Introduction

Michael Berlemann and Dominik Maltritz

Abstract

The Worldwide Financial Crisis stimulated intensified research on financial crises and sovereign defaults. In this edited volume we provide a variety of papers about important issues related to the recent financial crisis. The papers discuss new modelling approaches to financial crises, defaults, their dependencies and consequences with a special focus on features of financial institutions and financial markets. Many papers have a focus on the European Union and crisis risks of developed countries. The book also provides interesting suggestions to the solution of crises and the improvement of financial stability. This concerns especially the design of institutional features and financial contracts. The introduction provides an overview on the book in general and the individual contributions.

Throughout the last 6 years Europe experienced two enormous financial crises: the Worldwide Financial Crisis and the subsequent European Debt Crisis. Throughout these crises many countries and regions faced banking crises or currency crises and many countries defaulted on their debt obligations or needed external help to avoid debt crises and outright defaults. Yet, in many countries the crises showed features of several types of financial crises at the same time. These problems, of course, did not only influence the financial sectors, but severely impacted the referring economies as well as the social and political atmosphere. The crises which occurred in the decades before, e.g. the Latin American debt crisis of the early 1980s, the

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D. Maltritz and M. Berlemann (eds.), *Financial Crises, Sovereign Risk and the Role of Institutions*, DOI 10.1007/978-3-319-03104-0_1,

Mexican Crisis of 1994/95, the Asian Crisis of 1997/98, the Russian Crisis of 1998/99 or the crisis in Argentina – to name a few important examples – also imposed severe burdens on the afflicted economies. However, while these crises were more or less restricted on single developing countries or regions, the two recent financial crises also affected the entire or at least large parts of the developed world.

Due to the often enormous impact of financial crises on economic, social and political life in the affected countries, the causes, the development and the consequences of financial crises have always been an important topic on the agenda of economic research. Economists which have been active on the field of research on financial crises are often fascinated by the complex and challenging topic, as it becomes obvious from a statement of Nobel Price laureate Paul Krugman[1]: “And so I am a bit like a tornado-chaser who has just caught up with a monster twister. I’m as sorry as anyone about those poor people in the trailer park, but I am also more than a bit thrilled to have the chance to watch this amazing spectacle unfold. I can even offer an excuse for my mixed feelings: You learn a lot more about how the global economy works when something goes wrong than when everything hums along smoothly. And maybe the lessons we learn from this crisis will help us avoid, or at least cope better, with the next one.” Indeed the last two “next (big) ones”, i.e. the Worldwide Financial Crisis and the European Debt Crisis, displayed – besides many similarities to preceding crises – several new features. The most obvious news is that crises can also occur in the most developed countries. As pointed out earlier, most of the previous research focused on crises in the context of developing countries. In addition, the Worldwide Financial Crisis as well as the European Debt Crisis have underpinned the importance of an issue that researchers picked up just in the years before, the strong dependency between different types of crises, i.e. the dependency between banking and currency crises and their relation to sovereign default risk. Moreover, the recent crises revealed in an unpleasant way that weak or wrong features of the institutional setting in the financial sector and the financial markets as well as wrong politics and over-ambitious goals of policy makers (that neglect fundamental economic truths) are important causes of crises.

When the Worldwide Financial Crisis evolved, the crisis issue returned to the top of the agenda of economic research and has remained there since then. In this edited volume we provide a variety of articles written by experts that mostly have worked in this field since long before the current crises started. In these articles some of the most important issues related to the recent financial crises are discussed. The papers discuss new modelling approaches to financial crises, defaults, their dependencies and consequences. The contributions also highlight and discuss several features of financial institutions and financial markets’ design and in particular the risks they impose to financial stability. Many papers have a focus on the European Union and problems and risks of developed countries. The book also provides interesting suggestions to the solution of crises and the improvement of financial stability. This concerns especially the design of institutional features and financial contracts.

[1] Krugman, Paul (2002): Asia: What went wrong? (http://www.pkarchive.org/)

Such issues are discussed in the first half of the book while discussions and new economic modelling approaches of different kinds of risk are provided in the second half.

The volume starts out with a paper by Ansgar Belke who suggests an interesting policy alternative for the European Central Bank (ECB). Currently the ECB follows the Outright Monetary Transactions (OMT) approach in order to reduce interest rates for several European countries and to enhance their financing potentials. This approach has been criticized heavily for several reasons. Belke suggests an interesting alternative: The use of gold backed bonds for highly distressed countries. The paper discusses the specific benefits of this approach compared to the OMT approach. In particular there is almost no transfer of credit risk between high risk and low risk countries, losses are borne by specific countries and not by the largest shareholders of the ECB. In addition, the approach would be more transparent, lead not to inflationary risks and would contribute to fostering reforms.

The second paper, which is authored by Michael Berlemann, is concerned with the effects of the two recent financial crises on trust of the citizens of the European Union in the European Central Bank. Berlemann argues that trust is a necessary precondition for a political institution to be able to fulfill its tasks in the long-run. In order to study the effect of the two crises on trust he uses three cross-sections of the Eurobarometer Survey. Employing the results of a logit-estimation-approach Berlemann shows that both crises contributed to a significant decline in trust in the European Central Bank even after controlling for the inferior macroeconomic circumstances in consequence of the crises. Especially the European Debt Crisis turned out be detrimental to average trust in the European Central Bank. He also shows that there are huge differences in the perception of citizens of European Union member countries. Berlemann concludes that the two recent financial crises contributed to an even larger degree of (fiscal) integration of the Euro-Area member countries although this process was initially not intended. While the chosen measures might have been necessary to stabilize financial markets in the short-run he argues that it is inevitable to return to a substantial and democratically legitimized process of European integration. Without such a process European institutions and especially the European Central Bank would hardly be able to (re-)gain the necessary trust of Europe’s citizens.

