dismissal rules and severance penalties.

Furthermore, the overlapping synergetic global economy has overcrowded and downsized any local market and production in the dual market system and the rapidly industrializing hosting Asian countries have been globally outperforming all the local markets and has self enlarged and rapidly grown on a planetary basis.

The out breaking US trade deficit, alone, jumped from $65 billion in 1993 to a more than $700 billion annual average from year 2005 to 2008, about 5 percent of GDP.

Today imports from the *Middle Kingdom*, or *Chinese Empire*, and the petroleum deficit account for nearly the entire U.S. trade deficit. Chinese and Middle East exporters use their dollar proceeds from growing large trade surpluses to mainly buy U.S. bonds and real estate and industrial property. That global trend keeps long-term interest rates low, permitting Americans to borrow *recklessly and sub primarily* on homes and commercial buildings, and has been inflating property and stock prices in an enlarging derivative explosion, not overshadowed by any Central bank authority and misrepresented while asserting technology and productivity booms as factors offsetting inflation.

At any of the Banking committee, held every six months by the US Senate Committee on Banking[6], Mr. Greenspan, when chairing the Fed, was assuring that *innovation and productivity* were addressing price stability while non risk of inflationary factors was visible. Actually, the process was a subtle crowding out of western more expensive industrial productions by less expensive Chinese and far Eastern reallocated industrial numeric controlled productions all over the world retail shelves.

3. **The quantitative analysis.**

The result is easily perceived and measured recalling the actual volume of TEU traffic from same origins and its stable trend after the 9/11 attack, as yearly published by the *London Container Industry Review*, and listed in millions of Teu :

Overall Traffic: first 20 ports
Year 2002 – Geographic Area

Asia	84.951.148	65,89%
North Europe	22.448.422	17,41%
North America	14.381.242	11,15%
Middle East	4.194.264	3,25%
Mediterranean	2.954.571	2,29%
Total	128.929.647	100%

Overall Traffic: first 20 ports
Year 2006 – Geographic Area

Asia	148.365.970	71,27%
North Europe	30.020.396	14,42%
North America	20.853.024	10,02%
Middle East	8.923.465	4,29%
Mediterranean	-	-%
Total	208.162.855	100%

Overall Traffic: first 20 ports
Year 2007 – Geographic Area

Asia	170.334.729	72,24%
North Europe	33.759.457	14,32%
North America	21.045.404	8,93%
Middle East	10.653.026	4,52%
Mediterranean	-	-%
Total	235.792.616	100%

www.ci-online.co.uk

Overall Traffic: first 20 ports
Year 2008 – Geographic Area

Asia	187.317.049	80,84%
North Europe	30.063.736	12,97%
North America	14.337.801	6,19%
Middle East	-	-
Mediterranean	-	-
Total	231.718.586	100%

Overall Traffic: first 20 ports
Year 2009 – Geographic Area

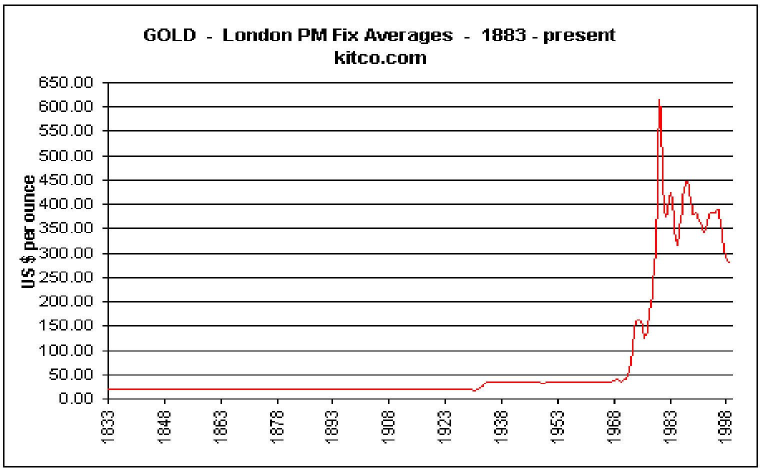
Asia	173.892.469	78,72%
North Europe	24.062.929	10,89%
North America	11.816.591	5,35%
Middle East	11.124.082	5,04%
Mediterranean	-	-
Total	220.896.071	100%

The stable Chinese trade balance surplus have systematically supported both the American deficits, the external and the internal one, trough the systematic purchase of public debt treasuries and bonds and reallocation of most of the excessive Chinese liquidity with North American banks without an acceptable risk caring liquid reserves diversification.

