

## **World Economy while Second Bretton Woods declines and Evaluation on Developing Countries\***

This work is aiming primarily at discussing the thesis that the search for new currency systems in World Economy is not the reason but the result of production crisis. The approach initiated with the three works of Michael Dooley, David Folkerts-Landau and Peter Garber which are carried out since 2003, i.e. the development of “2<sup>nd</sup> Bretton Woods” monetary system, and proposals of Eichengreen, Goldstein, Kamin, McKinnon, Obstfeld, Roubini, Truman and Stiglitz, who participated in this development with their works, will be examined within the thesis in question. Mainly, the effects of these discussions to the developing countries and Economy of Turkey will be focused on. Considering that the world trade volume and movements of currency determines the type of industrialization in developing countries, labor markets and the relation between sectoral structures in developing countries and foreign capital will be discussed by proceeding from the studies which are carried out by transnational foundations such as IMF, World Bank, Unido, OECD and UNCTAD. For instance, we have to opportunity to explain, why in spite of its current accounts deficit China does not want to reduce U.S. dollars / Yuan parity to its real value and why in spite of extraordinary current accounts deficit the U.S. dollars/ YTL parity in Turkey does not rise to its real value, in terms of trade and capital flows. It is not possible to say that the factors increasing and maintaining capital flows are different from the production types and industrialization periods. Therefore, we think that we can understand world monetary system or unsystematicness of it better by looking to real indicators behind interest rate parameter....

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## **1. Could there be an “International Currency” which constantly appreciating?**

In the first part of this work, the size of the international monetary system and/or unsystematicness of it, the conditions and expectations for future will be discussed. Afterwards, we will try to analyze the differences between Bretton Woods system and previous gold currency system; and new monetary balance in the post-90's called 2<sup>nd</sup> BW system by some economists.

First of all, we need to introduce the facts that make the currency international (world) currency. Marx puts value form of currency before circulation characteristic (De Brundoff, Foley, 2006). By putting forward the value form of currency Marx opposed the quantity theory of money of classical economists. According to K. Marx, for currency mass in a country to be the indicator of price of goods in that country as D. Hume first argued, the whole currency in that country must be in circulation. As we observe today, it is not possible to say that the money and the quasi money are fully in circulation in either the country or in international area. On the other hand, as K. Marx emphasized, almost limitless variety of goods also leads to different analysis that can not be compared to money according to the use value of goods, i.e. the level that it meets the needs of man. If there was only one good subject to exchange in the world of goods, it would be easier to determine the exchange relationship of the amount of that good and currency or gold "in circulation". (Marx K. , A Contribution to the Critique of Political Economy, 1993. pp.188)

Consequently, it is not always easy to establish a direct relationship between the price of goods and the amount of “currency”. The third argument of D. Hume is used later as the main theme in forming Cambridge equation (cash transactions) by A. Marshall, one of Classical economists, and again in developing the equation of exchange(cash balance) by another Classical economist I. Fisher. These two categories provided a basis for the

explanation of Classical and Neoclassical economic thoughts (with understanding the Monetarists) for the relation of money and quasi money with real sector. According to D. Robertson, Cambridge equation accepts currency as active as I.Fisher's equation of exchange accepts it inactive (Stanford, 1973, p.6).

Nonetheless, Keynes argues against the quantity theory of money proceeding from the data that the velocity of circulation, which is accepted as stable in quantity theory of money, is nonstable. This fact has actually very realistic proofs compared to analysis of Mishkin. According to the study carried out in USA between 1950 and 1990; the decrease in M1 velocity of circulation in the recession periods and the expansion in M1 circulation in expansion periods are spectacular when considered from point of the GDP (Mishkin, 2007, 170). It is also remarkable that velocity of circulation differ with respect to crisis and recovery periods in years since it introduces the problematical side of the quantity theory of money in long periods. We can conclude that value form and international mediation functions of currency are more realistic and directive for understanding the relation between the financial structure and productive sector. Moreover, when comparing the 1<sup>st</sup> and 2<sup>nd</sup> BW durations, the function of one international currency (such as U.S. dollars) as value form and international mediation is problematic and discontinuous. It is clear that for productive investments, instead of the characteristic of being a value of exchange and circulation, characteristic of international mediation of currency, i.e. credit currency, should become prominent (Tymoigne Éric and Wray L. Randall, 2006, 12). Reserve currency and the valuation problems between currencies of other developing countries disable the characteristic of money as a mediator for international settlements. Let's have a look at the problem from a historical point of view.

