NEWS
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Editorial

What is the Output of a Research Institute?

In Germany, years of slow growth, increasing public deficits and declining corporate profits have created tremendous pressure for reducing public spending and private sponsorship of basic research and higher education when disastrous international comparisons underscore the urgent need for improvement in those same areas. German universities and research institutes can be seen struggling to slim down their budgets, while at the same time aiming to raise the quality of research and education.

At CFS we have faced our own version of this struggle. 2004 marked a year of major restructuring in order to adjust to a reduced financial budget without compromising the CFS mission of producing policy-relevant research of first-rate academic quality and serving as an open forum for dialogue between academia, policymakers and the financial community. Simply put, we struggled to 'get more bang for the buck'– to continue achieving ambitious goals with more limited funds. Many of the lessons we learned in this process of restructuring simply echo the experience of our readers and sponsors in the private sector. However, as a non-profit research institute we also had to address some unique challenges and our responses to those may well be of interest for the on-going reforms at institutions of higher education and research. For example, seemingly simple questions such as "What is the output of your institute?" or "How do you measure the quality of your output?" or "What are your goals and how do you assess the extent to which you have met them?" are not trivial questions to answer for a non-profit research institute.

At CFS we had a clear view of our goals (CFS Mission Statement, page 2) and some of our contributions to Frankfurt's financial community were easily quantifiable. In 2004, for example, 7 CFScolloquia, 7 CFSlectures, 47 Joint Lunchtime Seminars and the CFSkey event 2004 with Axel A. Weber, former CFS Director and now President of the Bundesbank, were attended by over 3100 people. Also, 9 CFSresearch conferences had over 700 participants, CFS-related research was presented in 27 working papers and monographs and the CFS appeared in over 70 newspaper articles, radio and TV reports.

It is more difficult, however, to measure output quality. What is a top research paper? What are the aspects of an excellent research conference? In 2002 CFS had structured its research activities in the form of separate two-year programs, each under a program director with his own small budget. Thus, in 2004 the time had come to evaluate their performance. In close cooperation with the CFS Research Advisory Council led by Prof. Hermann Remsperger from the Bundesbank, CFS developed an evaluation system to measure not only the quantity but also the quality of each program's research output and contributions to the overall mission of the CFS. In the first section of this newsletter titled ‚Research and Policy' you will find a summary of the evaluation of the 2002-2004 programs as well as three articles contributed from the programs newly started in 2005.

Volker Wieland (CFS Director)

Evaluating the Performance of CFS Research Programs

How can the quality of academic research be measured? The ongoing public debate in Germany on elite universities and government funding for higher education and research is rich in opinions but short on practical answers to this question. It is essential for a non-profit research institution such as the Center for Financial Studies to develop its own measures of research output and indicators of research quality. Internally, such measures are useful in setting goals and providing proper incentives for those in charge of research activities. Externally, these measures provide a quantifiable basis for explaining and justifying the use made of voluntary contributions and donations by CFS sponsors.

In 2002 CFS structured its research activities in the form of separate research programs, each under a Program Director with his own budget for a period of two years. Thus, in 2004 the time had come for taking stock of the research output from the following four programs: Risk Management directed by Prof. Stefan Mittnik, Venture Capital & The New Markets directed by Prof. Marc Wahrenburg and Prof. Uwe Walz, Credit Management & Credit Markets directed by Prof. Jan Pieter Krahnen, and Central Banking & Monetary Economics directed by Prof. Volker Wieland.

In close cooperation with the CFS Research Advisory Council led by Prof. Hermann Remsperger from the Bundesbank, CFS developed an evaluation system for its research programs intended to measure the quantity and quality of research results and their contributions to the overall mission of the CFS as summarized in its mission statement (see below). The standard for evaluation was defined in terms of three guiding principles:

- **first-rate academic quality,**
- **high international visibility**
- **and significant policy or industry relevance.**

The evaluation proceeded in four steps:

Step 1: Program directors were requested to supply detailed information on the output of their programs in the form of a standardized program report. The information categories listed in this report are presented on page 3.

Step 2: Based on the information provided in the above reports, CFS staff prepared a set of standardized indicators to measure the quantity and quality of program output.

Step 3: Program directors presented key research findings and contributions to CFS activities to the CFS Research Advisory Council in June 2004.

Step 4: The CFS Research Advisory Council reviewed the individual research programs based on the program reports, the comparison of standardized indicators and the presentations of program directors.

CFS MISSION STATEMENT

The Center for Financial Studies (CFS) is an independent research institution with a strong international orientation. CFS conducts applied research in the areas of financial markets, financial intermediaries and monetary and macroeconomics. It serves as a forum for dialogue between academia, policymaking institutions and the financial community and offers specialized executive training and development. The CFS cooperates with other financial research centers and is an active participant in international research networks. CFS*research programs* directed by academic experts aim to generate collaboration on research projects between outside researchers, CFS staff and practitioners. Research findings should be presented at international conferences and published in international academic journals or practice-oriented outlets with wide reach in the financial community. CFS aims to be an active partner of policymaking institutions and the financial community in fostering the application of research findings in policy and industry practice. To facilitate this process, CFS promotes a variety of initiatives, including research and policy conferences, workshops and seminars.

CFS Program Report

1. Program Objectives and Participants
   - **1.1. Short description of program objectives**
   - **1.2. Participating institutions and researchers**
     - a. Outside institutions
     - b. Networks
     - c. Fellows
     - d. Collaborator
     - e. CFS staff

2. Research Output
   - **2.1. Selected publications**
     - a. Refereed journals (English)
     - b. Refereed journals (German)
     - c. Non-refereed contributions to journals and books
     - d. CFS*working papers* (not published to date in journals)
   - **2. 2. Other Output**
     - a. New data sets
     - b. New software
   - **2.3. Selected presentations**
     - a. Research seminars
     - b. Policy seminars/speeches
     - c. Seminars to financial industry

3. CFS Initiatives
   - **3.1. CFS*workshops and conferences***
     - a. Research workshops and conferences
     - b. Policy workshops and conferences
     - c. Financial industry workshops and conferences
     - d. CFS*lectures*
     - e. CFS*summer schools* and CFS*seminars*
   - **3.2. Impact of Research/ Workshops on**
     - a. Academic community (citations, etc.)
     - b. Policy (quotes, implementation, etc.)
     - c. Financial industry (usage, etc.)
     - d. Media coverage of program area (CFS*newsletter*, Newspapers, TV, etc.;)

Indicators measuring research program output

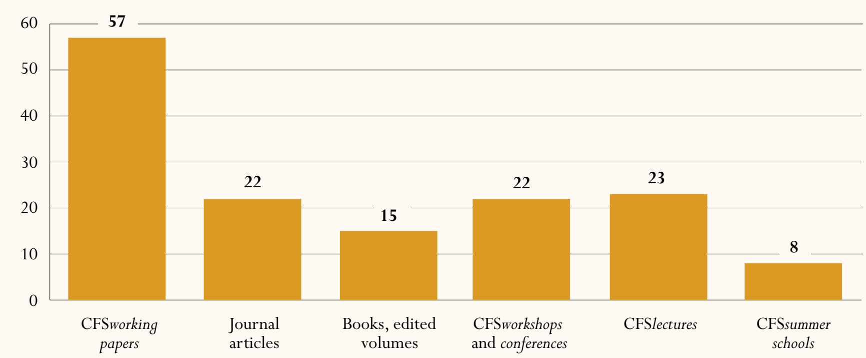
The first dimension of the evaluation concerned the results of research projects undertaken in the different CFS programs. Research findings are initially disseminated in CFS*workings papers* and presented at conferences and in seminars at universities, as well as at government and private sector institutions. Research often involves the creation of new models, new methodological tools or new data sets. Typically with some lag the findings documented in working papers are published in refereed academic journals, monographs or edited book volumes.

The second dimension of the evaluation concerned the contributions of CFS research programs to the CFS as a forum for dialogue between academics, policymakers and the financial community. These contributions take the form of seminars, workshops and conferences that bring together key players from around the world, creating substantial visibility and influencing opinion in academia, policy institutions and the financial community.

Output Quantity

Based on the information made available in the standardized program reports, **indicators of output quantity** are constructed by counting the contributions in different categories. **Figure 1** provides a summary of output quantity by adding up the contributions of all four research programs under evaluation (Risk Management, Venture Capital & The New Markets, Credit Management & Credit Markets, Central Banking & Monetary Economics). Between 2002 and 2004 research findings from these programs were made available in the form of 57 CFS*working papers* with many contributions from all four programs. Program directors and CFS staff presented their results at over 80 conferences and seminars at universities, central banks and financial institutions. Furthermore, CFS research was published in refereed academic journals with 10 of the 22 articles coming from the program in Central Banking & Monetary Economics. In addition, several program directors actively edited special journal issues and book volumes on topics central to finance and monetary economics.
Finally, each of the four research programs sponsored or co-sponsored several CFS events thereby contributing importantly to the CFS mission. For example, program directors co-organized at least two and in the case of Credit Management & Credit Markets ten research conferences. Program directors also invited speakers for CFS*lectures* and participated in or organized CFS*summer schools*.

Figure 1: Indicators of Output Quantity



Output Quality

Indicators of output quality require that weights are assigned to the entries in Figure 1 to capture the quality of CFS research output. To this end, CFS has developed a grading system for publications, presentations and CFS events with grades ranging from A to E, where A is the best grade.

Publications, for example, were rated according to the CFS Journal Ranking 2004 reported in **Table 1**. The impact of published articles on the scientific community and beyond is reflected in the number of citations these articles receive over time in subsequent research. The frequency of citation, however, differs significantly across journals. Articles in a few leading journals typically enjoy much wider readership than most others. Thus, the quality of research may be rated by the importance of a specific journal. In developing the CFS Journal Ranking 2004, several citation-based rankings published in the Journal of the European Economic Association in 2003 (Kalaitzidakis et al., Lubrano et al.), a ranking published in Econometrica, and an impact-factor based ranking were taken into account.

A quality-based comparison of publications across CFS*research programs* was prepared by multiplying the numerical weight (from 1 to 16) with the number of contributions from this CFS program in the respective category. Central Banking & Monetary Economics was conspicuous with three articles in A journals such as the American Economic Review. In addition, seven articles appeared in the top field journals receiving a grade of B. With this record CFS stands out among many much larger economic research institutions in Germany.

Table 1: CFS Journal Ranking 2004

Rank	Journal	Weight
A	American Economic Review	16
	Econometrica	16
	Journal of Finance	16
	Journal of Financial Economics	16
	Journal of Political Economy	16
	Quarterly Journal of Economics	16
	Review of Economic Studies	16
	Review of Financial Studies	16
B	International Economic Review	8
	Journal of Business	8
	Journal of Economic Perspectives	8
	Journal of Economic Theory	8
	Journal of Financial Intermediation	8
	Journal of Financial & Quantitative Analysis	8
	Journal of Monetary Economics	8
	Remaining TOP 15 in Kalaitzidakis et al.	8
C	Financial Management	4
	Journal of Banking and Finance	4
	Journal of Empirical Finance	4
	Journal of International Money & Finance	4
	Journal of Money Credit & Banking	4
	Mathematical Finance	4
	Remaining TOP 30 in Kalaitzidakis et al.	4
D	Other English-language economics or finance journals	2
E	Other published articles	1

Source: Kalaitzidakis, P./Stengos, T./Mamuneas, T. P. (2003) : "Rankings of Academic Journals and Institutions in Economics," Journal of the European Economic Association, MIT Press, vol. 1(6), pages 1346-1366.

While journal articles are relatively easy to rank on the basis of citation frequency, it is much more difficult to rank books or seminar presentations, or even workshops and research conferences. In this context, the evaluation of output quality is necessarily more subjective.

Nevertheless, CFS has formulated similar letter grading systems based on specific criteria in all those categories. These criteria had to reflect the guiding principles of first-rate academic quality, high international visibility and significant policy or industry relevance. For example, conference presentations at the American Economic Association or the American Finance Association would have received an A in the category of presentations. In the CFS conferences category an A-class event would count top academics, key policymakers and/or leaders of the financial community among its participants and would have had a significant media impact.
If you wish to receive more information about the evaluation procedure for CFS*research programs*, please contact the CFS (media_contact@ifk-cfs.de).

Stefanie Franzke / Volker Wieland
(CFS staff / CFS Director)

CFS Researchers Wieland and Krüger Among the Top Ten Younger Generation Economists in Germany

Yes, they do indeed exist - they, that is the new generation of young German research economists who can hold their own among the class of top researchers dominated by Americans and Britons and who have made an international name for themselves with publications in leading journals. This is the conclusion of a study that appeared in WirtschaftsWoche on March 20, 2005 (No. 14, pp. 116).

In order to select the ten best researchers under 40 years of age, more than 40 renowned professors of economics in Germany were ask to nominate the candidates of their choice. Then the ten most frequently cited were ranked according to the quantity and quality of their research publications.

The list is headed by Axel Ockenfels, an expert for experimental microeconomics and game theory at the University of Cologne, followed closely by CFS Director Volker Wieland. WirtschaftsWoche writes about Wieland "The expert for monetary macroeconomics at the University of Frankfurt is regarded by the European Central Bank as one of the most important contributors of ideas (concerning the design of monetary policy). Chief Economist Otmar Issing values the work of the 39-year old, who advised the ECB for several years with respect to the development of decision rules for monetary policy."