Bankers found, therefore, new ways and instruments to lend ever growing deposits against relatively small amounts of paid in capital, which should eventually provide their cushion against bad loans during a recession. They wrote *credit default swaps* - insurance policies - against loan defaults - that were generally backed by few if any assets. Financial investments houses and banks exchanged swaps in a grand *ponzi* scheme that shall take a decade to clearly unwind but just because producers were not investing and industrial output was progressively deteriorating credit demand were insufficient to match banks' liabilities.

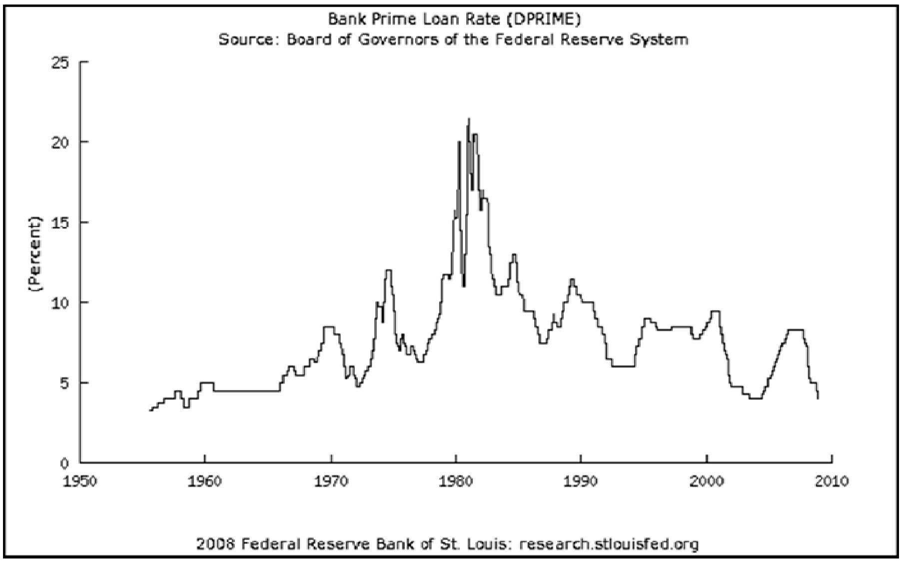
At the beginning there was just the monetary crisis, which started with the definitive repudiation of gold as endorsed in the year 1971 with an impressive effect on gold prices previously unchanged since 1933:

