Chapter

Introductory Chapter: Financial Crises

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1. Introduction

This book aims to present a collection of research papers which are related, in one way or another, to financial crises. The work contained herein ranges from topics such as the sources, origins and political and institutional dynamics of the global financial crisis we had during 2007/09 (GFC) to the liberalisation of economies, macroeconomic development, and the behaviour of interest and exchange rates during periods of political turmoil. Naturally, given its importance and far-reached economic, political and social effects across the globe, the majority of the chapters that will follow are related to the GFC. However, the timing of writing the introduction to this book is such that I strongly believe that the effects (and potential effects) on the financial system and banks of another crisis—a very different one—need to be addressed; I am referring of course to the ongoing economic crisis caused by the COVID-19 pandemic. As such, the prime aim of this chapter is to discuss the effects of this latter crisis on the global economy and the financial sector, in particular, and in doing so provide a 'bridge' between what is discussed in the chapters that follow and what is actually happening around us at this time.

The chapter unfolds as follows: Section 2 discusses the effect of the pandemic on the world economy and the financial system; Section 3 deals with the banking system; and Section 4 concludes.

2. The effect of COVID-19 on the world economy and the financial system

There is little doubt that the COVID-19 pandemic has caused an extraordinary human and health crisis. The measures taken by governments all over the world necessary to contain the virus have resulted in an economic downturn whose severity and length are still quite uncertain. Initially, the pandemic was seen as a China/Asian regional shock; however, very quickly, it became apparent that the virus was 'travelling' quickly and that the shock would indeed be a global one. It is now clear that the last time the world economy suffered such a shock was after the demise of Lehman Brothers in September 2008. Under this 'prism', Baldwin and Tomiura [1] point out that the GFC could provide a broad perspective on the range of likely outcomes this time around; more specifically, the authors refer to what came to be known as the 'great trade collapse', which was the steepest fall in world trade since the Great Depression (see **Figure 1**).

As far as global economic growth is concerned, recent IMF estimates [2] indicate a decline of 3% for 2020, which incidentally is worse than the one experienced during the GFC. At the same time, the timing and—importantly—the shape of a potential future recovery remain uncertain. Within this context, Mann [3] argues that this crisis will probably be a U-shaped one (rather than a V-shaped one), on the grounds of what happened as a result of other epidemics. Having said that, however, we need to stress out that, from an economic perspective (and not only), COVID-19 is different from other pandemics (Asian Flu, Hong-Kong Flu, Avian Flu, SARS, MERS, and Ebola Virus Disease), in the sense that they either 'hit' nations that were not so dominant economically or the number of registered cases was much smaller; we should not forget that the current pandemic has greatly affected the G7 plus China, among several other countries.

Given the above developments on world trade and economic growth, unavoidably the global financial system has also felt a dramatic impact with the asset prices falling sharply; actually, according to the IMF [2] (see **Figure 2**), several stock markets across the world experienced declines of 30% plus at the worst point of the sell-off (we should note that most of them have recovered since then). Moreover, worrying signs were also observed in important short-term funding markets, including that for US dollars, as well as other credit markets, with spreads rising substantially. The strain experienced by financial markets may also be seen through the volatility 'lenses', where spikes in volatility reached levels not seen since the GFC, reflecting the uncertainties caused by COVID-19 (see **Figure 3**).