It is also gratifying for CFS that with Dirk Krüger, CFS Research Fellow, another expert from Frankfurt is among the ten best young economists. Krüger, who returned to Germany in 2004 despite having secured a position as Assistant Professor at an elite university such as Stanford, develops mathematical models to estimate the quantitative effects of changing the pension system from a pay-as-you-go system to the funded system.
This report in the WirtschaftsWoche illustrates the success of the University of Frankfurt with its strategy of focusing on the fields of money and finance, and underlines the important catalytic role of private and public research sponsoring within the framework of CFS.

Stefanie Franzke (CFS staff)

Top in research

*The ten best German young economists**

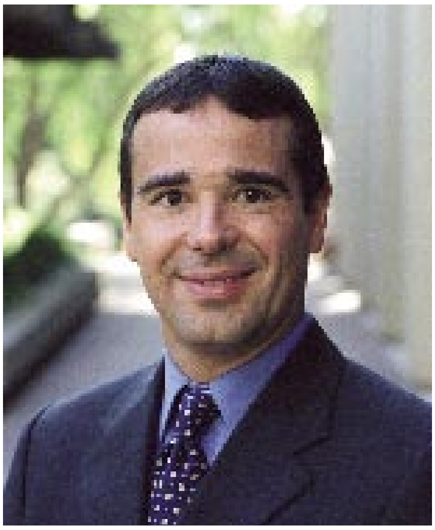
		Points
1.	**Axel Ockenfels**	**1073**
2.	**Volker Wieland**	**1009**
3.	**Felix Kübler**	**858**
4.	**Armin Falk**	**712**
5.	**Monika Piazzesi**	**457**
6.	**Lutz Arnold**	**385**
7.	**Lars Feld**	**369**
8.	**Ludger Wößmann**	**300**
9.	**Claudia Buch**	**273**
10.	**Dirk Krüger**	**255**

(*Selection based on a survey commissioned by WirtschaftsWoche among more than 40 German professors of economics. The ranking according to points is based on the quality and quantity of publications in the top 100 refereed journals. The evaluation of the journals follows Kalaitzidakis, Mamuneas und Stengos: "Ranking of Academic Journals and Institutions in Economics". A publication in the best journal is awarded 100 points, in the second best 99 points and so on).

US-Europe Growth Differences: Is the Focus of the Educational System Part of the Explanation?

by CFS Research Fellow Dirk Krueger [1], Goethe University Frankfurt, CFS, CEPR and NBER

If you plan for a year, plant a seed,
If for ten years, plant a tree,
If for a hundred years, teach the people.
[Kuang Tse 551-479 B.C., quoted from Bailey and Eicher (1994)]



Since the 1980's, European economic growth has become weak relative to that of the US. In addition, with the exception of a few countries (especially the Nordic countries), Europe has suffered from a "technology deficit" relative to the US. As measured by manufacturing productivity, the share of information technology (IT) investment, or by the contribution of IT to output growth, European technology has lagged behind.

These developments have happened against the background of an increased growth rate of technological progress embodied in new technologies, and a European tradition of fostering specialized, skill-specific, "vocational" education at the upper-secondary and tertiary level (such as the much-hailed German apprenticeship system).

In recent work with Krishna Kumar (Krueger and Kumar, 2004a, 2004b) I postulate the following hypothesis to explain these stylized facts. Vocational education enables workers to operate established technologies very productively, whereas general education enables workers to adapt more easily to new technologies. As long as the rate at which new technologies become available (the growth rate of embodied technological progress) is low, Europe's focus on vocational education is appropriate. But as this growth rate has been increasing since the 1980's, more generally trained workers are needed to make the economy adopt new technologies at the speed at which they become available. Now the American educational system is at an advantage, and a growth gap between the two regions is likely to emerge. While I certainly agree with the view that a more highly educated country may grow faster, my focus here is on the type of education a country tends to impart to its youth, especially between the ages of 15 and 22, holding quality constant. Thus, the recent popular discussion of the results of the PISA education study in Germany, while pointing to concerns about the overall quality of the education system, cannot be taken as evidence that our subject has reached a broader public yet. On the academic side, Lawrence and Schultze already in 1987 voiced the concern that "The European economies... now experience problems in graduating from a catch-up economy to one on the frontier of technology... Workers must have general training to adapt to new tasks, and European education, which has encouraged apprenticeships that provide specific skills, must adapt." (p. 4,5)

While it is beyond the scope of this essay to provide the details of the theoretical analysis used to arrive at our conclusion, I would like to provide more details about the motivating facts for our theory.

Table 1: Growth Rates in Output per Hour, Manufacturing

Country	1978-1984	1985-1991	1992-2002
USA	2,9%	2,4%	4,3%
Germany	2,4%	2,2%	2,7%
Italy	3,8%	1,7%	1,6%
France	4,8%	3,6%	4,2%
UK	3,5%	4,6%	2,9%

Source: Bureau of Labor Statistics

1 The author can be reached at dirk.krueger@wiwi.uni-frankfurt.de. This article only reflects my view on this issue, and not necessarily that of my co-author Krishna Kumar. The fact that our research was carried out when I was still living in the U.S. may have had an impact on the views expressed in this essay.

Motivating Facts

Table 2: ICT Contribution to Output Growth (%Points)

Country	1980-1985	1985-1990	1990-1996
USA	0,28	0,34	0,42
Germany	0,12	0,17	0,19
Italy	0,13	0,18	0,21

Source: Schreyer (2000), Table 4.

Table 1 provides data on manufacturing output per hour (labor productivity) relative to the US. The widening gap is clearly visible: growth rates for European countries, while even higher during the early 1980's and comparable during the late 1980's to US growth rates, were significantly lower than in the US in the 1990's (with the possible exception of France). The gap between the US and Europe is even more pronounced when technology-driven industries are examined. In the US, these industries recorded an average annual productivity increase of 8.3% in the 1990s, compared to the 3.5% achieved in the same industries in the European Union (see the European Competitiveness Report (2001)). Pharmaceuticals, office machinery and computers, motor vehicles, air and spacecraft, are a few of the industries classified as technology-driven industries.

There is direct evidence that Europe lags behind the US in the usage of new technology. Schreyer (2000) presents results from growth accounting studies, which show the contribution of information and communication technology (ICT) capital to output growth; these are presented in **Table 2**. The contribution of ICT capital to output growth has increased for all countries, but the gap between the US and European countries has increased as well.

Since I suggest the educational system as an important source of US-Europe productivity and growth differences, I shall now present evidence on the European focus on vocational education in **Table 3**. The classification of education into 'general' and 'vocational' should be viewed as a metaphor for the rigidity of European upper secondary and post-secondary education. The issue under consideration is broader than the distinction of college versus school education or overall attainment. In Europe, the channeling of students into either stream starts before college; indeed, a portion of the differences in university enrollment between the US and Europe can be attributed to such early pegging of students. One indication of such rigidity can be observed in Germany where only about 20% of university entrants are from the upper secondary vocational stream (see the OECD's "Education Policy Analysis" (1997)). Table 3 shows that in the EU more students were enrolled in the vocational stream (57.6%) at the upper secondary level than in the general stream (42.4%). In West Germany, 77% of upper secondary students and in Italy 72% were enrolled in vocational or apprenticeship programs. In contrast, there is no separate stream of vocational education in the US at this level; even the percentage of students who completed 30% or more of all credits in specific labor market preparation courses was just 6.8% in 1990. Since education at this level is typically fully funded by the government, this data suggests that the European governments spend a greater fraction of their resources on vocational training than the US. Vocational education in the US is typically imparted in

Table 3: Education Indicators

Country	% of Upper Second. Students in General Education	% of Upper Second. Students in Vocat. Education	University Net Entry Rate	Non-University Tertiary Attainment in %	University Attainment in %	Non-Univ. Tertiary Return to Education, in %	University Tertiary Return to Education, in %
Austria	23	77	26	2	6		
Finland	48	52		9	12	11	15
France	47	53	33	8	11	18	14
Germany	23	77	27	10	13	17	11
Italy	28	72			8		10
Netherlands	30	70	34		22		11
Sweden	44	56		14	14	7	8
EU	42,4	57,6					
US			52	8	25	9	13

Source: Education at a Glance: OECD Indicators (1997) two-year community colleges; of those students over the age of 18 enrolled in post-secondary education, only 13.8% were working toward a vocational Associate's degree in 1991. Table 3 also presents the net entry rate into universities, where general education is primarily imparted; it is 52% in the US but only 27% in Germany, 33% in France, and 26% in Austria. This lower European enrollment ratio is reflected in attainment; while 25% of adults had completed university-level education and 8% had completed non-university tertiary education in the US in 1995, in Germany only 13% had completed university education and 10% non-university tertiary education. Except for the Netherlands, no other country comes close to the US university attainment. Incidentally, while the rate of return for men from such non-university tertiary education is 9% in the US, it is generally higher in Europe - as high as 17% in Germany and 18% in France. This differential might be an indication of better employment opportunities for the vocationally educated in those countries.

Conclusion

The recent growth gap between the U.S. and Europe may be partially explained by Europe's stronger focus on vocational education, compared to the U.S. If my hypothesis is valid, education reform towards more general education in Europe may have beneficial consequences for technology adoption and economic growth. There are signs that such reforms are underway; for example the planned introduction of bachelor degree programs at selected German universities, the introduction of the Swedish general training program "Kunskapslyftet" and many other initiatives. From the perspective of our research these are reforms in the right direction.

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The Changing Profile of the Stockholder Base

by CFS Program Director Michael Haliassos (Goethe University Frankfurt and CFS)

Broadening the stockholder base sounds like a good idea to many people, for different reasons. To name a few, managers of public companies like extra liquidity and wider name recognition, policy makers like promoting equality of opportunity for wealth accumulation (especially if this reduces future reliance on troubled Social Security systems), and some politicians even view it as a way to garner support for legislation favoring industry.

All those in favor of a broader stockholder base had reason to smile in the 1990s. Household direct participation in stockholding, or indirect through mutual funds and retirement accounts, grew substantially in the US and in major European countries (see **Table 1**, and the contributions in Guiso, Haliassos, and Jappelli, 2002).

Yet members of this enlarged stockholder pool were not randomly selected, but were self-selected according to certain characteristics. We can now take advantage of recent research based on detailed household-level data to uncover factors that significantly increase household propensity to hold stocks, to study changes in stockholder composition resulting from the spread of equity culture, and to derive implications for attempts to expand the stockholder base further in the future. In this piece, I highlight some pertinent findings in this literature, including some new findings in ongoing research under the new CFS Program on Household Wealth Management.

Table 1: Household Participation Rates in Direct and Indirect Stockholding

Year	Direct Stockholding					Direct and Indirect Stockholding				
	U.S.	U.K.	Netherlands	Germany	Italy	U.S.	U.K.	Netherlands	Germany	Italy
1983	19,1	8,9	n.a.	9,7	n.a.	n.a.	n.a.	n.a.	11,2	n.a.
1989	16,8	22,6	n.a.	10,3	4,5	31,6	n.a.	n.a.	12,4	10,5
1995	15,2	23,4	11,5	10,5	4,0	40,4	n.a.	29,4	15,6	14,0
1998	19,2	21,6	15,4	n.a.	7,3	48,9	31,4	35,1	n.a.	18,7

Source: Guiso, L., M. Haliassos and T. Jappelli, "Introduction" in Guiso, Haliassos, and Jappelli (Eds.), Household Portfolios, Cambridge: MIT Press, 2002.

Recent research has identified a number of household characteristics that contribute to stockholding participation, regardless of whether we look at the US or at major European countries. An important factor is being richer in income or in assets. Perhaps this finding is less surprising to non-economists than to economists trained in traditional models where optimal asset holdings are proportional to income and the rich are simply blown up versions of the poor (i.e. they simply have x times more income and more of each asset than the poor). The rich are now shown to be fundamentally different, not only in scale of asset holdings, but also in variety of held assets, compared to their poorer counterparts with similar other characteristics.

But portfolios of the rich also hold a surprise to those of us who have been trained to speak of "baskets and eggs". The rich have a marked tendency to tie up a lot of their wealth in one business, and to have a riskier remaining portfolio than their poorer counterparts (Carroll, 2002). Simple principles of diversification would instead dictate that they hold small positions in a variety of private companies or a variety of stocks in a well-diversified portfolio. Some economists now argue that other factors, such as power or control or bequest motives dominate the desire for diversification, but formalizing this in a theoretically acceptable way has proved a challenging task.

Education has been shown to play a non-trivial role in stockholding participation, in the US and in major European countries. Being more educated, especially college-educated, raises the probability that a household enters the stock market, even controlling for current income, wealth and other characteristics. Some of my recent work with Bilias points to two conflicting effects of education (Bilias and Haliassos, 2005). More educated households tend to expect higher income growth over their working lives and to face lower income risk, the latter coming mainly from reduced probability of unemployment. These factors actually reduce incentives to save, and thus militate against stock market participation. What seems to lie behind the positive effect of education, however, is a much lower level of participation costs faced by the more educated, which usually overcomes the disincentives generated by their income process. Greater exposure of the more educated to financially pertinent information, better information processing ability, more informed choice of financial advisors, and high-level social interactions are potential factors contributing to this result.

Would you feel young or old in a room full of stockholders? Participation peaks among households with heads in the second half of their working lives and is much lower among the young and retirees. Yet, econometric research has shown that age per se has little to do with this hump-shaped profile (Guiso et al., 2003). It arises because incomes and wealth peak during that period of life, and households are no longer young borrowers (or borrowing constrained!) but asset holders planning for retirement. Retirees, on the other hand, rely mostly on accumulated wealth to finance their consumption, and this makes them quite risk averse. Moreover, retirees have short remaining horizon for spreading losses if asset returns turn sour (less opportunity for "time diversification", discussed by Gollier, 2003), and possess limited or no ability to adjust their labor supply to mitigate stock market losses.