Price of gold as daily traded in London

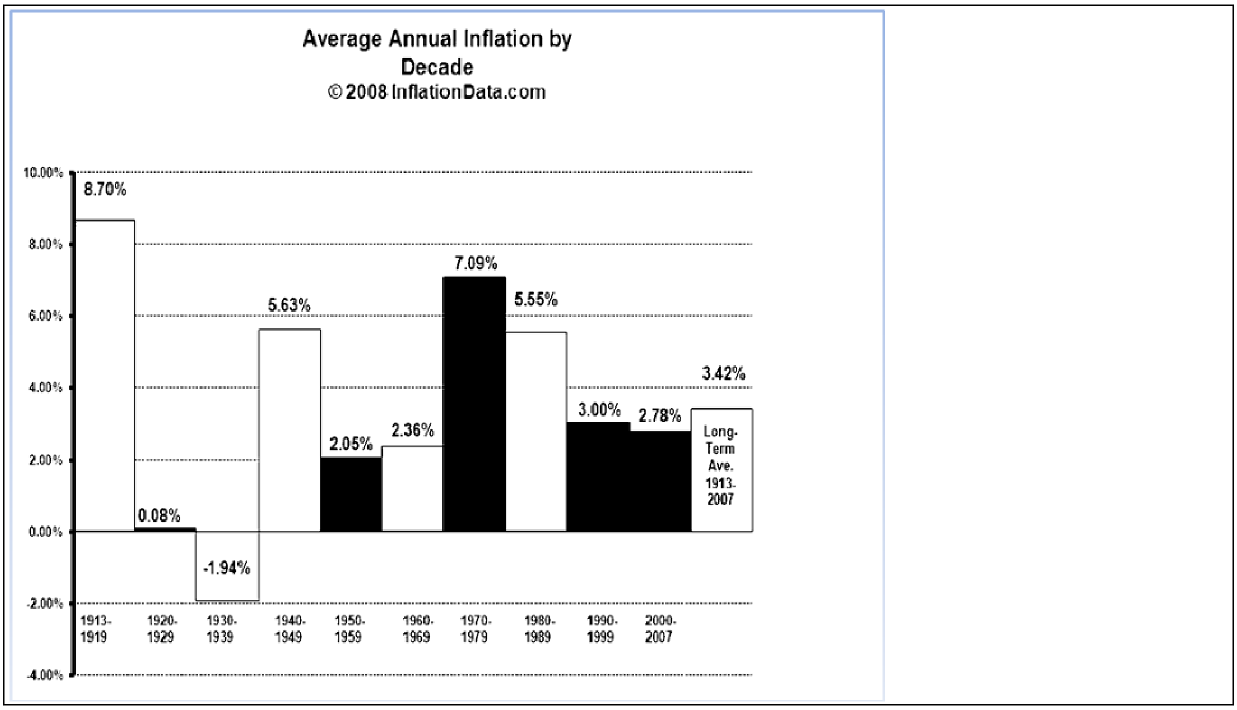


<www.kit.com>

From such a disruption of a long lasting price and prevailing foreign exchange stability, an interest rates symmetric trend was immediately discovered and driven out by market forces.



The historical inflationary factors, cleared out since 1913 – 1919 First World War period, further were prevailing down the line closely reflecting both the deflationary and the inflationary policies alternatively implemented:



Since autarchy, custom barriers, protectionism and nationalistic attitudes with devastating military effects have been rejected after the 20th Century tragic events, at least in current present scenarios, and are not invoked and considered unrepeatable, a soft exit to the present stalemate may be supported through a set of guidelines targeting realistic resources, population and global social welfare standards, within a global enforcement of legal and institutional similar non competitive regulation rules.

4. **The unresolved monetary issues.**

The economic case against protectionism is that it distorts incentives: each country produces goods in which it has a comparative disadvantage, and consumes too little of imported goods. And under normal conditions that's the end of the general prosperity.

From an economic point of view, the final collapse of the monetary *Gold Standard*, the consequent market monetary abuse of the late eighties, started in the year 1987, induced by the Fed trough a progressive lessening of the previous tight monetary policy, in connection with some tax, social welfare and reporting worsening factors, have promoted a slow but progressive shift of most Western productions towards the East Asian tigers cheap manufacturing areas, misrepresenting price stability and monetary social balances as productive increase and technology progress.

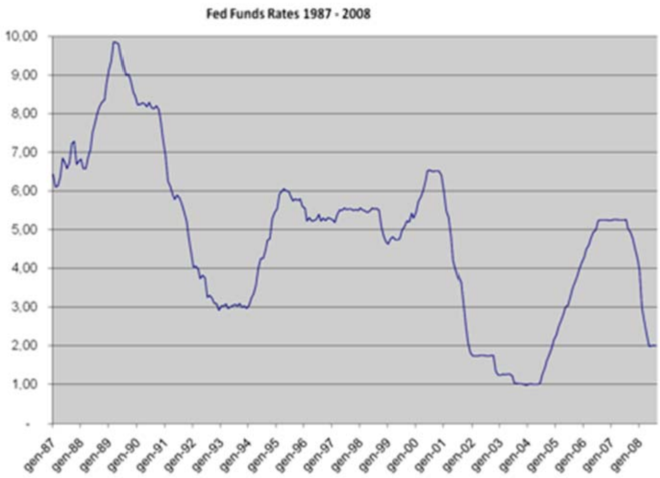
The unreliable efforts to exploit new form of money standards and payment systems: from *bancor* at Bretton Woods, to the *special drawing rights* in the seventies, to the Ecu or *European currency unit* in the eighties and lately to the *Euro*, with challenging Asian low wage countries competition growing in the last Century's decades, have lead a real global imbalance in a world split in a progressively more industrialized half hemisphere and a consuming but not competitive supplier other half, leading to the present monetary crisis, the growing oil prices inducing a huge energy general issue.

