



**9TH INTERNATIONAL ASECU CONFERENCE ON
“SYSTEMIC ECONOMIC CRISIS: CURRENT ISSUES AND PERSPECTIVES”**

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IS THERE A BUBBLE IN THE ALBANIAN HOUSING MARKET?

UDC:332.85(496.5)

Abstract

Since the financial crisis has become more than everyday news for all of us and the media treats it almost in every moment and from many aspects, seems more than natural to ask ourselves if we are actually having a crisis in Albania and if this is consisted of a bubble in the housing market. As the world crisis roots are back in 2008 “bubble” in USA, ones tries to understand the market behavior in a small developing country like Albania and realize what’s happening, analyze the factors and represent proper academic advice.

Previous research has developed various theories regarding the crisis effects in developed and developing countries and it seems from a critical point of view that Albania as a developing country is not affected much from the “subprime crisis”. This is due to factors such as lack of financial derivatives market concept and certain in time measures from the regulators. Nevertheless, the most active trade partners of the country (Greece and Italy), the economy of which is positively correlated with the Albanian, are passing the most deep economic crisis ever.

This study is actually trying to represent the Albanian housing market from an independent point of view, by trying to identify the “bubble” in the housing market from real data of prices. Bank finance of housing loans has created a “golden age” for housing prices during 2005-2007 in Albania. During 2008 though this increase has slowed down and the housing loan portfolio of banks shrank. The next years followed with lending restrictions from the banks, austerity measures from the Central Bank and reduction in household income. All these led to a decrease in housing prices.

We are trying to understand if this reduction in prices was due to the measures and the general economic conditions, or was due to very high prices in the housing market which had to melt down at some time.

Key words: housing market, financial crisis, house price index



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1. Introduction

Subprime crisis that started in the American market has been considered in the research literature as an effect of the American government policy to shelter the part of the population with low income and certain minorities. Even though the initial target was a humanitarian one, there were some main reasons that changed completely the effects of this policy. The fact of lending to riskier borrowers that had insufficient funds for the down payment when purchasing a house, lack of credit history, inability to document income as well as lack of information combined with the ARM (Adjustable rate mortgage) products that gave lenders the possibility to decide in each case how to finance the borrowers created a continuous increase in house prices. The re-financing of loans that the borrowers had failed to repay due to decrease in their income as well as poor credit policies of the lenders deepened more the bubble. On the other hand investment banks and investors created the market of CDOs without analyzing the quality of the portfolios and by spreading internationally the investment base. This continued until 2006, when the initial borrowers failed to repay their financed and re-financed debts and three combined trends signified the beginning of the crisis: increase of risky loans, increase of subprime loans and the stopping of increase of housing prices.

In the European developed markets the effects of mortgage loans crisis in the United States and the CDOS to which investors had invested were associated with the volatility of the value of financial assets in all markets. In general, the credit markets in the euro area were characterized by a reduction of the corporate rating, as a result of a general reassessment of risk by investors, despite the lack of direct exposure to the phenomena of non-financial sector that brought the crisis. Consequently, for the near future it was expected an increase in the cost of financing for nonfinancial corporations

In the literature review financial crises are classified into four types/groups as defined by Claessens and Kose (2013): currency crises; sudden stop (or capital account or balance of payments) crises; debt crises and banking crises. All these different types of crises are demonstrated in various ways, but the most obvious characteristics of them are linked with changes in asset prices, disruption of financial intermediation, large scale balance sheet problems and government support. Though it is quite common in the literature to define some factors that led into crisis, it is difficult to define the causes in each case and much more to predict from the actual data that we are going to have a crisis in the near future. Most of the crises are shown with an asset price boom and a burst following in and it is more than impossible to define there is a bubble.

We have tried to analyze the case of house price bubble in our market by constructing a house price index. Even though the situation is not very likely to be the same with the American market subprime crisis, from the financial crisis point of view regarding asset price boom and burst, we try to indicate if the bubble theory applies in our case. We believe that in our developing market the effect of the crisis was mainly linked with the general economic figures than the house prices themselves. Albania has passed through a developing period in the construction area starting from year 2000 and on, until 2007. The reasons behind this lie upon a behavioral tendency on having a privately owned house for



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most people, the buying of houses from immigrants, the population shift in the cities (especially in the capital) rather than the villages, and a general development of the economy. Nevertheless the past five years a stop in this growth has been experienced, due to global factors and is reflected also in the house prices. When we try to define the general trend of house prices, we should mention two major difficulties:

1. There isn't a formal house price index that can reflect the tendency of house prices.
2. There isn't a formal database on selling prices or evaluation prices that could be used for the analysis.