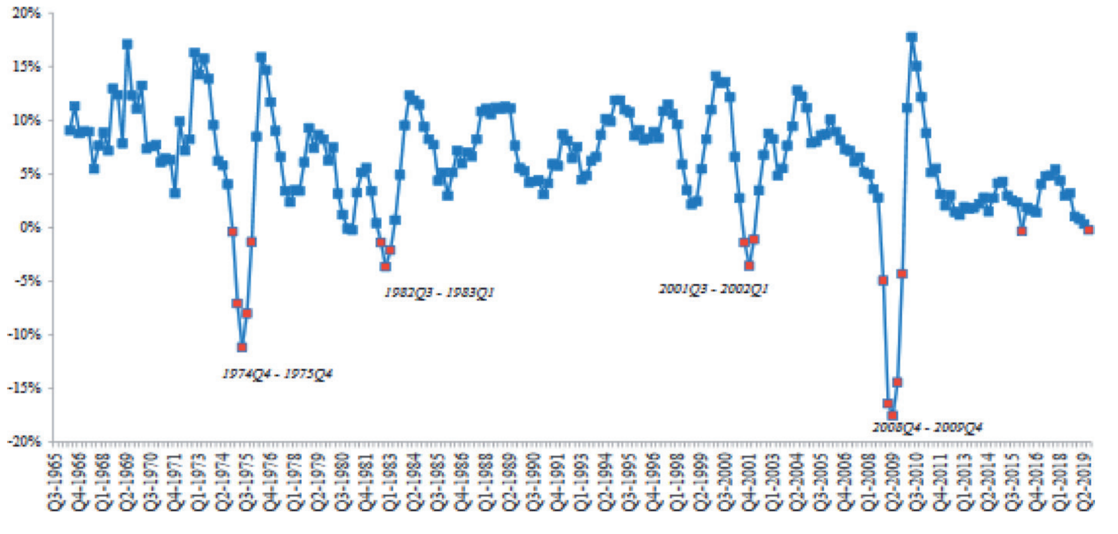

Figure 1.
Quarter-on-quarter growth, world imports volume, 1965–2019 Q3. Source: Baldwin and Tomiura, elaboration on WTO online data (www.WTO.org).

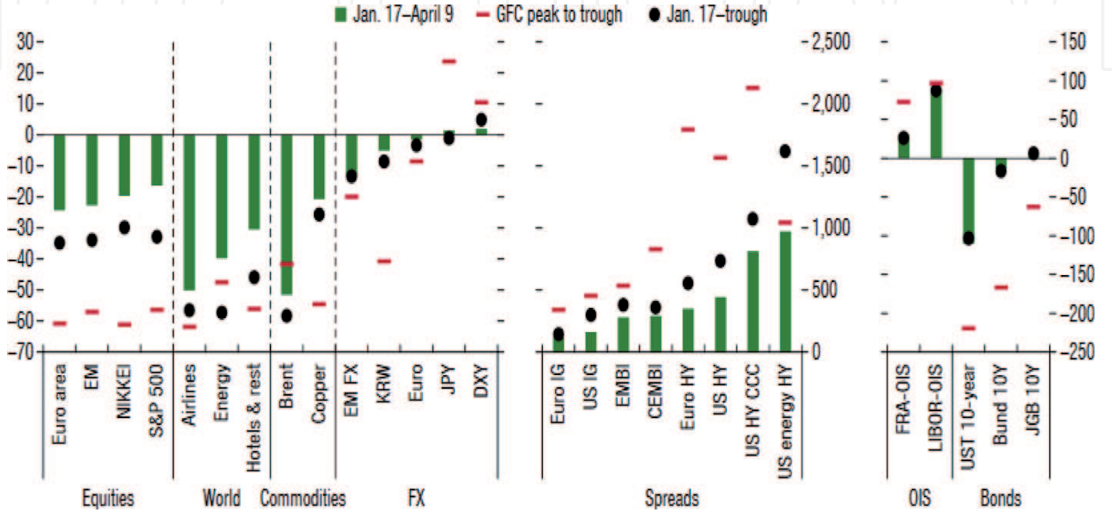

Figure 2.
Asset market performance as of April 9, 2020 (measured in percentage points and basis points). Source: IMF, global financial stability overview, April 2020.

Within the above framework, and given the need to stabilise the global financial system so as to support the real economy, as is often the case, central banks had to take bold action. To do this, they had to re-activate 'weapons' used during the course of the GFC in order to contain the upward pressures on the cost of credit and make sure that firms and households would have access to credit (at a reasonable price); effectively, central banks stepped in as 'buyers of the last resort' of risky assets, such as bonds issued by firms, including high-yield ones. Moreover, central banks in advanced economies cut interest rates to historically low levels (see **Figure 4**) while substantial interest rate cuts were also observed in emerging markets. Finally,

