GLOBAL RELATIONS FORUM YOUNG ACADEMICS PROGRAM
ANALYSIS PAPER SERIES No.9

Financial Crises and Social Capital: Global Evidence

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Ph.D. in Economics at University of London

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July 2020

ISBN: 978-605-06588-1-1

Publisher Certificate No: 22780

Printed in Turkey
Gren Agency, Istanbul. *www.grenajans.com*
Design and Layout
Wodern Web Developing & Design Services *www.wodern.com*

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This publication can be downloaded at gif.org.tr

Contents

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This paper, entitled *"Financial Crises and Social Capital: Global Evidence"* is authored by Cevat Giray Aksoy and Orkun Saka as part of the *GRF Young Academics Program Policy Paper Series*.

GRF convened the following group of distinguished members to evaluate and guide Aksoy and Saka's paper:

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GRF is grateful to all members who participated in the evaluation commission for their invaluable insights and informed guidance, as well as for the time and effort they dedicated to the program.

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Abstract

We combine data on social capital from a global sample of individuals between 2005 and 2017 with cross-country information on financial crises in order to investigate how social capital evolves in the aftermath of financial turbulence. We find a strongly negative contemporaneous effect of crises on social capital. We also document that this association is independent of income shocks at the individual level. Our results suggest that financial crises can exert a powerful influence in shaping social capital.

1. Introduction

More than ten years after the Global Financial Crisis, we are still trying to comprehend how it may have shaped our current economic and political climate. If we had not experienced it, would there still have been a Brexit? Would Donald Trump still have been elected as the President of the United States? Would we still have the same social and political preferences or the values/norms that we believe should govern our societies?

As documented in the literature, financial crises have devastating effects on economic growth in the short and medium term.[1] However, the long-term socio-economic consequences of financial crises have so far been largely understudied. One of the crucial channels through which these crises may impact long-term economic outcomes is their potentially harmful effect on trust between economic agents, as well as individuals' resulting loss of social capital.[2]

Social capital (sometimes called 'civic engagement') has been shown to shape economic exchanges not only across countries,[3] but also among individuals living in the same country.[4] Therefore, the potential loss in this dimension following a financial crisis may not only translate into social (and possibly political) turmoil; it might also generate longer-term economic costs for the entire society.

In this paper, we investigate the relationship between financial crises and social capital. To do so, we integrate two primary data sources: Gallup World Polls and the IMF Financial Crises database. Gallup World Polls include more than one million respondents from 118 countries, spanning 2005 to 2017. It contains two key variables that allow us to measure social capital. One is individuals' likelihood of helping a stranger, and the other is their inclination to engage in volunteer activities. As we discuss later, these measures help us isolate social capital from monetarily or economically motivated transactions in society.

One can think about social capital in terms of supply and demand. For example, after a financial crisis, people may be less able to help or supply social capital due to financial and/or time constraints. On the demand side, people may ask for more help. To account for country-specific differences and trends in volunteering, we include country fixed effects and country-specific linear time trends in our main specification. In addition, we use a different outcome variable (that is, "helped a stranger"), which produces qualitatively similar results. These

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[1] For recent evidence and a comprehensive review, see Christina D. Romer and David H. Romer. "New evidence on the aftermath of financial crises in advanced countries." *American Economic Review* 107, no. 10 (2017): 3072-3118.

[2] In Section 2, we briefly review the literature on the economics of social capital and provide relevant definitions.

[3] Luigi Guiso, Paola Sapienza, and Luigi Zingales. "The role of social capital in financial development." *American Economic Review* 94, no. 3 (2004): 526-556.

[4] Luigi Guiso, Paola Sapienza, and Luigi Zingales. "Civic capital as the missing link." In *Handbook of Social Economics*, vol. 1, pp. 417-480. North-Holland, 2011.

approaches alleviate potential omitted variable concerns and help us avoid the interpretation that the outcome variables might be influenced via channels other than social capital.

The second source, the IMF Financial Crises database, is one of the most commonly used datasets in the literature on financial crises and has recently been updated to include 165 countries over the period between 1970 and 2017.[5] Importantly for our purposes, it provides the starting dates of three main types of financial crises: (i) banking, (ii) currency, and (iii) sovereign debt crises. We combine all these three types in a single variable to understand the relationship between financial crises and social capital.