Through this work we try to build a house price index, we show its trend and we analyze its fluctuations, based on analytical economic factors that we believe that affect it.

The next chapter presents the literature review on the subprime crises, while the following two analyze the Albanian economic framework and the house price index trends and factors respectively. The last one concludes and suggests through advice what can be done and what should be our next research objective.

2. Literature review on the crises

Literature has to offer a lot regarding the financial crises, which have been a studying object for many researchers in terms of types, effects and prediction methodologies.

Attempting to generalize through the working paper of Claessens and Kose (2013) there are mentioned two types of crises: those that can be quantitatively defined and those that can be qualitatively defined (Reinhart and Rogoff, 2009a). In the first type are considered the currency crises and the sudden stop crises, while in the second type are classified the banking crises and the debt crisis. Regardless their types most of the crises are linked with asset price booms, which then followed a burst. The rationale beyond that relies on the macroeconomic or microeconomic factors such as individual collective mispricing or irrationality of the investors, or simply asset price representing the expectations of future returns. Asset price boom has also been accompanied with a credit boom, which has been induced by changes in productivity, economic policies and capital flows.

Especially the recent literature on the subprime crisis refers to various factors of explaining the bubble. Karl Case and Robert Shiller (2004) with their article "Is there a "bubble" in the housing market?" attempt to answer the question by trying to determine exactly what would be called a "bubble" in its philosophical aspect, analyzing and getting real data on housing prices, income and population and interviewing people in different countries. Although their results from the economic standpoint exhibit a logical flow of increased house prices, which can identify a "bubble burst", however from the completed questionnaires in different countries to see the general psychology and to identify the psychological reasons, the authors conclude that most likely it will not be an immediate "burst" in house prices in all countries simultaneously to justify that there is a "bubble". However in this study they



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did not consider the financial innovations, nor the "dominoes" effect that the U.S. economy faced later.

In the same spirit the article of Jonathan McCarthy and Richard W. Peach in 2004, trying to answer the same questions about housing prices, and studying the data in house prices since the early '70s, reaches the conclusion that the rising prices of homes in America were due to the development of construction, real estate market, population demand and the reduction of interest rates by lenders. So even in periods of large increases in interest rates and housing prices were not significantly affected, and therefore the authors conclude that there is no concern for a "bubble burst".

Several years later and seeing clearly now how the crisis expanded Martin Neil Baily, Robert E. Lita and Mathew S. Johnson in 2008 discuss the origins of the financial crisis, citing as factors of the crisis of housing price growth combined with financial innovations, the failure of risk management structures of the financial institutions and from the regulatory aspects lack of supervision over financial markets. Similarly in 2008 Longstaff with an empirical model confirms that the indexes of CDOs and MBS's can provide index returns of Treasury bills and stock market proving contaminating effect of subprime crisis in these markets.

Since the crisis had knocked, acknowledging that this was a part of the financial cycle and taking into consideration that steps must be taken the following to overcome it, the literature after studying in depth every aspect of the crisis, finally passes to the conclusions and suggestions, as indicated in the article Buiter in 2007 with lessons taken from the crisis of 2007-es. Buiter thinks that the capitalist system is cyclical and as such it will pass its stages in which we cannot intervene. But strengthening the rules of financial markets, increasing interest rates, reducing the money supply in the long term market could restore normality. The author refers to the crisis in global terms, saying that this crisis will be felt in Europe, and its effects are still undetermined on developing economies, therefore, measures must be taken quickly in order to avoid wasting of time.

Naude 2008, studying financial crisis in developing countries expresses little optimism that the crisis will not affect these countries deeply based on the following "(i) the epicenter of the crisis are the developed economies, not the developing ones, (ii) financial markets in emerging economies are not affected, (iii) there was a mass withdrawal of economic growth among developed economies and developing ones (iv) many developing economies are quite flexible, because they had a good economic and political growth after the lessons of Asian crisis in 1998 (v) the major developing economies, China and India, will continue to grow, albeit more slowly (vi) the duration of fiscal expansion programs undertaken will extend the period of economic reduction.

