Monetary transmission channels and an assessment within the framework of the 2008 global financial crisis

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Monetary and fiscal policies are the economic policies that are pursued in the solution of macroeconomic instabilities. Solutions to economic problems, to be produced by monetary policies, are built on the channels through which monetary policies could influence the economy. Especially time periods of financial crises are closely related to the healthy operation of monetary transmission channels. Monetary transmission channels played a significant role in the spread of the 2008 global financial crisis, which started in 2007 and peaked in 2008, since the crisis primarily affected financial markets. The aim of this study was to provide an assessment of monetary transmission channels and of how the 2008 global financial crisis became a global issue through these channels. It was concluded in the study that all transmission channels played active roles in the spread of the crisis.

Key words: Monetary transmission channels, financial crisis, monetary policy strategy.

INTRODUCTION

The global financial crisis, which started to come into focus in the second half of 2007, erupted following the problems emerged in the US housing markets. This crisis, which shortly spread globally, disrupted countries' financial and economic stabilities, and brought about a long-lasting effort in quests for stability. In the history of global crises, there exist three big crises that the world economy has undergone within the climate of capitalist economics. The first one of them is the Long Depression, which emerged in Germany in 1873 and shortly spread into Europe and the USA, and whose influences continued to be felt until the First World War. The second is what is called Great Depression, which erupted in the US and rapidly spread into Europe. Eventually the Second World War was built on this crisis and it also initiated the Keynesian macroeconomic analysis. The last one is the Global Financial Crisis-Global Recession, which erupted in mid-2007 and whose effects still persist. The most peculiar characteristic that distinguishes this crisis from others is its rapid spread at the global level (Eğilmez, 2010). The crisis was fed by the uncontrollable lack of discipline in financial markets stemmed from the 2010). The crisis was fed by the uncontrollable lack of discipline in financial markets stemmed from the liberalization of capital movements, which started in the 1980s and peaked in the 2000s, and this phenomenon accelerated the spread of the crisis (Yılmaz, 2009a).

The aim of this study is to primarily discuss monetary transmission channels theoretically and then to evaluate how the 2008 global financial crisis erupted and through which channels it became global. In this respect, firstly, the place and functions of monetary transmission channels in monetary policy were discussed from Keynesian and monetarist perspectives. Then, individual monetary transmission channels and the ways they influence economies were discussed. Finally, the ways monetary transmission channels operate were addressed within the framework of the 2008 global financial crisis.

MONETARY TRANSMISSION CHANNELS AND ITS FUNCTIONING PROCESS IN MONETARY POLICY

Monetary transmission channel, which displays a complex structure both in theory and in practice, is the channel that demonstrates the interaction between the
monetary policy and the real economy, that is, through what ways and to what extent monetary changes influence aggregate demand and production. The importance of monetary transmission channel stems from the realization of the influence of the decisions made towards monetary policy instruments on macroeconomic variables (employment, growth, inflation, balance of payments, cost of borrowing etc.) through monetary transmission channel (Central Bank of the Republic of Turkey, 2007). Monetary transmission channels firstly starts with the change in the money supply. In this respect, various discussions have been made between Keynesians and monetarists over the issue of money's capacity to influence macroeconomic variables; however, no common ground has been found (Seyrek et al., 2004).

Keynesian policies that became prevalent following the 1929 Great Depression suggested that the role of money in economic activity could become possible only with the establishment of change in interest rates (Parasız, 2000).

According to monetarists, it is not possible to explain the influences of the change in the volume of money on the aggregate demand only through the interaction of interest rate and investment expenditures. How the relationship between volume of money and volume of production will be actualized is uncertain (Parasız, 2007). Real interest rates are taken into consideration in borrowing and investment decisions rather than nominal interest rates (Keyder, 2002). Money supply, according to Friedman, is external, and an increase in money supply has a short-term effect to decrease interest rates, a medium-term effect to increase nominal income, and a long-term effect to increase interest rates since prices and borrowing requirement go up (Orhan et al., 2007).