Our results indicate that individuals become less likely to volunteer for charities or help a stranger in their community when their country is struck by a financial crisis. These effects are robust not only to the inclusion of a rich set of controls at the individual-level, but also to saturating our estimations with country-specific linear time trends. Importantly, the negative impact is not driven by the economic impact of the crises on individuals' income, as we directly control for this both in linear and non-linear forms. To understand the heterogeneity of the effects, we consider the OLS estimations for various subsamples. We find that our results are driven by younger cohorts, those who live in rural areas, and low-income households.

The paper proceeds as follows. The next section briefly summarizes the literature on social capital. Section 3 describes the construction of the dataset and outlines our empirical strategy. Section 4 presents the results. Section 5 concludes.

2. Literature Review

The literature on the determinants and consequences of social capital can be traced back to Banfield's famous contribution to social science, namely *The Moral Basis of a Backward Society*.[6] He argued that the main reasons why some societies are economically lagging behind could be found in the apparent lack of mutual trust among their members. Some scholars used the same idea to explain the seemingly persistent economic differences across sub-regions of Italy.[7] More recently, Putnam[8] defined social capital as "connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them," and many other scholars have investigated the relationship

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[5] Luc Laeven and Fabian Valencia. *Systemic Banking Crises Revisited*. International Monetary Fund, 2018.

[6] Edward C. Banfield. *The Moral Basis of a Backward Society*. New York: Free Press, 1967.

[7] John F. Helliwell and Robert D. Putnam. "*Economic growth and social capital in Italy.*" *Eastern Economic Journal* 21, no. 3 (1995): 295-307.

[8] Robert D. Putnam. Bowling Alone: *The Collapse and Revival of American Community*. Simon and Schuster, 2000.

between social capital and different outcome variables.[9]

The primary role of social capital in economic transactions is to enhance the way agents interact by replacing the need for formal contracts or reducing the transaction costs. Thus, such mutual trust among the members of the same society creates a positive externality for everyone involved and increases the speed and extent of economic exchange. Citizens might have a high social capital preference not only because they are exposed to inherent norms of their society, but also because they observe the possibility of a strong punishment in case of a deviation from the socially optimal behavior.[10]

A large body of the literature has focused on how social capital can improve economic outcomes in various dimensions. However, little effort has been spent on understanding the determinants of social capital and how some societies reach a high level of social capital while others get stuck at low levels. An influential study argues that individuals respond to incentives but are also influenced by norms of good conduct inherited from earlier generations in which parents rationally choose what values to transmit to their children.[11] This, in return, creates a path dependence, where initial conditions may play a considerable role in shaping the eventual level of social capital. Similarly, some scholars have studied whether a positive historical shock can generate long-term persistence in development.[12] Authors show that Italian cities that achieved self-government in the Middle Ages have a higher level of social capital today than similar cities in the same area that did not. They argue that the medieval experience of self-government fostered beliefs of self-efficacy, and that this positive attitude, transmitted across generations, enhances social capital today. On the other hand, even temporary positive shocks of cooperation (such as in the aftermath of natural disasters) might affect social capital in the long term.

Although we have not come across any paper that directly studies the relationship between financial crises and social capital, there exist a number of studies that investigate how past personal difficulties may change the values and social preferences of individuals. Studying personal victimization, scholars conclude that such negative past experiences are positively associated with current left-wing political support.[13] Some show that people may become

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[9] See for example: Luigi Guiso, Paola Sapienza, and Luigi Zingales. "The role of social capital in financial development." *American Economic Review* 94, no. 3 (2004): 526-556; Rafael La Porta, Florencio Lopez-De-Silane, Andrei Shleifer, and Robert W. Vishny. *Trust in large organizations*. No. w5864. National Bureau of Economic Research, 1996; Edward L. Glaeser, Bruce Sacerdote, and Jose A. Scheinkman. "Crime and social interactions." *The Quarterly Journal of Economics* 111, no. 2 (1996): 507-548; Alberto Alesina and Paola Giuliano. "The power of the family." *Journal of Economic Growth* 15, no. 2 (2010): 93-125.

[10] Alejandro Portes. "Social capital: Its origins and applications in modern sociology." *Annual Review of Sociology* 24, no. 1 (1998): 1-24.

[11] Guido Tabellini. "The scope of cooperation: Values and incentives." *The Quarterly Journal of Economics* 123, no. 3 (2008): 905-950.

[12] Luigi Guiso, Paola Sapienza, and Luigi Zingales. "Long-term persistence." *Journal of the European Economic Association* 14, no. 6 (2016): 1401-1436.

