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REASONS FOR FINANCIAL CRISES IN THE CONTEXT OF THE
MORTGAGE MARKET CRISIS

Abstract

The following paper addresses the question whether the recent mortgage crisis is a cause or an effect of the global financial crisis of 2007-2009. According to authors of the paper mortgage market is not considered to be the main reason of present financial crisis. A wide spectrum of others factors that has evoked financial system instability in 2007-2009 is presented.

Keywords: financial crisis, financial markets, mortgage market, financial market disruption
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„Financial markets are in constant conflict. This war has been going on from their beginnings, that is from the onset of the commodity and money economy until nowadays. There is no end to this war: the struggle for profits lasts 24 hours a day, 7 days a week, and 365 days a year.

(Lundell D., 1999, Sun Tzu's Art of War for Traders and Investors, p.IX.)

„Conflicts on the financial market sometimes end in spectacular financial crashes.”

(Pietrzak B., Polański Z., Woźniak B. (2008), System finansowy, p.275)

The following paper addresses the question whether the recent mortgage crisis is a cause or an effect of the global financial crisis of 2007-2008.

Financial crises have occurred in the economy since the close of the 17th c. They appear irregularly, and each time they come unexpected, ruining the established order on the financial market. Transactions on the financial market are carried out by means of financial instruments. The basic elements of the financial market are: market entities, objects of transactions, entities supporting the operation of the market (a financial safety net), as well as principles of conducting transactions on the financial market. Depending on the transaction object, financial markets can be divided into money markets, capital markets, foreign exchange markets and derivatives markets. Financial market institutions include:

- financial intermediaries, transaction participants (buying and selling financial assets),

- safety net institutions, necessary for the secure functioning of the financial market (supervisory and regulatory institutions, establishments which increase market transparency, rating agencies, institutions protecting market participants).

An important area of the financial market covers the principles of its functioning – **rules of the financial market**. There are three kinds of rules governing the operation of the market: regulations specified by legal acts, standards established by the financial system entities, and customs shaped in the course of time (Jajuga, 2007).

The operation of the financial market must be safe and stable owing to its significance to the economic and social system, and due to imperfections of the financial market (asymmetric information, moral hazard and adverse selection). Moreover, the financial market stability is regarded as public good. Thus, for the reasons mentioned above, state intervention is needed in the operation of the financial market. Institutions of the financial market are supported with the institutional infrastructure of the financial system, usually established on the initiative of the state (safety net institutions).

The desired condition of the financial market is its stability, defined in a number of ways:

- as a condition of dynamic and continuous equilibrium on interconnected financial markets (Solarz, 2001, pp. 195-200),
- as a condition when the financial market does not exhibit regularly a loss of liquidity (Crockett & Jackson, 1997, pp. 8-14),
- as development in the circumstances of no financial crisis (NBP, 2004, p. 3).

Financial crises are defined in various manners – as e.g.:

- overtrading (Smith, 1776)
- banking panic, market rush, market euphoria (Pigou, 1927)
- a situation when the bankruptcy of one bank creates an atmosphere of distrust around other banks and brings ruin to banks which are actually in good condition (Marshall, 1923, p. 305),
- speculations turning into rushes and crashes with the „inherent” instability of credit (Hansen, 1957),
- an effect of mistakes in the monetary policy, i.e. errors in money creation which is incompatible with changes of production volume (Schwartz & Friedman, 1963),
- a situation when markets whose normal functioning is just right get caught in a trap and a banking panic follows (Kindleberger, 1999),
- a process of the financial market disruption, where due to market imperfections (adverse selection and moral hazard in the circumstances of asymmetric information) the financial markets no longer fulfil their role of a channel through which financial resources are efficiently allocated to the best investors (Mishkin, 1990, p. 42),
- a situation when the financial system does not carry out its functions,
- a situation when a considerable group of financial institutions have in their balance sheets liabilities exceeding the market value of assets (Sundararajan & Balino, 1991, p. 3),
- episodes of abrupt changes on the financial markets, connected with liquidity deficit and insolvency of market participants and (or) interventions of state authorities which are to prevent them (Bordo et al., 2000, p. 22),

- strong disturbances in the financial intermediation system, causing disruptions in the real sphere of the economy (Sławiński, 2002, p. 175),
- a consequence of shaking the confidence in the stability of the whole economy, the financial system, the stability of the financial market (its particular elements – financial intermediaries, prices of financial instruments, rules of the market's operation), the ability to maintain equilibrium in balance of payments by a given state (Mishkin, 2002, p. 8),
- an abrupt change (a decline/increase) in assets prices, leading to a crisis situation of financial market participants (Eichengreen, 2004),
- a situation in which the financial markets are unable to manage risk properly (Stiglitz, 2008).

