

## THE GLOBAL ECONOMY: RECOVERING FROM THE EDGE OF A FINANCIAL AND ECONOMIC ABYSS

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### Onset of the global financial crisis and recession

The global financial crisis of 2007–09 will go down in history indubitably as the foremost economic and financial cataclysm of the twenty-first century, a seismic economic and financial event. It also acquired the dubious distinction of being the gravest crisis since the Great Depression, adversely affecting both the financial and real sectors of the global economy. Banking and financial system in the advanced industrial economies was the epicenter of this crisis, which was driven close to a collapse. Soon it had dismal consequences for the global economy. Crises of this dimension transpire once or twice in a century. The contemporary phase of financial globalization was progressing at a commendable pace until the crisis interrupted. According to the McKinsey Global Institute (MGI 2009), financial assets in the international markets, which included equities, private and public debt and bank deposits, had increased almost four-fold during the 1980 and 2007 period. The crisis brusquely stopped three decades of expansion in the international financial markets.

Although multiple short- and long-term factors were responsible for the financial crisis, it was sparked by the bursting of the housing bubble in Britain and the United States in the autumn of 2007. The US housing bubble burst in August 2007 and in Britain the Northern Rock failed in September 2007. That said, the seeds of subprime mortgage crisis in the United States were sown much earlier, in the late 1990s. Large inflows of foreign capital and low interest rates had created easy credit conditions

for several years before the financial crisis essentially materialized. This financial environment not only promoted a housing market boom but also encouraged debt financed over-consumption. Such excesses are never sustainable. History testifies that such excesses, without fail, culminate in financial crises. Subprime loans were the riskiest category of loans. Consequently, in 2007 a dramatic increase took place in mortgage delinquencies and foreclosures in the United States, which had a severe adverse effect on banks and financial markets around the globe. The largest banks in the world like HSBC and Citigroup had begun writing down their holdings of subprime related mortgage-backed securities (MBS) since early 2007.

### *Financial crisis spills out globally*

The financial crisis spilled over globally when Lehman Brothers declared bankruptcy on 15 September 2008. This event traumatized financial markets, causing panic in the global financial system (Reinhart and Rogoff 2009). The failure of a reputed investment bank of long standing shocked the financial world. It took a heavy toll on market confidence. Other similar catastrophic events included near-failure of AIG, which occurred because it sold large amounts of credit default swaps (CDS) without properly offsetting or covering their positions. As market confidence plunged, many financial giants struggled to remain on their feet. After the failure of Lehman Brothers, Merrill Lynch came under pressure and agreed to be acquired by Bank of America. Other high-profile debacles included Washington Mutual, a prominent thrift institution, which was resolved by the Federal Deposit Insurance Corporation (FDIC). Wachovia, a large commercial bank, suffered large liquidity outflows and agreed to be sold. This list of demise of elite financial institutions is far from exhaustive. It manifestly caused unimaginable loss of wealth.

At this point many of the world's largest banks were undercapitalized. Day by day, the global financial system was inching close to sheer disarray and disintegration. These catastrophic events proved to be a



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catalyst for a massive sell-off in the credit and stock markets. They set off a general flight from risk to safety in the capital markets of the advanced industrial economies first and the emerging market economies (EMEs) followed suit. The financial crisis went into an intensified phase and mutated into a global recession. According to NBER (2008), the US recession had begun in December 2007. In its composition and character, this recession was a balance-sheet drive recession. It originated in the financial sector and spread into the real economy. Its tentacles spread into household budgets and balance-sheets of business firms, banks and non-bank financial institutions.

