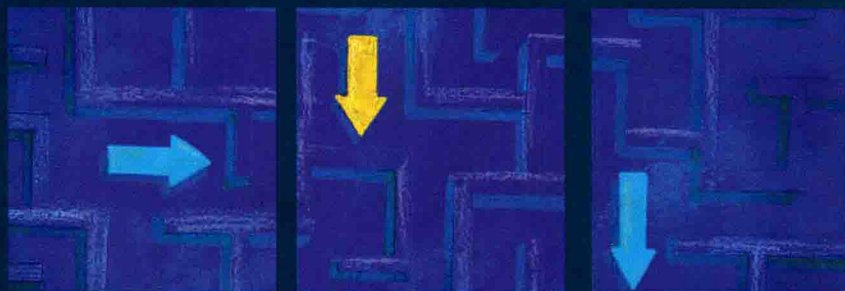


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# Crisis, Risk and Stability in Financial Markets



Edited by  
Juan Fernández de Guevara Radoselovics  
and José Manuel Pastor Monsálvez



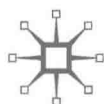
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Juan Fernández de Guevara Radoselovics and  
José Manuel Pastor Monsálvez

*University of Valencia, Spain*

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# Introduction

*Juan Fernández de Guevara Radoselovics  
and José Manuel Pastor Monsálvez*

The current crisis has taught us the key role the financial sector plays in developed economies. Once the financial crisis had exploded in 2007 and 2008, its consequences spread rapidly to the rest of the economy, causing many economies around the world to enter one of the worst recessions since the 1929 crash and the Great Depression of the 1930s. The financial turmoil that began in the summer of 2007 and the subsequent financial crisis that started in the summer of 2008 has led financial markets to witness a dramatic decline in their activity. According to the World Federation of Exchanges, world market capitalization reduced in 2008 by 46.5 per cent in a single year, the New York Stock Exchange fell by 41 per cent, Nasdaq by 40.3 per cent, NyseEuronext (Europe) by 48 per cent, the Nasdaq OMX Nordic Exchange by 52 per cent, the London Stock Exchange by 33 per cent and the Deutsche SE by 45 per cent. At the same time, market values plunged and public debt markets became refuge markets during the peak of the crisis, but later on, in 2010, the contagion of the crisis also spread to the sovereign debt markets, especially in Europe. Banking activity also fell; bank credit plunged in the most developed countries as financial institutions were forced to restructure their balance sheets due to either exposure to toxic assets, or excessive concentration in real estate markets, or both. The European Union authorities were forced to increase deposit insurance to prevent bank runs. Also, public intervention in Europe was needed – and still is – to recapitalize numerous banks.

Now that five years have passed since the eruption of the crisis, it is crucial to understand its causes and to evaluate the measures implemented in the financial sector. The aim of this book is precisely to address different topics related to the financial activity and the financial crisis. The chapters included in this book are a selection of original research focused on the effects and consequences of the financial crisis in the European banking and financial sector. The collection of chapters has been drawn from the most outstanding papers presented at the European Association of University Teachers of Banking and Finance Conference held in Valencia in September 2011.

Chapter 1, by Santiago Carbó-Valverde (University of Granada, Spanish Savings Banks Foundation and Federal Reserve Bank of Chicago) and Luis Pedraza Sánchez (University of Granada), analyses the relationship between the development of a country's financial sector and its growth rate, taking into account the effect of financial stability. There is significant evidence in the literature showing that although financial development leads to economic growth this is not always the case for countries where the financial sector is not well developed or is financially unstable. The results show that financial instability affects the relationship between credit and output. To achieve this, a Multivariate Threshold Vector Autoregression model has been designed to test the hypothesis that the influence of financial development on economic growth is asymmetric, depending on the state of the economy. The tests are undertaken for Spain, Germany and Norway, and show that financial instability affects not only the economic significance of the effect of credit on output growth but also the sign of this relationship.

Ted Lindblom (Gothenburg University) and Magnus Willeson (Linnaeus University) focus in Chapter 2 on the effects of the financial crisis on both bank profitability and risk-taking in the EU in the first two years of the crisis, 2008–2009. Interestingly, they emphasize how the crisis affected banks' profitability with respect to their exposure to different kinds of financial risk (credit risk, liquidity risk, interest rate risk and capital risk), comparing different types of banks in different regions of the EU. Overall, they seek differences in the financial performance and risk taking of the banks, depending on both their geographical operation area and their legal form. The results show that the overall profitability of the EU banks was, as expected, clearly affected by the financial crisis, particularly in the West European region. Banks in Eastern Europe appear to have been better off on average, although they did suffer a significant decrease in nominal returns; according to their results, their decreasing profitability in 2008 was not entirely caused by credit losses, as they did experience losses from their exposure to liquidity risk and a considerable decrease in non-interest income. In 2009, however, non-interest income improved, and so did the banks' exposures to liquidity risk. Banks' exposure to interest rate risk was also remarkable in both 2008 and 2009 in all regions, but the West European banks appear to have been relatively more affected. The capital risk exposure of the average bank seems to have been affected only marginally by the financial crisis and was in that respect not a major source of changing profitability.

At present, capital requirements, which aim at ensuring the solvency of individual banks, are the cornerstone of bank regulation. However,