More recent studies have presented the importance of housing prices in the real economy, by studying the global housing prices movement (Hirata, Kose, Otrok and Terrones, 2013) and their affection from shocks from the real market. The authors find that housing prices cycles are more synchronized lately, but cannot define real factors beyond this. Moreover they find that the shocks of changes on global interest rate do not affect global house price



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movements, nor the productivity shocks or the credit shocks appear to have a significant effect on them. On the other hand the uncertainty shocks seem to have a more important role on house price movements.

Following the above review we will attempt to make an overview analysis on the house price market of Albania by constructing a House Price Index and analyzing its trend.

3. Methodology

The foundation of a reliable analysis is the data used to derive the proper conclusions. As in the local market we are facing difficulties in concluding from the available data, the compilation of a house price index is needed in order to define any changes or trends in the market. The challenge on developing such a measure seems to increase when it is thought that it will create a basis on further research and data analysis.

As expressed in the work of “Constructing a House Price Index for Turkey” from Kaya, Bizkurt, Bastan and Ayanoglu (2012) there are four main methods covered from the literature for constructing a house price index: Repeated Sales Method, Hedonic Regression, Sales Price Appraisal Ratio and Stratification. From the data availability, it is more obvious for our market the usage of the third method.

3.1 Data sources and scope

The housing prices in the Albanian market are highly affected from the independent evaluators. Since the price of the house is only made available when selling it, it is not able to create a consequent database of the price of the same house in a time period.

The data to construct our index came from contracted individual independent evaluators of a financial institution. The market value of the houses they evaluate according to different evaluation methods consider also certain qualitative factors of the house, such as construction year, methods and materials, the zone/position of the house and the market prices of the certain period.

The steps below were followed:

1. A number of 100 houses randomly with different characteristics (surface, construction quality, old or new houses) were chosen over 13 regions according to the percentage of population in each region. These houses have been at least evaluated once for the financial institution and were used as collaterals for the credit accorded to individuals.
2. A number 13 independent evaluators were chosen all over the country and were asked to define the real market price of the house at the time of evaluation and the hypothetical market price of the same house in the years before or after the evaluation, ex. If the evaluation was made in 2008, then they had to present the market price also for 2007, 2009, 2010, 2011 and 2012 considering as well the changes in the market.



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According to the prices they presented, we collected the price/square meter for 100 houses in 13 cities for a period of 5 (five) years 2007-2012. Then we constructed the House Price Index.

3.2 Sales price appraisal ratio and stratification

Considering the fact of heterogeneity of the housing market and the small amount of data, we tried to have as much realistic values as possible regarding the prices per square meter and to homogenize the data using the geographical stratum. We find an average price/square meter per stratum and then we weight this price to reach the overall price index. This is the simplest approach on creating an index based on the data collected. As such it has some disadvantages, because it does not depict the changes in qualities of the dwellings, and is subject to the number of data per stratum, which in case of missing may create a bias in the index.

In our study the strata are defined by 13 geographical locations, according to the different cities and the population allocation. For cities with no available data no weight in the index was provisioned. We couldn't choose the median over mean of a stratum, due to the fact that the number of available data was low, except in some cases.

3.3 Weighting and calculation

The weight chosen for each stratum is defined from the number of house prices available for the certain area. The House Price Index is calculated as follows:

$$I_{(t)} = \sum p_{i,t} * w_{i,t}$$

$I_{(t)}$: Index for the year t

$p_{i,t}$: Price for stratum i for the year t

$w_{i,t}$: Weight for stratum i for the year t

As base year has been considered year 2007 and the following years it is calculated the house prices tendency.

4. House price index in Albania

4.1 Results and tendency

While constructing a House Price Index, we also had to consider the reference prices. Reference prices are the legitimate selling prices per geographical area announced by the government. These prices though can't be considered as selling prices, due to a large gap with market prices as we will show below.



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We can observe from Figure 1 that the tendency of the House Price Index during the years 2007-2012 is increasing slightly for the first two years 2008-2009 and decreasing for the following years 2010-2012. In order to understand if this trend had any linkage with the reference selling prices that the government has defined during the years, we also constructed a “Median Reference Price Index”. The trend of the latter is not the same with our market prices. We assume this is due to a very large gap between the market prices and the reference prices (Figure 2). This gap as we can observe through the years 2007 – 2012 tends to become smaller during the recent years. As such we can assume that the market prices only reflect the market tendency and we can't speak of a “bubble” in the house prices.