[13] Rafael Di Tella, Javier Donna, and Robert MacCulloch. "Crime and beliefs: evidence from Latin America." *Economics Letters* 99, no. 3 (2008): 566-569.

more risk-averse and pessimistic about the stock market's future if they have experienced low market returns in the past.[14] Similarly, researchers find that people experiencing a recession in their early formative years are more likely to support redistributional policies.[15]

Our analysis contributes to this line of research and offers the broadest cross-national evidence to date on the relationship between financial crises and social capital. Whereas previous related papers have mostly looked at individual countries or smaller samples, our data cover more than 100 countries, both developed and developing, over a 13-year period. This allows greater confidence in the generality of the findings. It also makes it possible to investigate the heterogeneity of responses to trade shocks based on various individual characteristics.

3. Data & Empirical Strategy

The data used in this paper come from Gallup World Polls and the IMF Financial Crises database. The level of analysis is the individual level. We describe the data below.

3.1 Individual-Level Data from Gallup World Polls

Our primary data on political approval come from the 2005-2018 Gallup World Polls (GWP). These nationally representative surveys are fielded every year in over 140 countries and approximately 1,000 individuals are interviewed in each country on a wide range of topics. Our main sample includes more than one million respondents. The key outcome variables in this paper come from questions asked to all Gallup respondents on social capital: (i) "Have you done any of the following in the past month? How about volunteered your time to an organization?" (ii) "Have you done any of the following in the past month? How about helped a stranger or someone you didn't know who needed help?" Of course, social capital is a widely defined concept and the aforementioned variables might only partially capture its extent. However, our dataset covers more than 100 countries, both developed and developing. Given that previous papers have mostly looked at individual countries or smaller samples, our analysis offers greater confidence in the generality of the findings using these questions on social capital from GWP.

The GWP also provides detailed information on respondents' demographic characteristics (age, gender, educational attainment, marital status, religion, and urban/rural residence), labor market outcomes, and income. Controlling for employment status and income allows us to measure the impact of financial crises on social capital beyond the direct effect of crises on households' material well-being.

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[14] Ulrike Malmendier and Stefan Nagel. "Depression babies: do macroeconomic experiences affect risk taking?" *The Quarterly Journal of Economics* 126, no. 1 (2011): 373-416.

[15] Paola Giuliano and Antonio Spilimbergo. "Growing up in a Recession." *Review of Economic Studies* 81, no. 2 (2013): 787-817

3.2 IMF Financial Crises Database

For the dating of the financial crises, we will resort to the classic and recently updated dataset from the IMF.[16] This includes the starting dates for three different types of financial crises, namely banking, currency, and sovereign debt crises. Coverage is extensive compared to alternative datasets, including 165 countries between the years 1970 and 2017. All types of crises are represented with a dummy variable taking the value of 1 in the initial year of the crisis and 0 for the rest. Hence, we are unable to trace the length of a crisis (or depth for that matter) in general.

3.3 Empirical Strategy

To assess the relationship between financial crises and social capital, we estimate the following ordinary least squares models:

$$Y_{ict} = \beta_0 + \beta_1 X_{ict} + \beta_2 FinCrisis_{ct} + \beta_3 c_c + \beta_4 T_t + \beta_5 c_c{}^* t + \varepsilon_{ict} \quad (1)$$

where Y_{ict} is a dummy variable indicating that the respondent "volunteered their time to an organization" or the respondent has "helped a stranger or someone who needed help" depending on the model, for individual i in country c at time t. We estimate linear probability models for ease of interpretation.

Our empirical strategy closely follows previous research.[17] To account for the effect of demographic and labor market structure on the outcome variables, we directly control for time-varying, observable individual covariates. More specifically, X_{ict} is a vector of demographic variables that include (depending on the model): a male dummy; age and age squared; dummy variables for marital status (married/civil partnership and divorced/separated) and religion (Orthodox Christian, Catholic, Protestant/Other Christian, Muslim, other); a dummy variable for the presence of children in the household (any child under 15); and a dummy variable for living in an urban area. To account for pro-cyclical variation in labor market outcomes, we control for the log of household income and household income squared. Note that we do not control for individual-level unemployment in our specification since this information is only available in the GWP from 2009.

$FinCrisis_{ct}$ will first be an indicator variable equal to one when a country experiences a financial crisis. The main coefficient of interest is β_2, which captures the relationship between financial crisis and social capital.