The third paper is authored by Thilo Liebig and Sebastian Wider. This paper is concerned with the regulatory framework with special emphasis on systemically important financial institutions (SIFIs). The authors argue that there is an increased need of quantitative indicators measuring systemic importance of banks. Based on a set of indicators Liebig and Wider argue that the systemic importance of large German banks has somewhat declined over the last 4 years. However, this development is not the result of new policies directly addressing the too-important-to-fail-problem but likely due to the difficult economic environment so that it is too early to judge the newly introduced regulations.

Nikolay Nenovsky and Momtchil Karpuzanov discuss how the institutional framework in Europe in general affects the convergence aims of the European Union and whether it makes the region vulnerable to shocks and crises. Their main hypothesis is that Europe factually tends to disintegrate due to the fact that European member countries are on quite different stages of integration and differ enormously in their speeds of development. The authors argue this to lead to centrifugal processes within the European Union. As a consequence of the illusionary impression of a safety-net and risk insurance the overall level of risk would be too high and unfavourably distributed among member states, thereby making the European economic system highly vulnerable.

The fifth paper, authored by Andreas Bühn and Daniel Kraaijeveld van Hemert, focuses on the role of tax havens. The authors argue that tax havens are exposed to increased risk of financial collapse and liquidity crises and that this risk increases in the amount of profits shifted to them. Moreover, the authors argue on the basis of available data that tax havens are especially prone to illegal activities such as money laundering. Finally the authors present an analysis of multinational corporations' decisions to export profits to tax havens, taking into account both the risk of tax haven default and the corporate tax rates in high tax countries. Based on the theoretical results the authors derive proposals how financial stability can be increased in the presence of tax havens.

The following articles focus on risks of financial crises and defaults instead of the role of institutional issues.

The sixth paper, authored by Ephraim Clark and Radu Tunaru, may help to zoom out our maybe somewhat narrow view on current events by studying the development of geopolitical and crises risk over the past decades. Using Bayesian Hierarchical and Markov-Chain Monte-Carlo modelling techniques the authors show that the average arrival rate of crises and geopolitical events is about one per year, but arrival rates are non symmetrical and vary over time. Interestingly enough, Clark and Tunaru also find that there is a statistically significant, negative time trend in the arrival rate, which suggests that geopolitical risk is decreasing in the course of time.

A closer inspection of historical financial crises shows that many crises show features of banking, currency and debt crises at the same time. Thus, the relation between different types of crises was picked up in the recent theoretical and empirical literature. Dominik Maltritz discusses a theoretical approach to model this relation in a stochastic and dynamic framework based on stochastic differential equations and compound option theory. This approach especially makes it possible to consider the influence of uncertainty about the amount of the government is able and willing to spend (for crisis avoidance) on crisis risk. In addition, the influence of countries' indebtedness, and in particular the debt's maturity on crisis risk can be analyzed. It is shown that uncertainty increases crisis risk in most situations. The risk of a financial crisis is higher with (higher) outstanding debt repayments. A shorter maturity of debt also tends to increase crisis risk.

One of the most important questions in the current discussion about the European Debt Crisis is whether the Eurozone will survive in its current shape or not. Stefan Eichler analyzes empirically how this drop-out risk is related to the Euro exchange rate. More precisely, he studies whether foreign exchange market investors perceive the risk that vulnerable countries could leave the European Monetary Union. He finds that the Euro typically depreciates against the

U.S. Dollar when the incentive for vulnerable countries to leave the European Monetary Union increases, i.e. because of a rising sovereign default risk or an increasing risk of banking crises.

The following contribution, authored by Christian Hott, is concerned with the usually applied methods of evaluating market risk, which is necessary to calculate the capital requirements of financial intermediaries. Typically Value at Risk models are employed for this purpose. However, Hott argues that this type of model delivers highly pro-cyclical results, i.e. indicates low risks when prices go up and high risk when prices go down. As a result, capital requirements are rather low at the peak of an asset price bubble, right before the losses occur. In addition, the pro-cyclicality of regulation provides an incentive for banks to buy assets when prices go up and to sell them when prices go down, thereby amplifying price fluctuations. Against this background the analysis of Hott delivers two important contributions. First, he evaluates minimum standards for Value at Risk that should help to reduce its weaknesses. Second, he develops a capital add-on for market risk that is, in contrast to Value at Risk, linked to economic fundamentals.

In the last contribution to this book, Michael Graff analyzes one of the most influential economic theories, the quantity theory of money. He discusses to which extent the quantity theory can be applied today, especially in the light of the Worldwide Financial Crisis, and whether it has still potential to explain monetary policy. Although the measures taken to deal with the recent crises have led to a spectacular increase in the stock of money, no inflation can be observed, as it is predicted by the quantity theory. This leads to important questions: Is inflation in the pipeline, inevitably to emerge soon or later, as the critics of 'monetary easing' keep claiming? Does the failure of inflation to materialise finally falsify the quantity theory? The contribution tackles these questions by firstly highlighting the most important characteristics of the latest economic slump. Then, an empirical analysis drawing on data on 109 countries from 1991 to the present confirms that the theory still has predictive power: Excess money growth is a significant predictor of inflation although the classical proportionality theorem does not hold.

Altogether, this edited volume provides many interesting insights into the recent financial turmoil and the factors which contributed to the developments. It includes many interesting discussions and approaches to current issues on financial crises and sovereign defaults, the reduction of risk and the improvement of institutions. We therefore hope that this book will contribute to further developing the discussion on necessary regulatory measures and a reform of institutions, thereby hopefully contributing to Krugman's mission that "the lessons we learn from this crisis will help us avoid, or at least cope better, with the next one."