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EDITORIAL:

Fiscal behaviour and sovereign risk: looming fiscal limit increases the probability of sovereign default

It is not so long ago that many thought that sovereign debt default could only happen in developing countries. The most recent financial crisis has brought about a radical change in our thinking about the incidence of sovereign debt default risks. Currently, developed countries are facing fiscal challenges that are, in an historical context, unprecedented and in many of these countries public finances are deteriorating creating concern about the sustainability of public debt. An indication of the concern over sustainability of public debt is that during recent years rating agencies have downgraded the sovereign debt of several developed countries. Although there is evidence that developed countries have frequently been penalized for not been able to calm investor fears over the increased riskiness of sovereign debt, one of the interesting aspects of this evidence is that there is a tremendous diversity in levels of debt at which e.g. downgrades have occurred.¹

Academic literature on sovereign defaults in developed economies is clearly lagging behind and published research on the issue has only very recently started to emerge. One reason for this seems to be that the academic literature has traditionally been geared toward understanding the experiences of emerging economies.² Assuming that sovereign debt is always honoured in developed countries may be an innocuous assumption in normal times, but a financial crisis of the most recent type is obviously challenging this assumption. More generally, since government debt in developed economies is projected to increase from about 73 % of GDP in 2007 to about 108 % of GDP in 2015,³ one may argue that many of these countries are approaching their *fiscal limits*, i.e. the maximum level of debt the government is able to service.⁴

¹ See Huixin Bi (2012), "Sovereign default risk premia, fiscal limits and fiscal policy", *European Economic Review* 56, pp. 389-410 for a more detailed description of the evidence.

² Huixin Bi and Eric Leeper (2012), "Analyzing fiscal sustainability", *working paper*, <http://mypage.iu.edu/~eleeper/>

³ Huixin Bi (2012) p. 391.

⁴ Without resorting to inflationary finance, one would probably like to add.

In general, fiscal limits depend on the entire political and economic environment including expected fiscal policy behaviour, the distribution of exogenous disturbances and private agents' behaviour, where the latter is expectations-dependent and forward looking. Also, since the usual shocks that many of the economies face are persistent, fiscal limits depend on the current state of these economies captured by e.g. the level of productivity and stationarity of public sector expenditure as a share of GDP. On the other hand, for a given state of the economy, there exists a set of maximum debt levels that the government is able to service, which depends on the shocks that the economy faces in the future. That is, the fiscal limit is not only state dependent but also stochastic.⁵ Hence, shocks generate a *distribution of fiscal limits* for the economy.

The relevant recent literature has argued that fiscal limits are highly important not only for the dynamic behaviour of the economy and the effects of different policy measure, but also for the nature of policies that would contribute to preventing the economy from increasing the probability of hitting its fiscal limit.⁶ First of all, the dynamic effects of routine monetary and fiscal policy stabilization measures may be surprisingly different when the economy is near or at its fiscal limit, where the probability of default is non-negligible, relative to the case of low government indebtedness. For example, near the fiscal limit temporarily tighter monetary policy will reduce output more, while it reduces inflation only temporarily before leading to a sustained increase in inflation in the medium term. Increases in government expenditure also tend to be more inflationary near the fiscal limit.⁷

Secondly, anything that changes the expected present value of future government budget surpluses will change the shape of or shift the distribution of fiscal limits of the economy. For example potentially explosive government expenditure might, in some future states of the economy, keep the fiscal surplus very low for extended periods, generating distributions of fiscal limits with fatter lower tail. Given everything else, this, in turn, implies an increased probability of the economy hitting its fiscal limit.

Thirdly, default risk premium is a nonlinear function of the level of government debt. It emerges as the economy approaches the lower boundary of the distribution of its fiscal limits. Perhaps more interestingly, since the distribution of fiscal limits is state dependent an economic downturn can significantly compound a fiscal crisis. A fall in government tax revenues, due e.g. lower productivity growth, forces the government to borrow more and shifts down the distribution of the fiscal limits and increase the probability of default even if the government debt stayed the same. Hence, self-fulfilling hikes in bond risk premiums can result from the combination of higher government debt and lower distribution of fiscal limits which raise government borrowing costs.