## **2. Change in International Currency System 2<sup>nd</sup> Bretton Woods Debate**

Bretton Woods (BW) currency system, which arose as a response for the search of a system alternative to the gold currency system failed after II. War, provided U.S. dollars the attribute of being the second convertible currency after pound sterling. A fully convertible currency is in an important position for mediation in international settlements. After war USA had all the qualifications of a fully convertible currency that is conforming for reserve currency and international mediation. Thus, in 1944 35 U.S. dollars is accepted international parity for 1 ounce gold with the decisions made in the meeting in BW town of USA and this paved the way for IMF and World Bank.

By conferring on IMF freedom for devaluation up to 10% was given to the countries which has chronic balance of payments deficit. Thus the country with current accounts deficit obtained the opportunity to close the deficit by reducing the export costs and increasing the import costs. Devaluation was made against U.S. dollars and if there is current accounts surplus, there was no suggestion to make a revaluation. Governors of the country anticipated that they will not confront a sanction when there is CA surplus but in order to meet the CA surplus a process of adaptation the exchange rate adjustments to other prices will be suggested and this pegged rate will systematize capital flows.

According to John Weeks, in accumulation period financial liabilities together with technical advances creates new value formation. This fact of creating new value formation was applied successfully in some zones (Weeks J., 1981, 190). So that, in 1945, it is announced that U.S. and Canadian dollars transferred to full convertibility. In 1958, Germany, France and Italy among European countries other than Great Britain which was

convertible before, announced full convertibility. Japan could pass to full convertibility in 1964. As a result of the problems in their economy, the currencies of developing countries could not be convertible for a long time. Therefore, two dilemmas of BW system revealed around 60's. Expansion of countries with CS surplus against the countries with CA deficit increased the disequilibrium. Second, the currencies of developing countries met the currency areas like U.S. Dollars, Deutsche Mark and Japanese Yen other than Great Britain pound sterling. Despite the problems in its economy, U.S. dollars appeared as currency with the most powerful quality of reserve currency. This fact also mediated for the developments in U.S. economy to affect economies of other countries more. Since it did not expand in the same rate in all countries and there is always tendency for crisis, the first BW system became successful to some extent in 20 years after System was announced. As a reserve currency to U.S. dollars, two new currencies arose. U.S. dollars, which depreciated in a certain band against European currencies with the attempt of snake in the tunnel in 1971, became floating currency after 1973. It was thought that since IMF and World Bank fell behind in the intervention to fast speculation and movements of currency (Kindleberger, 2007, 290), fluctuation or flexible rate system would facilitate the work of these foundations.

The intention in entering Bretton Woods system was to control hot money or speculative currency flow, that corrupts national economy policies, to some extent. However, while the system was working, hegemony of USA was felt with all its oppression. This fact also revealed convulsive conditions for BW system. Inversion of the convertibility of U.S. dollars to gold, Vietnamese war and its aggravated circumstances (inflation etc.) followed and in 1973 BW declined. On the other hand, Euromarkets which appeared in 50's ended American hegemony in international finance markets in 60's. Thus, in the international value of dollar 'catastrophic liquidation' conditions started (Gill S., 1993, 92-97). Short term currency flows and to apply independent macro economy became difficult as well as illegal

financial flows could not be controlled by advancing technology. (Helleiner, 1993, 38-39).

Dooley and others objected to floating exchange rate system which is claimed to be applied since gold dollar parity had been abandoned in March 1973. According to them, in the last 15 years that financial deregulation became widespread, the developments in the environment created by the countries with high trading volume such as USA and China got more complicated. Undervalued currencies arose in developing markets in Far East that benefit from the global investment environment. Proceeding from the lesson they took from 1997 Asian crisis these countries continued to have a surplus in current accounts by intervening exchange rate system in order to market in-country production to abroad, especially to countries which are open to capital movements and by expanding export with their undervalued currency. Naturally, although the same exchange rate was not applied in all Asia, undervalued exchange rate policy still continues with different versions. High foreign exchange reserves are in the size of foreign trade surplus of these countries (Dooley, Folkerts-Landau ve Garber, 2003). A significant part of these reserves are invested to USA long term bonds. These countries have structure based on trade balance. In the background of this structure, far East countries are known as producing and saving countries and at the same time they are known as high foreign productive investment areas.