Given the economic, financial and trade inter-linkages of the global economy, the US financial crisis briskly spilled over into the other economies. The impact on and reaction from advanced industrial economies, EMEs and developing economies varied. They essentially depended on their degree of economic and financial integration with the global economy and the macroeconomic policy responses devised individually by them. Some large and venerable European banks were driven into enormous financial distress by their exposure to the so-called toxic assets. The Union Bank of Switzerland (UBS), the largest and most resourceful Swiss bank, which was reputed to be the world's largest wealth manager, was among the hardest hit banks by the sub-prime crisis. After suffering disastrous losses in the US housing mortgage market, USB was forced to write down the value of billions of franc worth of assets and retreat from its previously profitable investment banking operations.<sup>1</sup> Citigroup enjoyed the reputation of being world's most sophisticated financial institution with operations around the globe; this reputation was gravely tarnished by its *de facto* nationalization. Numerous hedge funds folded. There is no gainsaying that global financial system was driven to the brink of a collapse. So was the global economy. The worst point of the global financial crisis was the last quarter of 2008 and the first of 2009.

Stark forewarnings of dire consequences were given by Nouriel Roubini of Stern School of Business<sup>2</sup> and the Bank for International Settlements (BIS),<sup>3</sup> but they were ignored because relevant macroeconomic variables reflected sound economic health. Economic fundamentals justified rapid rise in asset

prices. Alan Greenspan (2005), erstwhile Federal Reserve Board (Fed) Chairman, supported the view that this was a new era of prosperity and its *causae causante* has improved productivity due to endemic use of computers, IT and other high-technology equipment. He found the pre-crisis years comparable to the periods of the advent of electricity and automobile. Large global capital flows into the US economy and worsening current account deficit was explained away by Greenspan by decline in home bias. To him global savers were reaching across national borders to invest in foreign assets. His logic was that the risk-adjusted expected returns in the US economy were higher, therefore, as the home bias declined, the demand for US financial assets increased globally.

#### *Failure of the economics profession*

No one foresaw the timing, extent, scale, intensity and severity of this crisis that convulsed the very foundation of the global financial system and economy. The economics profession was squarely excoriated from inside and externally for its failure to see the origins of the crisis and appreciate its worst symptoms. Trenchant criticism by Nobel Laureate Robert Lucas and Robert Barro was widely cited in the financial press. Paul Krugman (2009a) wrote about 'the dark age of macroeconomics' in his *The New York Times* column. A global recession of this dimension is undeniably an unmitigated economic adversity. One of this severity had occurred for the first time during the last eight decades. It is reasonable to ask to what extent it could have been foreseen. The answer is that its causes were a highly complicated and interconnected set of issues, errors and policy flaws. As seen below, no one institution or group thereof could be blamed for it.

However, on a fundamental level, failure of the economics profession to see the possibility of a catastrophic malfunction of market economy was unquestionably much worse than its predictive failure. During the halcyon period of global growth and

<sup>1</sup> In August 2009, it declared a loss of SFr 1.9 billion, the seventh quarterly loss in two years.

<sup>2</sup> On 7 September 2006, Nouriel Roubini told an IMF audience that a crisis was brewing. He admonished that the United States was likely to face once-in-a-lifetime housing bust, an oil shock, dramatic decline in consumer confidence followed by a severe recession. The sequence of events according to Roubini was going to be as follows: first the homeowners would default on their mortgage loans, trillions of dollars worth of MBS would be unraveled worldwide, which would lead to a financial disarray, if not a debacle, in the global financial markets. These developments in turn would cripple hedge funds, investment banks and other major financial institutions, like Fannie Mae and Freddie Mac. The moderator of the event reacted by asking for stiff drink in jest, while his audience was dismissive (Mihn 2008).

<sup>3</sup> See BIS (2004).

expansion, economists had come to the belief that markets were stable, even self-correcting. The economics profession went up the garden path because it “mistook beauty, clad in impressive-looking mathematics, for truth” (Krugman 2009b). For several decades they had regarded capitalism as a perfect and flawless system. They were in love with idealized vision of an economy in which rational individuals interact in perfect markets. During the contemporary period this idealized vision was fortified with fancy mathematical equations. This romanticized vision of the economy made economists disregard all that could possibly go wrong. They remained oblivious to “the limitations of human rationality that often led to bubbles and bursts; to the problems of institutions that run amok; to the imperfections of markets – especially financial markets – that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation” (Krugman 2009b).