Monetarists, liken the economy to a black bow whose functioning system is unknown. Thus, it is impossible to explain the influence of volume of money on total production. Moreover, a change (increase-decrease) in the volume of money will not only change (decrease-increase) the marginal utility of money against other assets but also change (decrease-increase) the prices of these assets other than money (Meltzer,1995). In addition, changes in money stock influence the current and future values of foreign assets. For example, within the scope of free exchange rate system, a decline will be observed in interest rates depending on monetary expansion. This will accelerate foreign capital outflow and increase exchange rates with the increase in foreign exchange demand. Then, while liabilities of those who borrowed in foreign currency will increase, the assets of those who credited in foreign currency will increase (Kasapoglu, 2007). Therefore, channels of volume of money to influence total production are both dynamic (shifting) and diverse. In conclusion, even if there exists a connection between volume of money and total production, the reason of the change in volume of production is not always a change in volume of money (Çakmakli, 2004).

Policies pursued in the functioning process of monetary transmission channels might be aimed at different objectives. The most important among them is to achieve price stability and, thus, to attain a sustainable economic growth rate. It should be noted here that the regular and correct functioning of monetary transmission channel is of great importance to ensure price stability. There might be numerous factors that disrupt transmission in this respect (Central Bank of the Republic of Turkey, 2007). The policymaker thus attaches importance to the presence of a healthy monetary transmission channel in the selection of monetary policy instrument. The course of interest rates has an important place within the monetary transmission channel. Given the fact that real interest rate is obtained by subtracting inflation rate from nominal interest rate, when inflation rate is constant, an increase/decrease in nominal interest rate will increase/decrease real interest rate. Within the framework of rational expectations, while flexibility of wages and prices are accepted, most empirical works demonstrated that wages are rigid in the short-run. Then, until long-term price adjustments are realized, in the short-run, real interest rates will increase/decrease in parallel with the rises/desclines in nominal interest rates (Taylor, 1995). It thus becomes possible to influence the economic activity as interest rates change.

For the monetary policy to fully demonstrate its effectiveness in solving problems to be encountered in economic life, the monetary authority should accurately calculate the influence of the policies pursued on the economy and the duration of these policies. In other words, in order to overcome the problems experienced in an economy, it is necessary to know how and to what direction the monetary policy affects economic indicators. The influence of the monetary policy practices known as monetary transmission channels on the economy is realized through different channels. It should be noted that it is in fact not possible to fully distinguish between these channels (Mishkin, 1995). Monetary policy practices influence economy through interest rate channel, asset prices channel, credit channel, exchange rate channel and finally expectations channel. In this respect, the 2008 Global Financial Crisis, which erupted in the USA, rapidly spread to world economies and contracted world trade with the effective functioning of these channels. Therefore, it is necessary to know these channels well in order to be able to analyze the spreading path of the global crisis.

The interest rate channel is a transmission channel operating as the changes in short- and long-term interest rates influence supply and demand of loans (İnan, 2001). Keynesians argue that economic activities are influenced by the changes in interest rates. According to this view,  

These factors can be summarized as; prices' inability to show signal effect due to price inflexibilities, high weights of products whose prices are managed - controlled in price indexes, low depth and strength of the financial system, long maturity periods of economic agreements, freedom of capital movements, and the incalculability of how the changes in financial structures of households and firms and in short-term interest rates will influence the economy (TCMB, 2007)
central banks can influence interest rates and determine the direction of economic activities through monetary policy practices (Orhan et al., 2007). Examining the transmission channel through the interest rate channel is, according to monetarists, too restricting and mechanical. In the monetarist view, it is not certain what variables money affects and how money causes a change in production. The interest rate channel involves a classical standard transmission channel through which Keynesians explain, through structural-model evidence, the consequences created in economic activity by a change in the volume of money. In this respect, the policymaker can determine the direction of the economic process, under an expansionary monetary policy, by decreasing nominal interest rates and short-term real interest rates. This channel operates in the conventional Keynesian thought as follows (Mishkin, 1995): When money supply is increased through open market operations, an excess demand for financial assets will emerge and, thus, values of these assets will go up whereas their profits (that is, real interest rates) will decline. Depending on the sensitivity of investments to the interest rate, investment expenditures will rise and the increased aggregate demand will increase employment and production. By constantly increasing the money supply, interest rates will keep declining. However, this is not a sustainable process that is observed in all cases. It should be noted that after a certain level, a condition, named “liquidity trap” by Keynes, in which interest rates become insensitive to downward movement will be witnessed. Especially during depression times, interest rates will not go further down after a certain threshold although money supply increases, and the increased money supply will be demanded and kept in reserve. At this stage in which everybody wants to stay in liquid (assets) and the lack of demand has reached serious levels, given that the interest elasticity of money demand is infinite, monetary policy efforts to increase demand through the interest rate channel will become in vain. Thus, in addition to Keynes’s argument that this channel regulates decisions about investment expenditures; Mishkin (1995) based on more recent researches, points out that this channel also influences consumers’ housing and durable consumer goods decisions.