On the other hand, USA is in the World System as a country with a high current accounts deficit We are of the opinion that when current deficit of USA is compared to far Asia's current surplus, it is possible to argue that increase in the velocity of circulation of the currency mentioned in the first part determines the international currency system by predominating over value form function of currency. The countries other than USA with current deficit such as Turkey, Mexico, England are joining to the process by an expansion predominated by capital account. While in Asian countries, especially in Japan and China,

predominated by trade account, exchange rate reserves are continually increasing, the countries predominated by trade account presents a structure binding to capital flow from abroad.

This mechanism works with the results of Washington Consensus (1989) that foundations like IMF, World Bank, U.S: Treasury Department, The Wall Street and WTO reconciled. As in the first BW, exchange rates are dependent on the interest and foreign exchange transaction decisions of Central Banks. That is why it is called 2<sup>nd</sup> BW: Because, there had been a world currency system predominated by a rate system called managed floating and similar to pegged system applied with Bretton Woods. Besides, although the role of IMF and World Bank as BW foundations had declined, they still affect macro policies and credit systems.

According to an econometric study made in BIS, even if independent monetary policies in developing countries determines foreign exchange rates as more flexible with financial deregulation implementation, not entirely a floating exchange rate but a exchange rate system, in which capital and amount of foreign exchange are effective and in which interest rates determined by the central banks decreases, is confronted. Impossible Trinity Hypothesis, which states the argument that fully free capital movements and pegged rate policies as the results of financial deregulation and Washington Consensus contradict with independent monetary policies, opened up for discussion. Again here, according to study of Saxena from BIS, independent monetary policy is based on interest rates of U.S. FED from 2000. Therefore, 2<sup>nd</sup> BW system as in first BW manages international monetary system this time with a different medium, with interest rates, through USA. In the first BW, pegged rate mediated international settlements through gold dollar parity. 2. For developing countries function of international mediation of currency is constituted by the relation between FED interests and domestic inflation targeting. The achievement of inflation targeting policy,

which aims at shaping the inflation rate in domestic field in accordance with the expectations, is at the same time measured as real achievement of central banks in developing markets. (Saxena, 2008, 95). this achievement is actually dependent on the developments determining the exchange rate in long term. In other words, while in short term interest arbitrage is determinant in the centers like USA and Japan (carry trade), in long term efficiency level, balance of payments deficit, tariff and quota treatments and relative inflation levels of countries will be the actual determinants on their own currency. Present capital movements can only postpone this valuation process. (Mishkin, 2007, 161).

So, let's state the problem. Considering the exchange rate regimes in Table 1-2, the countries, which attract high capital flows with financial deregulation, approach floating exchange rate rather than intermediate regime implementations in which they choose to determine their currency as over valued by supporting their own currency over their purchasing power parity or undervalued below purchasing power parity by being trade-oriented as in Asian countries. In terms of exchange and interest, transition from intermediate regime to exchange rate regimes necessitates more in 2<sup>nd</sup> BW than first BW to get involved in the economic area determined by the state policies predominated by USA and G7.



Table1 . The profile of exchange rate regimes today

Pegged Regimes		Intermediate Regimes	Floating Regimes
Hard Formal dollarization, currency union ad currency board supported by strict institutional and political stipulations in which retail is not possible.	Soft pegs- In this exchange rate regime, authorities aim to justify the predetermined value of exchange rate and its path without stipulations; and monetary policies only aim to support exchange rate. horizontal bands, crawling pegs and crawling bands.	Tightly managed floats- These are the regimes in which authorities have a strong surveillance and intervention on the exchange rate movements in order to peg the predetermined value of exchange rate and its path without stipulations.	Other floating regimes, freely floating regimes, managed floating regimes but excluding tightly managed floats.