A financial crisis is inability of the financial system to (Schinasi, 2006):

- a) perform the functions allocated to it,
- b) conduct transactions in confidence and at prices which are not subject to considerable short-term fluctuations,
- c) eliminate external shocks affecting the financial system,
- d) allocate efficiently financial resources of the economy,
- e) identify and manage efficiently risks in the financial system.

We should remember that crises always come unexpected. We can foresee some standard phenomena, but not disasters which happen for the first time. Some events occurring in the global economy in recent times were alarming and difficult to explain. They informed about certain unfamiliar processes taking place in the economy, but were not interpreted correctly. These phenomena are:

- A drop in the value of the dollar in relation to other currencies (the majority of them),
- An abrupt increase in prices of oil and other resources (signalling that a “speculative bubble” is emerging),
- A steady growth in prices of financial assets on the financial markets,
- Profits of the financial sector higher than in other sectors of the economy (rate of return of certain hedge funds was approaching even 900% annually),
- A growth in managers' wages (mainly in the financial sector), not related to their work effort,
- A rapid development of financial innovations (securitization and new financial instruments).

It is hard to agree with a thesis that the mortgage market gave rise to the crisis of 2007-2008. The ongoing crisis on the financial markets has much deeper causes. The crisis originated formally in the mortgage market crash, but the reasons for the current crisis are:

- Globalization of the financial markets at the lack of global democracy, global regulations and global safety net,
- Global imbalances (disproportions between the real and the financial sphere, the countries - debtors and creditors, the rich and poor countries),
- Flaws of the economic policy in globally dominant economies (low interest rates in the USA, generating huge money supply in the USA due to the development of securitization, and, at the same time, enormous reserves of the American currency in Japan, China and other countries, as a consequence a decrease in value of the

- American dollar in relation to other currencies, a corresponding deficit in the USA – balance of payments and a growing deficit of the federal budget),
- Greed and maximization of profits (both individual and corporate ones). Aiming at profits maximization and moral hazard led to the emergence of systemic risk,
 - Financial markets aiming at privatization of profits and nationalization of losses,
 - Taking risk, disregarding it, then shifting it onto others and concealing its effects,
 - Complicated financial instruments, whose construction and consequences were not fully understood even by their creators,
 - The financial safety net which was incomplete and ill-suited to the development level of the financial markets. A safety net can be an automatic regulatory factor of financial stability, on condition that it keeps up with the development of the financial market,
 - Speculative bubbles on the financial assets market and resources market, on an unprecedented scale, intensified by the mechanism of financial leverage,
 - Standards (methods) of valuating assets, liabilities and financial instruments, which enable creation of huge profits when prices of financial assets are going up, but cause havoc in balance sheets of enterprises and financial institutions (leading even to their bankruptcies) when prices drop rapidly on the financial markets (valuation by means of the market value method),
 - Lack of responsibility for wrong decisions on the financial markets,
 - Widespread decrease of confidence (in the government, the central bank and other banks),
 - Looking for liquidity, which enforced mass selling of financial assets and caused a rapid decline in prices of these assets (deflation of assets),
 - Freezing of the markets will lead in the long run to collapse of investments and to severe recession, whose depth will be conditional on the time the financial markets will rebuild confidence and resume credit creation and investors will be optimistic in estimating the prospects of their investments.

The scale and depth of the financial crisis of 2007-2008 convinced everyone that it is necessary to validate both the rules of the financial market's operation and relations between the market and the state, including the range of the state influence on the financial market. Economists do not agree who is to blame for the current crisis:

- is it the market which is not a perfect mechanism of allocation of resources due to financial market imperfections that need to be compensated for with actions of the state?
- are these institutions of the state which, through their policy aimed at long-term economic growth, led to the deformation of the financial market?

In everyday language the „state” is understood as central and local public institutions and their activity to the benefit of the society and the economy. The activity of these institutions can be categorised according to three functions: social, political and economic. The range of the economic function of the state can vary a lot, but the presence of the state in the economy is justified by the need to eliminate market imperfections, to establish a legal framework for the proper functioning of the society and the economy, to remove negative external effects of economic activity, on account of public goods, to protect the weakest members of the society, and to stabilize the economy (Kurczewska, 2009).