Surprisingly robust is the result that belonging to a minority in the US reduces the probability of holding stocks, even after controlling for income, wealth, education, and other demographics. It may be that minority status signals something about future income and employment prospects that is missed by the variables already controlled for, but many researchers attribute this finding to a tendency of the financial sector to target minorities less for stock-related financial products. If differential targeting is the main source of this result, it suggests an exploitable opportunity for the financial sector to attract minority segments of the population with similar other characteristics into the stockholder pool.

Other demographics play a less clear role. An extra child tends to discourage stock market participation, controlling for declared willingness to invest in risky assets and other characteristics, probably because of greater expenses associated with raising a child. Marital status has a less clear effect, while self-employment status sometimes encourages stockholding.

A direct implication of such findings is that stockholders are not randomly drawn from the population. As participation spreads and marginal investors enter the market, it is natural for the composition of the stockholder pool and of non-stockholders to change. This has various implications for companies and for financial practitioners.

A broader stockholder base can be associated with substantial changes in the configuration of stockholder characteristics. Our recent research (Bilias, Georgarakos, Haliassos, 2005) suggests that increases in the participation margin have been associated with substantial flows in and out of the stockholder pool and with important changes in the "quality" of the pool, at least as measured by its potential to generate equity wealth. Interestingly, we find evidence that the quality of the US stockholder pool deteriorated during the stock market upswing of the 1990s and improved following the subsequent downswing. Specifically, we look at US data for the period 1989-2001, when total (direct plus indirect) stockholding participation grew to more than 50% of households. The bulk of this increase came in the form of indirect stockholding. Techniques that decompose movements in equity wealth to a part resulting from the changing composition of the stockholder pool and to that associated with the changing stock market environment yield two striking findings.

First, a stockholder pool with the mix of characteristics of the 1989 stockholders would have done better by 1998 compared to what was actually achieved by the 1998 stockholder pool. Increased participation during the upswing was thus accompanied by a dilution of stockholder pool quality. Second, the stockholder pool of 2001, following the downswing, would have produced even higher equity wealth outcomes in 1998 than were produced by those actually in the market in 1998. This latter finding suggests a "cleansing effect" of the downswing, namely an exit of lower-quality stockholders and an entry by higher-quality ones, in slightly bigger numbers.

This may be good news for firms and financial practitioners who stand to benefit from a high-quality stockholder pool. It is not good news, however, for further expansion of the stockholder pool, as it suggests that outsiders are more difficult and perhaps less desirable to attract. This is consistent with findings in Bilias and Haliassos (2005), suggesting that the most likely future entrants in 1998 were of significantly lower quality than marginal stockholders, especially in terms of financial resources and of declared willingness to undertake risk. If the US stockholder pool actually improved between 1998 and 2001, it is likely that it will be orders of magnitude more difficult to get those who are now non-stockholders to hold stocks. But as participation expands, a choice may eventually need to be made between investing resources to attract new investors, and having to deal with too broad a stockholder pool.

Considerations of corporate governance and of financial sector regulation reinforce this view. Corporate governance issues are bound to arise when the composition of the stockholder pool changes, to the extent that shifts in the composition of voting stockholders matter. Even if stockholding is indirect, through mutual funds, pension funds or retirement accounts, it is unlikely that fund managers can ignore the needs of their now wider clientele, and this can reflect back to the companies issuing shares. Moreover, increased participation of households in indirect stockholding implies delegation of portfolio management to professionals, combined with reliance on financial advice coming from various –not always trustworthy– sources. It is very difficult for a broad base of stockholders that includes many inexperienced or less informed investors, to select, evaluate, and keep an eye on professional fund managers and financial advisors. This inability can generate incentives for mismanagement, bad advice, and ultimately market instability. Agency problems could perhaps be handled by regulation, especially of information flows to stockholders, but we are far from an effective plan on how to address these issues.

All in all, a broader and transformed stockholder base, with new preferences, needs, problems and potential is a reality in most financially advanced countries. Understanding who these stockholders are and how they behave seems to be a prerequisite for handling the multitude of new opportunities and challenges presented to the financial sector by the spread of equity culture.

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The Economics of Debt Securitization

by CFS Director Jan Pieter Krahnen
(Goethe University Frankfurt and Center for Financial Studies)

For a very long time the basic intermediation technology in banking has stayed the same, namely lending to creditworthy borrowers at an adequate margin, and funding these loans by taking deposits from savers. This funding strategy was not directly connected to the capital markets, which have witnessed the rapid growth of derivative markets and the development of structured financial instruments over the past 25 years. At last, innovation spills over to financial intermediation.

Over the past few years, the funding strategies of large banks around the globe have added an important element of structured finance, namely the sale of claims on specified loan portfolios. These claims are like bonds whose payoffs depend on the default realizations of a well-defined underlying loan portfolio. However, unlike uniform sharing in the risks, there are several classes of bonds being issued, differentiated by credit quality. Junior bonds, or tranches, bear all the initial losses up to the nominal value of the tranche. If accumulated losses in the underlying portfolio exceed the nominal value of junior bonds, mezzanine tranches take over these additional losses. Tranches of the best credit quality are called senior tranches, because they stand last in line to participate in the loss history of the underlying portfolio, and they do so only to the extent that all other subordinate tranches have been previously wiped out. Not surprisingly, senior tranches typically command an AAA-rating on the market.

In Germany, a True-Sale Initiative led by KfW, the state-owned Kreditanstalt für Wiederaufbau, has over the past two years prepared the ground for a massive securitization campaign. The initiative, which brings together major potential and actual issuers of loan portfolios, has developed a framework that allows the issue of securities backed by asset portfolios, in particular loan portfolios. These developments raise a set of interesting questions. For example, to what extent does loan securitization imply a transfer of default risk from banks to capital markets? With this new access to capital market funding, will banks increase the volume of their loan book? And from the perspective of a regulator, will loan securitization, if undertaken by many banks in an economy undermine the stability of the financial system?

Günter Franke (Konstanz University and CFS) and Jan Krahnen (Goethe University and CFS) are cooperating on a project that analyzes the economics of debt securitization. The project is part of CFS's Credit Management Research Program, which has major banks and rating agencies as team partners, among them securitization experts from Deutsche, Dresdner, Commerzbank and KfW, as well as Standard & Poors, and Fitch.

The first results of this project have now appeared in the CFS*working paper series* (see end of text for details). The authors argue that the economic consequences of securitization depend on the interplay of two characteristics of such a transaction, the way the underlying cash flows are tranched into bonds and the way these tranches are then allocated to investors. First and foremost, the tranching technique is an instrument of non-proportional risk sharing, which is widely used in insurance markets, but which has not been applied to banking before. This is an important innovation since it allows for the separation of the idiosyncratic from the systemic lending risk.

Assuming that the default risk of corporate loans depends on the relationship between the bank and its customers, tranching allows for the allocation of information-sensitive risks predominantly to the first loss piece, and to a lessor extent to the mezzanine pieces, while the senior tranches are largely free of these risks. In turn, extreme or systemic risks are borne predominantly by the holders of the senior tranches. This has implications for the pricing of tranches. The return of senior tranches is almost completely independent of the idiosyncratic risks in the underlying loan portfolio.

The economic consequences of loan securitization on financial stability also depend upon the allocation of tranches to different types of investors. To realize an optimal sharing of risk, the first loss piece of the issues should be retained by the originator of the loans, because then his incentives as a lender are kept intact. In contrast, senior tranches have to be allocated to remote investors in order to improve financial system stability. Remote investors, like pension funds, are defined as being located outside the financial system. The reason is that it is they who are in a best position to withstand a systemic shock to financial markets that would otherwise endanger the stability of the financial system as a whole.

The argument of the last paragraph suggests that banks and insurance companies are neither investing in CDO senior tranches, nor retaining the senior tranches. Both conditions are likely to be violated in many markets today. One may therefore speculate that transparency concerning tranche allocation vis-à-vis the supervisory authorities will one day become an important instrument of financial stability assessment and management.

What is the upshot? From a theoretical standpoint, as just argued, it appears that the securitization of bank loans provides an efficient new tool to combine the advantages of bank- and market-based financial systems. The ongoing empirical research will take a closer look at the extent of risk transfer from banks to markets in European CDO markets, and will shed light on the question posed above, namely whether we are witnessing a fundamental change of the intermediation technology, or just a passing fashion.

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CFS*working papers*

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DB-Prize

The Deutsche Bank Prize in Financial Economics

In 2004 the Center for Financial Studies in co-operation with the Goethe University Frankfurt established an international academic prize, which is to be known as "The Deutsche Bank Prize in Financial Economics". The prize, sponsored by Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft, carries a cash award of € 50,000.

The Deutsche Bank Prize in Financial Economics will honor an internationally renowned researcher who has excelled through influential contributions to research in the fields of finance and money and macroeconomics, and whose work has led to practice- and policy-relevant results.

The aim of the Prize, which will be awarded biannually, is to strengthen Frankfurt am Main as a location for financial sciences and attract a higher degree of international attention. The award will be accompanied by a scientific symposium, the aim of which will be to improve the transfer of knowledge between science and practical implementation. The symposium will be held on the occasion of the award ceremony on **October 6, 2005.**

Until March 24, 2005 a selected group of university teachers in the fields of economics and finance and leading researchers in comparable positions at economic research institutes worldwide had the right to nominate a candidate for the Deutsche Bank Prize in Financial Economics. We are happy that more than 25% of the invited nominees participated in the nomination process by proposing a candidate.

The ten-member jury, consisting of Michael Binder (Goethe University Frankfurt), Matthew Bishop (The Economist), Vitor Gaspar (Banco de Portugal), Jan Pieter Krahnen (Goethe University Frankfurt and CFS), Christian Laux (Goethe University Frankfurt), Hermann Remsperger (Deutsche Bundesbank), Mark Taylor (University of Warwick), Norbert Walter, (Deutsche Bank), Volker Wieland (Goethe University and CFS), and Josef Zechner (University of Vienna) had the challenge of selecting the laureate. For details on this year's laureate please have a look at the announcement enclosed.

For further information click on www.db-prize-financialeconomics.org or contact Stefanie Franzke, Tel.: +49 (0)69 242941-16.

The Deutsche Bank Prize in Financial Economics is part of a general promotion focusing on the "Finance" cluster of the Goethe University Frankfurt decided by Deutsche Bank's Group Executive Committee in the summer of 2003. The aim is to improve Frankfurt's profile as a financial center emphasizing, in particular, scientific aspects. The financial support totals EUR 1 m per year over a period of five years (2005 – 2009). Another important part of this promotion – besides the new science award – is the dual-degree Duke Goethe Executive MBA program which just started as a cooperation between Duke University and Goethe University Frankfurt.

CFS*colloquium series*

Basel II und die Konsequenzen für das Risikomanagement/Basel II and its Impact on Risk Management

Developing a Ratings System under Basel II: A Progress Report

The Basel II Accord is due to become effective in 2007/2008, and its revised requirements will place high demands on banks in terms of their internal credit risk management capabilities. Given the complexity of the task of developing systems and procedures that meet these new requirements, many banks have already had to spend significant amounts of time and resources on setting up the necessary infrastructure.

On 16 February 2005, **Hans-Dieter Brenner**, CFO of Landesbank Hessen-Thüringen (Helaba), gave a presentation to a packed audience of 250 on Helaba's own experience and current progress in developing an internal rating system that follows the internal rating-based (IRB) approach in compliance with the Basel II requirements.

Since any internal rating system needs to take account of a bank's different business segments, Mr. Brenner first gave a detailed overview of the business areas and organizational units within Helaba that will be most affected by Basel II. He emphasized that implementing the IRB approach requires much more from banks than merely assigning internal ratings to different asset classes and transactions. Areas such as investment policies, capital allocation, controlling, collateral management, and risk provisioning will necessarily all be affected. However, the procedure for assigning internal ratings remains the main focus of the project, and so Mr. Brenner continued by pointing out the challenges in sourcing some of the key inputs in the rating process and in the expected-loss calculation, in particular the default probability and loss given default.

Helaba has developed a master table that specifies a default probability for every rating category across segments. In combination with cash-flow simulations, this table facilitates a direct comparison of risks from different asset classes. Difficult to obtain, however, are the required data series for loss given default, which furthermore suffer from the scarcity or even complete absence of default events in certain rating categories and asset classes. This challenge has been overcome by the development of a credit-loss database that pools the data from different Landesbanks and is in turn mutually shared by those institutions.

Apart from the required initial validation and regulatory approval, the internal rating procedure needs to be validated and, if necessary, recalibrated on an annual basis. This already illustrates that the development of an internal rating system can never be a one-time effort, but that such a system needs to be audited, adjusted and further improved on a continuous basis and as future circumstances require.

Despite the fact that the development of an internal rating system constitutes a considerable investment for a bank, Mr. Brenner pointed out that Helaba expects an improvement in its profitability as a result of introducing the IRB approach. An improved bottom line would result not so much from the likely reduction in regulatory capital charges, but rather from a more reliable avoidance of losses, higher margins through risk-adjusted pricing and better identification of profitable customers, and ultimately a higher rating and better reputation in the market.

Looking ahead, Mr. Brenner anticipates a further development and refinement of the Basel criteria in the future, for instance by requiring the inclusion of financial derivatives and taking into account the correlations among individual assets and asset portfolios. Thus the question is not if but rather when a Basel III Accord will show on the agenda.