*Resource:* Bubula, Andrea., Inci Ötker-Robe., (2004), “The Continuing Bipolar Conundrum” Finance and Development March 2004, pp.32-35 (Washington DC : International Monetary Fund), p. 32

Table 2: Different exchange rate regimes in developing countries and the effect of crisis

Type of Transition	Voluntarily	Effect of crisi
From Pegged Regimes to Intermediate Regimes	Czech Republic,1996 Egypt,1999 Hungary,1994 India,1995 Pakistan,2000	Argentina,2001 Philippines,1997 Thailand,1997 Venezuela,1996
From Intermediate Regimes to Pegged Regimes	Chile,1999 Peru,1999 Philippines,2000 Poland,2000 South Africa,1997 Turkey,2001	Brazil,1999 Colombia,1999 Indonesia,1997 Korea,1997 Mexico,1994

### **3-2 On the way out from BW System, the state of Developing Countries**

When Dooley and others (2003, 2004) commented on the studies of N. Robini (2006, 2008) and Stiglitz (2006), it was clear that a new epoch started for developed central countries and developing countries.

Let's first have look on the state of developed central countries. Pegged exchange rate regime of first BW and U.S. dollars, floating against many European currency and Japanese Yen after the intervention of European Central Bank on March 19, 1973, became on the same condition. (Krugman, 2006, 509). After the recession in the beginning of 2000's as a result of the capital movements which increased more, the transition of USA from production economics to consumption economics gain speed. External and domestic deficit in USA and as a result the global disequilibrium, maintained the 2<sup>nd</sup> BW relation again by affecting developing countries in Asia, Latin America and Eastern Europe through U.S. dollars in different levels. This fact decreases the characteristics of U.S. dollars as reserve currency and mediator for international settlements after a period of 60 years.

According to journal Economist, international reserves tripled and almost became 6 billion dollars in the last 10 years. 1,4 billion of these reserves belong to China and 1 billion belongs to Japan. Moreover, the reserves of petroleum exporting countries increase significantly. According IMF resources these reserves are kept on U.S. dollar basis and used in U.S: bonds (The Economist, December 1st-7th 2007, 75). Therefore, external and domestic deficit off USA are met in U.S. dollars from Far East with foreign trade surplus (China and Japan). Latin America and Eastern Europe benefits from this mechanism, to which European region gets involved, with their high capital inflow. The problem here is that for all countries the increasing capital movement moves exchange rates away from real and purchasing power parity, albeit for different reasons; and it is as if under the name of intermediate regime exchange rate practices, the implementation resumed in pegged exchange rate regime. New

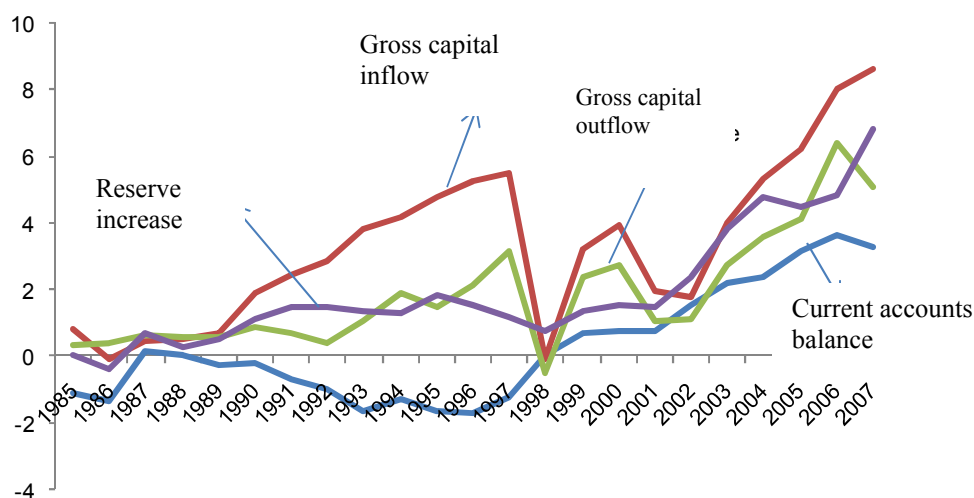
corrective actions can be expected on these developments which carried first BW system to 2<sup>nd</sup> BW in different aspects. The subprime agitation, which started in USA after August 2007, is the repetition of speculative movements in foreign exchange in the first BW system collapsed in 1973, through interests.