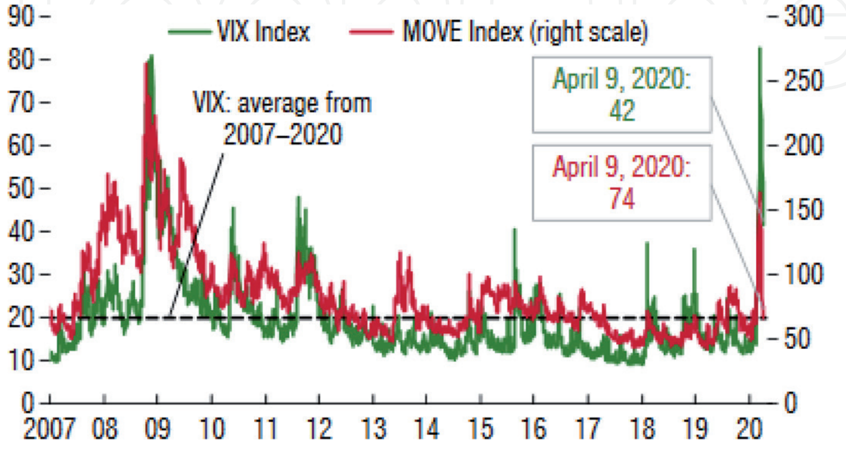

Figure 3.
Volatility indexes (measured in percentage points). Source: IMF, global financial stability overview, April 2020.

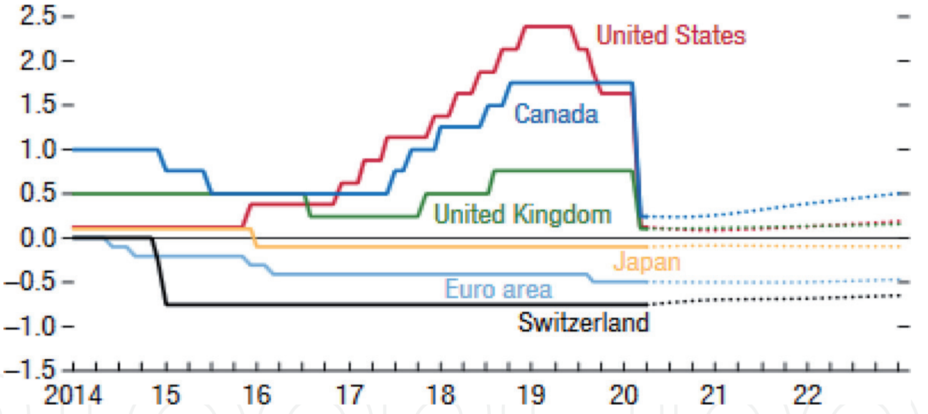

Figure 4.
Actual and expected policy rates. Source: IMF, global financial stability overview, April 2020.

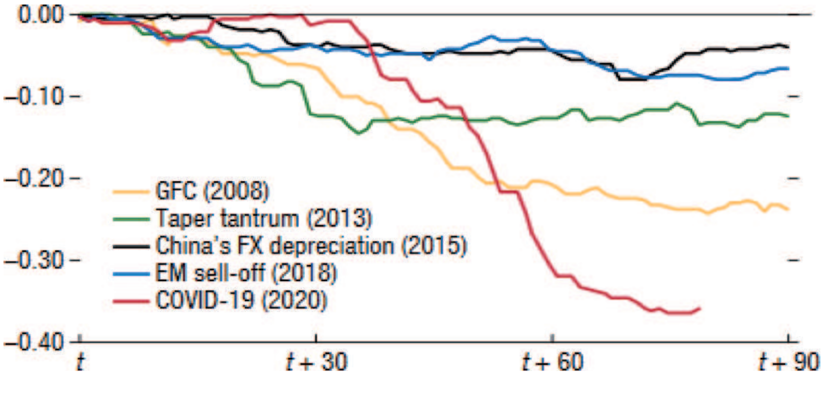

Figure 5.
Cumulative non-resident portfolio flows to emerging markets (% of GDP). Source: IMF, global financial stability overview, April 2020.

central banks have also provided liquidity to the financial system through Open Market Operations (OPM). These actions have certainly helped to 'calm' markets, some of which have substantially recovered lately; however, despite this, it should be noted that investor sentiment is still fragile.