Finally, *anchoring of fiscal expectations* is very important for a country to avoid hitting its fiscal limit. Nonlinear model simulations suggest that fiscal austerity measures trying to stabilize public sector finances in the short run do not change expectations of economic agents concerning long run fiscal policy. Consequently, even with sizeable budget cuts, such short run measures fail to contain the default risk

⁵ Huixin Bi (2012) p. 391.

⁶ The following discussion follows Huixin Bi (2012) closely.

⁷ See in particular Huixin Bi, Eric Leeper and Campbell Leith (2010), "Stabilization vs. Sustainability: Macroeconomic Policy Tradeoffs", *working paper*, <http://mypage.iu.edu/~eleeper/>

premium. A credible long term plan for fiscal reform will help anchoring private sector expectations about future fiscal policy in a way that can alleviate rising risk premiums and also help the country to avoid those potentially self-fulfilling hikes alluded to above.

Relevant literature on sovereign debt default in developed economies has just started to emerge. Quantitative analyses use dynamic stochastic general equilibrium models which are solved using nonlinear solution techniques. The Bank of Finland has gained some experience in using these models to produce quantitative analyses on issues related to the sustainability of public finances. The relevant literature seems to be growing and since the topic is very interesting and timely and since the problems involved are, from the point of view of both policy and economics, challenging there is lot to be gained from acquiring the necessary skills to be able to pursue this interesting line of research.

Jouko Vilmunen

Sovereign risk, European crisis resolution policies and bond yields

More often than not deep recessions bring with them intense, heated debates between two groups of economists and maybe also policy makers, one calling for substantial economic stimuli while the other group shies away from expansionary fiscal policy and instead calls for fiscal discipline and measures that stabilize government finances. In essence the debate is over the potential tradeoffs between stabilization policy and long-run sustainability of public finances. Countries differ greatly on how the associated public policy debate evolves and is organized. Huixin Bi and Eric Leeper in their recent study⁸ discuss two examples, which are in sharp contrast with each other.

In Sweden the fiscal policy infrastructure, which incorporates a Fiscal Policy Council, serves to institutionalize the fiscal policy debate. The combination of explicit rules to guide fiscal decisions and an independent fiscal council with access to the Parliament provides a context that makes the ground in Sweden especially fertile for constructive debate. In the US, on the other hand, fiscal discussions are dominated by politics, with little serious economic analysis to buttress the arguments. The country's fiscal decisions are not guided by any obvious economically based rules and what "rules" do exist are easily circumvented by the political process or accounting tricks.⁹

Bi and Leeper suggest that one reason for such a stark difference in fiscal policy infrastructures across the two countries is that the US, in contrast to Sweden, has no fresh memory of fiscal crises that called into question the "risklessness" of its central government debt.¹⁰ One natural question in this context is the one analyzed by Bi and Leeper (2010), i.e. the potential trade-off between stabilization policy and sustainability of

⁸ Sovereign Debt Risk Premia and Fiscal Policy in Sweden, *National Bureau of Economic Research wp. No. 15810*, March 2010.

⁹ Huixin Bi and Eric Leeper (2010) pp. 1-2.

¹⁰ Huixin Bi and Eric Leeper (2010) p. 2.



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public debt when the perceived riskiness of government debt depends, in part, on the fiscal environment in place.

One critical element to this trade-off comes from the evolution of public debt and in particular from the position of a government relative to its perceived fiscal limit, beyond which the government can no longer service its debt. An interesting possibility associated with the concept of a fiscal limit is that due for example to political constraints a country can hit its fiscal limit before the peak of the tax Laffer-curve. In any case, a looming fiscal limit implies that (temporary) stabilization measures may affect the economy in ways that are radically different from the ones at lower levels of government debt. Furthermore, sovereign bond risk premiums can rise sharply when the country is staring at its fiscal limit.

The fiscal policy infrastructure in the euro area builds on coordination between independent sovereigns and although coordination of national fiscal policies has increased over the years, particularly since the onset of the most recent financial crisis, fiscal policy remains decentralized and fairly heavily influenced by national politics. In such a fiscal environment sovereign debt problems in any one of the member countries can easily become contagious, as the events in recent years have witnessed. With sovereign bond risk premiums rising, countries under the threat of contagion may realize that they are approaching their fiscal limit far sooner than they expected. Consequently, uncertainty over area-wide public finances increases. Since it has proven to be difficult to stabilize government finances through coordinated fiscal measures in such a decentralized fiscal infrastructure the pressure on the common monetary policy to calm financial markets increases.