The role of the state in the society and the economy is one of the key distinguishing factors in the main trends of the economic theory. The dispute concerns not only the character of the state activity in the economic system, but also touches upon the degree of participation of the market and the state in allocation of resources in the economy. While certain trends (e.g. Marxism) assign some major tasks in the economic and social life to the state, others (e.g. liberalism) tend to reduce the role of the state in the society. Between these two extreme positions there are many branches of economics, attributing very different scope of activity to the institution of the state. Advocates of the strong involvement of the state in the social and economic life point to market imperfections (imperfect competition, public goods, production of harmful goods, incomplete markets, asymmetric information). On the other hand, supporters of the market mechanism point to the government failure and numerous deficiencies in the functioning of public institutions.

The bigger or smaller role of the state in the economy means exchangeability with market forces. Advocates of the free market argue that the competitive, free-market economy brings many benefits, and the „invisible hand of the market” guarantees high economic efficiency achieved in a natural way. In contrast, economists representing other schools of thought claim it is a duty of state institutions to carry out the economic policy (including fiscal and monetary policies) and to stimulate economic growth. Such an approach to the role of the state in the economy was characteristic of mercantilism, which reserved for the state also the area of customs protectionism. The physiocrats supported economic liberalism and emphasized the role of the market and freely fluctuating prices as a perfect mechanism of resources allocation in the economy. According to the classical economics and its eminent representative Adam Smith, private ownership and unrestricted market give wealth to the state and affluence to the individual (*homo economicus*) (Smith, 1954). The activity of the state should be limited to the function of a „night watchman”. Another representative of the classical economics, David Ricardo, was the first to signal the „crowding out” of private sector investment by public expenditure. The classics who wrote about the role of the state emphasized its vital political functions (national defence, as well as protection of ownership, public order, freedom of citizens and competition). The state should be strong, but intervening in the economy only to a small extent.

John Maynard Keynes and his followers also favoured state intervention in special circumstances (Keynes, 1936). In their opinion, the government’s responsibility and goal is to ensure sustainable, long-term economic growth, through a fiscal policy. By means of a revenue and expenditure policy and implemented formal conveniences, the state launches investment programmes and influences production of goods, provision of services, and citizens’ consumption. The state can take actions which determine the economic equilibrium and, in consequence, employment. The state intervention in the market economy does not have an obligatory character for enterprises. It should stimulate them through economic methods to guide their actions in the right direction, from the point of view of long-term social goals. According to Keynes, the economy left on its own will repeatedly fall into imbalances. Thus, the active role of the state in the economy is necessary.

Keynesianism was followed by monetarism which indicated another important area of the state activity, i.e. the monetary policy. While criticizing the policy of stimulating global demand, the monetarists advocated assigning the monetary policy to the central bank and the fiscal policy to the government. On the other hand, promoters of neoliberalism

criticized intervention of the state in the economy and suggested limiting its role to fighting inflation. Similarly, restriction of the function of the state in the economy was recommended by representatives of the new classical economics (R. Lucas), the Real Business Cycle Theory (R. Barro), and the new Austrian School (L. von Mises). It is also worth mentioning the institutional economics school which distinguishes two areas of the state activity (real and regulatory ones). Advocates of this theory support the strong involvement of the state, but in the regulatory area (and not in the real area) (Skawińska et al., 2008, pp. 17-27).

In the current circumstances of the global financial crisis, the question which role can – and should – be performed by the state has to be asked once again. In the economic literature there are many arguments in favour of the active role of the state in reinforcing stability on the financial markets. These arguments are generally known and they refer to the duties of the state connected with the need to ensure an effective economic system in terms of its legal side and institutional and organizational issues (Schumpeter, 1960). Most importantly, the state should establish legal norms and institutions protecting property rights, regulating private entrepreneurship and guaranteeing economic freedom. It is also a duty of the state to prevent such phenomena as: unreasonable use of productive capacity, large downswing in economic activity, unemployment and inflation, which result in destabilization of the economy and excessive social disparities. Another responsibility of the state is to determine the scope of public and private ownership, which facilitates the rational allocation of economic resources, maximization of social welfare, and efficient use of production factors. The state is also responsible for promoting rules of ethical behaviour in the economy and eliminating such pathological phenomena as corruption or lobbying. State institutions should monitor the processes taking place in the economy (also in the financial system) and, when there is risk of disturbances on the financial markets, should try and prevent their escalation.

The role of the state in the process of ensuring financial stability is hard to overestimate. The state is the last, and frequently the only authority able to exert substantial impact on the market. Moreover, the state can establish and make use of necessary institutions and instruments enhancing the stability of the financial market. The state has at its disposal some instruments suitable for integration of autonomous national institutions, thus promoting the financial stability and, in consequence, improving the economic security (Skawińska et al., 2008). Besides taking immediate actions to prevent disturbances of the financial stability (as e.g. “fiscal packages”, popular in 2008), the state should aim at creating the conditions of safety on financial markets.