The exchange rate channel is a channel that operates through foreign trade movements. In other words, with the flexible exchange rate regime and the liberalization of capital movements, monetary transmission becomes influential on the economy through this channel (Mishkin, 2001; İnan, 2001). This channel has effect on capital inflow and capital outflow with the influence of interest rates in an economy with full capital mobility. This condition is addressed in the literature within the framework of a model called Mundell-Fleming. According to this model, effectiveness of monetary policy is based on exchange rates. In the assumption of unlimited capital mobility, capital flight and thus devaluation of domestic currency is the case as a result of declining interest rates due to monetary expansion. In the exchange rate regime, depending on the assumption of flexible exchange rate, export goods become more attractive in foreign markets due to the devaluation of domestic currency and production rises since foreign demand increases. The conclusion to be drawn from this is that the flexible exchange rate regime should be adopted in order for the monetary policy to effectively function in the transmission channel through the exchange rate channel. Otherwise, since exchange rates will be interfered when fixed exchange rate regime is adopted, monetary policy cannot influence the economy through the exchange rate channel (Orhan et al., 2007). In addition, balances of firms and households are affected by changes in exchange rates. Since foreign currency liability-asset conditions of firms and households will change as exchange rates differ, significant differences will be observed in consumption and saving behaviours (Kamin et al., 1998).

Moreover, international interest rates are shaped according to the Law of One Price. Therefore, it is of high importance to make capital movements by considering exchange rate changes, because inflation and exchange rate changes that might occur in the country where investment is to be made will influence the real return of the investment. Therefore, there should be a difference equal to the expected change in the exchange rate between domestic and foreign interest rates in arbitrage on interest rate (Paya, 2002). It should be noted that the impact of exchange rate on foreign trade emerges with real exchange rate. Taylor (1995) pointed out that there exists a statistically significant negative correlation between real exchange rate and real net exports. In this system, exchange rate might become an important transmission channel that creates lasting influences on net exports and aggregate demand. In the exchange rate channel, under loose monetary policy conditions, deposits in domestic currency will become less attractive than deposits in foreign currency when domestic real interest rates decline due to the increase in money supply. The decline of the demand for deposits in domestic currency will pave the way for capital flight and for the depreciation of domestic currency (Mishkin, 2001). In this framework, for the value of domestic currency to be low will render cheaper the price of the same good in the domestic market than in foreign markets (export-increasing effect). On the other hand, this condition will also render cheaper prices of import goods in the domestic market compared to foreign markets (import-decreasing effect). As a result, net exports and thus total production and expenditures will rise. On the other hand, depending on exchange rate increase, the rise of prices of imported intermediate goods will negatively influence costs and cause supply-driven inflation (cost inflation) (Loayza et al., 2002; Horvarth and Rodolfo, 2006). Undoubtedly, this relationship will go in the reverse direction in a case of monetary tightening.
In monetary policy practices, a change observed in monetary size paves the way for the process of change in prices of assets like bill of exchange, stock and real estate; depending on change of interest rates (Kamin et al., 1998). This condition that affects economic units’ wealth levels is almost the attempt of the interest rate channel, which was presented earlier, to influence the economy except investments through interest rates with a different channel. This issue brought about differences of opinions between Keynesians and monetarists. Keynesians consider the influences of monetary policies on economy within the scope of IS-LM analysis and point to the impact on the total real output, based on the relationship between interest rates and investments. Monetarists, on the other hand, address the influences of monetary transmission on economy as well as taking into consideration real wealth and other asset prices (Mishkin, 1996). A change to occur in real wealth and asset level causes a change in behaviours of economic units.