Figure 1

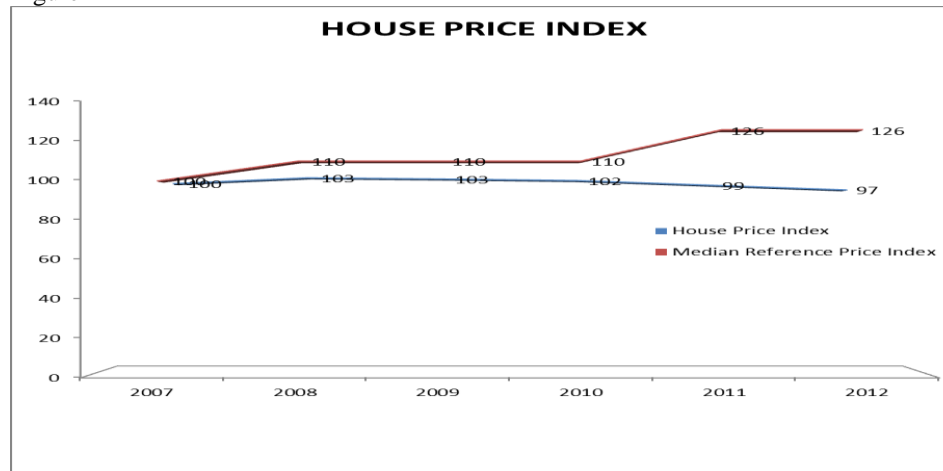
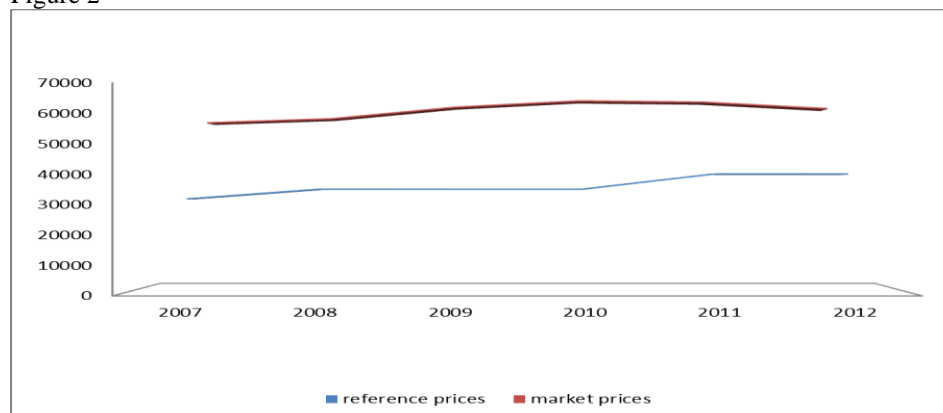


Figure 2



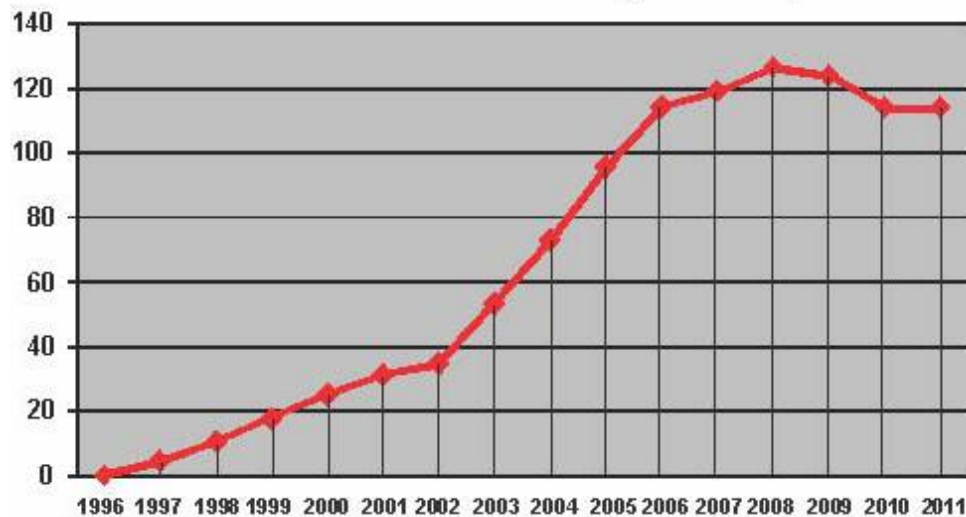


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If we would try to analyze the tendency of the index during the past five years and why it has such a trend, we would more likely try to create an idea of the development of the real estate market in Albania.