Marcus Pramor (CFS research staff)

Wettbewerb der Finanzplätze – Wettbewerb am Finanzplatz/Competition between and within Financial Centers

The German Financial Sector Making the Transition from a Credit-Based to a Capital Market-Based System

Labor market deregulation, sound corporate governance together with transparency are, according to Alexander C. Dibelius, the Managing Director and CEO Deutschland of Goldman Sachs, what constitute the necessary framework conditions that will enable the German financial sector to fulfill its growth potential.

Alexander Dibelius, who gave a presentation at the CFS*colloquium* on 30 November 2003, said that in particular it would ease the development of the German capital market if a growing proportion of economic activity were to be evaluated from the perspective of financial participators rather than consumers and wage earners. That this is the case is demonstrated, according to Dibelius, by the statistics published by the Deutsche Aktieninstitut (DAI) about the increasing number of shareholders in Germany. In Dibelius' opinion the chances passed up for such a socialization of productive property also include the Riester Rente (pension scheme). For all its undeniable shortcomings, if it had not been talked into the ground, it could have paved the way for a real change of regime, by which Dibelius means a change to people's capitalism in the Anglo-American sense.

The financial sector in Germany, according to Dibelius, is currently in the throes of an expedient and also inevitable transition from a bank-based to a capital market-based system. He expects the new equity rules for banks (Basle II) as well as an end to the privileges of those banks under public law to lead to far reaching changes, as are already being observed in the wake of globalization.

In Germany there is no longer an equilibrium in the relationship between labor and capital costs. "Overpriced wages in industry are virtually being subsidized with the help of too cheap loans," said Dibelius. In his view the costs of capital for small and medium-sized companies will rise in the future as the state guarantee for the Landesbanks and savings banks are abolished. In order to compensate for these higher costs of capital, wages will have to fall. The first signs supporting this assumption can already be seen, according to Dibelius, in the return, already underway, to the forty-hour working week.

Stefanie Franzke (CFS staff)

What Insurance Can Learn from Investment Banking, and Vice Versa

At the CFS*colloquium* on June 29, 2004 Leonhard H. Fischer, Chief Executive Officer of the Winterthur Group, presented his views on the topic "What insurance can learn from banking, and vice versa". He centered his talk on three questions: i) what can the insurance industry learn from banking? ii) What can banks learn from looking at how the insurance industry works? iii) How close are the interrelations between the banking industry and the insurance industry, particularly the life insurance industry?

In answering the first question, **Leonhard Fischer** suggested that the insurance industry might learn from the banking industry in two areas. First, insurance companies should look carefully at the massive changes that have occurred in the banking sector during the last two decades, as they are also very likely to happen in the insurance industry. The wave of deregulation, advancement in technology, globalization, and consumer finance has made banking a much more process-driven and scalable business. Similarly, the insurance industry is a very regulated industry, and technology is changing the distribution channels such that the business is becoming more process-driven. It is therefore reasonable to expect that this industry will also experience a massive wave of consolidation and technological investment.

Second, the insurance industry can benefit greatly from the much improved risk management and asset liability management of banks. This would help insurance companies to operate and design their strategies in an environment that is much less profitable than it was 20 years ago.

On the other hand, banks can also learn from insurance companies about selling strategies and the containment of costs. Insurance companies are very focused and aggressive; they approach prospective clients rather than waiting for the clients to come to them. Banks, however, usually wait for the clients to make the first move. This makes a big difference and reduces profits. Moreover, banks have much to learn in terms of keeping their compensation structures and their costs intact. Insurance companies have a productivity disadvantage in comparison to banks, but they are very cost-conscious, whereas banks, particularly in Germany, tend are not as adept at controlling costs.

Thus, according to Fischer, both industries have a lot to learn from each other, since they face similar trends and challenges. At the same time, however, they also differ in many respects, and for this reason it is difficult to combine the activities of the two sectors. For example, differences exist in the distribution systems and compensation schemes of the two industries. Insurance companies tend to be front-loaded, whereas banks realize their revenues immediately when they sell their products. Moreover, banks accumulate assets in the accounts of their clients and actively advise them to change positions in the course of an investment. Insurance companies, on the other hand, sell policies and do not encourage their clients to change positions. These different distribution systems make the bank-insurance model very difficult. Nevertheless, the banking industry would be well advised to try to understand the way in which the insurance industry functions because it covers a very large sector, managing on average something like 25% of European savings and investing in very correlated assets. This correlation is particularly important when stock markets begin to decline, given the massive proportions of equity in the investment portfolios of insurance companies and the minimum guarantee they offer to their clients. The combination of all these factors has contributed significantly to the decline and the volatility of European stock markets, and to the recent problems of life insurance companies in the UK, Germany and Switzerland. These facts also indicate that the insurance industry has much more to learn from banking about the diversity of positioning the risk profile of an investment portfolio.

Fischer concluded his talked by emphasizing once again the huge number of similarities and interdependencies between these two industries that are both major players in the field of financial services. Their developments are surely challenging for all those working in these industries and for the capital markets community as a whole.

Elena Carletti (CFS research staff)

CFS*forum*

Saving is Possible even in a Difficult Economic Climate

The European Finance Ministers could noticeably reduce public spending, stabilize budgets and reduce the state's share of economic output. According to Vito Tanzi, former Undersecretary of Economics and Finance in Italy and Director of Fiscal Affairs at the International Monetary Fund, there is no cause for the concern that this would drive the economy under the current difficult economic climate into recession.

As part of the CFS*forum* on 15 November 2004, **Vito Tanzi** presented his paper written jointly with Ludger Schuknecht (ECB) on the subject of "Reforming Public Expenditures in Industrialized Countries: Are there Trade-Offs?" In this study the development of public spending in relationship to GNP is analyzed for 22 industrial countries over the period 1982 to 2002. As measured in terms of the maximum level reached in each country during the sample period, the public sector share sank until 2002 on average by 6.6%. Ireland, New Zealand, the Netherlands, Belgium, all of which were included by the authors in the category of "early" (beginning to middle of the 1980s) and ambitious reform states even reduced the share by between 10% and 16%. This happened without incurring catastrophic short-term effects, and has even led to positive long-term effects. For Germany, Tanzi and Schuhknecht find a relatively low reduction in the public sector share. Whilst state expenditure in relation to GNP reached its maximum level in 1996 with 50.3%, by the end of 2002 it had sunk by only 1.8% to 48.5%. Thus Tanzi and Schuhknecht classify Germany, together with Denmark, France, Italy, Switzerland and the USA, as being a timid and late reformer.

Tanzi comments that it is noticeable that action with respect to the reform of public expenditure was undertaken in the first instance as a reaction to an economic or budget crisis. The most decisive reformers were in particular those countries with a public sector share at some point of partly more than 60%, such as Belgium, Finland and Sweden.

The most ambitious reform countries, as Tanzi notes, today belong to those industrial nations with the greatest capacity for growth.

Stefanie Franzke (CFS staff)

The Valuation of Banks: Theory and Application in Practice

Consolidation, i.e. the realization of synergies, is one of the possible approaches to dealing with a structural crisis, something from which the German banking system is obviously suffering. Inseparably linked to banking consolidation is the question of an adequate method for valuing a bank.

During the course of a CFS*forum* in September 2004, **Andreas R. Dombret**, Co-Head of Investment Banking at Rothschild Germany, presented different approaches to valuing banks. Dombret pointed out that the value of any firm depends to a significant extent on the subjective preference of a potential acquirer or seller. For the shareholder of a company, the value might be equal to the liquidation value. However, the value of any given firm might also induce a value-increasing strategic component leading to a transaction price that is much higher than the liquidation value. Dombret went on to explain why the valuation of banks is different to that of firms. First, the capital of financial institutions includes only equity. Second, the discount factor is equal to the cost of equity (and not the weighted average of the cost of capital), and third, driven by the need for large scale capital market funding, the rating is frequently of greater importance than it is in the case of firms. Taking a real-life example from the German banking sector, Dombret proceeded to look at the different valuation methods, analyzing their advantages and disadvantages. He considered in detail the most commonly used methods, i.e., the net asset value, multiples derived from peer groups or comparable transactions, the 'sum of the parts', and the dividend discount method. According to Dombret, the dividend discount method (DDM) is at the heart of any bank valuation. In a first step the disposable dividends are calculated and then discounted using the cost of equity that is usually based on the Capital Asset Pricing Model. In the next step, in line with the 'going concern principle', a dividend is calculated that will be distributed after a projected time frame of 5 to 10 years until a 'steady-state' is reached and a constant growth rate is assumed. This terminal value also has to be discounted and added to the net present value of the dividends over the forecast period. The result is the equity value of a bank. Dombret concluded his lecture by pointing out that the value of a bank is not only derived from a theoretical framework based on the fundamental principles of finance (risk – reward, value of money), and take into account real world experiences (multiples). 'Soft Factors', which require insight and judgement are critical and might well dominate in terms of relevance for the valuation results.

For more information on the valuation of banks see Andreas Dombret, Philipp Gossow, Joachim Haecker, Valuation of Banks - both Art and Science, in Matthias Fischer (Editor), Handbuch Wertmangement in Banken und Versicherungen, Gabler Verlag, Juli 2004

Stefanie Franzke/Christian Ossig
(CFS staff/Rothschild Germany)

Analysts Disagreement, Mispricing and Liquidity

Anna Scherbina (Harvard Business School) visited CFS at the end of August 2004, and on August 30 gave a lecture on a study conducted jointly with Ronnie Sadka (University of Washington). In her previous research, Professor Scherbina has shown that stocks with a high level of analyst disagreement are overpriced. This anomaly is robust even after controlling for other factors that explain stocks' realized returns, and it is shown to vanish within a fiscal year (as the uncertainty regarding the earning dissolves). The current research shows how this mispricing is related to liquidity.

Anna Scherbina and Ronnie Sadka conjecture that one reason for the persistence of this mispricing is the high trading costs related to stocks with high analyst disagreement. As analyst disagreement rises, the market maker becomes more vulnerable to biting by better-informed investors. Hence, the market maker widens the bid-ask spread to better protect himself and therefore causes the trading costs to rise. In such circumstances, arbitrageurs tend to lose their incentive to exploit the mispricing of these stocks, and thus the mispricing persists.

Scherbina and Sadka elegantly test their conjecture. They show using a cross-section analysis that analyst disagreement overpricing is more severe among less liquid stocks. Moreover, it is shown that aggregate market liquidity increases, prices tend to converge faster to fundamentals.

From a practical point of view, the results of this paper may also be interesting to practitioners. Although this research shows that the ability of arbitrageurs to exploit mispricing is constrained by trading costs, it also shows that the market's liquidity level should be the factor determining the right timing for 'make money'.

Anna Scherbina is Assistant Professor at the Harvard Business School. She received her Ph.D. in Finance from Northwestern University and has been teaching finance at two of the world's premier business schools, i.e. the Kellogg School at Northwestern and Harvard Business School. Her professional experience includes two years at the Federal Reserve Board in Washington as well as a stint at Goldman Sachs in New York.

Koresh Galil (former CFS research staff)

Admission to these lectures is free of charge. Please refer to the registration form on our website www.ifk-cfs.de or contact Birgit Pässler, Tel.: +49-(0)69-242941-14, Email: paessler@ifk-cfs.de

Joint Lunchtime Seminars

The Joint Lunchtime Seminars are a series of weekly research lectures inviting academics from other institutions to present their research in the fields of Monetary Economics, Macroeconomics, Finance and Econometrics. The speakers comprise both well-established senior researchers as well as those at the assistant and associate level from all over Europe and the United States.

Originally started in January 2001, the weekly presentations have become a fixed entry in the diary of many members of research institutions and central banks located in Frankfurt. As a result, seminars are usually accompanied by lively debates and subsequent discussions.
The Joint Lunchtime Seminars are organized by Klaus Adam (European Central Bank), Heinz Herrmann/Sandra Eickmeier (Deutsche Bundesbank) and Volker Wieland (Goethe University Frankfurt and CFS)/Günter Beck (Goethe University Frankfurt).

