Playing with financial risks in an uncertain world

W.G. Wolters

The concept of risk and the practice of financial risk management are important factors in the present-day financial world. Handbooks explain this focus on risk as a reaction to increased volatility of prices, interest rates and exchange rates since the early 1970s. Financial economists have developed mathematical models and quantitative techniques to hedge the risks of financial transactions. The financial innovations developed in this process, so-called derivatives, are derived from older forms of intertemporal transactions, such as options, futures, forwards and warrants. The use of derivatives has grown rapidly since the early 1970s. A number of authors has pointed out that the widespread use of these financial instruments to hedge risks at the level of banks and corporations has increased systemic risk at the macro-level. Some authors think that risk management is principally impossible, as uncertainty reigns the world. Others have pointed out that financial organizations have used derivatives not only for risk management, but also for other less lofty organizational purposes, such as creating excessive credit and taking highly leveraged positions. While this criticism is generally valid, it should be realized that the use of quantitative techniques and the practice of derivatives cannot be banned from the present-day financial world.

The financial crisis and corporate crime: four possible relations

W. Huisman

In this article four possible relations of the credit crunch and corporate crime are examined. A first relation is that cases of accounting fraud have contributed to the causation of the crisis. Due to these
scandals the trust in large corporations and the financial sector would have been eroded. A second possible relation is the reverse: the crisis will lead to more corporate crime. Because of the crisis companies run into financial difficulties. In their despair they could try to cut costs by not complying with regulations or they could try to gain illegal profits through fraud. The third relation is the criminalization of more unethical corporate behavior. The moral outrage on the behavior of banks and insurance companies that contributed to the crisis might lead to an increased labeling of risky or greedy of corporate executives as crime. This will result in more regulation. The fourth and final relation is that these amplification effects will lead to the discovery of more corporate crime.

**Financial crises and financial criminals**

*B.M.J. Slot*

Charles Kindleberger unravelled the anatomy of a typical financial crisis in his famous book *Manias, Panics and Crashes* (1978). He stresses that during a boom the tendency to swindle and be swindled runs parallel to the tendency to speculate. In this article five famous and non-famous swindles over the past ninety years are analyzed. Each financial boom, and each financial crisis during this period of modern capitalism experienced at least one famous financial swindle, which is to be seen as typical for the boom and the subsequent deception. The five swindlers described are Charles (Carlo) Ponzi in the 1920s, Ivar Krueger around 1930, Bernie Cornfeld in the 1960s/1970s, Michael Milken in the 1980s and – very recently – Bernard Madoff. His 65 billion dollar fraud is to be seen as the first worldwide Ponzi scheme – a fraud that lasted longer, reached wider and cut deeper than any similar scheme in history. An analysis of these five cases yields several striking similarities. It is concluded that financial swindles are no random events, but the result of both structural changes and circular waves of economic and financial boom and bust.

**The financial crisis and Kondratieff’s lessons; a doom scenario**

*E. Mecking*

The world is in the throes of the deepest economic depression since the 1930s. Worst is yet to come. The financial crisis has spread to the real economy on a global scale. A global recession combined with the current credit crunch is a rare, but a deadly cocktail. This
will lead to a recession of unimaginable magnitude – a deflationary depression. This doom scenario is based on the conjuncture waves of the Russian economist Nikolai Dimitrievitsj Kondratieff (1892-1938) and the strong similarities between 1920-1929 and 1980-2000, both autumn seasons in the Kondratieff cycle. Soon it will become clear that all measures taken by governments have had only a little, temporary positive effect. The stock markets, housing markets and world economy will reach new depths in the coming decade. Social chaos will be the result. The history of the 1930s could serve as our guide here.

**Who is responsible for the financial crisis?**

*B. Unger*

Many actors have been blamed for the financial crisis: Greenspan, banks, rating agencies, careless mortgage takers and incompetent mainstream economists. This paper however focusses on other explanations for the crisis which are usually neglected in mainstream economics. The imbalances in the income and wealth distribution worldwide have become so large, that the poor cannot buy the goods produced by rich countries anymore, while the rich have become so rich that they cannot spend all their income anymore in the real sector. This lack of demand for goods has artificially been filled by unsecured debts given to the poor, but eventually led to a taking off of financial markets, and to a crisis. When imbalances are too large, this backfires. Government packages aimed at stabilizing the economy should therefore not forget the income and wealth distribution in order to be successful in the long run.

**Financial supervision at the European level**

*D. Schoenmaker*

There is currently no legal base for financial supervision and crisis management at the European level. Powers are nationally based. This article develops the financial trilemma, which states that a stable financial system, an integrated financial system and national financial autonomy are incompatible. Any two of the three objectives can be combined, but not all three; one has to give. Assuming that a stable financial system is desirable, this article explores the trade-off between national financial autonomy and financial integration in Europe. Policymakers face a clear choice. If they want to preserve the benefits of the single market for financial services
(financial integration), financial supervision and crisis management have to be based on a European footing. This article stresses that a strong legal base is needed for such European arrangements. Voluntary cooperation does not work in a crisis, as national governments tend to follow their national interests. The alternative to European arrangements is preserving the current national powers. This article predicts that banking will then become national: each country has its own national banks.

**The economic crisis and the recovery of confidence and trust**  
*W.F. van Raaij*

Trust between people and institutions is essential for the functioning of society. In this paper the author distinguishes trust and confidence. Confidence is the optimism or pessimism of consumers and investors about the future, about the Dutch economy and about the financial situation of their own household. Consumer confidence declined sharply after 2007, with negative consequences for the sales of houses and cars. A low level of trust is threatening for the functioning of institutions and society. Determinants of trust are: competence, stability, integrity, benevolence, transparency, value congruency and reputation. The first four determinants are ‘dissatisfiers’, while the last three are ‘satisfiers’. Financial institutions have to meet the criteria on the first four determinants without a compensation by the last three determinants. The last three determinants offer options for additional profiling, positioning and differentiation. The recovery of confidence will happen sooner than the recovery of trust. Confidence is related to general economic developments. The recovery of trust is a slower process, because of the integrity of persons and institutions. People want to see ‘proofs’ of a changed behaviour before they trust persons and institutions again. This means that a prolonged trust crisis is to be expected, even when confidence is already optimistic.