The Americans made a historical plan for reforms that included a world currency called the unitas at Bretton Woods in 1944 U.S. President Franklin D. Roosevelt told U.S. Treasury Secretary Henry Morgenthau, Jr. to prepare for an international currency to be implemented after World War II. Harry Dexter White from the U.S. Treasury formulated plans for the unitas.

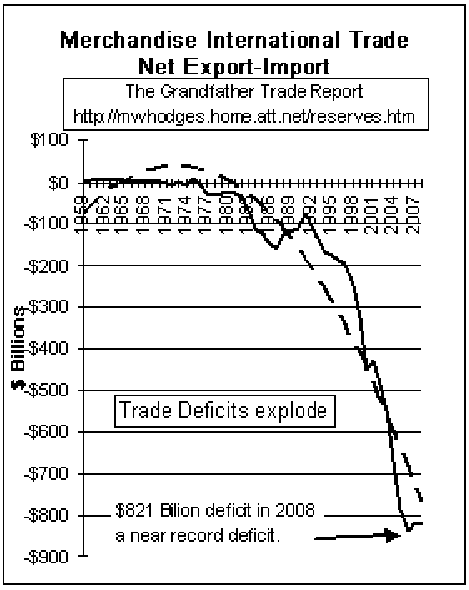
In practice, up until the final collapse of the Bretton Woods system in 1971, gold itself filled again this role, with the U.S. dollar valued and multilaterally traded among central bankers at 35 dollar an ounce and all the other currencies pegged to either the U.S. dollar or directly to gold with an official parity declared to the IMF.

The 1987 stock market collapse was surprising most of the specialist observers and a reaction was unavoidably due to following loose monetary policy, on the contrary of what happened in 1929 when the effort to return to gold was already in full gear.

The consequences are now well known and may be seen in the following charts:



The Fed funds slope reflects both the monetary bubbles formation and the bubble bursting in the market affected prices, not foreseen under the prediction of Greenspan's *soft landing* as a return to the true market price discovery function, after the monetary supply extravaganza would have been removed. Actually, the Dow Jones reeached unprecedent and unthinkable levels and the inflation started to develop in the year 2004 in an imperfect market.



<www.mwhhodgeshome.att.net/reserves.htm>

The figure reflect the huge growing of both internal and external US debts, which are a clear and effective sign of what was producing the loose monetary policy enforced to the system. Since then, the resulting trend appeared to look like:

– an unprecedented huge trade deficit with global exchange disruptions and world-wide financial turmoil;

– a huge internal deficit with unprecedented outstanding US liabilities to most of foreign Central Banks, especially the Bank of China which now owns almost three trillion dollars;

– an energy dependency due to the self adjusting oil prices which reflect the gold price movements, almost pegged in setting itself in a range of 5% to 10% of gold’s price movements.

The idea to introduce the Euro as a reserve currency and to strengthen the European economic presence in the World scenario has faded as the Asian economies have undertaken a cost competition that has crowded out most of the western industrial production and hoarded huge amount of US currency supporting the internal and external US deficit at same moment.

The world financial activities and monetary base expansion has not been developing into an inflationary factor because of the productivity and technological asserted innovation but, on the contrary, mostly because of Eastern low cost growing and improving quality standards and large scale productions.

5. <u>Conclusions - The exit strategy and its alternative choices, a new approach.</u>

Within these angles, only deep continental agreements seem to be an exit strategy to face a challenging economic struggle in an open and integrated trade space, which requires critical large mass production capable of huge synergies and finally levelling off the asymmetries in the global structural costs.