27.04.2005	**Forcasting Quarterly German GDP at Monthly Intervals Using Monthly IFO Business Conditions Data** **Peter Zadrozny** (U.S. Department of Labor, Bureau of Labor Statistics)
20.04.2005	**Schumpeterian Restructuring** **Patrick Francois** (University of British Columbia)
13.04.2005	**Lending Relationships in the Interbank Market** **Joao Cocco** (London Buisiness School)
06.04.2005	**Hyperbolic Discounting and the Phillips Curve** **Liam Graham** (University of Warwick)
30.03.2005	**Co-breaking** **Michael Massmann** (University of Bonn)
23.03.2005	**A Model to Analyse Financial Fragility: Theory and Applications** **Dimitrios Tsomocos** (Oxford University, Said Business School)
16.03.2005	**Gains From Coordination in a Multi-Sector Open Economy: Does It Pay To Be Different?** **Zheng Liu** (Emory University, Atlanta)
09.03.2005	**Do Retail Incentives Work in Privatizations?** **Matti Keloharju** (Helsinki School of Economics)
02.03.2005	**Inflation Targeting, Committee Decision Making and Uncertainty: The case of the Bank of England's MPC.** **Sean Holly** (Cambridge University)
23.02.2005	**The Political Economy of Dominant Investors** **Ernst Ludwig von Thadden** (University of Mannheim)
16.02.2005	**Tradability, Productivity, and Understanding International Economic Integration** **Paul Bergin** (University of California, Davis)
09.02.2005	**Taking Two Steps at a Time: On the Optimal Pattern of Policy Interest Rates** **Petra Gerlach** (Swiss National Bank)
02.02.2005	**The Impact of International Financial Integration on Industry Growth** **Ellen Vanassche** (KU Leuven)
26.01.2005	**The Transmission of Monetary Policy Shocks from the U.S. to the Euro Area** **Stefano Neri** (Bank of Italy)
19.01.2005	**Optimal Sticky Prices under Rational Inattention** **Mirko Wiederholt** (Humboldt University in Berlin)
12.01.2005	**Why Inflation Rose and Fell: Policymakers' Belief and US Postwar Stabilization Policy** **Giorgio Primiceri** (Northwestern University, Evanston)
05.01.2005	**An Assignment Theory of Foreign Direct Investment** **Volker Nocke** (University of Pennsylvania)
15.12.2004	**Money, Credit and Banking** **Aleksander Berentsen** (University of Basel)
08.12.2004	**Zombie Lending and Depressed Restructuring in Japan** **Anil Kashyap** (University of Chicago)
01.12.2004	**Lending Booms and Lending Standards** **Robert Marquez** (University of Maryland)
24.11.2004	**Financial Innovations, Liquidity, and Banking Stability** **Wolf B. Wagner** (Tilburg University & Cambridge University)
17.11.2004	**New Evidence on the Interest Rate Effects of Budget Deficits and Debt** **Thomas Laubach** (OECD)
10.11.2004	**Government Deficits and Interest Rates: A No-Arbitrage Structural VAR Approach** **Thomas Philippon** (New York University)
03.11.2004	**Non-Walrasian Labor Markets, Business Cycles and Monetary Policy** **Francesco Zanetti** (Bank of England)
27.10.2004	**Macroeconomic Sources of Risk in the Term Structure** **Mike Wickens** (University of York)
20.10.2004	**A,B,C's (and D)'s for Understanding VARs** **Juan Rubio-Ramirez** (Federal Reserve Bank of Atlanta)
13.10.2004	**Employment and Technology Shocks** **Fabrice Collard** (University of Toulouse)
06.10.2004	**Long-Run Real Exchange Rates and the Theory of General Relativity** **Mark Taylor** (Warwick University)
29.09.2004	**Using Market Information for Banking System Risk Assessment** **Martin Summer** (Oesterreichische Nationalbank)
22.09.2004	**Does Income Inequality Lead to Consumption Inequality? Evidence and Theory** **Dirk Krüger** (Goethe University Frankfurt)
15.09.2004	**A Model of Job and Worker Flow** **Nobuhiro Kiyotaki** (London School of Economics)
08.09.2004	**Futures-based Forecasts as Risk-adjusted Forecasts of Monetary Policy** **Monika Piazzesi** (University of Chicago)
01.09.2004	**The Social Cost of Heterogeneous Information** **Christian Hellwig** (University of California, Los Angeles)
28.07.2004	**Real-Time Model Uncertainty and the Fed: 1996 – 2003** **Robert Tetlow** (Federal Reserve Board)
21.07.2004	**Size and Value Anomalies under Regime Shifts** **Massimo Guidolin** (University of Virginia)
14.07.2004	**Optimal Constrained Interest-rate Rules** **Bruce McGough** (Oregon State University)
07.07.2004	**Monetary Policy, Endogenous Inattention, and the Output-Price Volatility Tradeoff** **William Branch** (University of California, Irvine)

CFS*research conferences*

The Second RICAFE Conference, October 15th -16th, 2004

The conclusive moment of the second year of the RICAFE ("Risk Capital and the Financing of European Innovative Firms") Research Network was the conference organized by the CFS and held at University of Frankfurt's Campus Westend. The event put together many of the leading scholars of the field, with a mix of both European and American people, and attracted over 70 attendants. The Conference program spanned a diverse set of topics, all relevant for the financing of innovative companies through risk capital. Papers focused on topics such as the role of legal systems for risk capital financing in Europe, empirical and theoretical analyses on the role and efficiency of public policies, patent defense financing, investment styles in private equity, the role of competition for human capital and organizational structures, portfolio size of venture capital funds or the use of specific contractual forms in risk capital financing.

One of the central parts of the conference was the panel discussion on "Financing Entrepreneurial Companies – What Role is There for Public Policy?", chaired by **David Webb** (FMG/LSE). Both invited academics and practitioners, such as **Stefan Elsser** (3i Germany) and **Ari Hyytinen** (ETLA Helsinki), and the conference attendants discussed public policy issues and exchanged ideas. In the course of the discussion, all participants agreed that the provision of public funds often is highly problematic as it threatens to crowd out private funds and may lead to price distortions which hinder the efficient allocation of funds and the successful development of promising businesses. Guarantee programmes in particularly were found to be problematic instruments of public policy support. The participants saw a clear need for policy makers to be aware of these issues and called for the academic community and the practitioners to help policy makers understand the investment processes and the necessity of well-designed programmes, such as public-private partnerships.

While none of the participants saw a lack of funds available to be invested, all acknowledged a lack of investment opportunities. Among the issues identified by the discussants were taxation, excessive regulation for setting up new firms and the fear of negative stigma effects if entrepreneurs fail with their companies. From international experiences, one public policy measure which fosters the development of entrepreneurial firms is the establishment of incubators at universities and research institutes. In the past, these institutions proved to be very helpful for aspiring entrepreneurs in the successful development of their business ideas.

Other participants active at the conference were (in alphabetical order): **Renée Adams** (Stockholm School of Economics), **Stefan Ambec** (University of Grenoble), **Sridhar Arcot** (FMG/LSE), **Gennaro Bernile** (Rochester), **Wolfgang Bessler** (University of Giessen), **Marco Da Rin** (Turin University), **Vincenzo Denicolò** (University of Bologna), **Antoine Faure-Grimaud** (FMG/LSE), **Stefanie Franzke** (CFS), **Guido Friebel** (IDEI Toulouse), **Mariassunta Giannetti** (Stockholm School of Economics), **Ulrich Hege** (HEC Paris), **Julia Hirsch** (Frankfurt University/CFS), **Vesa Kanniainen** (University of Helsinki), **Christoph Kaserer** (TU Munich), **Dima Leshchinskii** (Lally School, RPI), **Ibolya Schindele** (Norwegian School of Management), **Armin Schwienbacher** (University of Amsterdam), **Alessandro Sembenelli** (Turin University), **Orna Serban Levy** (University of Tel Aviv), **Javier Suarez** (CEMFI), **Tuomas Takalo** (Bank of Finland), **Uwe Walz** (Frankfurt/CFS University) and **Harry Yuklea** (Hebrew University Jerusalem). Further information on the conference and the RICAFE research network can be found on the CFS website and under www.lse.ac.uk/collections/RICAFE/ .

Patrick Herbst
(Goethe University Frankfurt)

The "Risk Capital and the Financing of European Innovative Firms" (RICAFE) research network is formed by members of the Financial Markets Group at the London School of Economics and Political Science, HEC School of Management in Paris, University of Turin and the Center for Financial Studies. RICAFE is financed by the European Commission, DG-Research (Grant HPSE-CT-2002-00140). It aims to provide research breakthroughs in the economics of risk capital financing of innovative companies, thereby offering informed and insightful research advice to the European Commission.

The Allianz-CFS Conference on "Capital Markets in the Long Term: Demography, Economic Development and Funded Pension Systems"

That people are getting older may not be a new phenomenon, but that more and more people are at the same time getting rather old now appears striking. What is clearly a very welcome development at the individual level also has important implications for society as a whole.

On September 23, 2004, Allianz Group and the CFS jointly attempted to shed some light on the economic consequences of these ongoing demographic changes. The focus of the discussion was on the long-term impact on capital markets and pension systems, and the speakers tried to identify the direction and magnitude of potential changes as well as the likelihood of an eventual asset meltdown. The setup of the event was novel in that the CFS for the first time joined forces with a major financial market participant in organizing a conference. **Michael Heise** (Allianz Group) and **Volker Wieland** (Goethe University Frankfurt/CFS) chaired the event and in their opening remarks emphasized the advantages of combining insights from academia with those from the financial community in order to provide a more comprehensive outlook on capital market developments. This cooperation was well reflected, not only in the different presentations by panel members but also in the audience, which showed that the conference was appealing to both market practitioners and academic researchers alike.

Manfred Neumann (University of Bonn) and **Klaus Masuch** (ECB) discussed inflation, growth, and productivity. Manfred Neumann looked at changes in the relationship between money growth and inflation resulting from the start of EMU and concluded that the ECB ought to tighten money growth. Klaus Masuch, on the other hand, made the case for price stability and low inflation uncertainty as a result of a credible monetary policy regime and showed that macroeconomic stability would thereby be obtained as a by-product.

Michael Schröder and **Martin Schüler** (both Centre for European Economic Research, Mannheim) jointly presented the results of a survey on capital markets and demography that had been commissioned by Allianz Group. The focus of the study was on long-term effects with a 15-year horizon, and the survey sample consisted predominantly of banks, with the remainder comprising corporates and insurance firms. The survey predicts an increase in the importance of capital markets in the future and shows an expected shift towards higher-risk assets and into emerging markets. The presentation was followed by a lively debate on potential sampling biases and worthwhile extensions of the survey.

After lunch, **Dirk Krüger** and **Michael Haliassos** (both Goethe University Frankfurt) discussed savings drivers and the importance of demographic trends. Dirk Krüger showed that based on a standard life-cycle model of consumption and saving, rich countries should see an increase in domestic savings and capital exports until around 2020, after which there would then be a decline in savings and an increasing inflow of foreign capital. These trends would become even more pronounced through a change in pension policy from the current pay-as-you-go system to fully funded pensions. However, the level of investment should be largely insulated from such savings patterns through internationally integrated capital markets. Michael Haliassos looked at the link between household demographics and savings compositions. Considerable differences across households can be observed in their decision whether or not to participate in risky investments, which are to a large part due to entry barriers in the form of fixed participation costs, or simply to a lack of information. In contrast, households that participate in risky investments display greater homogeneity in their portfolio compositions.

Savings and interest rates were the topic of a follow-on panel with **Joachim**

Winter (Mannheim Research Institute for the Economics of Aging) and **Helmut Reisen** (OECD). Joachim Winter discussed the results of a simulation using a multi-region OLG model. He finds a future decline in the savings rate resulting in minor declines in capital growth and the return on capital. While the latter would be only slightly affected by a fundamental pension reform, it is heavily influenced by international capital mobility. Helmut Reisen arrived at predictions on saving patterns similar to Dirk Krüger's, suggesting that international demographic differences should make investments in non-OECD countries more attractive over the coming decades. The consequences of demographic changes will significantly outweigh potential benefits from better global diversification.

In the final panel, **Alan Pickering** (European Federation for Retirement Provision) and **Peter Lockyer** (Allianz Dresdner Asset Management) specifically addressed pension security and asset management. Alan Pickering pointed out that there will necessarily be a significant amount of risk inherent in any pension system and that this risk cannot entirely be laid off. An important prerequisite for the long-term success of a pension system is a framework that provides the right incentives for regulators and politicians alike. Peter Lockyer's presentation looked at risk management for defined benefit and defined contribution systems and a desirable scope of regulation.

All presentations suggested that an asset meltdown is a very unlikely scenario for the foreseeable future and that the importance of capital markets is instead likely to increase further.

Marcus Pramor (CFS research staff)

CFS Summer Schools, August 25-30, 2004: "International Macroeconomics" and "Corporate Finance, Corporate Governance, and Political Economy"

The CFS Summer Schools took place on 24-30 August, 2004 at the Training Center of the Deutsche Bundesbank in Eltville/Rheingau, and included classes on both finance and macroeconomics.

CFS Summer School on "International Macroeconomics"

About thirty-five international students participated in the CFS Summer School on "International Macroeconomics". Organized by **Michael Binder** (Goethe University Frankfurt), the Summer School featured a most distinguished faculty comprising **Giancarlo Corsetti** (European University Institute in Florence), **Steven Durlauf** (University of Wisconsin-Madison) and **Mark Taylor** (University of Warwick). Their lectures focused in particular on the "new open economy macroeconomics", on economic growth, and on cross-country price and exchange rate dynamics.

Giancarlo Corsetti gave a synopsis of the "new open economy macroeconomics" literature using a stylized dynamic stochastic general-equilibrium model for open economies. This model yielded insights into stabilization and transmission in open economies by means of both algebraic and graphical analysis. This part of Corsetti's lectures provided students with a valuable exposition of the new generation of macroeconomic modeling at institutions such as the International Monetary Fund that have begun to adopt this type of modeling approach, which owes much to the vision of Corsetti. In his lectures at the Summer School, Corsetti also devoted some time to discussing the international price differentials of tradable goods. He demonstrated how country-specific deviations from the law of one price can arise endogenously from the optimal pricing decisions of monopolistic firms operating with local-input-intensive distribution services. Corsetti also discussed how exchange rate transmission is incomplete in such a world because of optimal cross-border price discrimination, explaining how large movements in exchange rates translate into small changes in consumption, employment and price levels.