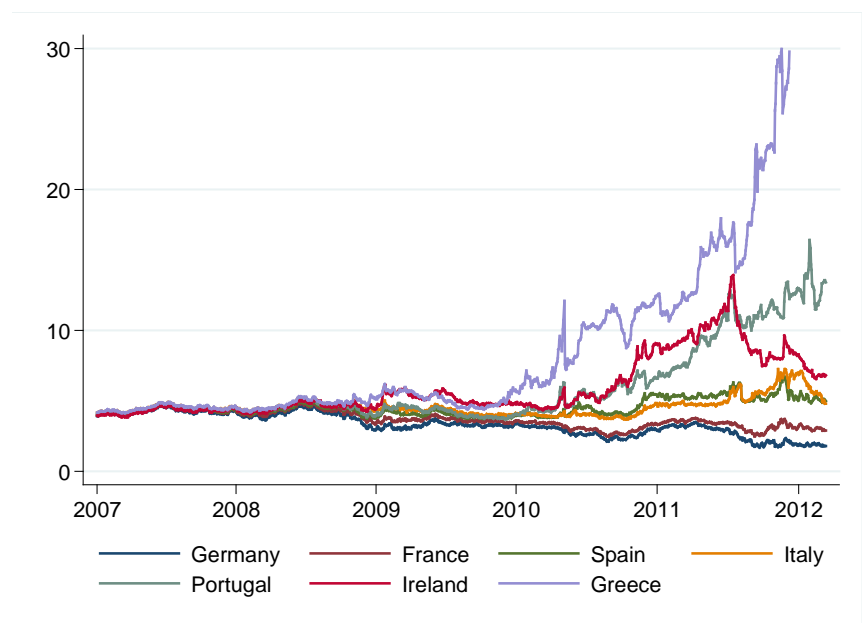
During recent years the European Central Bank has taken various policy measures to stabilize financial markets and to secure the functioning of the monetary policy transmission mechanism in the euro area. The natural question in this context is whether these policy measures have had any effects on the euro area financial markets in general and on sovereign bond yields in particular. In a recently published Bank of Finland discussion paper *Sovereign risk, European crisis resolution policies and government bond yields* (no 22/2012) Juha Kilponen, Helinä Laakkonen and Jouko Vilmunen (hereafter KLV) construct a fairly extensive daily data on long-term, 10 year, sovereign bond yields and various crisis resolution policy measures decided and implemented by euro area governments and the ECB. The data set covers the period 1.1.2007 - 21.3.2012 and includes additional control variables that the relevant background literature finds important for explaining the (perceived riskiness of the) changes in long-term government bond yields.

In their brief review of the short history of the monetary union, the authors note that following the creation of the monetary union in 1999, yields on euro area sovereign bonds began to converge rapidly, most likely reflecting the elimination of inflation and exchange rate risks from bonds of individual countries. The convergence in sovereign bond yields was supported also by the "risklessness" - in the form of zero risk weights - of government bonds incorporated in capital adequacy regulation and the European Central Bank's collateral policy. The period of convergence was followed by a few-year phase when sovereign bond yields remained stable and low despite divergent macroeconomic and fiscal developments in euro area countries.

It was soon after the collapse of Lehman Brothers in September 2008, under the heightened Knightian uncertainty, that investors again focused on the riskiness of sovereign debt. As the financial crisis

escalated and threatened the stability of the real economy, the pressure on European governments to support to their banking sectors increased. Governments also introduced fiscal stimulus measures to support their economies. Macroeconomic fundamentals deteriorated faster in some countries than others. Government debt accumulated during the apparently tranquil phase prior to the crisis rapidly became a problem for those countries which, due to persistent budget deficits, had a limited room to manoeuvre their fiscal policy. Consequently, sovereign bond yields began to increase in countries with a weakened macro-economy and a fragile initial fiscal position or with a banking sector that had a critically large exposure to international financial shocks. As market funding eventually dried up for these countries, they had to seek financial support in the European crisis mechanisms and the International Monetary Fund.