The reputation of market forces and the institution of free markets took a knock during 2007–09. Particularly the financial meltdown of 2008 did considerable discredit to the mystique of free markets. Anglo-Saxon model of liberalism and deregulation was upbraided by many, ranging from Kevin Rudd to Yukio Hatoyama. Some of the ideas of Keynes, which held sway early during the post-World War II period, became relevant again in 2008. Keynes regarded market economies fundamentally uncertain and markets far from self-correcting. Large shocks like the current financial crisis were not anomalies but normal market behavior. Governments therefore need to intervene in crises, providing a judicious and firm hand on the tiller (Keynes 1936). Since the adoption of the free-market ethos of Reagan and Thatcher, Keynesian ideas were spurned.

### Sparks of an inchoate recovery from the crisis

In late 2008 and early 2009 the big question was whether recession would become depression. Global economy contracted by 6.4 percent in the first quarter of 2009 (IMF 2009b). European EMEs and members of the Commonwealth of Independent States (CIS) were the worst affected economies. However, the developing and emerging-market economies (other than European EMEs) relatively suffered less damage. Cline (2009) observed that these two groups

of economies were damaged less than they were during the debt crisis of 1982, for Latin America, and the financial crisis of 1997–98, for Asia. In general the EMEs (other than those of Europe) weathered the storm better than the rest of the global economy, which includes the advanced industrial economies. Conversely, several fiscal challenges will confront the advanced industrial economies in the near future. They will essentially stem from the high costs of the bailouts and recessionary fiscal losses.

Some indications of a nascent recovery in Asian EMEs became evident in the second quarter of 2009. This subgroup of EMEs performed far better than the rest of the global economy in the second quarter of 2009 and was in the forefront of a subdued global economic recovery. At the end of the third quarter of 2009 and the beginning of the fourth, the global economy began exhibiting signs of a slow recovery and bottoming out of the recession. The EMEs of Asia were projected to return to 6 percent GDP growth in 2010, the best recovery performance by any subgroups of the global economy. The role of Asian EMEs in underpinning the global recovery was widely acclaimed. The IMF opined that the global economy was being “pulled up by the strong performance of the Asian economies” (IMF 2009a, 1).

The signs of recovery included improved conditions in the global financial markets, which demonstrated decisive improvement. Dow Jones index topped 10,000 on 14 October 2009, which was indicative of a fairly rapid recovery in the US financial market. Also, most regional stock markets rose by approximately 50 percent from their lows around March 2009. Credit markets had improved markedly since the last quarter of 2008 and the first quarter of 2009, when the global financial system virtually froze. In addition, interest rate spreads were declining, business and consumer confidence in some advanced industrial economies was improving and inventory levels were declining. By mid-2009, anxieties of a systemic financial collapse had receded and the pall of gloom and insecurity began to lift.

That being said, even in the last quarter of 2009, high rates of unemployment in the advanced industrial economies not only persisted, but were also not showing any signs of amelioration. In addition, housing prices were still on the decline. Bank lending necessary for growth continued to remain anemic. Demand for credit was also weak as businesses and consumers had to be cautious. Capacity utilization

rates were low globally. Most forecasters expected the pace of recovery to be sluggish. This observation applied particularly to the advanced industrial economies, where unemployment rates were being projected to remain high.

The subdued recovery was developing at a characteristically uneven pace. The EMEs and large developing economies were ahead on the recovery path. The EMEs (other than those in Europe) managed financial turmoil well. These economies were damaged relatively less than the rest of the global economies by the current financial crisis. One of the reasons was that in response to the previous crises of the 1990s and early 2000s, their policy framework had significantly improved, which rendered economic resilience to this group of economies. It proved beneficial to the EMEs during this financially stressful period. Asian EMEs were leading the recovery. They in turn were led by China.

Unevenness of recovery extended to the two principal sectors of the global economy. That is, the financial sector moved up to the recovery path earlier than the real sector. This applied *a fortiori* to the advanced industrial economies, where the real sector remained sluggish and was expected to remain so in 2010. The high unemployment scenario was the result of sluggish real sector recovery in the high-income industrial economies, giving rise to anxiety about the threat of a jobless recovery. In contrast, with gradual recovery, commodity prices began to recover slowly. In particular, oil price reached 77 US dollars per barrel on 16 October 2008, the highest level in a year. It continued the rise thereafter and hovered around 80 US dollars per barrel. In February 2009 it had fallen to 34 US dollars per barrel.