To account for other unobservable characteristics, we include a full set of country (Cc) and year (Tt) dummies. Country dummies are included to minimize

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[16] Luc Laeven and Fabian Valencia. *Systemic Banking Crises Revisited*. International Monetary Fund, 2018.

[17] Cevat Giray Aksoy, Sergei Guriev, and Daniel S. Treisman. *Globalization, Government Popularity, and the Great Skill Divide*. No. w25062. National Bureau of Economic Research, 2018.

all time-invariant variation in the outcome variable caused by factors that vary across countries. Year dummies are included to eliminate the time-variant shocks that lead changes in the outcome variables shared by all countries over time. In addition, we control for country-specific linear time trends, which remove variation in within-country social capital behavior caused by factors that are country-specific and change linearly over time. In fully saturated models, the estimates are identified by exploiting within-country variation, in which fixed effects and country-specific linear time trends are expected to minimize the unobservable effects that may be correlated with other explanatory variables. Finally, we cluster standard errors at the country level and use sample weights provided by Gallup to make the data representative at the country level.

4. Results

Table 1 presents the results from the OLS estimation where the dependent variable is a dummy variable indicating that the respondent "volunteered for an organization" in the top panel and respondent has "helped a stranger" in the bottom panel. Column 1 reports the estimation with fixed effects (country and year); column 2 adds demographic characteristics; column 3 adds the log of household income and its square; and column 4 adds county-specific linear time trends.

The results in column 1 of Table 1 indicate that financial crises are negatively associated with both measures of social capital. Columns 2 to 4 show that the estimated effects are similar, and remain significant, as additional controls are added. In column 4 of Table 1, our findings indicate that financial crises lead to a 2.3 percentage point fall in the likelihood of reporting to have volunteered for an organization and a 1.8 percentage point fall in the likelihood of reporting to have helped a stranger. Of course, the depth of financial crisis in a given year will vary across countries, so these estimates only capture the change in social capital when a country experiences a financial crisis.

We also conducted a number of robustness checks.[18] First of all, the time period we study includes the global financial crisis. Is the result driven by the—highly atypical—years of the great recession? To check this, we tried excluding the recession years (2008-2010) and also dropping individual sub-periods (2005-2008, 2009-2011, and 2012-2015) one at a time. The results remained similar. Second, changing expectations about the labor markets and financial situation may prevent people from volunteering or helping others. To investigate this possibility, we controlled for measures that capture attitudes about a community's efforts to provide economic opportunities. Our results did not change.[19] Finally, our findings do not change (i) when we exclude the top and bottom five

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[18] These results are not reported here, but are available upon request.

[19] These variables include: (i) Right now, do you think that economic conditions in the city or area where you live, as a whole, are getting better or getting worse? (ii) Thinking about the job situation in the city or area where you live today, would you say that it is now a good time or a bad time to find a job? (iii) Right now, do you feel your standard of living is getting better or getting worse? All variables are defined such that favorable answers are coded as a "1" and all pessimistic answers are coded as a "0."

percent income groups and (ii) when we include country-specific quadratic time trends.

To understand the heterogeneity of the effects, we use our fully saturated specification and examine associations for various demographic groups. In columns 1 and 2 of Table 2, we break down the results by gender and in columns 3 and 4 we split the sample by age groups (below median and above median). The coefficients are broadly similar for men and women, but our findings suggest meaningful differences in responses between younger and older cohorts: those aged 40 or less seem to be more responsive to crises.

Table 3 reveals interesting descriptive heterogeneity by the level of education and urbanity status. For example, there is a notable urban/rural difference, as those who live in rural areas are significantly less likely to have engaged in civic activities after the crisis. On the other hand, we only observe limited education-based differences in the data.

Table 4 presents results by respondents' income level (low-income tercile households, middle-income tercile households, and high-income tercile households). We find that low-income households are more responsive to crises and the average results are mostly driven by this group. For high-income and middle-income households, the effects are smaller in magnitude and often statistically insignificant. Taken together, these results indicate that financial crises were associated with statistically and economically significant deterioration in social capital across a broad demographic spectrum.

5. Conclusion

Is there a relationship between financial crises and social capital? Analyzing data from 2005-17, our results suggest that financial crises are negatively associated with social capital. In other words, exposure to financial crises leads to a contemporaneous fall in individuals' civic engagement. Moreover, we document that the effects we identify are widespread across many demographic groups. Our results suggest that financial crises can exert a powerful influence in shaping social capital.