According to the Basel Committee on Banking Supervision, the macroeconomic determinants of the financial markets’ stability belong, in principle, to the scope of operation of state institutions, as well:

- a healthy and steady macroeconomic policy, suited to the needs of the economy and leading to sustained economic growth;
- well-developed public infrastructure, i.e. a system of economic law which creates favourable conditions for entrepreneurship, accounting rules and principles which conform to international standards and guarantee financial transparency of companies, an independent auditing system for financial settlements of larger companies, effective financial supervision, well-defined rules of operation of the financial

- markets, secure and efficient payments and settlements system for financial transactions with controlled risk associated with the transaction partner,
- efficient market discipline (ensuring market transparency, competitive conditions on the market, good information flow to market participants, and accountability for managing financial institutions);
 - efficient procedures in case of bank problems (creating the conditions for gradual withdrawal of problem institutions from the market, carrying out the restructuring, possibly recapitalization),
 - mechanisms of ensuring a proper level of system protection (for depositors, investors or consumers of financial services).

Another important task of the state is building a safety net which can be an automatic factor regulating financial stability. A safety net is a group of institutional solutions and regulations whose aim is to protect the financial system against destabilization (creating conditions of financial stability) (Żukowska, 2007, p. 8). The safety net can be viewed in a broad or a narrow sense. In its broad meaning, the safety net comprises all institutions, legal regulations and codes of good practices of the financial market, protecting the economy and the general public against the effects of liquidity loss and insolvency of financial institutions. In its narrow sense, the safety net consists only of institutions dealing with the banking system (the central bank, banking supervision – more and more frequently integrated with financial supervision – and a system of guaranteeing deposits).

One of the significant responsibilities of the state is modification of the safety net to follow the changes occurring on the financial market and around. Poor adjustment of the safety net architecture to the development of the financial market and to the conditions of its functioning can be a catalyst for a financial crisis. The current safety net is not prepared to operate in the circumstances of globalization of the financial markets. There is no international Lender of Last Resort, there are national models of supervision and protection of depositors, national systems of crisis management, and there are no rules or mechanism of sharing fiscal costs of restoring the financial market's stability. Thus, major changes in safety net institutions are necessary, initiated both on the national and global level.

The financial crisis, which became stronger in the second half of 2008, stimulated a search for the solutions that would offer better protection of the financial system's stability. The state has at its disposal various instruments of crisis management. These actions can be divided into two groups: overcoming the crisis (crisis management) and preventing another one (crisis prevention).

The crisis management function covers actions which can be classified into the following three groups:

- 1) short-term actions (overcoming panic on the market and reconstructing the liquidity of the financial market, of a market segment, or of financial institutions important to the financial market; actions preventing spread of the financial crisis to other (healthy) institutions, segments of the market and the whole economy (causing recession),
- 2) medium-term actions (eliminating effects of the financial crisis, repair and restructuring actions in the financial system, including the banking system),
- 3) long term actions (eliminating causes of the crisis, preventing another crisis).

Panic on the financial market can be stopped in several ways: by the market itself – market participants will notice the undervaluation of assets and will start buying them, administrative close – e.g. closing down a stock-exchange, banking „holidays”, restoring

confidence in the market by the Lender of Last Resort, introducing deposit guarantees and raising them, introducing government guarantees for transactions on the interbank market, and other actions. An important element of curbing panic is an information policy of the government and of the central bank.

Owing to the fact that in the crisis situation it is cash that is the most sought after financial asset, it is vital to rebuild the liquidity of the financial market. This should be done while maintaining the standards of providing liquidity to individual banks by the central bank in the function of the Lender of Last Resort. The problem of emergency supply of liquidity to the banking system is whether it is the market or individual financial institutions that should be provided with liquidity. In practice, it is often hard to determine which approach should be adopted in particular situations and to distinguish clearly between the two (Borio, 2004). In general, financial supply to individual institutions should be adopted when:

- a) it is highly probable that the systemic risk will become materialized,
- b) there is no alternative to using funds of the central bank,
- c) moral hazard is excluded,
- d) reliability and accountability of the central bank is not threatened.

Nevertheless, in the situation of a global financial crisis, financial resources of central banks are deeply inadequate (especially in small economies and when there are cross-border banks in the banking system). Central banks are searching for other ways to restore liquidity of the financial system, e.g. guarantees (of the central bank or the government) for transactions on the interbank market. Central banks give up the Lender of Last Resort function (that is, providing liquidity to individual banks) in favour of the Market Maker of Last Resort (providing liquidity to the market).