As the liquidity supplied by the Far eastern Central Banks on one side supported the Fed policy, the credit potential due to the imbalances, the repudiation of the 1933 *Glass and Steagall Act* and the adoption of the *Gramm - Leach - Bliley Act* in the year 1999, under the name of *Commodity Futures Modernization Act*, backed by the Treasury secretary Lawrence H. Summers, supporting the Clinton deregulation lead, on the other, to the aggressive *subprime* lending in the mortgage market.

The explosion of financial derivatives and finally the general slowing down economies, lead to the *sub prime* new experience, and to the final fatal collapse of all the financial markets when the Fed tried, unsuccessfully, to frame the inflationary symptoms in the year 2004 raising the Fed rates which lead to the collapse of the financial institutions in the year 2007. Afterwards followed the fatal demise of both the *Federal National Mortgage Association* Fanni *Mae*, and the *Federal Home Loan Mortgage Corp* (*FHLMC*) *Freddy Mac* and most of the Investment Banks in 2008.

"*First you say you do, and then you don't. And then you will and then you won’t. You are undecided now, so what are you gonna do?”*

- Undecided, by Sid Robin and Charlie Shavers.

This funny refrain reflects how Henry Paulson Jr. tried all the ways to find a solution on both sides of banking institution crisis, the toxic bonds issue and the bad bank emerged, but there was not a single common agreement about what to do and when do it.

The World has been organizing meeting at top level with plenty of financial ministers but every floor was promoting a different explanation and a different strategy.

Unfortunately, Treasury Secretary Henry M. Paulson Jr. has turned this old song into the unofficial theme of *the Troubled Assets Relief Program*, the TARP $700 billion bailout. The frequent changes of direction have not only been embarrassing, they also upset the very markets this program was designed to calm. The fact is that among so many choices, the Administration has not known how to solve the unsolvable problem of a declared banking system failure which has already become history and probably couldn't be solved. Either you declare inconsistent the assets, or the equity or you declare that the banks don't exist any more since they are bankrupt.

So, the music is strong with the financial and banking industry but what really matters is the crisis of the bank clients, either private mortgage borrowers which are now unemployed or the firms within the corporate banking listings that are not able to service their scheduled payments as the fugitives are fighting toughly from the far East on rebates which are crowding out General Motors, Ford, Chevrolet as these are not global market products like Lexus or Tata anymore.

The Japanese liquidity trap has already shown the ineffective role of loose credit policy and inefficiency of all the set of Keynesian remedies: it has been already a decade since the Japan trade marks have disappeared from western shelves with the Bank of Japan keeping interest rates close to zero while the continental Europe has been facing a debacle in its automotive, electronic and durables productions.

This real problem has turned now in a growing unemployment rate and in an overwhelming unique purchase power in the hands of few oriental Central Banks to be likely spent in overtaking Western industrial complexes. China, Singapore, Korea and Taiwan which have the largest vault of assets in the world history and are facing a dilemma in avoiding a monetary collapse which could lead to a disruptive inflationary wave will be largely buyers in the major stock exchanges.

All has been stemming from a two layers misunderstood economy system: a local split set of national and regional markets and a contextual synergetic global economy, fighting each other. The final victory lies in the mass scale openings linked to the single global market potential and to the loosest social infrastructure which should adapt to a new era, where the global versus local exit strategy has one and only one solution.

As Joseph E. Stiglitz[7] stressed out, a consequence of the recent crisis may stem from the following principles learned trough the last decade:

– markets are not self-regulating

– market information is too huge to be handled

– it is not enough to fight inflation

– financial innovation has not been always successful.

His remarks are not correct as most of present financial chaos stems out of the asymmetries which are generating the huge reallocation of world production according to the free market rules. Since the welfare State has been built up during the cold war as a remedy to avoid global dissemination of communism, reforms have lead to the social and political costs affecting industrial and services production, the collapse of the Berlin wall has freed the basic of market competition all over the Eastern hemisphere causing the hugest depression ever in the western area reflected in the bank essential dynamics.

