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CENTRAL BANK REACTION TO PUBLIC DEFICIT AND SOUND PUBLIC FINANCE: THE CASE OF THE EUROPEAN MONETARY UNION

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Abstract

The paper aims to shed light on the relation between monetary and fiscal policy in EMU, focusing on the interest rates and deficit dynamics. We present a theoretical model in which monetary and fiscal policy independently interact through their own instrument, namely, the rate of interest for the central bank and deficit spending for governments. We demonstrate that the possibility of the two policy authorities producing not conflicting results depends on the idea each has of the workings of the economic system and on the influence each variable has on inflation and equilibrium income. Furthermore the inflationary opinion of the ECB about deficit spending leads to the result that public finance becomes surely unsound, unless governments stop using expansionary instruments. We provocatively conclude that the limits set by the Maastricht Treaty are a necessary solution to avoid unsound public finance.

Keywords: public finance, policy coordination, European Monetary Union

JEL Classification: F42, F53, E63

1. Introduction

Modern economic theories have profoundly reduced the role of policy both in theoretical and applied terms. These results have, as corner stone the statements that “only unanticipated money matters” (Lucas 1972, Sargent, and Wallace 1975) and that public expenditure have not any permanent effect on equilibrium income (Barro 1974). They have been reinforced by the conclusions about the general limits of discretionary policies in the shape of time inconsistency (Kydland, and Prescott 1977). The main overall idea is that there is a long run convergence toward the equilibrium income.

These are the foundations of the European Monetary Union in which national fiscal policies are strictly subordinated to the inflation targeting of the European Central bank. National governments are obliged to respect rigid parameters and cannot use fiscal policy freely to increase growth and employment. Deficit spending and public debt has been transformed into a policy objective and the interest rate – fixed by the central bank – almost the sole main policy instrument. Furthermore the Maastricht Treaty and the Stability and Growth Pact with their parameters and procedures to achieve sound public finance, ensure that fiscal policy authorities share the price stability objective. In the framework of the European monetary union there is, therefore, just a very little room for policy coordination.

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THEORY OF ARGUMENTATION IN FINANCIAL MARKETS

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Abstract

This paper aims to explore the relevance of the Theory of Argumentation TA in the complex area of financial reporting. Specifically, we investigated the scope of the phenomenon of persuasion in advertising. It examines advertisements in publications notable economic movement in Colombia. The financial communication is important to distinguish how to run the models of behavior based on beliefs of agents. Consequently, investors' beliefs can also change systematically with changes in market prices. This paper is the first part and its purpose is to prepare from the Theory of Argumentation TA an application to the financial sector in Colombia.

Keywords: financial markets, economy, theory argumentation, information, advertising

JEL Classification: G1, G14, D8, D81, M3, G1, G11, D1, D85

1. Introduction

Persuasion is part of the broad field of the Theory of Argumentation, TA (Bondarenko, Dung, Kowalski, and Toni 1997). In the model presented by these authors a hypothesis can be defeated (or attacked) if it can be demonstrated that the opposite is more consistency. This phenomenon responds to reasonable dispute that must exist between different views about a particular problem. More concisely, TA is an extension to the classical and modern conception of rhetoric Aristotle / (Perelman, which comes from the semantic and non-monotonic logic, and extends to the accession of arguments in logic programming and Artificial Intelligence (AI). Persuasion suggests a set of hypotheses that adheres to an auditorium capable of confronting conflicting positions. In short, the theory of argumentation is a variant of the pragmatic applied to various fields of social sciences: business, advertising, political campaigns, religious sects and media.

This paper aims to explore the relevance of the Theory of Argumentation TA in the complex area of financial reporting. Specifically, we investigated the scope of the phenomenon of persuasion in advertising. It examines advertisements in publications notable economic movement in Colombia. The financial disclosure is important to distinguish how to run the models of behavior based on beliefs of agents. Consequently, investors' beliefs can also change systematically with changes in market prices.