Putting all the above together, the deterioration of the global economic outlook has dramatically changed the 1-year ahead projections of global economic growth; actually, according to the IMF [2], it has shifted it massively to the left (there is a 5% probability that it will fall below –7.4%; same as referring to an event that is expected to happen once every 20 years). It is quite possible that, as so often happens at times of financial crises, emerging markets are hit the hardest, since investors tend to withdraw their capital and look for so-called 'safe-haven' assets (**Figure 5** below 'speaks for itself').

3. What about banks?

From a historical point of view, some of the most striking examples of contagion in the financial sector have involved international banks; recall for example the GFC and the euro area crises, or the crisis in South East Asia in the late nineties, among many others[1]. According to Beck [5], this time banks are not likely to be a major 'channel' of transmission, due to the fact that adherence to stricter regulatory requirements in recent time has meant that their capital buffers are much stronger now, and the system—as a whole—is presumably safer. In particular, the author argues that in the case of European banks even under a scenario of an 8.3% decline in GDP over 3 years, banks would still be in good shape. Furthermore, the coordinated and substantial action by central banks in providing ample liquidity to banks in several countries has further 'insulated' the banking system, at least for now.

Nonetheless, others such as Cecchetti and Schoenholtz [6] appear to be more concerned in case there is a confidence crisis, which in turn might result in 'bank runs' that are, by definition, contagious; as the authors put it *The news about a run on a specific bank alerts everyone to the fact that there may be other 'lemons' among the universe of banks, turning a run into a panic.* As such, it is of paramount importance that people are well informed about the 'linkage' between the economic and the medical effects of the pandemic, so as not to over-react without reason; effectively, what we should be looking for are honest and transparent governments. Cochrane [7] 'paints' an even bleaker picture pointing out that 'shutting the economy down' could cause large financial problems related for example to companies that will have to continue paying their debts and bills and people that will have to pay rent or make mortgage payments; all this could lead to a wave of bankruptcies and insolvencies.

Eventually, how things will turn out for banks will depend, to a great extent, on how the situation evolves going forward; for example, if the global spread of COVID-19 requires imposing tougher containment measures, these are likely to lead to an even more severe economic downturn. Such a development would probably unveil crucial vulnerabilities of the financial system; for instance, investment managers are likely to face substantial capital outflows and thus will be forced to sell assets in falling markets thus accentuating the downward prices 'spiral'. At the same time, companies are more likely to face distress, with default rates rising; recall for instance what happened to Flybe, the UK airline, which struggled to meet

[1] A comprehensive discussion of international banking crises can be found in the work of Reinhart and Rogoff [4].

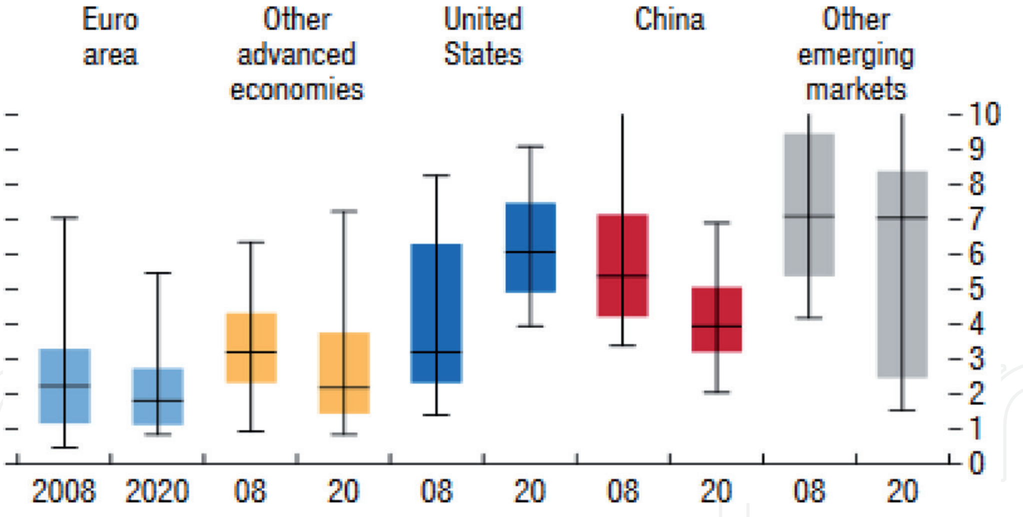

Figure 6.
Decline in bank market capitalisation. Source: IMF, global financial stability overview, April 2020.

its obligations and went into administration in early March, 2020. Events like this are likely to harm credit markets, especially their riskier parts (e.g. non-investment grade bonds).