According to the monetarist approach, the asset prices channel operates through the wealth effect that depends on changes in stock prices (Tobin’s Q Theory) and in real asset prices (Tobin, 1963; Üzümçüoğlu, 2002).

According to Modigliani (1975), consumption expenditures are determined by the resources that consumers possess in their whole lives. Consumers’ most important resource is the stock. The rise of stock prices through expansionary monetary policy increases individuals’ wealth. This rise in individuals’ wealth increases consumption expenditures and, thus, aggregate demand and production. In other words, the essential argument of Modigliani’s hypothesis is that consumers extend their consumption over time and finance these expenditures with resources they obtain in their whole lives. A significant portion of lifelong resources is financial wealth, an important proportion of which is constituted by stocks. Therefore, financial wealth will rise as stock prices increase. In this case, consumers’ lifelong resources grow (Mishkin, 1996). Since a rise in money supply will increase public’s demand for stocks, stock prices will go up. The rise of stock prices that have a significant share in financial wealth, on the other hand, will increase wealth and, thus, lifelong resources. In addition, since lifelong resources finance consumption expenditures, it will also trigger consumption. Increased consumption, then, causes a rise in total production and expenditures. On the other hand, economic units obtain wealth through houses and lands. Contraction of money supply will increase interest rates and decrease housing loans and housing demand. Thus, real estate prices will go down, which will create loss of wealth and shrinking demand (Kasapoğlu, 2007).

The functioning of the credit channel is closely related to asymmetric information in credit markets. Asymmetric information in credit markets stems from the lack of adequate knowledge of credit suppliers about credit demanders. Adverse selection-moral hazard constitutes the core of this situation (Orhan et al., 2007). The credit channel functions through bank loans channel and balance-sheet channel.

Bank lending channel, depending on a tight or loose monetary policy, operates under the functionality of rise or decline of the banking system’s potential to provide loans to firms (İnan, 2001; Öztürk, 2003). A loose monetary policy will enhance bank reserves and deposits; a condition which expands bank’s credit volume. Since most entrepreneurs finance their investments with bank loans, expansion of banks’ credit volumes will incentivize investments and consumption and, thus, production will rise.

Balance-sheet channel is closely linked with the structure of asymmetric information observed in credit markets. In credit markets, firms obtain external financing on the basis of their net balance sheet values. A firm’s net value is the sum of liquid assets and marketable collaterals. The higher this value is, the lower the cost of external financing (interest). Therefore, firms’ balance sheet values influence their investment decisions since they have impact on external financing cost and credit conditions (Bernanke and Mark., 1995; Telatar, 2002).

Under the assumption of monetary expansion, depending on the decline of interest rates, improvements are observed in firms’ balance sheets since cash flow accelerates. Thus, the problem of unreturned loans and moral hazard gets less threatening (Mishkin, 1996). According to the balance sheet channel, the increase in money supply will increase stock prices, which will increase firms’ net assets. On the other hand, this situation is connected with households’ balance sheets. Households’ balance sheets include assets with low liquidity like durable consumer goods and real estate as there exists asymmetric information about their quality. Therefore, it is not likely for such assets to be sold for their real values. On the other hand, the financial assets in households’ balance sheets can be converted to cash easier (Mishkin, 1996). This is valid for durable consumption expenditures as well as for housing demand. For households to possess more financial assets like stocks than their liabilities decreases the likelihood to experience financial difficulty. This increases the demand not only for durable consumer goods but also for houses.

Expectations about future have influence in economic units’ decisions about their economic activities. In this respect, monetary policy might affect expectations and, thus, direct economic units’ decisions. At this point, expectations channel might be considered to be an independent transmission channel of monetary policy. This channel functions with the influence of expectations on inflation, on the one hand, and on the output level, on the other hand (Orhan et al., 2007). Attaining the political objective in monetary policy practices can become possible by leading economic units to the same objective. This is also closely linked with the level of trust in the policymaker. It cannot be expected from a policy practice,
which is thought to be temporary, to motivate economic units to the desired direction and extent. It should be noted that, when the loss of time created by long durations of contract is ignored and given the fact that expectations tend to change instantly, monetary policy practices on the expectations channel can yield immediate results (Cengiz, 2009). Although the functioning of expectations channel does not exhibit highly concrete interaction stages like other channels, it alters expectations for change in monetary policy and, thus, inflation and volume of production gets affected through prices. The functioning of expectations channel is built on principles like reliability in monetary policy, independency of central bank, transparency in monetary policy practices and accountability (Orhan et al., 2007). In addition, it should be taken into consideration that rule-governed policy choice, rather than activist policy choice, is influential in enhancing the reliability level.