The line of analysis proposed is as follows. Section 2 describes, in general, core materials for the state of the problem. Session 2 summarizes the main differences with the traditional rhetoric of persuasion and its effects on the behavior of agents. Later, Section 3 processes the data of financial reporting in Colombia and the perception of investors. Section 4, describes a basic model that allows the proposition of hypotheses on the content of financial advertising over the course of changes in dollar prices. Sections 5 and 6 contain some empirical evidence supporting the hypothesis. Section 7 presents some conclusions.

With this delivery we deal only sessions 1 and 2. Consequently, the aim is to give a theoretical framework from the Theory of Argumentation TA. The hypothesis is that financial markets run, taking into account variations in the beliefs of agents. Investors do not behave as rational agents. By contrast, economic decisions are in most cases the result of irrational intuitions. The financial disclosure is essential. And in this sense, persuasion and the media play an outstanding role.

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VOLATILITY CO-MOVEMENT OF ASEAN-5 EQUITY MARKETS

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Abstract

Economic cross-linkages and the increased co-movement of asset prices across international markets are important outcomes as the result of globalization. Hereby, the nature of international stock markets and the extent to which the 1997-1998 East Asian turmoil had affected the market relationship of five countries of Association of Southeast Asian Nations (ASEAN-5) remain as probing questions. Using an array of econometrics analysis upon the stock price volatility series, we found partial market integration for the pre-crisis; whereas in the post-crisis, complete integration prevails. Hence, the financial meltdown in 1997 is said to be a contagion led crisis as markets integrate well off after the crisis than prior to it. Nonetheless, long run portfolio asset diversification benefits across the ASEAN-5 basin are reduced as markets are integrated in both the pre- and post-crisis. As such, the formation of the ASEAN Investment Area (AIA- 1998) parallel with the establishment of a developed ASEAN Index-Financial Times Stock Exchange (FTSE) regional index is viable to foster deeper regional market convergence.

Keywords: ASEAN-5, portfolio diversification, volatility co-movement

JEL Classification: G15, C22, C32, F02

1. Introduction

Important linkage emerges between the real economy and both the financial and capital market structures. Evidences persistently points to the crucial role of capital markets in economic growth prospect (Bekaert, and Harvey 2002). Nonetheless, attributing causal chain between the real economy and the financial system can be rather complex.

In respect to the various studies conducted on capital market integration, Markowitz (1952) had notioned that diversification cannot eliminate all variance. However, considering the expected returns-variance of returns (E-V) rule, not only does it imply diversification, it somehow emphasized on the 'right kind' of diversification for the 'right reasons'. Elsewhere, Tobin (1958) had highlighted the empirical advantages of explaining diversification which provide a basis for liquidity preference in contrast to Keynes who believed that investor only holds one asset at a time.

Basically, foreign investment returns give rise to substantial gains in welfare to wealth holders (Grubel 1968). Similarly, exchange of financial assets and the combinations of returns and risks all of which are superior to the undiversified portfolios as international diversification offers opportunities towards the elimination of certain domestic specific risks (Forbes 1993). Holding diversified assets does not change the expected rate of return but does however reduces the risk of these portfolio investments as compared with holding only one-asset portfolio (Masih, and Masih 1999; Hunter 2006).

The integration of stock market relegates a structural change within capital markets. However, note that although market liberalization does integrate markets, regulatory liberalization does not necessarily define market convergence (Bekeart, and Harvey 2002). Considering that laws may pass all barriers to foreign participation in local markets, it might not be effective to result in market integration. Hereby, the growing sense of financial deregulations and liberalization of capital movements create an overwhelming phenomenon for both the integration and globalization of capital markets.

Market liberalization has somehow been associated with episodes of severe economic turbulence. The outset of the East Asian 1997-1998 financial crisis had caused notable implications towards the five Association

of Southeast Asian Nations (ASEAN-5) economies including Korea¹. Likewise, the nature of the international stock markets and the extent to which the financial crisis may affect the relationship within the ASEAN-5 markets remain as probing questions.