The forces driving this recovery were somewhat temporary in nature. For one, central banks and governments were not expected to play the roles in 2010 that they did in 2009. Although considerably improved, the financial sector in most advanced industrial economies was still far from healthy. Credit conditions were still tight and de-leveraging by banks was still a possibility. If de-leveraging does take place in the future, credit flows may be reined in again in the advanced industrial economies, which in turn would stall the real economy. Thus, complaisance would be premature and unwarranted. The financial sector recovery that was underway in the third and the fourth quarters of 2009 could not be regarded as

one on the firm and steady footing. At this point, supportive macroeconomic policies were needed to be followed for the medium term. Global economy could then recover and be on an even keel. The next important policy measure will be to begin unwinding the exceptionally high level of public intervention that occurred during 2009.

#### *Tenuous recovery in the advanced industrial economies*

In the advanced industrial economies there were some feeble signs of recovery in the second quarter of 2009. For instance, France, Germany and Sweden, all three recorded minuscule positive second quarter GDP growth and were tentatively edging out of recession. Japan also began to show signs of a fledgling recovery, growing non-annualized 0.9 percent in the second quarter. In contrast, the third quarter growth performance in this group of economies was a trifle superior. The United States posted 0.9 percent growth. This was the first quarterly growth after four quarters of contraction. Although the largest economy in the world emerging out of recession was indeed a healthy development for the global economy, countering this was the consumer spending in the United States. It not only failed to pick up even in the third quarter but declined. The US recovery was *inter alia* driven by government programs like popular discounts on new motor vehicles which stimulated auto sales and production as well as an USD 8,000 tax credit for the first-time home buyers. The Japanese economy grew by 1.2 percent during the third quarter of 2009. Japanese exports contributed to it by jumping 6.4 percent. Also, capital spending jumped by 1.6 percent.

After a contraction of five consecutive quarters, the 16-country Eurozone recovered insipidly in the third quarter of 2009, with GDP expansion of non-annualized 0.4 percent. This weak rebound was supported by a strong revival in industrial production. It was also driven by the stimulus packages and less aggressive de-stocking. The Eurozone rebound was powered by 0.7 percent GDP growth in Germany, the largest economy in the Eurozone. Exports and investment had supported German growth, making up for a decline in consumer demand. Italy was another large European economy that performed well by growing at 0.6 percent and ending its recession. However, the French economy posted a surprisingly feeble 0.3 percent growth again. Strong industrial production had led to higher growth

expectations for France (Atkins 2009). Consumption did not grow in France at all. Austria, Belgium, the Netherlands and Portugal also emerged from recession in the third quarter. Conversely, GDP contracted in both Greece and Spain. Technically the Eurozone escaped recession in the third quarter. In contrast, GDP growth in Britain, the second largest economy in Europe, was – 0.4 percent even in the third quarter of 2009 and it continued to be in a recession. The fact that the advanced industrial economies began on their path of tenuous recovery was confirmed by the fact that the 30 members of the OECD grew by 0.8 percent during the third quarter.<sup>4</sup>

In 2010 and 2011, recovery in the advanced industrial economies of Eurozone and the United States will be supported by the rebound in world trade underpinned by increasing demand from the EMEs, particularly the large ones. Stockpiling by businesses and stabilization of housing market will have the same favorable impact on these economies. Recovery in Japan will be supported by strong growth in Asia, albeit weak domestic demand will continue to constrain growth. Consumer prices have been falling in Japan. It was partly because the economy was loaded with excess capacity after a sharp decline in exports during the crisis. Deflation may continue to plague the economy (OECD 2009).