Following the privatization process and reforms in 1991, the real estate market faced tremendous changes. In 1993 the privatization process has been completed and during 1994 the construction of new apartments has started in the major cities, especially Tirana. From 1996 until 2006 as it is mentioned in a market study from Sila (2011) there was an increase of the house prices at a ratio of 190%.

Figure 3. Prices in percentage increase during the period 1996 – 2011



This seems very irrational in terms of market continuity and what would be rather normal, but the prices do not reflect more than the market demand, according to the same evaluator. For as long as market demand is higher than the supply the increase will continue.

Another analysis from Qilimi (2008) regarding the trend of real estate's value for the year 2008-2009, points out that there were different factors that affected the market development and increase of prices such as:

1. Increased demand for sheltering, especially in large cities (Tirana, Durrës, Elbasan)
2. Construction in city centers, due to infrastructure and services. This infrastructure tends to meliorate during the years
3. Increase of the construction areas from which the plot owners benefit (this benefit may become up to 35% of the construction area)
4. Usage of the new building mainly for apartments, parking areas and stores



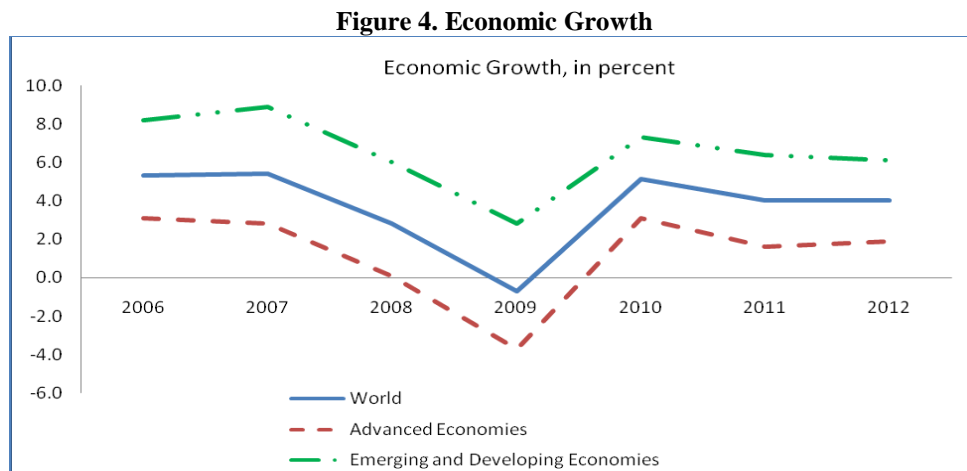
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5. The increased quality of the construction materials
6. The enforcement of the fiscal policies and the reduction of informality in the economy
7. The improvement of the legalization process, return or compensation process from the government authorities as well as
8. The increase of the selling index.

The author for the year 2008 – 2009 predicts a continuing increase in the house prices due to higher demand, which is enforced also from the above factors. This has actually happened and it is reflected in our index trend, but the most important is to understand why the index has decreased slightly during the latest years.

4.2. Explaining crisis and house price index in the Albanian market

If we would accept Naude's reasoning for the affection of developing countries from the global crisis, than the Albanian economy as a developing one has faced the crisis better than many developed countries.



Source: World Economic Outlook 2011, IMF

The lack of financial markets at this point turned to be a benefit to Albania. Just as in 2005, Albania, a small open economy in Southeast Europe, was "saved" by the Russian and Turkish crisis, respectively in 1998 and 2001, during which most countries in the region suffered negative consequences, and the reason was very little development of the Albanian financial market, in comparison with other countries in southeastern Europe. The same conclusion can be drawn also for the current crisis. In connection with its financial system, in Albania we can say that there is a lack of an organized stock market and bond market. There is a well-organized primary market for government securities, with most banks



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imposing their excess funds, but the secondary market is much less developed. The more sophisticated market is the foreign exchange market. Derivatives are never used by corporations, but they appear only in the balance sheets of commercial banks in the foreign currency section. So the lack of financial market development means limited opportunities for investment/speculation. Banks only issue mortgage loans with higher interest rates or invest in government securities. Diversification is almost inexistent. The banking sector appears strong due to lack of investment in foreign assets, and because of securing their funds from parent banks.