There had been significant studies with regards to the events of stock market crisis. The volatility associated with the 1987 crash was brief and transitory for the US (Schwert 1998). Tang, and Mak (1995) examined the effects for periods before and after the stock crash in October 1987, while Ewing *et al.* (1999) basically were not in favor of the contagion notion from the 1987 US market crash as long-run international diversification benefits across the markets of North American were found. Through the inclusion of structural breaks though, Narayan, and Smyth (2005) had discovered cointegration between New Zealand and US market. And within the Asian front, Fernández-Serrano, and Sosvilla-Rivero (2001) suggested that the economies of Korea and Japan are integrated from April 1987. Concerning the 1997 crisis though, which did not seem to foreshadow disruption in the real economy, market are said to interact differently during the crisis and before the crisis (Jochum *et al.* 1998).

However, studies on market volatility had been lacking. With more recent developments in both the theoretical and application aspects of economic modeling, this study serves as a platform to fill that gap. This study seeks to examine the market integration and volatility co-movement within this region. Specifically, this study examines the relationship among markets of the ASEAN-5 economies, namely: Jakarta Stock Exchange (JSX- Indonesia); Bursa Malaysia (KLSE- Malaysia); The Philippines Stock Exchange (PSE – Philippines); Stock Exchange of Thailand (SET – Thailand); and Singapore Exchange (SGX- Singapore)².

The remaining of this paper is structured as follows: Section 2 provides the theoretical underpinnings. Section 3, presents the data description and methodological analysis that are to be adopted for this research purpose. Section 4, provides the empirical results, interpretations and discussions. Section 5 concludes the study with the summary and policy implications.

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¹ The Association of Southeast Asian Nations (ASEAN) was being established through the agreement of the ASEAN Declaration, known as the Bangkok Declaration, on August 8, 1967. Initially, this declaration involves five nations of the Southeast Asian region: Indonesia; Malaysia; Philippines; Singapore and Thailand (which makes up the ASEAN-5). Along the way, it had expanded with other member countries joining the ASEAN. This includes Brunei (joined in 1984), Vietnam (joined in 1995), Laos and Myanmar (joined in 1997) and its latest member Cambodia (joined in 1999).

² Bursa Malaysia was formerly known as 'Kuala Lumpur Stock Exchange'. The abbreviation of it, 'KLSE', is still being frequently used.

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An Empirical Study of Exposure at Default

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Abstract

In this study we empirically investigate the determinants of and build a predictive econometric model for exposure at default (EAD) using a sample of Moody's rated defaulted firms having revolving credits. We extend prior empirical work by considering alternative determinants of EAD risk, in addition to the traditional factors (e.g., credit rating.) Various measures of EAD risk are derived and compared. We build a multiple regression model in the generalized linear class and examine the comparative rank ordering and predictive accuracy properties of these. We find weak evidence of counter-cyclicity in EAD. While we find EAD risk to decrease with default risk, utilization has the strongest inverse relation. We also find EAD risk reduced for greater leverage, liquidity, more debt cushion; and increased for greater company size, higher collateral rank or more bank debt in the capital structure of the defaulted obligor. The models are validated rigorously through resampling experiment in a rolling out-of-time and sample experiment. In addition to the credit risk management implications of this study (the parameterization of pricing and portfolio management models), there is use in quantifying EAD risk for banks qualifying for the Advanced IRB approach in the regulatory framework of the Basel II accord.

Keywords: exposure at default, recoveries, default risk, bankruptcy, credit risk, Basel II

JEL Classification: G33, G34, C25, C15, C52

1. Introduction

Committed revolving credit facilities offer borrowers an option to draw funds up to specified limits as dictated by changing circumstances. A great interest in analyzing these stems from the unique characteristics relative to other credit products, which have implications for pricing and credit risk management. Revolving lines appeal to a clientele of borrowers with particular financing strategies and there is an attractive return profile from investor's perspective. There is potential also relief on regulatory capital relative to similar investments. However, these instruments present a great challenge in valuation and risk management, as estimates of revolving credits facility's expected usage at default of the borrower need to be formed. We term this quantity the exposure at default (EAD), or the loan equivalent exposure, and recognize this to be a key parameter in estimating expected loss and credit risk capital for unfunded commitments. A related quantity is the loan equivalency factor (LEQ), which is the proportion of the undrawn commitment that is drawn down upon in the event of default. Financial institutions have a great interest in estimating such quantities from their internal histories, to parameterize credit risk models, as well as to satisfy regulatory requirements. In this study we shall build upon a limited practitioner literature by empirically estimating EADs from publicly available data, and relating these to a set of variables predictive of realized EAD.