Monetary transmission channels played a significant role in the spread of the 2008 global financial crisis, which started in 2007 and peaked in 2008, since the crisis primarily, affected financial markets. In this respect, accurately comprehending the route of the crisis, or how the crisis spread, will help analyze the crisis. Transmission channels had different impacts in different countries on the route the crisis spread, whereas all transmission channels had influence during the crisis. In the spreading channels of the crisis in individual countries; factors like economic conjuncture, monetary policy strategies pursued, exchange rate regimes followed and countries’ fragile macroeconomic indicators became influential.

THE 2008 GLOBAL FINANCIAL CRISIS AND THE FUNCTIONING OF MONETARY TRANSMISSION CHANNELS

The roots of the 2008 global financial crisis can be traced back to 1980 in which capital movements began to be liberalized. With this development, the impossible trinity theory by Robert Mundell has become prominent, which argues that only one of exchange and interest rates can be controlled in an environment where capital movement is free. In the process, flexible exchange rate regime has been adopted by many countries as controlling interest rates became important (Eroğlu and İlhan, 2010). At this point, establishment of capital mobility paved the way for rapid spread of financial crises. Capital movements, which peaked in the 2000s, planted the seeds of the 2008 global financial crisis (Yılmaz, 2009a). How did the crisis begin? How did it become global? It is possible to shortly answer these questions within the framework of monetary transmission channels as follows.

Low demand during the global crisis decreased inflationist pressures and provided those central banks that shape their monetary policy practices around inflation targeting with the opportunity to implement an effective monetary policy. In this respect, the interest rates that had been high in 2007 in developed countries like the USA, England, the Eurozone and Japan began to decline in early 2008 as a result of shrinking demand. In developing countries like South Africa, Brazil, Hungary and Turkey, shrinking demand made itself evident in 2008 and, due to the retarded spread of the crisis; monetary policy makers took generous decisions after early 2009 in decreasing interest rates (Figure 1). On the other hand, giving priority to public expenditures with a Keynesian approach in order to stimulate domestic demand increased budget deficits and serious disruptions were observed in countries’ borrowing ratios. This condition brought about the confidence problem and forced banks to hold public bonds with low risks (and low profits) in their portfolios as well as exposing the private sector to the threat of exclusion. Besides, low demand observed in developed countries signalled that these countries would not be able to increase interest rates for a long time, whereas the obligation to increase interest rates earlier emerged for developing countries like India, Malaysia and Brazil, who had better financial conditions, as a requirement of increasing demand (Central Bank of the Republic of Turkey, 2010). As is seen, the interest rate channel has played an active role since the beginning of the crisis.

Credit channel: Excess liquidity increased banks’ tendency to borrow short-term with low interest rate and to loan long-term, thus, a wide credit expansion was observed in the housing sector. As discussed in the subject of monetary transmission channels, the primary risk of the credit market is asymmetric information, which means the lack of knowledge of credit suppliers about demanders. This condition was observed in the US housing sector; banks diversified credits in order to further increase the demand for housing loans and rendered credit conditions easier. However, banks did not take into consideration the threat of wrong crediting called “adverse selection-moral hazard”. Therefore, banks offered facility in borrowing to people with low income (subprime) without considering their likelihood/resources to repay (Central Bank of the Republic of Turkey, 2008).