On the other hand, although Albania, not having a functional financial market through which banks will have the opportunity to diversify their portfolio in foreign markets and be affected from the crises, we note that:

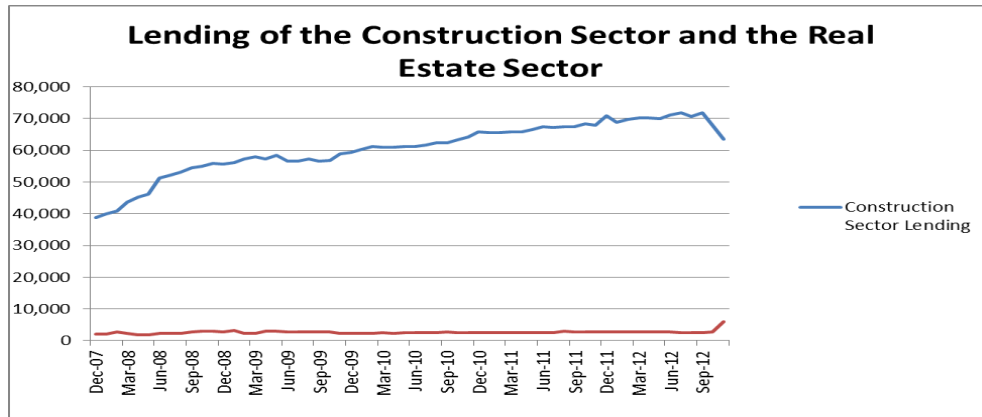
1. New commercial banks operating in the market, mainly foreign-owned means not only increased competition in the banking sector, but also investment in information technology systems, providing significant improvements in this sector. Thus there is an increased possibility of “transferring” financial crises from parent banks to their subsidiaries in Albania.
2. The crisis of 1997 and the panic of 2002 showed that Albania is not unaffected and mostly is not prepared for such situations. Information asymmetry led to the creation of incorrect expectations of the public for the ongoing events in the financial system.
3. Moreover the global financial system shocks was reflected in the reduction of deposits of individuals particularly in 2008 and was associated with increased interest rates, reduced lending and tightening lending standards, something which is seen even today. Focusing on the microfinance sector and in particular to the individual lending, banks have allocated their funds and their portfolio among companies and individuals, focusing on the individual mainly during 2006 up to 2008. During this time banks promoted ARM products with period offer and due to high competition it was observed a decrease in interest rates. During the same period a significant increase in house prices is also observed, mainly in Tirana, where the most of the population lives. As the main factor for this increase in house prices was the increased demand as we explained earlier.

Such can also be observed from the figures below regarding the construction sector lending and the individual real estate lending, through the years 2007 – 2012. We can observe that the lending of the construction sector has faced a decline, while the real estate sector has been steady all over the period. This can explain the reduction in prices of the houses. As constructors feel financial difficulties, they try to sell in lower prices and create cash flows. At the same time the construction cost index faces an increase, due to increased prices, lowering more the margins of the constructors.



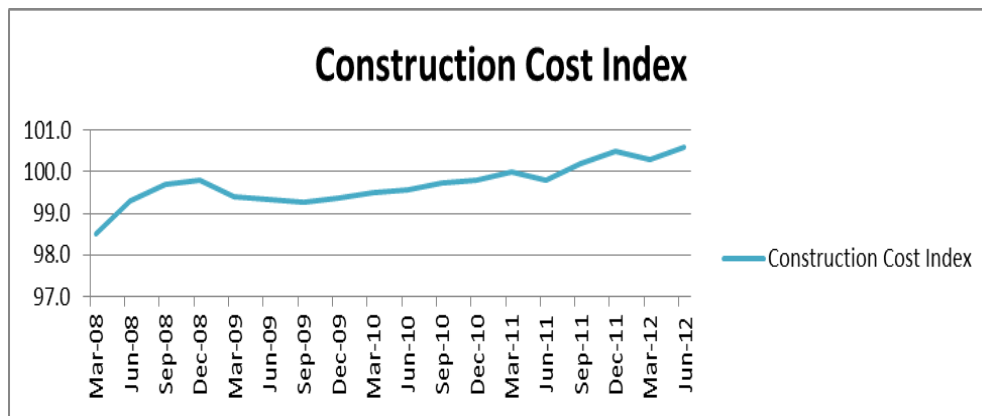
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Figure 4