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SOURCES OF EXCHANGE RATE DYNAMICS IN THE EUROPEAN TRANSITION ECONOMIES

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Abstract

Exchange rates in the European transition economies are currently exposed to the exogenous shocks as a result of higher uncertainty on the foreign exchange markets related to the various kinds of world economic crisis implications. Higher vulnerability of exchange rates of these countries to the exogenous shocks reflects decreased confidence of financial markets to the recovery process as well as an ability of the governments to sustain persisting fiscal pressures leading to higher fiscal deficits and public debt. Another issue that emphasizes the role of exogenous shocks in determining the exchange rate development in the European transition economies is the ability of national central banks to perform "suitable" monetary policy that would be able to support the recovery process in these economies while still being able to protect exchange rate of the national currency against speculative attacks and to keep exchange rate stable in the medium term horizon.

In the paper we analyze the sources of exchange rate movements in the European transition economies (Bulgaria, the Czech republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania) in the period 2000-2009 using SVAR (structural vector autoregression) approach applied on each country individual data as well as panel data. We decompose the variability of NEER and REER in these countries to permanent and temporary shocks. Impulse-response functions are also computed in order to estimate the behaviour of NEER and REER after structural one standard deviation innovations. The relevant outcomes of the analysis we compare with the results of the tests for the whole euro area (represented here by old EU member countries - EU-12 group). This approach helps us to understand the common as well as differing features of NEER and REER determination in the European transition economies and the old EU member countries.

Keywords: exchange rates, exogenous shocks, structural vector autoregression, variance decomposition, impulse-response function, panel data analysis

JEL Classification: C32, E52

1. Introduction

Exchange rates in the European transition economies are currently exposed to the exogenous shocks as a result of higher uncertainty on the foreign exchange markets related to the various kinds of world economic crisis implications. Higher vulnerability of exchange rates of these countries to the exogenous shocks reflects decreased confidence of financial markets to the recovery process as well as an ability of the governments to sustain persisting fiscal pressures leading to higher fiscal deficits and public debt. Another issue that emphasizes the role of exogenous shocks in determining the exchange rate development in the European transition economies is the ability of national central banks to perform "suitable" monetary policy that would be able to support the recovery process in these economies while still being able to protect exchange rate of the national currency against speculative attacks and to keep exchange rate stable in the medium term horizon.

In the paper we analyze the sources of exchange rate movements in the European transition economies (Bulgaria, the Czech republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania) and euro area (represented here by old EU member countries - EU-12 group) in the period 2000-2009 using SVAR (structural vector autoregression) approach on each country individual data as well as panel data. As sources of the exchange rates movements we consider three common exogenous structural shocks (also known as primitive shocks). In order to meet this objective we decompose the variability of the nominal effective exchange rates (NEER) and real effective exchange rates (REER) in these countries to permanent and temporary shocks (we assume three types of shocks - nominal³ (liquidity) shocks, demand⁴ shocks and supply⁵ shocks). Impulse-response functions

³ Nominal shocks are usually associated with the changes in relative money supply, liquidity preference, velocity shifts, varying risk premium, effects of financial liberalization and speculative currency attacks. Higher exposure of the real output to the nominal shock would indicate its higher sensitivity to the unexpected effects of money demand disturbances, money supply disturbances or both, etc.

⁴ Demand shocks are usually associated with sudden changes in exports, government expenditures, etc.

are also computed in order to estimate the behaviour of NEER and REER after structural one standard deviation innovations. The relevant outcomes of the analysis we compare with the results of the tests for the whole euro area (represented here by old EU member countries - EU-12 group). This approach helps us to understand the common as well as differing features of NEER and REER determination in the European transition economies and old EU member countries.

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⁵ Supply shocks are usually associated productivity and labour market shocks, sudden changes in the input prices, etc.