Highest bank share price to book values in 2000

	Market cap ($bn)*	Price to book ratio **
Bank of New York Mellon (US)	34.6	6.6
Lloyds (UK)	57.9	3.9
Morgan Stanley (US)	44.8	3.9
Citigroup (US)	103.4	3.7
Wells Fargo (US)	148.3	3.6
Goldman Sachs (US)	93.7	3.3
UniCredit (Italy)	57.5	3.2
Itaú Unibanco (Brazil)	92.3	3.2
Credit Suisse (Switzerland)	63.3	2.9
BBVA (Spain)	70.1	2.9
US Bancorp (US)	46.5	2.9
Standard Chartered (UK)	51.8	2.7
Westpac (Australia)	68.3	2.7
Royal Bank of Canada	75.5	2.7
Barclays (UK)	57.4	2.6

Source: Bloomberg Photo: Dreamstime

Highest bank share price to book values in 2009

	Market cap ($bn)*	Price to book ratio †
China Merchants Bank	48.0	4.3
China Citic Bank	40.4	3.4
ICBC (China)	259.7	3.1
China Construction	199.5	3.1
Itaú Unibanco (Brazil)	92.3	3.1
Bank of Communications (China)	61.6	3.1
Bradesco (Brazil)	60.1	2.7
Commonwealth Bank of Australia	78.0	2.7
Banco do Brasil	43.6	2.5
Royal Bank of Canada	75.5	2.5
Sberbank (Russia)	60.3	2.4
Bank of Nova Scotia (Canada)	46.5	2.4
Bank of China	151.5	2.4
Standard Chartered (UK)	51.8	2.2
US Bancorp (US)	46.5	2.2

*Jan 7 2010 **Dec 29 2000 † Dec 31 2009

Such an immense success of the Far Eastern new economies is the final proof that State politics intervention, mainly supported by legal tender monetary expansion (*fiat money*) has showed once more to be the loosing side of the game. No regulation of the financial markets henceforth may be required to fulfil the gap between a free economy and a regulated one, since Adam Smith to the Wall Street collapses and to Hu Jintao.

Fortunately, the speed of this reallocation process has left untouched the firms, trading marks brands and fortunes of the reallocating entities. Not a single new Chinese trade mark has surfaced out of the industrial Chinese redemption but, as long as the liberal welfare state will stand in front of the free Eastern situation, there is no foreseeable future solution of such discrepancies, even in the best regulated of the markets.

From an exchange rate point of view, the Chinese currency exchange rate, versus other foreign denominated currencies, base to the international liquidity seems definitely irrelevant. From competition considerations, as long as labour costs are freely adjustable to any price movements, not being fixed or under labour unions monitoring, cost production factors are easily adjustable to exchange rate fluctuations. The elasticity in labour costs is potentially offsetting any foreign exchange variation at least in short periods and as Keynes said, in the long run we are all dead.

	2000	2005	2007	2008
GDP (current US$) (billions)	32,001.93	45,232.14	54,891.06	60,587.02
GDP growth (annual %)	4.1	3.5	3.8	2.0
Inflation, GDP deflator (annual %)	4.7	4.9	5.4	8.1

http://www.worldbank.org/

As can be easily seen, the world GDP has doubled from 32 trillion US$ at the beginning of the millenium to over 70 trillions today, in only eight years, from the year 2000 to year 2008, it had grown dramatically and more than ever in history, from 32 to 60.5 trillion, this is one of the greatest world economic successful growth and can be just inappropriately called recession or even depression, either financial or economic if considered from a global point of view.

This history chapter is a revision of previous economic obsolete models, old industrial production technology, markets restricted fragmentations and stems likely from a huge monetary two steps crisis, as a consequence of the end of the cold war, the refusal of the gold standards guidelines discipline as restored at Bretton Woods but repudiated in the '70 by President Nixon and the end of the affluent society patterns, collapsing within the welfare state deficit spending worship, which must be reconsidered and set up in a financially compatible new pattern. All the modern welfare political costs and inefficiencies are surfacing as a freer competition arises from the Eastern radically different social models.

Only a slow adjustment to the new global open markets efficiency and to the related unquestionable new standards prevailing in the world wide competition, under new critical corporation sizes, and a deep monetary reform will bring new chances of surviving as self adjusting economies and production chains, hopefully without recurring to the old illusory remedies of protectionism, revolutions or even fatal aggressive or defensive wars.

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