On the other hand, the relation established between relative unit labor costs (RULCs) and exchange rates became problematic for U.S. dollars. The increase in exchange rate in terms of domestic currency (outright exchange rate), which affects RULCs negatively, are realized depending on the capital flows (interest rates) rather than trade, efficiency or external deficit. Unit labor costs calculated according to U.S. dollars does not seem to give realistic results. Because the real value of dollar and the real value of currencies of developing countries can not be known.

The uncertainty in the real value of exchange rate is closely related to gross capital flow for developing countries. Gross capital flow for developing countries since the late 80's, as shown in Figure 1, helped some of them to have current accounts surplus as well as it caused reserve increase in these countries. Nonetheless, incisive attempts observed in the late 90's and beginning of 2000s since it was an appropriate ground for gross capital outflow. In terms of current accounts deficit, the effect of undervalued rate policies, in the countries other than the ones in the same position of Turkey and some developing Eastern European countries, is observed on current accounts surplus. There is only one factor for Turkey to keep domestic currency overvalued in spite of high current account deficit: High real interests which both cause high raw capital inflow and low inflation through inflation targeting by putting forward the value of circulation. From the point of the regions of developing countries, the same and different effects of 2<sup>nd</sup> BW system can be observed.

Figure1 . Gross Flows, Current Accounts Balance and Reserve Movements

(As a percentage of GDP of developing markets)



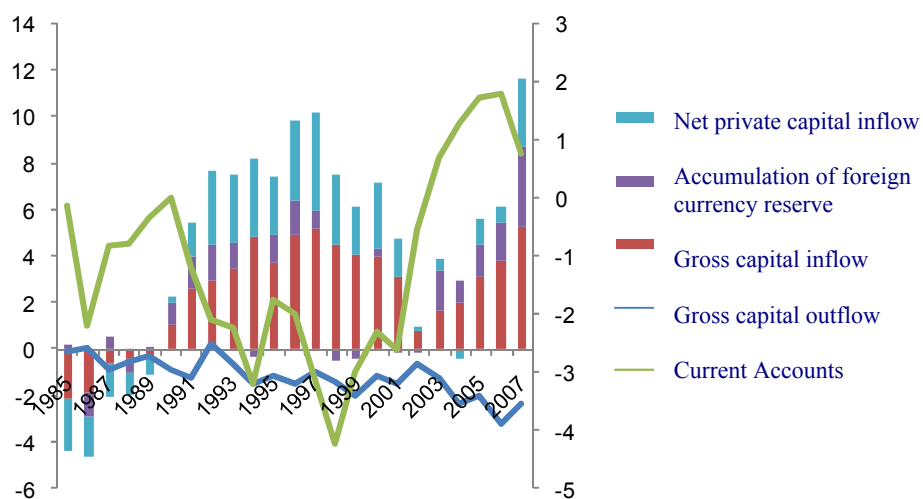
*Resource:* International Monetary Fund.,(2007), “World Economic and Financial Surveys: World Economic Outlook; Globalization and Inequality”, October 2007 pp.1-29 (Washington DC: International Monetary Fund, October 2007)

Net private capital flow to **Latin America** had been collected as a percentage of GDP since 2004 and this year it is expected to gain the level in 90’s. <sup>1</sup> Gross private capital flows are mostly balanced with constantly increasing gross capital outflows- It reached to its highest level in 2006-. The increase in the net private capital flow occurred in the same amount with current accounts position of region. The major external deficit in 90’s and the significant reserve accumulation in 2006 resulted in an external surplus as a record. (Figure 2)

<sup>1</sup> Region consists of Argentina, Brazil, Chile, Colombia, Costa Rica, Paraguay, Peru, Uruguay and Venezuela. .

Figure 2. Latin America

(as a percentage of regional GDP)