Source: Bank of Albania

Figure 5



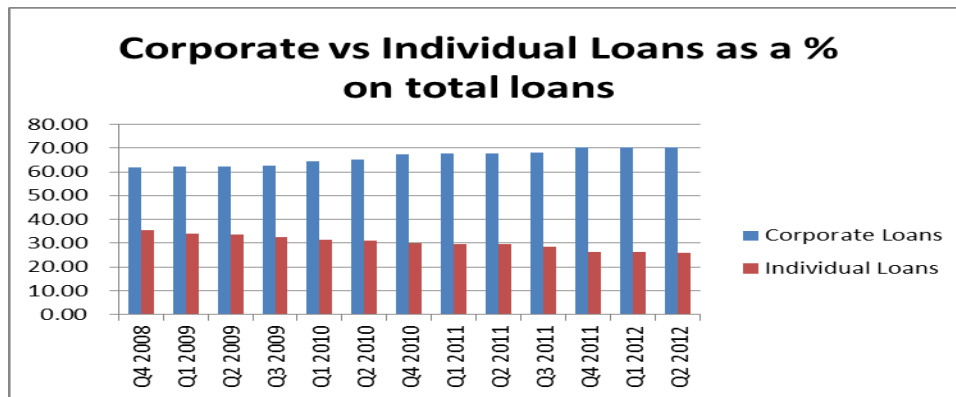
Source: Instat

Purchased homes are generally financed from individual funds, or through loans that banking institutions offer. Bank loans for home funding have had their greatest increase during 2005-2007. Annual growth of credit to households has slowed evenly throughout the year 2008, falling to 30%, compared with 62% marking at the end of 2007. This has led to falling share of household credit portfolio at the end of the year at 35.6% compared with 36.7% in October 2007. The slowdown in loans to households was observed both for housing and for consumer loans. Household loan portfolio is dominated by real estate loans reaching 66% of it. This type of credit has contributed to the increase the total outstanding of loans and especially to the increase of foreign currency lending in 2008. If we carefully observe the performance of credit to households in absolute terms it has



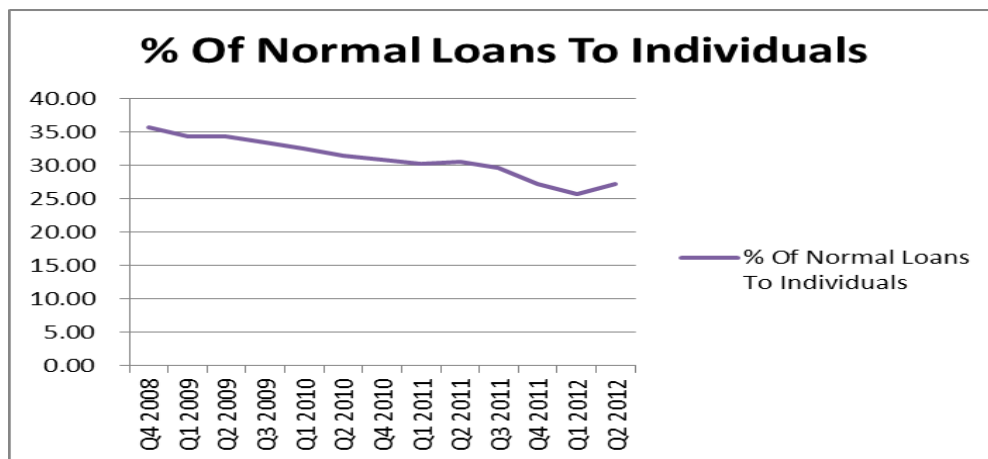
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grown, and as a percentage of total loans in particular has suffered a decline during 2011 and 2012 (Figure 6).



Source: Bank of Albania

Continuing and studying the report of the Bank of Albania in connection with regular loans and those with problems, in the case of individuals it is shown that regular loans as a percentage of total number of normal loans had a significant decrease from July 2010 and December 2011, and as a percentage of the total loans outstanding have a continuous tendency to decline even in 2012.