Figure 1. Yields on the 10-year government bonds for selected euro area countries



If it is credit risk, long-term sustainability of public finances is the key

After reviewing the relevant background literature on factors affecting sovereign bond yields, KLV postulate an empirical model for the change in the yield spread between the 10-year government bond yield and the 10-year euro swap rate. As the authors note there is empirical evidence that sovereign bond yields are primarily determined by three factors: credit risk, liquidity risk and the general risk appetite or risk aversion. Consequently, KLV use proxies for these control factors in their estimating model for the yield spread. More specifically, as a measure of credit and liquidity risk KLV use the 10-year CDS spread and the bid-ask spread of the 10-year government bond, respectively. General risk appetite of the global investors, on the other hand, is proxied by the VIX-index, while the iTraxx Europe index measures the general risk atmosphere in the European debt markets.

In addition to these control factors KLV provide a list of event points

in time that refer to crisis resolution decisions taken by European policy makers over the period covered by the sample. The authors identify 50 such policy decisions. Each such decision is represented by a dummy in the data set, but in order to avoid multi-collinearity in estimation – due to the high number of such dummies – the policy decisions are grouped into eleven categories. Examples of such categories are ECB's interest rate decisions (up vs. down), ECB's liquidity support measures, decisions on European Stability Mechanism (ESM) and European Economic Recovery Plan. Moreover, lagged yield spreads of all the countries in each individual country's estimating equation seek to capture potential contagion effects among the sovereign bond yields. As the authors rightly note, daily data is noisy, so identifying contagion effects is a challenge. The approach taken must then be seen as a first approximation.

Ordinary Least Squares estimation of the empirical specification indicate that KLV are able to pick some patterns in the response of the sovereign bond yield spreads to both the controls and the policy dummies. First of all, credit and liquidity risk mostly affect the spreads in the expected way, ie. the estimated effects of the CDS spreads and bid-ask spreads on the spreads are positive. Ireland and Portugal are exceptions in the sense that the estimated effect of the bid-ask spread on the bond yield spread is negative. KLV tentatively conclude that the effect arises from ECB's policy intervention to increase liquidity in the secondary market for Irish and Portuguese government bonds. Drying liquidity (widens bid-ask spreads and) puts upward pressure on bond yields. By increasing liquidity in the secondary markets through successful policy intervention, the ECB manages to counteract increasing sovereign bond yields.

Of the proxies for general risk appetite, the estimated effect of the VIX index (Market Volatility Index) is significantly negative for all countries. KLV interpret this as indicating that the VIX index does not, after all, adequately capture the dynamic evolution of uncertainty in the financial markets during the sample period: variations in the VIX index reflect changing perceptions about uncertainty in or riskiness of the stock market and since the index peaked in the beginning of the financial crisis, it could be that sovereign bond market offered at that time reasonable returns with less perceived risk – sort of a (temporary) safe haven role of the sovereign bond markets. The iTraxx Europe index, on the other hand, enters significantly for Germany only (negative) and weakly for Ireland (positive). Furthermore, estimation results on contagion are mixed and, as the authors note, it is difficult to interpret them as a sign of systematic pattern of contagion across countries.

Finally, the estimation results on the effects of the various policy decisions reported by KLV indicate that, firstly, the interest rate decision by the ECB affect the long bond yields only weakly. The empirical specification allows for separate effects from interest rate hikes and reductions and the latter appears to have a statistically significant negative effect on long bond yields in some countries.

Secondly, whereas the liquidity support and covered bond programme of the ECB apparently has had no effects on long bond yields, the effect of the announcement of the security market programme (SMP) is according to the results significant and relatively large in all the countries in the sample. However, caution should be exercised in interpreting this results, because on the day of the announcement of the SMP (May 10, 2010), a decision on the EUR 750 billion rescue package was taken. The latter decisions seem to have affected long bond yields in a statistically significant, but mixed way: there has been a fall in bond

yields of the receiving countries and an increase in bond yields in Spain and Italy. Contagion may be the underlying driver, but this result may also reflect the risk sharing aspects of the financial rescue packages, as the authors also note.