Steven Durlauf, one of the pioneers and driving forces of (inter alia) the empirical growth literature, in his lectures gave a stimulating survey of this literature and also discussed some recent research developments in detail. Durlauf placed considerable emphasis on the derivation of statistical models of cross-country growth differences from theoretical growth models, noting how the "open-endedness" of the theoretical literature created unique challenges for empirical evaluation. In discussing empirical methods, Durlauf focused on the sensitivity of results due to model uncertainty and how this issue has been addressed in the literature by using extreme bound analysis and modifications thereof for variable selection. Durlauf also introduced a new framework for model selection based on Bayesian model averaging ideas. Further issues discussed included possible methods for dealing with the cross-country heterogeneity of model parameters, multiple regimes and measurement error. Durlauf also provided in his lectures valuable insights into his influential work on the problems of instrumentation in cross-country growth regressions, and then concluded his presentation with a discussion of the future of "growth econometrics".

Combining his practical insight into the workings of foreign exchange markets with rigorous econometric analysis, Mark Taylor, who has been behind a considerable number of important recent advances in empirical research on exchange rate dynamics, surveyed in his lectures the Purchasing Power Parity (PPP) debate. He argued that the empirical literature on PPP is a particularly good example of how dependent successful empirical work is on the availability of appropriate data, model selection and the proper use of econometric techniques. Taylor's particular emphasis was on non-linear adjustments in the real exchange rate, reflecting how trading behavior will, mainly as a consequence of transaction costs, depend on the size of the deviation of the real exchange rate from PPP. Taylor presented threshold autoregressive models that can capture such market features, and discussed how it has helped to provide evidence in favor of PPP as a medium- to long-run anchor in exchange rate determination.

A further important element of the Summer School were the paper and poster presentations by many of the students, addressing themes ranging from current account crises and currency adoption to the transmission of business cycles and long-run growth forecasting. These presentations contributed to a lively and research-oriented atmosphere at the Summer School that is likely to shape the future work of many of the participants.

Susanne Bröck/Jan Mutl
(both Goethe University Frankfurt)

Summer School on "Corporate Finance, Corporate Governance, and Political Economy"

The Finance Summer School was organized by **Jan Pieter Krahnen** (Goethe University Frankfurt, and CFS) and **Christian Laux** (Goethe University Frankfurt) and comprised lectures by **Antoine Faure-Grimaud** (London School of Economics), **Enrico Perotti** (University of Amsterdam), and **Hyun Song Shin** (London School of Economics). The 28 participants of the school came from the private sector, central banks, and universities in Germany and abroad.

The program consisted of a blend of lectures by the faculty and student paper presentations. The lectures covered topics in corporate finance, corporate governance, and political economy. Antoine Faure-Grimaud started with an introduction to incomplete contracting and pointed out that in contrast to a world with comprehensive contracts, control rights matter in situations of contractual incompleteness. He continued to explain how the allocation of these rights differs among contracts. For example, debt contracts differ from equity, not only in their cash flow rights but also in how they allocate control, shifting control from equity holders to debt holders in case of default. In addition, Faure-Grimaud covered theories of the maturity structure of optimal financial claims as well as the optimal number of creditors.

Enrico Perotti's lectures centered on the political economy of finance. First, he reviewed the literature on legal origins and illustrated the relationship between different legal systems, especially common and civil law, and their implications for the ownership structure, the amount of external financing, financial development, and economic growth. Second, he presented a theory of strategic privati-

zation, that is, how politicians can use privatization to influence the median voter and build political support for re-election. Furthermore, he showed how to measure the impact of political risk on asset prices. Then Perotti asked what constitutes the political determinants of a country's corporate governance structure and under what circumstances the median voter might choose a market or a bank-based system. Finally, he analyzed how financial development could be endogenous and subject to the political environment. Departing from the literature on median voter models, Perotti showed how, in societies with high inequality, the elite might seek to limit entry by lobbying on inefficient financial institutions.

Hyun Song Shin explained how capital markets are prone to endogenous risks due to synchronous trading strategies and the positive feedback-mechanism of falling prices and the fire sales of collateral, drawing on, for example, the crisis of the hedge fund Long-Term Capital Management (LTCM). He stressed the importance of market liquidity and its public-good nature. In a second lecture, Shin analyzed how a company's optimal disclosure policy might result in empirically observed pricing anomalies (short-run underreactions and long-run overreactions).

In addition to the lectures by the faculty, the summer school also provided a stimulating environment for Ph.D. students and young researchers to discuss their own research. Eleven students opted to present their own research papers. The empirical papers covered topics such as the relationship between a firm's managerial ownership structure and its debt maturity, the impact of auditing rules on firm performance, the use of bank-debt within close Japanese bank-firm relationships, and the information content of directors' share transactions. The theoretical papers analyzed, among other things, the impact of mergers on the financing of R&D, a bank's capital structure decision with non-verifiable lending risk, and the optimal allocation of control rights to stakeholders.

Conrad Zimmer
(Goethe University Frankfurt)

The next CFSsummer school will take place on August 15-22, 2005, in Eltville (near Frankfurt/Main). The Finance summer school will be on "Empirical Research in Banking and Corporate Finance", with courses taught by ***Jay Ritter*** *(University of Florida) and* ***Philip Strahan*** *(Carroll School of Management, Boston College). The topic of the summer school in Macroeconomics will be "Learning in Macroeconomic Models – Recent Advances and Policy Applications", and lectures will be given by* ***Timothy Cogley*** *(University of California),* ***Seppo Honkapohja*** *(University of Cambridge),* ***Ramon Marimon*** *(Universitat Pompeu Fabra), and* ***Volker Wieland*** *(Goethe University Frankfurt). As in previous years, participants will also have the opportunity to present their own work.*
If you are interested to attend, please apply online at www.ifk-cfs.de.

The ECB and Its Watchers VI
Frankfurt, July 2, 2004

The 6th installment of the CFS trademark conference series 'The ECB and Its Watchers' organized by Volker Wieland (CFS) brought together 22 distinguished speakers from banks, think tanks, central banks and academia for an open discussion with ECB officials regarding current challenges faced by European policymakers. Registered conference participants comprised 170 professionals from the financial community, central banks and academia and close to 40 media representatives.

In his welcome address **Volker Wieland** emphasized the uniqueness of this event in terms of bringing together central bank critics and central bank decision makers for a public exchange of opinion and thanked **Otmar Issing** (ECB) and the former organizer **Axel A. Weber** (Deutsche Bundesbank) for having set up such a practical example for transparency in central banking. As in previous years, the conference featured presentations by several ECB monitoring groups with a direct response by Otmar Issing (ECB). Furthermore, a second panel starting off with a speech by **Gertrude Tumpel-Gugerell** (ECB) debated the current state of European financial integration as well as necessary further

steps. The two remaining panels were dedicated to a debate on the extent of international imbalances and the need for policy responses.

In his opening remarks Otmar Issing stressed the usefulness of the former ECB Watcher conferences noting that the ECB had learned much from the exchange with ECB watchers even if the recommendations of different groups were often at odds with each other, this process helped and that it had tried to take on board some of the recommendations but also learned in other cases why not to adopt them. Pointing out the large number of distinguished speakers and participants at this year's conference, he concluded that this type of exchange continues to be of significant interest to the public.

ECB Monitoring

The first session, chaired by Volker Wieland, started off with a presentation by **Harald Uhlig** (Humboldt University and Center for Economic Policy Research) based on the 5th MECB (Monitoring the European Central Bank) report of the CEPR's ECB watcher group. Harald Uhlig stated that the ECB had failed to keep inflation below 2% for most of the time. He considered the ECB's goal of inflation close but below 2 % to ambitious and suggested replacing it with a range from 1 to 3%. He argued that neither inflation nor money growth, but economic sentiment played the most important role for recent interest rate decisions of the ECB.

Daniel Gros from the Center for European Policy Studies (CEPS) emphasized that the ECB should adjust its policy to a macroeconomic scenario characterized by deteriorating demographics, declining productivity growth and a performance gap between big and small countries. His co-author on the CEPS report, **Roberto Perotti** (Bocconi University) focused on

fiscal policy and proposed to create an independent institution that should assess the quality and credibility of government forecasts regarding economic growth as well as fiscal measures.

Manfred J.M. Neumann (University of Bonn) from the EMU Monitor group pointed out that the inflation forecasts of the ECB had not been very precise in the last three years and had been worse than those of the European Commission. Discussing recent policy decisions, **Angel Ubide** (Tudor Investment) from the OBCE group concluded that there would have been a strong case to cut rates in April 2004, which had already been priced in by the market. Since the ECB did not deliver a cut and did not provided further clarification on the intended path of policy, it caused an implicit tightened of monetary conditions.

In his reply Otmar Issing expressed support for proposals such as Perotti's that are intended to de-politicize fiscal policy. but felt that the problem who to appoint to such an independent office is still not solved. Issing strongly refused the notion that the ECB would base area-wide policy considerations on country-specific aspects such as real interest rates in Germany. Issing readily agreed with the suggestion that asset price inflation and deflation would represent a bigger problem for inflation targeting central banks than the ECB indicating that the ECB is forced to look carefully at the developments in money and credit due to its emphasis of a separate monetary pillar in the strategy.

Issing strongly contradicted Uhlig's verdict that the ECB had failed to achieve its inflation objective noting instead that euro area inflation performance of roughly 2 % in recent years was a great achievement of the ECB. But he also expressed strong concern about the recent increase in inflation expectations indicating that the ECB would have to deal with that.
While recognizing the repeated underestimation of inflation mentioned by Manfred Neumann, Issing rejected possible suggestions that this might have been deliberate and stated that the ECB's inflation projections were done in an objective way using state-of-the-art techniques. He also refuted the claim that the

ECB gives much weight to economic sentiment. Rather than considering sentiment, Issing expressed his conviction in favor of following rules/principles, while recognizing that some flexibility is also needed.

European Financial Integration

The second panel, chaired by **Vitor Gaspar** (ECB), began with an opening statement by Gertrude Tumpel-Gugerell (ECB). She stressed that much progress had been made with respect to integration across European financial markets. She noted that the high level of integration in money markets was "quasi automatic" with a common currency and indicated that progress in integrating corporate bond markets was related to the dynamism of a "new market".

Rudolf Ferscha (Eurex) pointed out that U.S. distribution was a major growth factor for European products and that even local contracts benefited substantially from US distribution. Furthermore, he provided evidence that the introduction of the central counterparty for equities (CCP) had significantly improved the liquidity in the open order book and that CCP reduced total order execution costs to the benefit of investors. **John Lipsky** (JP Morgan Chase) considered the hope that such financial integration would ultimately support higher growth of potential output in the euro area. To shed more light on the outlook for Europe Lipsky drew on the experience of the U.S.A., for example, to assess what it would take for growth a securitized corporate debt market. Lipsky also emphasized the importance of a strong and reliable competition policy in Europe. **Claudio Borio** (Bank for International Settlements) provided an "outsider's perspective" on European financial integration and discussed whether the creation of the euro has added more ‚ballast' to its markets. He showed evidence that the euro has become more attractive to non-residents both in terms of bond issuance and deposits and that its creation has reduced intermediation costs in capital markets.

International Imbalances

The first segment on international imbalances, chaired by **Huw Pill** (European Central Bank), focused on the U.S. current account and implications for the euro area. **Ted Truman** (Institute for International Economics) argued that the US current account deficit was unsustainable, but that the extent and timing of its adjustment were uncertain. He stressed that the eventual adjustment would take place through a combination of substantial changes in exchange rates, a modest, largely endogenous slowing of US growth and hopefully some acceleration of domestic demand in the rest of the world. As to fiscal policy he urged the U.S. to address its fiscal imbalance,

but saw less cause for compensating fiscal action in the Euro area. Instead he indicated a major responsibility for the ECB in sustaining growth and stimulating demand. He emphasized that policy coordination could assist the adjustment process.

Carlo Monticelli (Ministero dell' Economia e delle Finanze) pointed out that there was uncertainty about the size of the required adjustment in the U.S.A. He added that the international community and the US could not afford the risk of a disorderly adjustment and emphasized the necessity that the adjustment should start as soon as possible and that there was scope for policy coordination. Michael Wickens instead argued that the current account composition is largely a problem not of the U.S. owns making. Rather he related its mirror image, the capital account surplus, to the demand for U.S.$ reserves by China and other Asian economies. **Joerg Kraemer** (Invesco) suspected that the US current account could increase further but that an orderly correction was likely. He stressed that the U.S. should reduce the deficit but did not expect any sharp euro appreciation, nor see any scope for policy coordination.

The second segment, chaired by **Ignazio Angeloni** (ECB), focused on the role of the exchange rate and monetary policy. **Takatoshi Ito** (University of Tokyo) reviewed the dismal performance of the Japanese economy in the last decade and evaluated the recent recovery and promising outlook for 2004. In particular he focused on Japanese exchange rate policy and the effectiveness of exchange rate intervention. He emphasized that interventions had kept the pace of yen appreciation moderate, that they had contributed to an expansion of monetary base and had stimulated the economy. **Charles Wyplosz** (GIIS, Geneva) focused on the role of the exchange rate in monetary policy design. While conventional wisdom of central bankers is not to try to influence the exchange rate, he argued that real world policymaking sometimes requires to address the exchange rate. **Joachim Fels** (Morgan Stanley) emphasized that the Fed could not conduct monetary policy for the US alone but needed to take the whole dollar zone into account. The same would hold for the ECB and the wider eurozone. **Thorsten Polleit** (Barclays Capital) reviewed the relationship between the real effective US exchange rate and the trade and budget deficits.