The aim of **the crisis prevention function** is to eliminate possible causes of crises, which comes down (in a simplified way) to the following actions:

- at the macroeconomic level: ensuring monetary stability, pursuing „good” economic policy adjusted to the business cycle and taking into account „delays” and limitations in the economic policy - e.g. the trinity of impossible, pursuing a stabilization policy,
- at the financial system level: monitoring systemic risk, preventing the emergence of „speculative bubbles” on the real assets market and financial assets market, adjusting the safety net to the developing financial market,
- at the microeconomic level: preventing panic on the market, maintaining good management standards, creating order on the market, ensuring market discipline.

Thus, as the crisis prevention, the following three types of actions should be undertaken:

- a) Correct identification and monitoring of instability symptoms,
- b) Designing strategies aimed at easing crises,
- c) Preventing causes of crises (building financial stability).

The causes of a financial crisis are usually accumulated and are impossible to eliminate by forces of the market mechanism itself. For the analytical purposes, the reasons for crises can be classified into several groups. However, when a crisis occurs, it is typically occasioned by numerous reasons, linked with feedback. The causes of financial crises are (Żukowska, 2007):

- 1) **Macroeconomic reasons, including these of the foreign character:**
 - Reasons at the international level – globalization of the financial market at the lack of global state institutions and global safety net, deregulation which enables creation of systemic risk, liberalization of capital flows, contagion of bank systems in other countries with the crisis,
 - Reasons at the macroeconomic level of a given financial system – an unfavourable macroeconomic situation, recession, the character of pursued economic policy, deficiencies in coordination of the economic policy (partial policies) in globalization conditions – the trinity of impossible, insufficient demand, contagion with financial crisis on the part of the economic crisis, a foreign exchange policy not adjusted to other areas of the economic policy and conditions of the economy, macroeconomic imbalances at the national and global level, separation of the financial sphere from the real sphere of the economy (global financial assets exceed almost tenfold real assets), inadequate market discipline, and others,
- 2) **Mezzoeconomic reasons, concentrated around the financial system (the financial market and its segments, financial instruments),** regulation of the financial system (insufficient or excessive), safety net institutions which are deficient or do not work properly, inadequate ownership supervision, inability to manage risk at the level of the whole financial system (systemic risk), unjustified decline or rise in assets prices (speculative bubbles), imperfections of the financial market (moral hazard, adverse selection and asymmetric information),
- 3) **Microeconomic reasons (at the level of individual markets, institutions and financial instruments)** – poor management of institutions from the real and financial sectors, inability to manage risk at the level of entities, innovations on the financial market (financial derivative instruments, securitization),
- 4) **Psychological factors, that is behaviour of the financial market participants affected by asymmetric information, moral hazard and adverse selection** (panic on the market, herd behaviour and imitation, lack of confidence in the financial system, greed, “casino” behaviour).

It appears that in fighting crises, both at the time of peace on financial markets (crisis prevention in the conditions of stability) and at war (crisis management), the state plays a major role. The state has to determine the conditions of the financial market's functioning, defend the established rules of the market's operation, and protect all market participants against imperfections and irregularities on the market. According to the New Institutional Economics, the role of the state in the social and economic life consists in establishment of efficient institutions (based on rules):

- a) institutions creating the market (ownership protection, creating the conditions for fair competition, market discipline),
- b) institutions stabilizing the market (safety net),
- c) regulatory institutions (issuing regulations – formal law and common law),
- d) protective institutions (defending the rights of the weakest participants of the financial market).

To sum up, it should be stated that there are no easy answers to the question about the reasons for financial crises. Neither the financial market nor its narrow segment – the mortgage market – can be identified as occasioning the crisis. The crisis of 2007-2008, a financial crisis on a global scale, has been caused by the accumulation of numerous reasons

paralyzing the financial market mechanism which – at a smaller scale of the reasons – would be able to neutralize disturbances on the financial market. Nevertheless, the financial market, frequently called „the risk market”, must be organized once again with a considerable share of the state, in order to prevent materialization of systemic risk. The relation between the state (regulation) and the financial market must be shaped taking into account the experiences of the current crisis, but also bearing in mind that the market is the best mechanism of resources allocation in the economy and transformation of savings into investments. It is also essential to determine again the order on the market in the financial sphere. Let all participants of economic relations perform their duties as well as they can – citizens sell their work, entrepreneurs produce goods and render services, sellers trade in goods and services, financial institutions sell financial services (and not illusions) on the market, whose rules are formulated by the state. The state should establish clear rules of the financial market’s operation, in regulations restricting the impact of market weaknesses (asymmetric information, moral hazard, adverse selection), ensure that the rules are observed and eliminate „fraudsters” from economic relations.

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