The decisions on the ESM and European Financial Stability Facility (EFSF) have had opposite effects on long bond yields in the euro area. The former decision seems to have increased long yields, the German 10-year bond yields in particular, while the latter has, on balance, had the opposite effect of reducing long yields, particularly in Ireland and Greece, but maybe also in Germany and Spain. The tentative conclusion seems to be that the decision on EFSF has been successful in containing the cost of long-term funds for the governments in the short-run, whereas the decision on the ESM may reflect risk sharing aspects of the mechanism.

That the estimated effects of the European Economic Recovery Plan (EERP) on long term sovereign bond yields are positive may reflect the perceived trade-off between short-run stabilization and long-term sustainability of public finances. Although KLV bring out this as a potential explanation, they also note that for the small open economies of the sample countries - Ireland and Portugal - the estimated effect is negative. One possible explanation argues that the gains from short-run stabilization policies are the greatest for Ireland and Portugal, whose export sectors will get a sufficiently big kick from the increase in area-wide aggregate demand to actually reduce fears about long-run sustainability of public finances in these countries.

At the end of their empirical analysis, KLV argue that overall the results survive various robustness checks like heteroscedasticity and non-linearities. However, parameter instabilities may be a problem once the estimation period includes more observations from the tail end of the sample. KLV suggest an interesting common factor underlying these parameter instabilities: non-linear effects of changes in uncertainty.

The empirical exercise performed by KLV is both very interesting and relevant. Although the analysis has a number of econometric challenges which need to be dealt with in future work, it seems to suggest that some of the policy measures have had the intended beneficial short-run effect on sovereign bond markets. However, as the authors rightly point out in the concluding section, it is very important to understand which part of the yield changes is caused by expectations regarding changes in economic fundamentals and which part by risk appetite. If increases in the yields predominantly reflect increases in credit risk, they are probably going to stay up for a long time. It is not enough then to provide time and liquidity to the markets, since stabilizing sovereign bond markets requires anchoring fiscal expectations through a credible reform of public finances.

Jouko Vilmunen

Russian regions are different

Even though the focus of research at the BOFIT is very much on macroeconomic questions, it is sometimes helpful to look at regional variation e.g. in Russia. This approach may also help in assessing broader trends at national level. Obviously, both in Russia and China the geographical size of the countries alone generates differences between



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regions. In addition, timing of various reforms during the past decades has, for example, affected institutional quality in the various regions. In the case of Russia the regions' differing experience during the Soviet era can be significant.

BOFIT has recently published several discussion papers that examine factors relating to regional economic and institutional development. In one of them (Berkowitz, Hoekstra and Schoors: 'Does finance cause growth? Evidence from the origins of banking in Russia', BOFIT DP 10/2012) the authors assess how establishing special banks, 'spetsbank', during the late Soviet period affects regional banking development during the later, transition, period. Their results indicate that the presence of one additional spetsbank per million inhabitants increased total lending to private firms and individuals by 14 to 26 percent in the early 2000s, which is quite significant. Nevertheless, the presence of a spetsbank had no effect on investment or per capita income. Despite that, it also seems that spetsbanks increased growth in regions in which they were less connected to government, as well as in regions that were better at protecting property rights. Thus the results strongly suggest that banks' origins, political connections, and property rights are important determinants of effective finance.

In another paper (Belousova, Goel and Korhonen: 'Causes of Corruption in Russia: A Disaggregated Analysis', BOFIT DP 31/2011) it is found that corruption is also linked to many local variables. Interestingly enough, the number of private enterprises in a region increases the perception of corruption, but it does not have any effect on the actual incidence of corruption. Therefore policies encouraging the formation of new companies may be unpopular, at least initially. Many of the same factors found to affect corruption in international comparisons also influence the occurrence of regional variations in corruption in Russia. For example, more affluent regions have less corruption, although the largest cities, Moscow and St. Petersburg, seem to be more corrupt than one would expect given their income levels. The large variation in corruption across Russian regions also tells us that merely looking at national averages may be inadequate when, for example, deciding on investment in Russia.

Ilkka Korhonen

Conferences and seminars

Financial and Macroeconomic Stability: Challenges ahead June 4–5 2012, Istanbul

The presentations given at the conference are now available at http://www.tcmb.gov.tr/yeni/konferans/fms/Home_files/ProgramPrelim.pdf. The conference was organized by the central bank of Turkey jointly with the Bank of Finland and Bank of Brazil and in cooperation with the Journal of Financial Stability.