FOREIGN DIRECT INVESTMENTS, AS A FACTOR FOR ECONOMIC GROWTH IN ROMANIA

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Abstract

The most important aim of the article is to present the influence of foreign direct investments (FDI) on the economic growth in the Romania in period of 2000-2009. The article consists of two pieces. The first part deals with theoretical analysis of the FDI-led growth hypothesis. Moreover, in this part, there is made a brief overview of empirical researches involving this subject. In the next part of article, there is analyzed the importance of foreign direct investments for economic growth in Romania using the Vector Autoregression Model (VAR). There are estimated elasticity coefficients of gross domestic product (GDP) to changes in gross fixed capital formation, employment, exports of goods and services, and foreign direct investments in Romania on the basis of impulse response function. Then, there is made decomposition of the gross domestic product variance to assess the degree of GDP determination by changes in gross fixed capital formation, employment, exports of goods and services, and foreign direct investments in Romania.

Keywords: economic growth, foreign direct investments, vector autoregressive model

JEL Classification: F43

1. Introduction

The main aim of this study is the analysis of the factors which determined the growth rate in Romania during 2000-2009, with particular emphasis on the importance of the inflow of foreign direct investments. In this paper there are used methods based on literature studies concerning international economics and international finance as well as econometric methods (vector autoregressive model-VAR). All statistics used in article comes from statistical databases of the International Monetary Fund (International Financial Statistics).

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The Role of Central Banks in Sustaining Economic Recovery and in Achieving Financial Stability⁶

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Abstract

Whenever a financial crisis occurs, threatening a possible financial meltdown, central banks have to be at the forefront in combating, neutralizing the crisis and restoring financial stability and economic growth. In this regard, the present sub-prime crisis which originated from the US highlights a few key issues for the SEACEN group of central banks. This paper reviews the policy responses to the crisis which include exit policy strategies from stimulus monetary packages. To strengthen the soundness of the financial system going forward, the paper also highlights counter-cyclical and macro-prudential regulations that central banks need to actively look into.

Keywords: SEACEN, central banks, financial stability, prudential regulation, supervision

JEL Classification: E52; E58; G28

1. Introduction

The recent global financial meltdown, which originated from a dramatic rise in mortgage delinquencies and foreclosures in the United States, has caused havoc for financial institutions and markets worldwide. Fortunately, a series of post-crisis reforms implemented following the Asian financial crisis of 1997, have improved the overall soundness of financial institutions of SEACEN countries by contributing to the strength of their balance sheets even prior to the onset of the present financial crisis (Table 1).⁷ However, the real sectors, especially the trade sectors, of these economies have not been spared from the adverse consequences of the recent global economic slowdown.

Since the second half of 2009, signs are increasingly showing that the world's economies are stirring back to life. According to the IMF Outlook (IMF 2009a), financial conditions have improved and the risks to the global financial systems have moderated somewhat from the extreme levels. Commodity prices have recovered and portfolio flows have resumed in many emerging markets. The Outlook also notes that emerging and developing countries are leading the economic recovery. Although the storm may have passed, and the worst has been averted, the global economy remains highly vulnerable. This fragile recovery was made clear on November 25, 2009 when the city-state of Dubai shocked the global investment community by requesting creditors of its ports-and-property conglomerate, Dubai World, for a six-month payment standstill on its debts of billions of dollars.

⁶ Reza Y. Siregar, and Vincent Lim are the Director and Senior Economist of the Research and Learning Contents Department of The SEACEN Centre respectively. The authors would like to thank SEACEN member banks for the replies to the various questionnaires. However, the views and comments expressed in the paper are those of the authors and do not necessarily represent those of The SEACEN Centre, or the SEACEN member central banks/monetary authorities. Contribution of fellow colleagues for research assistance and editorial work is gratefully acknowledged. This paper was initially presented as a Background Paper to facilitate discussions at the 45th SEACEN Governors' Conference in Siem Reap, Cambodia on 26-28 February 2010.