#### *Early and strong rebound of China*

China rebounded faster from global downturn than any other large economy. It was able to lead Asia, particularly the EMEs, to a recovery. It also led the global recovery (OECD 2009). Estimated annualized quarter-on-quarter GDP growth plummeted to a low of 4 percent in the fourth quarter of 2008, but picked up to 8 percent in the first quarter of 2009 (Mussa 2009). China was helped by its limited direct exposure to the global financial crisis. Additionally, it had relatively sounder fundamentals and prepared a powerful policy response to the great recession. It also made a meaningful contribution in preventing the global financial crisis from getting worse. China had launched one of the largest fiscal stimulus packages, when measured as a proportion of GDP (see below). Its GDP growth rate picked up from 7.9 percent in the second quarter of 2009 to 8.9 percent in the third. It was well on track to hit its growth target

of 8 percent for 2009. However, according to the September 2009 Consensus forecasts, economy was projected to expand 8.3 percent in 2009 and 9.4 percent in 2010, when it is projected to become the second largest global economy, not in PPP terms but at market prices (Wolf 2009). This would be another notable milestone for China.

Earlier pick up of the Chinese economy was supported by a massive 4 trillion *yuan* (= 585 billion US dollars) stimulus package. It was one of the largest stimulus packages and was 4.8 percent of Chinese GDP (= 3.9 trillion US dollars). A major part of China's fiscal stimulus spending was committed to infrastructure projects. In addition, a huge surge in government-mandated bank lending followed, which amounted to 7 trillion *yuan* between January and June 2009. This monetary expansion resulted in new credit expansion of a huge proportion, almost 20 percent of the GDP. It made the economy vulnerable to overinvestment in several sectors; overcapacity had reached troubling proportions in steel, cement, glass, chemicals, coal, poly-silicon and wind-power equipment sectors (Roberts 2009).

China's GDP growth during 2009 stemmed largely from the investment. In addition, there was a revival in private real estate expenditure and resilience in consumer sector. Retail sales grew by 15.1 percent in first three quarters of 2009. Thus viewed, domestic demand supported and reinforced China's recovery. During the first half of 2009, real net exports made a significant negative contribution to the rise in GDP. China made a net positive contribution to demand of goods and services produced in other countries (Mussa 2009).

The recovery continued to broaden in the Chinese economy and with that it favorably influenced the neighboring Japan and Asia, in that order. As noted above, together the EMEs of Asia proved to be a locomotive force in slowly tugging the global economy out of recession. In the fourth quarter of 2009 China began implementing its exit strategy, which entailed gradual reduction in the level of stimulus, credit expansion and infrastructure spending. Rising private investment and consumption could pick the slack.

#### **The G20 and its role in stabilizing the global economy**

It was continually debated in the academic literature that the G7 or G8 had ceased to be a representative

<sup>4</sup>The quarterly growth statistics here come from media sources and various publications in which the announcements of the respective governments are reported.

group of economies in the present-day globalized economy. In addition, given the geography of large payments imbalances, the role, value, helpfulness and effectiveness of G7 or G8 had steadily diminished. Except Japan and Russian Federation, all the countries that succeeded in accumulating large forex surpluses are the non-G8.

In the backdrop of the global financial crisis, three successive summits of the G20 took place, in Washington DC (November 2008), London (April 2009) and Pittsburg (September 2009). The G20 economies were cognizant of the need of a harmonized global policy response to the crisis. The first G20 summit in Washington DC essentially focused on the fiscal stimuli, which played a crucial role in stabilizing the global economy. The G20 policy makers agreed to launch concerted and coordinated fiscal stimuli. China and the United States responded in the most forceful manner.

As the present crisis was essentially that of the banking and financial systems of the advanced industrial economies, the G20 members assigned a great deal of importance to strengthening financial regulation and supervision network in the first two meetings. The objective of the G20 summit of London was to stabilize the battered financial and banking systems in the EU and the United States. At this juncture, the G20 had achieved an unprecedented fiscal expansion as well as adoption of appropriately relaxed monetary measures, which became the turning point in addressing the worsening global recession. The G20 countries also agreed on and initiated national and international reforms in the oversight, supervision, and regulation of financial systems. They helped initiate a process of reform of the international financial institutions (IFI), which went a long way in restoring the IMF to its pivotal position in the global financial system along with the resources it needed to carry out this role (Bradford and Linn 2009). The G20 leaders also committed 1 trillion US dollars to assist the developing economies through the IMF. Many of these countries did not have adequate resources to assemble fiscal stimulus packages and rescue their respective financial sectors.