In his concluding remarks, Otmar Issing (European Central Bank) noted that a temporary current account deficit – or surplus – should be regarded as a natural phenomenon especially in an increasingly integrated world economy. More recently, however the US saving-investment gap has been largely matched by a fiscal deficit of similar size, thereby reviving the "twin deficit" debate of the 1980s. The U.S. current account deficit might become a matter of concern for the following three main reasons. First, protectionist pressures in the deficit country could result from persistent current account deficits – and, in particular, trade deficits. Second, the allocation of world savings might be inefficient. Third, there is the risk that an adjustment would take place in a disorderly fashion, with sudden disruptions in key financial markets and the global economy. The role of monetary policy in resolving international imbalances is to provide a stable environment in which structural reforms could develop their fullest potential. From a longer-term perspective, Issing considered the maintenance of price stability the best contribution monetary policy could make to strengthening economic growth, by keeping real interest rates low and confidence among consumers and firms high.

Günter Beck / Volker Wieland
(both Goethe University Frankfurt / CFS)

CFS*seminars*

The Discussion on the Accounting for Financial Instruments Continues

by Volker Thier, Partner at KPMG Deutsche Treuhand-Gesellschaft, Head of Financial Risk Management Germany

"FASB Statement 133 does not work. Those who prepare financial statements cannot figure out 133's labyrinth of detailed rules. Those who audit financial statements similarly are flummoxed by 133. Investors, who are supposed to benefit from the FASB work product, are mystified by the results of 133's application". This illustrative statement was used by Walter P. Schutze, former Chief Accountant of the SEC, as an introduction to an open letter addressed to the members of the Financial Accounting Standards Board. It is symptomatic for the continuing and intensive discussions, both in the US and Europe, on the accounting for financial instruments in general, and hedge accounting in particular as outlined in the FASB Statement 133 "Accounting for Derivatives Instruments and Hedging Activities".

The letter was triggered by the broad media coverage on the way the Federal National Mortgage Association (Fannie Mae) had applied FASB statement 133 in its financial statements. Since the respective supervisory bodies did not agree with the way in which the standard was interpreted, Fannie Mae had to retrospectively adjust its financial statements leading to an adverse effect on profit and loss of several billions. This initiated and revitalized a discussion in the press on the accounting and reporting for financial derivates. The discussion particularly covers those instruments, which, according to company records, are used to protect the companies against market price risks.

Accordingly, the discussion focuses regularly on the specific rules relating to hedge accounting, and the question, if these rules actually enable preparers of financial statements to achieve an improved concordance of the current risk management practices, the economic situation and the reflection of these factors in the financial statements.

Also in Europe, the discussion on the appropriate accounting for financial instruments has lately increased in intensity. It initially focused on practical problems in connection with the implementation of IAS 39 "Financial Instruments Recognition and Measurement" which is comparable to FAS 133. Lately, the current discussion with regard to the endorsement process of IAS 39 has once more initiated a more general debate on the soundness and practicability of the current framework and principles for the accounting for financial instruments. The IASB has already taken up criticism, particularly coming from the banking sector, and has introduced an amendment to IAS 39 (Fair Value Hedge Accounting for a Portfolio of Interest Rate Risk; March 2004) which enable companies to adopt a "macro hedging" type of approach to portfolios of interest-bearing assets and liabilities.

Although, according to users, these changes are aiming into the right direction, they are still not regarded as being sufficient to solve the difficulties which had been encountered in connection with the implementation of IAS 39. Even subsequent to these amendments, there is still a high level of complexity. The primary problem of profit and loss volatility resulting from the adoption of IAS 39 has been reduced, but not eliminated.

From a practical point of view, a Full Fair Value Approach as propagated by the Joint Working Group appears to provide an attractive solution for the above problems, since all financial instruments are valued at their market value and the changes in these market values being reflected in the same period in the profit and loss statement. As a result, synchronization of valuation effects from underlying transactions and derivative instruments used for hedging purposes should be achieved automatically. Following this logic, the IASB has introduced a further amendment to IAS 39 allowing for certain assets and liabilities to be carried at value with changes in fair value immediately being reflected through profit and loss (so-called "fair value option"). Upon purchase or acquisition, these assets and liabilities will be assigned to a specific category which will subsequently be carried at fair value.

However, once again the potential pitfalls for the users lie in the details. Respective discussions particularly address the reliability of fair value estimates of loans as well as the potential effects from carrying the company's own debt at fair value. The pure fact that a company would recognize a gain in case of a deterioration of its own credit rating might be correct from a mathematical perspective. However, to explain the economic sense behind this mechanic to the financial statement reader is expected to be challenging.

Following this continuing criticism, the EU in November 2004 has endorsed the main components of IAS 39 but has particularly exempted several areas from this endorsement. Thus, there are in effect two versions of IAS 39, the "original" and the so-called "carve out version" as endorsed by the EU. It is predictable that the urgently needed reduction in uncertainty amongst those preparing financial statements will not be achieved along these lines. Furthermore, there is cause for the concern that due to the focus on the accounting debate, the necessary discussion about meaningful ways on limitations and reductions of risks will not be pursued with the necessary intensity.

The CFS Seminar "Die Bilanzierung von Finanzinstrumenten nach HGB, IAS und US-GAAP" scheduled to take place on 17/18 November 2005 will be led by Volker Thier, Partner at KPMG Deutsche Treuhand-Gesellschaft and Head of Financial Risk Management Division, and Martin Glaum, Professor for International Management and Communication at the Justus-Liebig-Univeristy of Gießen. The aim of this seminar is to provide and transport practical knowledge about accounting and the evaluation of financial instruments according to the HGB (German Commercial Code), IFRS (International Financial Reporting Standards) and US-GAAP (Generally Accepted Accounting Principles). This encompasses in addition to providing an overview of the theories and methodologies underlying the respective accounting regulations the joint work on practical examples which will be subsequently discussed with the participants.

Axel A. Weber
From CFS Director to President of the Deutsche Bundesbank

Axel A. Weber has now been in office as President of the Deutsche Bundesbank and Member of the Governing Council of the European Central Bank since 30 April 2004. Previously Axel Weber was a Director at the Center for Financial Studies from 1998 to 2002 and a Member of the German Council of Economic Experts. He held a chair at the Goethe University of Frankfurt from 1998 to 2001 before moving to the University of Cologne. He gave his first public presentation in his capacity as Bundesbank President on 6 July 2004 as part of a CFS*key event*.

Axel A. Weber in the Press:

Handelsblatt: 21. Apr 2004, The surprise candidate – observers welcome the decision for Weber

Academics and bank economists let out a sigh of relief on Tuesday evening. The concern that the German government might nominate a compliant, politically conform candidate to head the Bundesbank was according to experts laid to rest by the decision taken in favor of the Cologne University professor for monetary policy, Axel A. Weber.... (...) Weber is regarded among central bank experts and economists as a first rate academic and a proven expert for monetary policy. (...)

Die ZEIT: 22. Apr 2004, The Agenda of the Head of the Bundesbank - Axel Weber to become new President of the Monetary Authority

The economics professor is refreshingly undogmatic. (...) This personnel decision by the German government is only logical; in selecting the 47 year old Weber, they have simply chosen the best. (...) The designated Bundesbank President has only one weak point. He is somewhat reserved and tends to be reticent about disclosing his opinion when dealing with issues unrelated to his field, which ranges from international financial markets through emerging markets to exchange rate theory. Thus, his aspiration to test economic policy demands empirically beforehand did not establish itself in his circle of colleagues from the German Council for Economic Experts.

Süddeutsche Zeitung: 24. Jun 2004, Better living without villas – in the long run the Bundesbank does not intend to maintain any significant real estate property

The new Bundesbank President Axel Weber is not having an easy time. Scarcely has he taken up office than he is confronted by the so-called villa affair (...). In the villa affair current and former top executives of the central bank are accused of living cheaply in the luxurious properties belonging to the Bundesbank. Weber made it clear that firstly it is a case of inherited burden whose elimination had already been initiated via the structural budget reform begun before his assumption of office, and secondly the majority of properties will be sold. (…)

Handelsblatt: 21. Jul 2004, Bundesbank Executive Board draws up a new code of conduct

(…) The Executive Board of the German Bundesbank has a new code of conduct. (…) The most important change to previous practice is that remuneration will no longer be accepted for lectures that are to be regarded as part of the main line of duties. In general it will be forbidden to accept favors. (…) It is also new that the official salaries of each member of the executive board are in future to be published in the Annual Report. (…)

dpa-AFX: 23. Sep 2004, Weber against political intervention in banking mergers

The Bundesbank President Axel Weber warned against public intervention in the further consolidation of the banking sector. "Public industrial policy is questionable as far as economic policy is concerned", said Weber (…). In his opinion, it would result in further intervention. Furthermore, publicly-induced mergers could indeed compromise the neutrality of public financial supervision. (…) The Bundesbank President also spoke out against the "credit factory" planned by the government and the KfW banking group as a means for improving the financing of small and medium-sized businesses, maintaining it was doubtful whether the supply of credit could be better regulated by public than by private institutions. (…)

Frankfurter Allgemeine Zeitung: 5. Oct 2004, Axel Weber warns against an erosion in the commitment to stability in Europe

(…) "We are currently observing an erosion in commitment to stability in the euro area. Serious efforts at consolidation are necessary if we are to put a hold on this trend" said Weber (…). The monetary policy authority recommended the German government to tighten its belt further with the aim of pushing the budget deficit to below 3% of GDP in the coming year "This can be done without endangering the economic upturn." (…)

Die Welt: 21. Dec 2004, - Only eight rather than 120 tons of gold sold - the Bundesbank heads for confrontation with Eichel

Contrary to expectations, the German Bundesbank will reduce its gold reserves by only a fraction over the next twelve months. (…) "The Executive Board does not see the necessity to make use of its sales option at this point in time", said the Bundesbank President Axel Weber in an interview with WELT. And incidentally selling off gold reserves should not be regarded as a substitute for an enduring consolidation strategy in fiscal policy. (…)

Börsenzeitung: 18. Jan 2005, Bundesbank abstains from the stock exchange location debate; Weber: Efficiency gains and liquidity are the deciding factors

For the Bundesbank, according to its President Axel Weber, the regional context of a financial system is no longer of paramount importance. (…)"The well understood national interest even of a large country is not sufficient reason for justifying discrimination between national and international service providers" (…) Thus for the Bundesbank, according to Weber, "unimpeded access for market participants to capital funds and their associated services is decisive" together with "the quality of services and the liquidity of the corresponding markets". (…)

Financial Times Deutschland: 31. Jan 2005, The Bundesbank criticizes development aid plans – Weber warns against new deficit financing

The Bundesbank President Axel Weber has criticized the German government's plans for increasing development aid on the basis of new financing measures. This must not be allowed to lead covertly to larger deficits in Germany, but rather should be openly included in the budget and correspondingly counter financed. (…) Conceivable options for reaching a balance could be to cut public expenditure in Germany or to impose an extraordinary domestic tax similar to the solidarity surcharge. (…)

Süddeutsche Zeitung: 31. Jan 2005, Weber calls for measures against weak dollar

Only a few days before the G7 Meeting, the Bundesbank President Axel Weber admonished all currency areas involved to take steps against the dollar's weakness. (…) Everyone must play their part in reducing global inequalities "The dollar rate can contribute to this process, but the adjustment certainly cannot only be made via movements in relative prices" said the ECB Governing Council Member Weber. The USA must increase savings and Europe must strengthen its growth potential via reforms. (…)

Frankfurter Rundschau: 19. Feb 2005, Interest Rates/Head of the Bundesbank sees no need for action

The European Central Bank (ECB), according to the Bundesbank President Axel Weber, must keep an eye on the threat of inflation, but does not yet need to take action by raising interest rates. (…) "We must, however, remain vigilant in case additional shocks occur such as exchange rate movements or an increase in the price of oil." In the face of an increase in money supply growth the long-run risk of inflation has risen. (…)

Dow Jones Newswire: 23. Feb 2005, Weber calls for a reform of corporate taxation

The Bundesbank President Axel Weber has spoken out in favor of a quick reform course for corporate and investment income tax as a stimulus to the domestic economy. Only if firms are prepared to invest on a bigger scale again in Germany as a business center will it be possible to create any impetus for boosting growth (…).

"European Financial Market Integration"

On Tuesday, July 6, 2004, Axel A. Weber gave his first major public speech as President of the German Bundesbank on the topic of "European Financial Integration" (Europaeische Finanzmarktintegration). This lecture was only the third in the series of CFS*key events*. The two previous CFS*key events* speakers were Jean-Claude Trichet and Alan Greenspan. In his laudatory speech introducing Axel A. Weber, CFS Director Volker Wieland mentioned three personal attributes likely to serve Weber well in his role as President of the Bundesbank, that is, his internationality, his intellectual independence and his excellent communication abilities.

Axel A. Weber started his lecture by emphasizing the importance of financial market integration on growth and stability. He stressed that goods market integration often leads to financial market integration, and that historical events like the introduction of the euro or international agreements like the Basle II accord have marked significant progress in the integration of international financial markets. He pointed out that a higher degree of integration among capital markets has a positive growth impact as it leads, amongst other things, to a better allocation of capital, more competition, increased liquidity and positive network externalities. However, greater integration also has significant consequences for the conduct of monetary policy. It leads to a change in the transmission of monetary policy since the more market-based transmission channel becomes more important. In addition, both positive and negative effects on the stability of the financial system can be observed. On the positive side, it is the case that more liquid markets areceteris paribus more stable. On the other hand, the dangers of contagion are greater across more integrated markets.