⁷ The South East Asian Central Banks (SEACEN) Research and Training Centre group of central banks and monetary authorities was established in 1982. Presently, the group has 16 members, namely Ministry of Finance, Brunei Darussalam, National Bank of Cambodia, Reserve Bank of Fiji, Bank Indonesia, The Bank of Korea, Bank Negara Malaysia, The Bank of Mongolia, Central Bank of Myanmar, Nepal Rastra Bank, Bank of Papua New Guinea, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Central Bank of Sri Lanka, Central Bank of the Republic of China (Taiwan), Bank of Thailand and State Bank of Vietnam in 2006.

Although the near outlook may still remain uncertain, the recent crisis has, however, undoubtedly underscored the rising global integration of the financial sectors of the SEACEN countries and raised new and profound challenges facing the central banks in this region and around the world. Going forward, it is important that the central banks forge ahead and consider a number of reforms to enhance the stability of their financial systems. This paper puts forward some of these pressing challenges, covering the regulatory and supervisory fronts, facing the central banks around the world, including SEACEN member banks and monetary authorities.

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INVERSE VERTICAL RATIO PUT SPREAD STRATEGY AND ITS APPLICATION IN HEDGING AGAINST A PRICE DROP

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Abstract

The paper proposes a generalization of a strategy known as the Long Two Buy One Ratio Put or Put Backspread Strategy. Moreover, it proposes an application of the strategy in hedging against a price drop of the underlying asset to a future date in a way which enables hedging with zero cost. We have found a profit function, as well as a function of income from a hedged position in the analytical form, which simplifies the application in particular hedging.

Keywords: option strategy, hedging, price drop, profit function, premium zero cost

JEL Classification: G32, G11, G13

1. Introduction

Asset price volatility on financial markets has been very high in the past decades and its presence in the future is real as well. It is the volatility that had led to the creation of a scientific discipline called Financial Derivatives. These are instruments which enable, among other things, hedging of an underlying asset to the future. This hedging at a certain date is possible to do in a simple way, i.e. by buying a put option (when hedging against a drop) or by buying a call option (when hedging against an increase) with expiry at a given date. In this case we need resources to buy the options, which is the most common criticism by the opponents of hedging.

However, there are even more sophisticated methods of hedging, i.e. using option strategies. In papers [3], [4] and [6] the authors deal with hedging proposals using Long and Short Combo, Long Straddle and Long Strangle option strategies. In paper [1] hedging against a price increase of the underlying asset is suggested using the Vertical Ratio Call Back Spread Strategy. The advantage of using this strategy to hedge is that it is a so-called zero-cost hedging, i.e. no costs are needed for its creation.

The objective of this paper is to propose hedging against a price drop of the underlying asset using the Inverse Vertical Ratio Put Spread Strategy with zero cost. As this strategy is not analyzed in literature, we will first find its profit function in the analytical form. This will enable us to perform an exact analysis and subsequently to propose its application in hedging. In the second part we will show its application in hedging against a drop in SPDR Gold Shares traded at New York Stock Exchange.

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BREAKDOWN OF TRUST IN FINANCIAL INSTITUTIONS IN LIGHT OF THE GLOBAL FINANCIAL CRISIS

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Abstract

Growing interconnectivity of the global economy brings about extensive shocks resulting in increased economic uncertainty. In order for economies to handle these shocks, they need to understand the new normality and design macroprudential policies to increase the stability and resilience of the financial system, necessary for a proper functioning of the world economy. The recent global financial crisis, a turbulence of great magnitude, took the world by surprise and has had an enormous impact on the world economy. One of the negative impacts is a breakdown of trust in financial institutions. Banks are now facing an urgent need to restore public confidence. The objective of this paper is to identify the reasons behind the present global financial crisis and determine actions for banks to take in order to regain the lost trust and build long-term relationships with their clients.

Keywords: global financial crisis, macroprudential policies, trust in banks, financial stability

JEL Classification: G210

1. Introduction

The current global financial crisis has had enormous effects on the world economy. As risks in the global financial system had been underestimated, expansion of credit at the global level emerged and led to global imbalances and a distorted adjustment process of world economies (Truman 2009). Except for the negative effects on real economies, an issue of increasing loss of trust in banks, as parts of the financial system, is alarming. Growing distrust in banks can, if unaddressed, lead to a panic in the market and, subsequently, cause instability of the whole system.

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