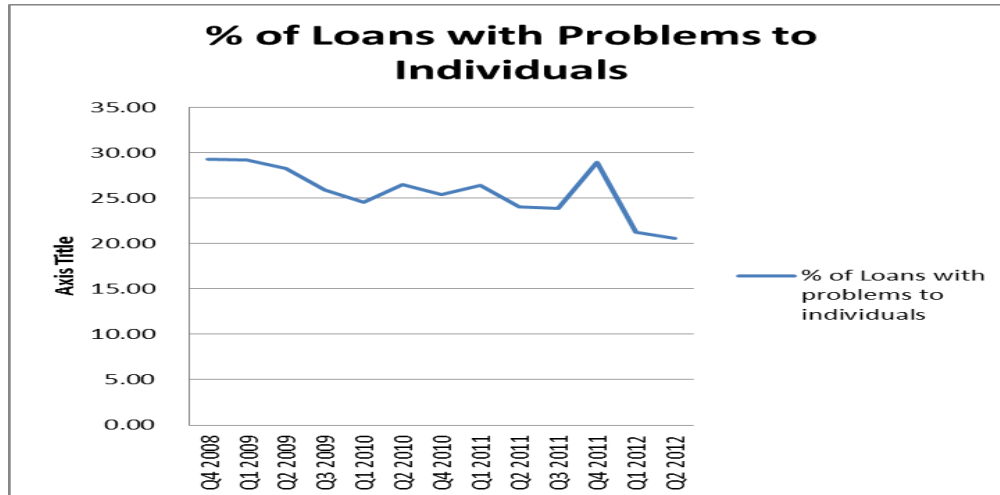


Source: Bank of Albania

Loans with problems as a percentage of total loans with problems have a tendency to increase in absolute value, but as a percentage of the portfolio of loans with problems have a slight fluctuation that tends to decrease.



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Source: Bank of Albania

All these observations can be easily explained since:

1. Lending by financial institutions has been decreased due to the uncertainties created for the performance of individual income in the domestic labor market and alternative sources.
2. Household income has declined, so the tendency for a part of regular loans tends to change towards those with problems.

Trying to parallelize mortgage credit growth and house prices in America that marked the beginning of the global crisis with the Albanian market data, we can conclude that the isolation of Albanian economy and the delays of the economy shocks so far, have resulted in avoiding a "bubble" in house prices and since financial institutions stopped lending to individuals they established some rules to the game. Financial institutions reacted quickly to new market data and parent austerity policies were reflected in the domestic market. In this way, even though the individual has less access getting a loan than at the beginning of 2006, we can say that the economy is protected from any possible bubble. On the other hand financial institutions were aware before too late that the right operation of the market requires more care and control.

In summary the declining tendency of the House Price Index during the past five years recognizes the decreased demand in the housing market, which is affected by:

1. The world crises that affected international financial institutions acting in the local market.
2. Austerity measures and tight lending policies from the banking institutions as a consequence of the local authorities' measures.
3. Lack of liquidity in the construction area as a result of tight lending and increase of construction costs.



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4. Lack of liquidity of individuals, either from their personal income (increased loans with problems) or due to inability to borrow from financial institutions (decreased normal loans). As such the decrease of the House Price Index can be considered a normal market behavior of the prices rather than a price burst.

5. Conclusions

While analyzing the factors of the crises referring to the international literature, it was noticed that the compilation of a House Price Index became more than necessary in order to complete the whole picture of the situation. Building a House Price Index constituted a challenge due to restricted data, but it may be considered, even the disadvantages that it carries, as the first attempt to describe the housing market from a real research prospective.

The analysis of the tendency of the House Price Index, combined with the theories and the current market situation, led us to the conclusion that the housing market in Albania does not suffer a bubble, nor the decrease in prices refers to a burst. They rather show the real demand and supply in the market, which has been affected for sure from the overall world crises.

We may conclude that:

1. The Albanian housing market although not directly affected by the subprime credit crisis, it is not likely to experience a global crisis, one or the other way.
2. Financial institutions in the local market cannot afford errors made by U.S. financial institutions and thus they followed the term "prevention is better than cure."
3. Regulatory framework seemed effective in mitigating the impact, since the figures show stability in the market place.

Nevertheless the crises still persists in our market, as our main partners (Greece and Italy) are facing difficulties in the market, construction sector is suffering lack of liquidity and the banking sector is trying to recover in a very slow rhythm, average income has declined and immigrants are returning in the country.



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