The existing literature on financial crises has examined extensively the direct channels that translate financial shocks into losses in economic growth. Our study, however, provides a more indirect (and thus less visible) channel by which financial crises reduce a society's social capital. Our findings – while intuitive – have important implications. One could conclude, for instance, that policymakers should take a more active approach in dealing with the social effects of financial crises, especially when those effects are concentrated on younger cohorts, as illustrated in this paper. Potential destruction of civic engagement for these younger generations naturally brings to mind the possibility of very long-term persistence in the economic losses generated by financial crises. Further research, alongside a longer-term dataset, is needed to investigate whether such persistence exists in the data.

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Table 1: Financial Crises and Social Capital – OLS Estimation

	(1) OLS	(2) OLS	(3) OLS	(4) OLS
Outcome: Volunteered for an organization				
Financial crises	-0.023***	-0.024***	-0.024***	-0.023**
	(0.009)	(0.009)	(0.009)	(0.010)
R-squared	0.061	0.069	0.070	0.074
N	1,128,505	1,128,505	1,128,505	1,128,505
Outcome: Volunteered for an organization				
Financial crises	-0.017*	-0.017*	-0.017*	-0.018*
	(0.009)	(0.009)	(0.009)	(0.010)
R-squared	0.049	0.062	0.064	0.068
N	1,124,043	1,124,043	1,124,043	1,124,043
Country fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Demographic characteristics	No	Yes	Yes	Yes
Household income	No	No	Yes	Yes
Country-specific linear time trends	No	No	No	Yes

Notes: * significant at 10%; ** significant at 5%; *** significant at 1%. Demographic characteristics include: a male dummy; age and age squared; dummy variables for marital status (married/civil partnership and divorced/separated) and religion (Orthodox Christian, Catholic, Protestant/Other Christian, Muslim, other); a dummy variable for the presence of children in the household (any child under 15); and a dummy variable for living in an urban area. Results use the Gallup sampling weights and standard errors are clustered at the country level.

Table 2: Financial Crises and Social Capital – OLS Estimation, Sub-sample Analysis by Gender and Age

	(1) OLS	(2) OLS	(3) OLS	(4) OLS
Sample is →	Male	Female	Below median age (<=40)	Above median age (>40)
Outcome: Volunteered for an organization				
Financial crises	-0.021***	-0.025***	-0.029***	-0.017*
	(0.010)	(0.011)	(0.011)	(0.010)
R-squared	0.078	0.073	0.065	0.093
N	512,007	616,498	574,412	554,093
Outcome: Helped a stranger				
Financial crises	-0.018*	-0.019*	-0.027***	-0.008
	(0.010)	(0.011)	(0.009)	(0.013)
R-squared	0.071	0.067	0.066	0.075
N	510,146	613,897	572,613	551,430

Notes: * significant at 10%; ** significant at 5%; *** significant at 1%. Specification is column 4 of Table 1.

Table 3: Financial Crises and Social Capital – OLS Estimation, Sub-sample Analysis by Educational Attainment and Urbanity Status

	(1) OLS	(2) OLS	(3) OLS	(4) OLS
Sample is →	Tertiary or more	Less than tertiary	Urban	Rural
Outcome: Volunteered for an organization				
Financial crises	-0.019	-0.023**	-0.011	-0.031***
	(0.012)	(0.010)	(0.009)	(0.012)
R-squared	0.069	0.072	0.060	0.086
N	169,033	959,472	450,284	678,221
Outcome: Helped a stranger				
Financial crises	-0.012	-0.019*	-0.005	-0.028***
	(0.011)	(0.010)	(0.012)	(0.011)
R-squared	0.060	0.067	0.063	0.070
N	167,712	956,331	447,675	676,368

Notes: * significant at 10%; ** significant at 5%; *** significant at 1%. Specification is column 4 of Table 1.

Table 4: Financial Crises and Social Capital – OLS Estimation, Sub-sample Analysis by Income Terciles

	(1) OLS	(2) OLS	(3) OLS
Sample is →	Low-income households (bottom tercile)	Middle-income households (middle tercile)	High-income households (top tercile)
Outcome: Volunteered for an organization			
Financial crises	-0.049***	-0.020*	0.000
	(0.016)	(0.012)	(0.009)
R-square	0.081	0.081	0.063
N	414,573	380,424	333,508
Outcome: Helped a stranger			
Financial crises	-0.023***	-0.022*	-0.010
	(0.013)	(0.013)	(0.014)
R-squared	0.071	0.069	0.076
N	414,822	378,785	330,436

Notes: * significant at 10%; ** significant at 5%; *** significant at 1%. Specification is column 4 of Table 1

GRF Young Academics Program Publications

The GRF Young Academics Program Publications consist of policy and analysis paper series written by the participants of the Young Academics Program. While both series are concerned with thoroughly analyzing a topic of interest, policy papers additionally propose policy recommendations.