If such a scenario was to unfold, despite the fact that banks have more capital and liquidity than in the past, it is plausible that their resilience might eventually be tested. Declines in asset prices are likely to result in losses in the investment portfolios of banks (especially with respect to risky assets), while rising bond yields for highly indebted governments might just remind us of the sovereign-financial sector nexus, which provided so much pain in the course of the euro area crisis. In addition, the longer the pause in economic activity, the more likely it is that the banking sector will register credit losses on their lending portfolios to companies and households, especially the more vulnerable ones (e.g. think of energy companies and falling oil prices or a shutdown factory that nonetheless still has to pay its workers and debt). Finally, lower bank profitability would imply—by default—that banks will have less income (and potentially reserves) against which to write-off losses resulting from the above.

Actually, looking at the market reaction of bank stock prices during the unfolding of the pandemic, we observe large declines, which indicate investor concern regarding the prospects of the sector. Interestingly, **Figure 6** seems to suggest that bank capitalisations fell more in 2020 than during the GFC in several parts of the world.

Given the above, financial regulators and supervisory authorities have taken some bold steps (in addition to those of central banks discussed in Section 2), which may be summarised as follows: (a) some countries have allowed banks to operate below their normal liquidity requirements and to utilise their capital conservation buffers[2]; (b) some countries have also adjusted (temporarily) their supervisory priorities and eased regulatory requirements (e.g. delay of stress-tests and flexibility in the treatment of non-performing loans); (c) restriction of bank dividend payouts. It is worth noting that similar measures have been taken to support other non-bank financial sector firms such as insurance companies and asset managers; for example, in the case of the latter, we have seen measures such as bans on short sales.

[2] According to the European Systemic Risk Board (ESRB), the capital conservation buffer is a capital buffer that equals 2.5% of a bank's total exposures that needs to be met with an additional amount of Common Equity Tier 1 capital. The buffer sits on top of the 4.5% minimum requirement for Common Equity Tier 1 capital.

4. Conclusion

Last time around, in the course of the GFC, world leaders moved together to provide a common, coordinated response to the crisis; it was probably not perfect, but eventually it worked. Today, global leaders are facing a similar, if not greater and more complex, challenge, and their 'measures' will be assessed by their ability to deal with this global threat. Obviously, priority should be given to the public health aspects of the virus and in containing as much as possible the pandemic.

Regarding the financial system, it is quite possible that COVID-19 could have important repercussions for banks and other financial institutions. On a positive note, these repercussions do not seem likely to be imminent, as banks are stronger this time around. This means that adequate preparation by the regulatory authorities is possible, without of course any room for complacency, as markets can react quickly, unpredictably and in a contagious manner. Within this context, according to Beck [5], regulatory authorities should focus on (and prepare for) the following: (1) possible operational disruptions in the financial system, (2) strengthening confidence in financial markets by clearly signalling that they stand ready to intervene (they have shown this intention to a great extent so far), and (3) preparing for possible interventions in and resolution of failing banks.

Beyond any doubt, the aforementioned and in particular the role of central banks will be very crucial to maintain stability in global financial markets and make sure that credit flows to the real economy. But we need to remember that this crisis is not only about liquidity, it is also about solvency; after all, large segments of the economies of many countries have come to a standstill. As such, fiscal policy also has a vital role to play, where along with monetary and other policies; they should provide a 'cushion' against the impact of the pandemic, paving the way for an economic recovery later on.

To conclude then, there are currently several questions of economic nature that are seeking answers, for example, how far will the economic damage go? How bad will things eventually get? What will be the extent of economic contagion? And, importantly, what can policy-makers do to alleviate it? And will it work? Unfortunately, we do not have answers to these questions, only time accompanied by good research will provide them. For sure, however, the crisis caused by COVID-19 will rightfully take its own place in the long list of economic and financial crisis, some of which are discussed in this book, and is likely to make interesting reading for future market analysts and policy-makers.

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