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Leibniz Institute for Financial Research SAFE

Dear Marius Luta,

In this edition of SAFE Update, the digital newsletter of the Leibniz Institute SAFE, we examine lessons learned from recent turbulence in the banking sector and also consider the policy implications of dollar hegemony.

We hope you enjoy this newsletter and welcome your feedback at newsletter@safe-frankfurt.de.

SVB's Collapse: Lessons for Europe

SAFE calls for comprehensive demand deposit protection

The collapse of Silicon Valley Bank (SVB), followed by UBS's sudden takeover of Credit Suisse, demonstrates the vulnerability of financial institutions to bank runs. According to a team of SAFE economists and legal scholars, the failure of SVB in particular should be a wake-up call for European regulators. In their Policy Letter, Florian Heider, Jan Pieter Krahnen, Loriana Pelizzon, Jonas Schlegel, and Tobias Tröger argue that SVB-style bank runs can be avoided given the adoption of a deposit insurance system that draws a clear line between loss-absorbing capital and demand deposits.

While loss-absorbing capital – that is, equity capital plus bail-inable debt – is an important source of market discipline, the authors note that uninsured short-term deposits are a primary cause of bank runs, and thus argue for the inclusion of such deposits in a more comprehensive deposit insurance system. Specifically, according to the authors, the deposit insurance system should be expanded to cover retail and commercial demand deposits over 100,000 euros. This would close a gap in Europe's current regulatory framework.

Naturally, such a deposit insurance system would not come for free, but would require the levying of insurance premiums that would be used to cover insured deposits in the event of a bank failure. However, as an expanded deposit insurance system would eliminate the cause of bank runs, there would rarely be a need for outgoing payments. This would reduce the likelihood of taxpayer money being required to prop up ailing banks.

The authors also point to the need for the public backstopping of the system, ideally as part of a reinsurance system that transcends national boundaries, in order to make the promise to pay fully credible.

[Read SAFE Policy Letter No. 98 here]

Research Highlight: The policy implications of dollar hegemony

Optimal Policy under Dollar Pricing

By Konstantin Egorov, SAFE Department of Macro Finance, and Dmitry Mukhin, London School of Economics

"Optimal Policy under Dollar Pricing," a forthcoming paper in *American Economic Review*, explores the policy implications of the fact that the prices of most goods in international trade are set in US dollars. By influencing the value of the dollar, the US can affect global trade flows. This may limit the ability of other countries to stabilize their economies through exchange rate management.

Using an open-economy model, the authors show that the best way for non-US countries to stabilize their economies is not to peg their exchange rate to the US dollar. Rather, they should focus entirely on domestic price stabilization. The logic is simple: the value of a local currency can affect the volume of external trade only indirectly, e.g., by influencing the pricing decisions of individual exporters. But in this case, there is alignment between the incentives of exporters and policymakers, as both want to generate the greatest returns for the domestic economy. In this way, policymakers can improve the volume of external trade merely by focusing on domestic objectives.

Furthermore, the authors argue that other policy instruments, such as unilateral capital controls or foreign exchange interventions, are similarly ineffective and should not be used in this case. The US, by contrast, can manipulate the dollar exchange rate to take advantage of the dominant status enjoyed by its currency in international trade. In particular, this allows the US to extract additional rents in international goods and asset markets. It follows that there are incentives for other economies, including the euro area, to promote their currencies in global trade.

[Read the paper here]

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Review
Together with Ilse Munnikhof, Head of Investment Advice at

ING Germany, and Alina Bartscher, Senior Research Economist at the Danish Central Bank, SAFE professor Christine Laudenbach discussed factors influencing gender-based wealth inequalities on 22 March 2023. The event, organized by the "Frauen mit Format" association, the House of Finance, the Institute for Banking and Financial History, the Center for Financial Studies, and SAFE, addressed a range of questions, including why women earn less than men in the same occupations, and why they are more likely to experience poverty in old age. Read the full follow-up report here.

Outlook
SAFE will be hosting the 7th Household Finance Workshop at the Schmerlenbach Monastery conference center near Frankfurt a.M. on 13-14 July 2023. Florian Zimmermann from the University of Bonn will give the keynote address at this face-to-face event. Young researchers in the field are encouraged to submit their work. The deadline for submissions is 30 April 2023. Additional information about the workshop, including a link to the submission portal, can be found here.

Handpicked paper

Alexander Morell, Professor of Business Law and Economics at Goethe University Frankfurt and Coordinator of the Doctoral Program in Law,

Finance, and Economics at SAFE, recommends the research paper *The Emergence of the Corporate Form*:

"*The Emergence of the corporate form* by Giuseppe Dari-Mattiacci, Oscar Gelderblom, Joost Jonker, and Enrico C. Perotti reads like a historical novel yet is also remarkably informative, shedding light on how corporations work. By carefully reconstructing the evolution of the Dutch East India Company from historical records, the authors reveal how the invention of delegated management, entity shielding, asset partitioning, capital lock-in, transferable shares, and limited liability helped the Dutch East India Company to solve its gigantic collective action problems and thereby gain an edge over its arch rival, the British East India Company, which was more hesitant to adopt such innovations. The paper illustrates why the corporate form that originated in late medieval Europe evolved to become the dominant form of business organization today. An additional highlight is that the authors skillfully connect their analysis to social and cultural factors prevalent at the time, including the growth of cities and the rise of the merchant class. However, the harsh fate of those subjected to the rule of the Dutch East India Company could have been featured more prominently in the paper. It still is an unusual example of interdisciplinary work in law, economics, and history. It shows how brilliant scholarship can result when people who think very differently come together and learn to talk to each other. A must read."

View the paper here

Further content

- **News:** A guarantee for all bank deposits
- **Video:** SAFE-CEPR Policy Lecture: Stabilizing Financial Markets – Lending and Market Making as a Last Resort
- **SAFE Finance Blog:** Review of Europe's deposit insurance framework: harmonization is not enough (by Jan Pieter Krahnen and Tobias Tröger)
- All upcoming events and SAFE publications

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