In this process, low attractiveness of long-term interest yields inclined investors to mortgage securities that offer high profit and risk. Banks, through the sale of these securities, found the opportunity to fund their future housing loans. Then, financial instruments index-linked to houses with rising prices faced a great deal of demand and they were overvalued through the pricing called bubble. Financial institutions, which had these securities in their balance sheets, firstly made high profits but then they had to bear high losses due to the decline in real estate prices (Gökçe, 2008). In this respect, as a result of shrinking demand for real estate after 2005, problems experienced in the repayment of housing loan...
worsened the balance sheets of financing institutions that gave credits covered by mortgage, and even they started to struggle to pledge the securities in possession as collateral (Akgüç, 2009). This proved the necessity of tightening in crediting conditions in financial markets and paved the way for the slowdown of economic activity (Central Bank of the Republic of Turkey, 2008). Throughout the year 2008, in which the crisis peaked in the USA and Europe, loaning conditions were tightened, on the one hand, and loans’ maximum payment terms were shortened, on the other hand. As a result of confidence building measures, a loosening was observed after early 2009 both in loaning conditions and in payment terms (Figure 2).

**Exchange rate channel:** The spread of the 2008 Global Financial Crisis through this channel was closely linked with the exchange rate policy pursued. In this respect, rises were observed in currencies in countries that followed flexible exchange rate policy, as a result of foreign exchange demand as capital movements rapidly relocated and the capital tended to find safe ports. In this case, while a rise was expected in exports of countries in question, export-driven demand (foreign demand) did not rise enough. In this sense, the exchange rate channel did not produce the expected result. It should however be noted that it mitigated the damage of the crisis. On the other hand, in countries implementing fixed exchangerate regime, the increased foreign exchange demand as a result of capital outflow due to the crisis was met by central banks’ foreign exchange sales and currency levels were maintained. This situation, due to

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**Figure 1.** Policy Interest Rates in Selected Countries Source: TCMB (2010). *Overnight borrowing interest rates were used for Turkey.

**Figure 2.** Findings of the US and European Banking Sectors Credit Questionnaire (%) Source:FED, ECB; TCMB (2010). *Net numbers obtained by subtracting the percentage of banks that eased loaning conditions from that of banks that tightened them. Whereas positive numbers imply tightening, negative numbers indicate loosening in loaning conditions. ** Net numbers obtained by subtracting the percentage of banks that prolonged maximum payment terms from that of banks that shortened them. Whereas positive numbers imply tightening (rise), negative numbers point to loosening (decline) in loaning conditions.
liquidity shortage, increased interest rates and exacerbated the harm of the crisis as economic activity significantly slowed down (Başcı, 2008). This condition was clearly observed in 2009 in examples of developing countries (South Africa, Brazil, Hungary and Turkey) (Figure 3).

On the other hand, as a result of the measures taken in developed countries, low short-term interest rates directed capital flows towards developing countries and currencies of these countries were thus overvalued. Countries, in this respect, have been recently trying to limit exchange rate movements through practices like controlled flexibilization (as in China) and Tobin tax (as in Brazil) (Gürses, 2010).

**Asset prices channel:** This channel operated within the framework of 2008 global financial crisis through both changing financial asset prices and changing real estate prices. Especially in the period in which liquidity was high, the increase in financial asset prices as result of the rise in real estate prices created a wealth-increasing effect for economic units. Then, an increase in demand and a rise in economic activity were observed. However, with the negative operation of the credit channel (adverse selection-unreturned loans), demand shrinking was experienced as a result of wealth decrease in both financial assets and real estate properties, and the slowdown in economic activity became a crisis (Gökçe, 2008).

As seen in Figure 4, stock prices went up in 2007, in which markets heated up, and created a wealth-increasing effect for economic units, whereas a sharp decline was observed in stock prices throughout the year 2008, in which the crisis erupted, and economic units that had stocks and bonds in their balance sheets experienced a serious wealth loss. When considered the fact that this creates demand shrinking, it is not difficult to estimate that growth data, which is the last chain of transmission channel, would follow a negative course. Besides, the course followed by commodity prices continued to decline until the end of 2008 due to the demand shrinking. After the signs of recovery in 2009, an upward movement is observed especially in oil prices.