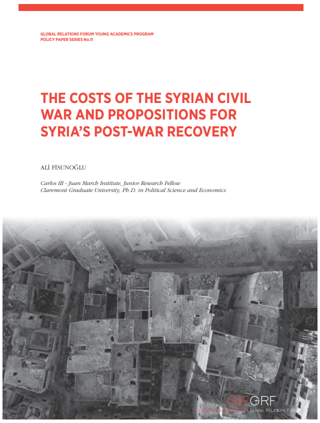
The Young Academics Program and its publications are directed by Burcu Baran Türem, GRF Director of Policy Communities.

GRF Associate Duygu Söyler is the editor of the series.

For further information, please contact GRF at info@gif.org.tr.

Following is a selection of papers published under the GRF Young Academics Program Publications:

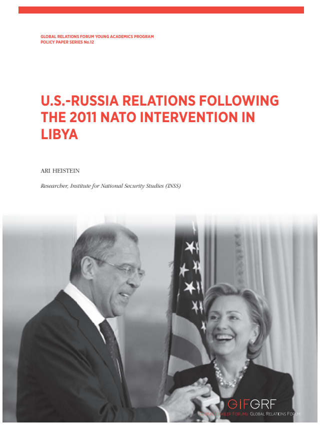
Policy Paper Series



No: 11

"The Costs Of The Syrian Civil War And Propositions For Syria's Post-War Recovery"
by Ali Füsunoğlu

Carlos III - Juan March Institute, Junior Research Fellow
Claremont Graduate University, Ph.D. in Political Science and Economics



No: 12

"U.s.-Russia Relations Following The 2011 Nato Intervention In Libya"
by Ari Heistein

Researcher, Institute for National Security Studies (INSS)

No: 13

"Overcoming The Global Interregnum: Considerations From Brics"
by Klaus Kotzé

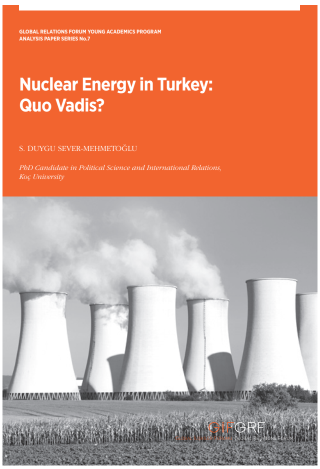
Ph.D. in Rhetoric Studies, University of Cape Town

Analysis Paper Series

No: 6

"Iran's Foreign Policy in Iraq and Syria after 2011"
by Ezgi Uzun

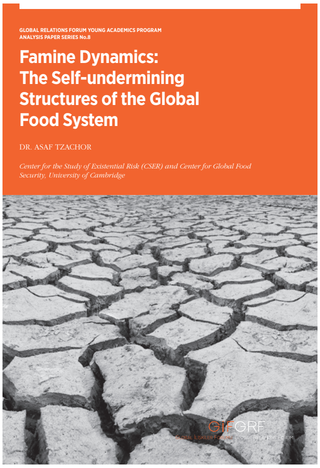
Ph.D. in Political Science, Sabancı University



No: 7

"Nuclear Energy in Turkey: Quo Vadis?"
by S. Duygu Sever-Mehmetoğlu

PhD Candidate in Political Science and International Relations, Koç University



No: 8

"Famine Dynamics: The Self-undermining Structures of the Global Food System"
by Dr. Asaf Tzachor

Center for the Study of Existential Risk (CSER) and Center for Global Food Security, University of Cambridge

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Global Relations Forum Young Academics Program
Analysis Paper Series No.9

Financial Crises and Social Capital: Global Evidence

July 2020

GRF Young Academics Program brings together young academics who are currently pursuing or have recently completed their doctoral studies. The goal of this program is to provide a forum for accomplished young academics to discuss and debate long-term policy challenges.

The GRF Young Academics Program Publications consist of policy and analysis paper series written by the GRF's Young Academics.

Through this program, GRF is establishing an expanding network of young academics to enrich policy discussions in both the national and international spheres.

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www.gif.org.tr

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