Search Frictions and Aggregate Dynamics 18–19 October 2012, Helsinki

Dynamic macro-models that allow for search and matching frictions not only in labour but also credit markets could improve our understanding on the dynamic interaction between macroeconomy and capital markets. The need for such joint modelling has been highlighted by the most recent financial crisis. This theme will be explored from various viewpoints at a conference organized jointly by the Bank of Finland (Research), the CEPR (Centre for Economic Policy Research) and the Federal Reserve Bank of Philadelphia.

For the draft programme, please visit the conference site

http://www.suomenpankki.fi/en/tutkimus/konferenssit/tulevat_konferenssit/Pages/CEPR_2012.aSPX

China's Financial System and Internationalization of the Renminbi 17–18 September 2012, Helsinki

As China's importance in the world economy has grown, so has interest in its financial sector. Furthermore, the on-going liberalization of China's capital flows and the internationalization of the Chinese renminbi will have far-reaching consequences for the Chinese financial system. These topics will be discussed at a research workshop hosted by the Bank of Finland Institute for Economies in Transition (BOFIT) and organized by the Central bank-Academia Network on the Chinese economy, a joint venture between the Chinese Economic Association (Europe) and BOFIT.

Please see the Call for papers for further details at

http://www.suomenpankki.fi/bofit/bofit/ajankohtaista/tapahtumat/Pages/cfp_china2012.aspx

CEEI 2012 – Conference on European Economic Integration: Achieving balanced growth in the CESEE countries 26–27 November 2012, Helsinki

Central banks of Finland and Austria jointly organize the annual Conference on European Economic Integration. This year the special theme of CEEI is *Achieving balanced growth in the CESEE countries*. The economic crisis in several European countries has illustrated the importance of sustainable economic policies and of institutions promoting such policies. Achieving sustainable economic growth is of utmost importance in solving the current economic problems. In many cases, countries' economic difficulties are not just a result of adverse external shocks or even mistakes in economic policy, but rather reflect long-term problems inherent in economic and political institutions. At the CEEI 2012, we provide a forum for policymakers as well as academic and non-academic experts to discuss the prerequisites of balanced and sustainable economic development in the CESEE region, and also elsewhere. Topics covered range from the most recent challenges for the banking sector to the unwinding of large external imbalances.

For further information, please visit the BOFIT conference site

http://www.suomenpankki.fi/bofit_en/tutkimus/tyopajat/Pages/CEEI2012.aspx.

Bank of Finland Research Seminars

Research seminars organized by the Bank of Finland's research unit are held on the first Thursday of the month at 13.30–15 in Rauhankatu 19, 3rd floor big meeting room (unless indicated otherwise). Research seminars are open to all interested parties. Please register in advance at seminars@bof.fi by noon of the preceding day. For further information please visit the [seminar site](#).

BOFIT seminars

Tuesday 4 September 2012

Liping Lu

Tilburg University

[Informal or Formal Financing? Or Both? First Evidence on the Co-Funding of Chinese Firms](#)

Wednesday 19 September 2012 at 10.30

Xiaoqing (Maggie) Fu

University of Macau

Bank Competition and Financial Fragility in Asia

BOFIT seminars, open to all interested parties, are held on Tuesdays at 10.30 in Rauhankatu 19, 3rd floor big meeting room (unless indicated otherwise). Please register in advance via Liisa Mannila (firstname.lastname@bof.fi). For further information please visit the [seminar site](#).

Bank of Finland Research and BOFIT summer workshop August, 2012



Recent Bank of Finland research publications

Scientific monograph

E:45

Matti Hellqvist – Tatu Laine (eds.): [Diagnostics for the financial markets – computational studies of payment system: Simulator seminar proceedings 2009–2011](#)

Bank of Finland Research Discussion Papers

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23/2012

Andrés Fernández – Adam Gulan: [Interest rates and business cycles in emerging economies: The role of financial frictions](#)

22/2012

Juha Kilponen – Helinä Laakkonen – Jouko Vilmunen: [Sovereign risk, European crisis resolution policies and bond yields](#)

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Ari Hyttinen – Hanna Putkuri: [Household optimism and borrowing](#)

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13/2012

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Irina Andrievskaya: [Measuring systemic funding liquidity risk in the Russian banking system](#)

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