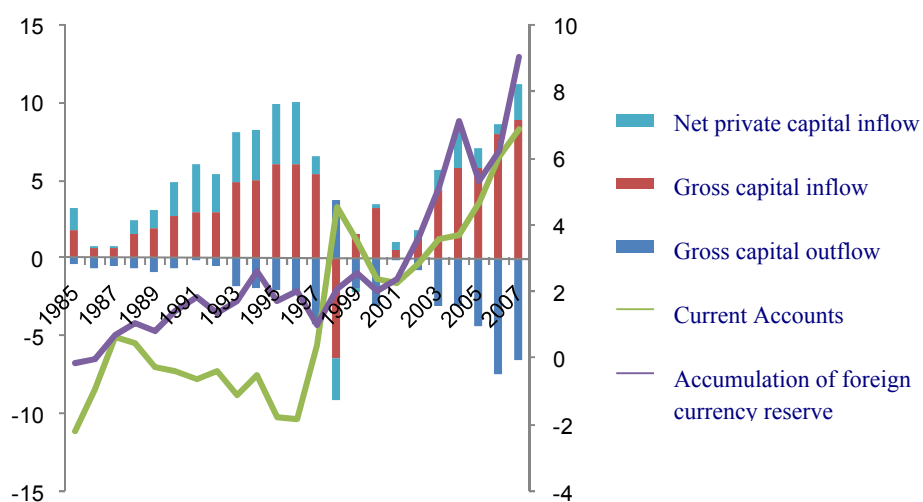
Resource: IMF (2007)

In **Developing Asian** countries, net private capital flows recovered from the level they came down in 1997-98 crisis.<sup>2</sup> The gross capital flows to the region regained the level as it was before crisis but private capital outflow- especially portfolio flow- gather speed from the beginning of 2000s and this situation caused net flows to remain under the pre-crisis level. (Figure 3).

<sup>2</sup> Region consists of China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Thailand and Vietnam.

Figure 3. Developing Asia

(percentage of regional GDP)



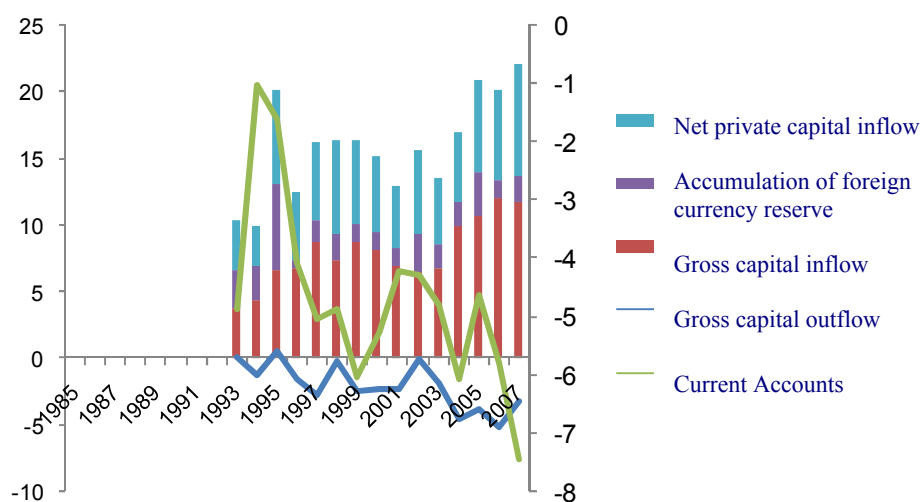
Resource: IMF (2007)

**Developing Europe and Commonwealth of Independent States<sup>3</sup>** net capital flow gather speed from the beginning of 90's. Joining to European Union resulted in gross capital inflow to the developing market economies in a level never seen in the history. Distinct from other regions, net capital flows together with current accounts deficit caused foreign position to be corrupted. In the region including Turkey, in 2006 there had been 6 percent current accounts deficit except for Russia. (Figure 4).

<sup>3</sup> The countries in this region are Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovak Republic and Ukraine.

Figure 4. Developing Europe

(As a percentage of regional GDP)



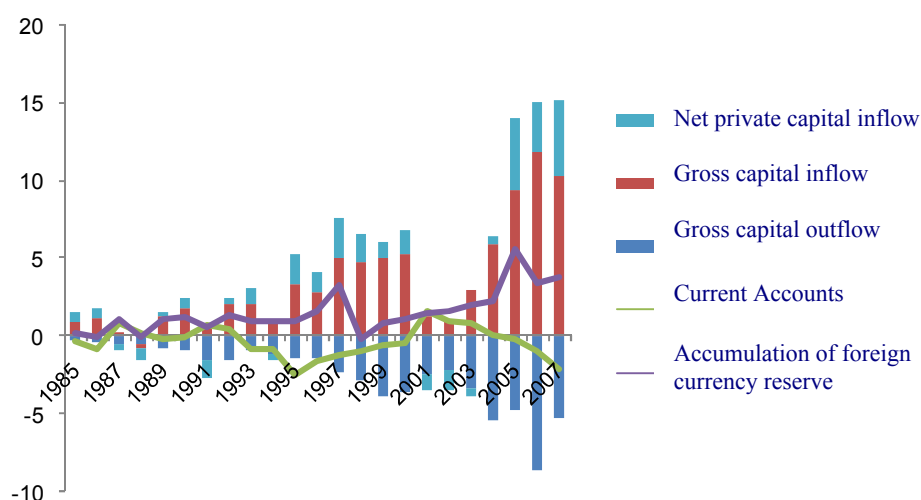
Resource: IMF (2007)