A timely decision with far-reaching consequences taken during the Pittsburg G20 summit was regarding supplanting of the old G8 by G20. The latter was designated the premier forum for glob-

al economic and financial cooperation; this represented a defining change in world economic order. It was an acknowledgement of the fact that global economic and financial coordination needs to be handled more broadly by a larger group of countries than the G7 or G8. This decision was of historic significance and denoted passing of the baton. In the Pittsburg summit members went further to 'commit to sustained recovery' until a durable recovery is secured. The communiqué was substantive and emphasized the need for a regulatory system for banks and other financial institutions that could "rein in the excesses that led to the crisis" (G20 Communiqué, 1). The Pittsburg communiqué also promised to peer-review members' economic policy, which was a first in global economic cooperation. The themes deliberated on were appropriate and courageous. Some of the notable concerns were regarding harmonization of macroeconomic policies to correct global payments imbalances with the IMF playing a central role, a meaningful shift of voting power towards the EMEs, reform of global reserve system and capital increases for the multilateral development bank (Dervis 2009).

There is little disagreement regarding utter lack of market discipline in the large financial markets being one of the causes behind the global financial crisis. Also, national financial regulators did not have a tradition of cooperating with one another. These limitations encouraged the G20 members to develop recommendations for strengthening national regulatory frameworks and cooperation among them. They also took initiative in strengthening the Financial Stability Board (FSB) and its mandate. Membership of the FSB was expanded to include all the G20 members, which drew in the large EMEs and some Gulf Cooperation Council (GCC) members (Lombardi 2009).

The G20 is gradually establishing itself as a forum responsible for global macroeconomic as well as monetary and financial policies. China and other EMEs had an input in the Pittsburg summit and they benefited from a greater voice in the IMF. The non-G7 members of G20 will be a part of the new steering committee for the global economic and financial decision making process. In the past, creditor countries tended to set the rules of global monetary system. It is logical then to assume that the influence of creditor Asian economies, particularly that of China, will soon rise.

## Summary and conclusions

Three decades of commendable progress in financial globalization was brusquely stifled by the current financial crisis and recession. Its background was *inter alia* laid by the macroeconomic, financial and payments imbalances that steadily grew in the global economy over some ten years before the outbreak of the crisis.

Finance ministries and central banks in the systemically important economies of the world moved briskly, purposefully, resolutely and in a collaborative manner to avert a Great Depression like prolonged and severe crisis. Several of them designed and launched fiscal and monetary stimulus plans with alacrity. In this context, the G20 summit in London on 2 April 2009 and the successive G20 summits proved to be meaningful and fairly successful.

Financial crisis stalled financial globalization in its tracks; it proved to be an effective trend breaker. With the onset of recession, firms, investors and financial institutions in the advanced industrial economies began a large-scale repatriation of their capital. Deglobalization in the form of stalling or reversing of trans-border capital flows began and multilateral trade contracted at an alarming rate. Trans-border FDI flows also suffered seriously. After contraction in 2009, the OECD economies are projected to recover at a subdued pace in 2010. This, in turn, would affect the performance and recovery in the developing economies. The EMEs in general were showing symptoms of recovery earlier than other economies. In particular, Asian EMEs began to show inchoate signs of recovery in the second quarter of 2009. They were leading the recovery from the global financial crisis. Financial sector in the advanced industrial economies was recovering at a more rapid rate than the real sector, albeit unemployment continued to remain high and was persistently showing signs of worsening.

Global economy contracted in the first quarter of 2009. However, the EMEs weathered the storm better. Some indications of a nascent recovery in the EMEs of Asia became evident in the second quarter of 2009. This group of EMEs was the first to give an indication of coming out of the recovery and pulling the others out. At the end of the third quarter of 2009 and the beginning of the fourth, symptoms of a subdued global recovery in 2010 became more evi-

dent than in the past. The financial crisis, recession and the process of recovery from the crisis would change the post-crisis global economic and financial scenario to a considerable extent.

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