**Expectations channel:** As mentioned earlier, the functioning of the expectations channel becomes possible by directing economic units to the same objective in monetary policy practices. The most effective factor in creating expectations in line with monetary policy objectives is the issue of confidence. The confidence crisis has become the most important factor behind the spread of the 2008 global financial crisis. In this respect, high uncertainty required investors and consumers to reconsider their high expenditure plans. Such cautious behaviors based on delaying consumption bring along demand shrinking. During the crisis, economic units’ tendency to be reluctant to borrow and loan increased. The most notable feature of crisis is for the desire to stay in cash to peak. In this respect, especially financial institutions made loaning conditions more difficult. In this depression atmosphere, in order to rebuild confidence, guarantee systems (for example, credit guarantee fund) became a current issue against the risk of unreturned loans (Özatay, 2008). While a financial institution can borrow from another financial institution under normal conditions in order to overcome temporary shortage of...
cash, loaning nearly became impossible due to the confidence crisis in the housing market. Along with security attempts for loans to be provided, it was observed that central banks often assumed the mediator role between the creditor and the borrower in order to eliminate the confidence crisis (Yılmaz, 2009b). The reflection of expectations on the economic conjuncture in the crisis period, as shown in Figure 5, was in the direction of recession in the period of 2008 to 2009 and of boom in the period of 2009 to 2010. The confidence-building and demand-increasing measures taken against the crisis during this period positively influenced expectations and paved the way for economic recovery.

On the other hand, asset prices went up and volatility tendencies declined as economic units reflected their opinions that the recovery would be rapid and strong on prices. In parallel with this, according to International Monetary Fund (IMF)’s estimations in April 2010, world growth rate is estimated to be 4.2%. In addition, the support provided by governments to financial markets has become decisive in determining the direction of expectations after March 2009. It should however be noted that a cautious attitude remained in financial markets as fragility in debt structures of several EU countries, particularly of Greece, came to the surface. Therefore, it should be taken into consideration that the recovery from the crisis will be slower as demand increase is extended over time.

**Conclusion**

The 2008 global financial crisis started with problems observed in US housing market. Those who purchased houses experienced several problems in the repayment of housing loans. As the bubble prices started to dissolve,
people who used mortgage loans became unable to repay their debts as their collaterals depreciated. As real estate prices began to go down, low income groups (subprime) with low repayment capacities encountered the problem of inability to repay loans. In this respect, the 2008 Global Financial Crisis is seen as a product of the lack of discipline in financial markets. The financial assets, created by putting houses in pledge and used by banks to finance their loans, were given “bubble” prices as a result of non-realistic valuation. Under the light of observations and findings, the spreading path of the crisis through monetary transmission channels can be summarized as follows: The crisis started with the interest rate channel. In the USA, interest rates went down as a result of excess liquidity with the fear of recession before 2005. The interest rate channel was followed by the credit channel. Housing loans expanded excessively and real estate prices started to rise rapidly. After this stage, the asset prices channel started to become effective in the spread of crisis. The rise of asset prices increased wealth and thus demand, and then inflationist pressures grew. With the influence of the asset prices channel, the interest rate channel stepped in again as FED increased interest rates. This decreased the demand for new credits, on the one hand, and made the return of existing credits, diverted from prime customers to subprime customers (adverse selection), more difficult, on the other hand. Decreased demand for housing reduced firstly house prices and then mortgage-based securities. This situation caused financial institutions that had these assets in their balance sheets to make losses and to have trouble in obtaining liquidity. As a result of liquidity shortage, foreign capital inflow to countries decreased and existing foreign capital started to go out, and the crisis continued to spread through the exchange rate channel at this stage. Especially those countries implementing fixed exchange rate regime were affected by the crisis through this channel. Finally, under the light of the abovementioned developments, economic units’ expectations got worse and the tendency to turn towards liquidity accelerated. At this stage, in which the expectations channel became influential, loss of confidence affected the duration and strength of the crisis. Demand shrinking, an outcome of loss of confidence, began to affect all countries and rendered the crisis global.

To overcome the crisis, bailout plans were declared especially by the USA and European countries. In the resolution of the 2008 global financial crisis, turning expectations that played a significant role in the internalization of the crisis towards a positive direction and re-establishing the environment of confidence are of crucial importance. In an environment where confidence is not established, it cannot be expected from other monetary transmission channels to function healthily. Besides, another development that needs to be taken into consideration is the disruptions in debt dynamics observed in several EU countries, particularly in Greece. These developments will negatively affect the crisis-recovery performances of these countries by enforcing fears of returning to the crisis of confidence as well as of other countries that trade (with low foreign demand) with these countries (for example, EU countries constitute 50% of Turkey’s exports).

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