**Other developing market economies**<sup>4</sup> The capital inflow in these countries promptly increased and became more than it was in the last three years by the mediation of Turkey and South Africa after the depression experienced in these countries in 2000. Lately gross capital inflow occurred by balancing the gross capital outflow trend. The countries, in which unit labor cost is affected by exchange rates, maintain their overvalued rate policies by having CA deficit. In this region net private capital inflows reveals as the main reason for overvalued exchange rate. (Figure 5).

<sup>4</sup> These economies consist of Albania, Algeria, Cyprus, Egypt, Israel, Malta, Morocco, South Africa, Tunisia and Turkey.

Figure 5. Other developing market economies

(regional GDP percentage)



Resource: IMF (2007)

The main factor, that distinguish the second floating of net capital flows occurred lately from floating in the beginning of 90's, is that in all four regions net direct foreign investments predominates compared to portfolio investments and financial flows named as other. (IMF,2007: 4-5).

Briefly, the point that the last trend in capital investments is that it is included in a broader country group and supported by a stronger current accounts position (excluding developing European countries) and also it is financially more integrated with world economy, i.e. at least capital outflows are partially supported by capital outflows. (IMF, 2007: 4-5).

#### 4. Why should a problem expected in 2<sup>nd</sup> BW?

Capital mobility in the developing countries as we try to state above might be a subject to different discussions among different schools of economics. The biggest dilemma of 2<sup>nd</sup> BW system is that as a result of China's incredible external surplus against USA Remninbi



(Yuan) holds its overvalued condition although it has to appreciate around 15-25%. (Goldstein, 2005). The overvalued condition of the currencies of other Asian countries, which has current surplus, is presented as second BW effect of China by Kamin (Kamin, 2005). As mentioned before, increase in the labor productivity of one country leads to an increase in the value of its currency. In order to decrease relative labor costs, China kept competition alive by not increasing the value of its currency even though it maintained four times more efficiency than USA between 1994 and 2003. (McKinnon, 2005, 5) As Stiglitz mentioned, it does not seem to be possible for USA on one hand, on the other hand for China and developing countries which attract capital to maintain this under the circumstances of present rate and interests (Obstfeld and Rogoff, 2005; Eichengreen, 2004; Truman, 2004). Stiglitz, who argues that USA has a savings deficit and therefore can prevent the danger of external budget deficit by meeting the saving deficit, warned USA in October 3, 2006 (before subprime crisis) in New York Times. Stiglitz, who does not use the concept of 2<sup>nd</sup> BW, made the assignation that Chinese Yuan is undervalued and USA had a big deficit from the trade with China. After this assignation he emphasized that the main problem lies in changing the tax system in USA because even if China increases the value of Yuan, it is inevitable for USA to make capital imports of 2 billion dollars in a day. According to him, an increase in the savings and a decrease in expenses will be seen by undertaxing the ones with low income and overtaxing the ones with high income (Stiglitz, 2006). Here the opinion of considering monetary system with endogenous variables, as both Stiglitz and Keynes mentioned, predominates.

In Second BW unlike in first BW, rather than implementation that will fix the rates, it had to modify international trade policies and limitations by putting WTO in effect. Nevertheless, not proceeding in the meetings of WTO causes problems in rates (Panic, 2003, 377). On the other hand, it is presupposed that Robert Wade Basel 2 standards will be ineffective and create herd behavior as Basel 1 (Wade, 2007, 127). U.S: dollars, of which

intermediation power in international settlements diminishes, may cause developing countries to lose time by being affected negatively from the deadlock called “2<sup>nd</sup> BW system”.

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