In the second part of his speech, Weber presented several indicators that are used to measure the integration of financial markets. He pointed out that inference on the integration of capital markets is based not only on price, information and quantity measures, but that comparisons of transaction costs are also used. These indicators depict the following situation regarding the degree of financial integration across European countries. The money and swap markets are relatively well integrated (even though differences for collateralized money market instruments are still significant). European markets for government and corporate bonds appear to be relatively well integrated. Integration of equity markets has also made considerable progress, however significant segmentations still exist. The same holds true for credit markets, where differences are even more pronounced.

Weber devoted the next section of his lecture to the topics of supervision and regulation. He stressed that the integration of supervision and regulation has made considerable progress in recent years. He pointed out that the Basle II accord has been successfully concluded. Furthermore, the EU Financial Services Action Plan (FSAP) is close to being implemented. The cooperation of national supervision has also made progress. On 5 November 2003, the European Commission adopted a decision establishing the Committee of European Banking Supervisors (CEBS). This decision came into force on 1 January 2004, and the first meeting of the new Committee was held on 29 January. In addition, the International Accounting Standards (IAS) will probably be passed in the near future.

Weber then turned to the role of the Bundesbank in the context of the topic under consideration. He pointed out that the development of financial markets has gained increasing importance for the conduct of monetary policy. Furthermore, financial markets have become more important for economic development and financial stability. Insuring the stability of financial markets is one of the major tasks of a central bank. Weber pointed out that the task of the Bundesbank was to put more emphasis on financial indicators in monetary policy analysis, improve the analysis of financial markets and contribute to the public discussion of this topic (e.g. by publishing an annual stability report).

The last section of the speech focused on an analysis of the German financial markets. Weber stressed that German capital markets are still bank-dominated. However, there is an increasing trend to a more capital market based system. The Bundesbank takes a neutral position in this process. It supports any market-driven development, but still aims to ensure the observance of stability aspects.

Weber concluded his speech by emphasizing that the process of financial integration must not be forced or allowed to slow down. He also stressed that the most important contribution of the European System of Central Banks (ESCB) to financial integration and stability was to ensure price stability and confidence by pursuing credible and transparent monetary policies.

Günter Beck (Goethe University Frankfurt)

Interview with Axel A. Weber President of the Deutsche Bundesbank

Question: *As President of the Deutsche Bundesbank, what do you expect from theoretically based policy advice at the point where monetary policy and the financial system intersect?*
Answer: It is precisely the point where monetary policy and the financial system intersect that we need empirically based research on the interplay of real and financial variables. There are three key areas where I would like to see robust models. Firstly, there is the issue of market liquidity. Given the structural changes brought about by the euro and advancing financial integration, we need models that can give a better explanation the role of liquidity in maintaining monetary and financial stability (asset prices) in the changed environment. For this, we must try to combine monetary and real economic models. Secondly, we need to keep a close eye on the monetary policy transmission channels. Developments on the financial markets are likely to alter the channels for transmitting monetary policy impulses, ultimately making them faster but also more volatile. Thirdly, I think there is a need for manageable indicators of risks to financial stability. Recent financial crises were triggered by specific and complex factors, but we still have to uphold the requirement that they are fundamentally and sufficiently explicable and, to that end, improve the existing models.

Question: *What do you consider to be the greatest challenge in your role as President of the Bundesbank?*
Answer: Internally, the greatest challenge is to restructure the Bank into a lean, dynamic institution that focuses on it core competencies. In doing so, however, we want to cut costs and streamline the Bank's structures without impairing the motivation of the people who work there. At the same time, we have to ensure that the Bank is more geared towards the increased importance of the financial markets and financial stability in relation to monetary policy, and as an autonomous task. I perceive the expansion of financial market analysis and the Bank's involvement in maintaining financial stability to be an external area of growth. The main challenge will be carrying out both tasks simultaneously.

Question: *What do you consider to be the greatest challenge for our society over the next two years?*
Answer: Even more so than other euro-area countries, Germany, not least for demographic reasons, is facing the challenge of overhauling the incentives structure of its social security system. This also means redefining the role of the Government. Restructuring is needed for bringing the costs of the social security system back down to a reasonable level. This has to be tackled as soon as possible because any further delay will push up the costs. The actual challenge in this regard will be the social acceptability of these changes. We have to put across the message that a society which relies more on private provision and competition does not necessarily have to be lacking in solidarity or deliberately burdening the poor, but does definitely provide opportunities for economic development. In this context, I would like to see a clearer identification of the cases of redistribution at the expense of weaker members of society which are implicit in the present system. As the most important of these, I would like to cite the current high level of unemployment which is also due to the high gross/net differential of wages.

Examples of Weber's legacy at the Center for Financial Studies:

The ECB and Its Watchers

In January 1999, the Euro was introduced as the new currency of eleven European countries. Since then, one central institution - the European Central Bank – has conducted monetary policy for this heterogeneous group of countries. At the start of European monetary union, the ECB faced the task of establishing its reputation for sound monetary policy aimed at maintaining price stability. Key factors for such reputation-building include the transparency of monetary policymaking and the accountability of policymakers. The ECB had to develop its own approach for communicating its actions and policy choices to the public. In this context it was vital for the ECB to engage in an active and often critical debate with academics and market participants about the design of monetary policy.

In 1999 Weber established "The ECB and its Watchers conference series" at the Center for Financial Studies in close cooperation with Otmar Issing from the European Central Bank. This conference formed a unique forum for bringing together central bank critics and central bank decision makers for an open, unscripted and public exchange of opinion.

The first ECB and its Watchers conference was opened by Ignazio Angeloni, Vítor Gaspar and Oreste Tristani (all ECB), who presented a detailed account of the ECB's monetary policy strategy. This was followed by presentations of the three main academic monitoring initiatives, the Centre for Economic Policy Research (CEPR) rep-

resented by David Begg (Birkbeck College, University of London and CEPR), the Center for European Integration Studies (ZEI) represented by Jürgen von Hagen (ZEI, University of Bonn) and the Centre for European Policy Studies (CEPS) represented by Daniel Gros (CEPS) and Thomas Mayer (at that time Goldman Sachs and CEPS). As independent academic observers Lars Svensson (Stockholm University) and John Taylor (Stanford), among others, were invited to comment on the ECB's policy strategy. Issing (ECB) then responded to the criticism and proposals of the ECB watchers.

Over the last six years the ECB and its Watchers conference has become a regular event focusing on topics such as the "ECB's Monetary Policy Strategy", the "International Role of the Euro", the "Transformation of Financial Markets in Europe", the "Price Stability and Macro Adjustment in the European Monetary Union", the "EU Enlargement", and the "European Financial Integration". Since 2004 the conference has been organized by Volker Wieland as Weber's successor.

In 2005 the need for the type of interaction among policymakers, academics and market participants that takes place at the ECB and its Watchers conference remains as vital for an effective monetary policy as it was in 1999. This year's conference will take place on June 3, 2005. On its agenda are panels entitled the "ECB Watchers: Academic and Market Perspectives", "Monetary and Fiscal Policy: Political Economy of the Stability and Growth Pact" and "Monetary Policy and Central Bank Communication". Among the speakers will be Otmar Issing (European Central Bank), Lawrence Meyer (Former Governor of the Federal Reserve), Caio Koch-Weser (German Federal Ministry of Finance), Michael Deppler (International Monetary Fund), Lucas Papademos (European Central Bank), Lars Svensson (Princeton University), Jürgen von Hagen (Bonn), Daniel Gros (CEPS), Richard Clarida (Columbia University and Clinton Group), David Walton (Goldman Sachs), Thomas Mayer (Deutsche Bank), Vincent Reinhart (Federal Reserve Board) and Willem Buiter (EBRD).

For more information please visit our website: www.ifk-cfs.de

International Research Forum on Monetary Policy

In July 2002 the "International Research Forum on Monetary Policy" was established as a new transatlantic dialogue, sponsored by the European Central Bank (ECB), the Board of Governors of the Federal Reserve System, the Center for German and European Studies (CGES) at Georgetown University, and the Center for Financial Studies (CFS). The organizers were Ignazio Angeloni, Matthew Canzoneri, Dale Henderson and Axel A. Weber. The purpose of the series is to encourage research on monetary policy issues that are relevant from a global perspective. The Forum meets regularly at locations alternating between the euro area and the United States, i.e. in 2002 it was organized by the ECB, in 2003 by the Federal Reserve Board. Among the keynote speakers have been Willem Duisenberg (Former President of the European Central Bank), and Alan Greenspan (Board of Governors of the Federal Reserve System).

The next International Research Forum on Monetary Policy will be held at the European Central Bank on May 20 to 21, 2005. The Forum will address topics such as "Monetary and Fiscal Interactions", "Model Uncertainty and Learning", and "Operational Monetary Policy Rules".

For more information please visit our website: www.ifk-cfs.de. Attendance is by invitation only.

Joint Lunchtime Seminar Series

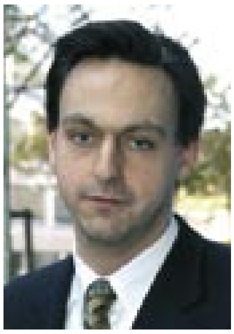
The "Joint Lunchtime Seminars" are a series of weekly research lectures inviting academics from other institutions to present their research in the fields of Monetary Economics, Macroeconomics, Finance and Econometrics. The speakers comprise both established senior researchers as well as those at the assistant and associate level from all over Europe and the United States.

Originally started in January 2001 and organized by Frank Smets (ECB), Heinz Hermann (Deutsche Bundesbank) and Axel A. Weber (then Goethe University Frankfurt and CFS), the weekly presentations have become a fixed entry in the diary of many members of the research and central bank institutions located in Frankfurt. As a result, seminars are usually accompanied by lively debates and subsequent discussions.

For more information see page 19 of this newsletter.

Roberto Mario Billi joined the Center for Financial Studies (CFS) in February 2004 as a researcher in the Money and Macroeconomics area. In August 2001 he enrolled as a Ph.D. candidate at Goethe University Frankfurt, working as research assistant to Prof. Volker Wieland. He previously graduated with a Master in Economics from the London School of Economics. His fields of expertise are Dynamic Macroeconomics and Monetary Economics, Computational Economics and International Finance. In particular, he focuses on the design of optimal monetary policy in forward-looking models with an occasionally binding zero lower bound on nominal interest rates. In Summer 2004 he was invited as a dissertation intern with the Division of Monetary Affairs at the Board of Governors of the Federal Reserve System, and since Spring 2005 he is a research visitor with the Directorate General Research of the European Central Bank. Further information about Roberto's research is available on his personal homepage: www.rmbilli.com

Elena Carletti joined the CFS in April 2004 as a post-doctoral researcher in the area of "Financial Intermediation". Her previous positions include that of assistant professor at the chair of Professor Marting Hellwig at Mannheim University, and that of Tutorial Fellow in Finance at the London School of Economics. She holds a Ph.D. in Economics from the London School of Economics, a Doctorate in Economics from University of Bologna, and a Master in Economics from Bocconi University in Milan.
Elena's research interests are in the areas of banking, financial stability, industrial organization and competition policy. Currently, she is working on the number of bank relationships, the relationship between competition and stability in banking, bank consolidation, and the implications of the structure of policy institutions for the efficiency and stability of credit markets. Her work is published in the Journal of Financial Intermediation.Further information about Elena's research is available at www.elenacarletti.com.



Marcus Pramor has been a member of the research team at the CFS since December 2003. Prior to joining the CFS as a Ph.D. candidate, he had spent three years in the Risk Management Division of Goldman Sachs in London and Frankfurt, where he evaluated the credit risk resulting from derivative transactions and advised corporate clients on their credit ratings. Marcus holds a B.Sc. in Economics from the London School of Economics (LSE) and an M.Sc. in Economics from the Universitat Pompeu Fabra in Barcelona. He serves as a coordinator of the new CFS program area "Financial Markets" that is headed jointly by Jan Pieter Krahnen and Volker Wieland.

Julia Le Blanc joined the research team at the CFS in March 2005. In November 2003, Julia enrolled as a Ph.D. candidate in the "Graduate Program in Finance and Monetary Economics" at Goethe University Frankfurt. Previously, Julia completed a Master of Science in Economics from the Universitat Pompeu Fabra in Barcelona and holds a Master of Science in Economics and Management from Humboldt University in Berlin. Before joining the CFS, she worked several months as a Research Analyst in the Monetary Policy Research Division of the European Central Bank. At the CFS, Julia will be working in the Money and Macroeconomics area which is headed by Volker Wieland.

CFS*colloquium series*

„Basel II und die Konsequenzen für das Risikomanagement / Basel II and its Impact on Risk Management“

May 11, 05 — Fully booked — Risiken im Finanzsystem: Herausforderungen für Bankenaufsicht und Notenbank
Dr. h.c. Edgar Meister (Mitglied des Vorstands, Deutsche Bundesbank)

Jun 8, 05 — Operationale Risiken: Neue Methoden und Managementtechniken (Arbeitstitel)
Prof. Dr. Clemens Börsig (Mitglied des Vorstands, Deutsche Bank AG)

Jul 6, 05 — Basel II und danach
Helmut Bauer (Erster Direktor Bankenaufsicht, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin))

Oct 10, 05 — What Senior Bank Management needs to understand about Risk: The Challenges of Basel II and Sabanes-Oxley
Howard Davies (Director, The London School of Economics and Political Science (LSE))

Admission to the lectures of the CFScolloquium is only possible after registration. Interested parties who do not receive Email information regularly may contact Birgit Pässler, Tel. +49 (0)69-242941-14 or Email: paessler@ifk-cfs.de

CFS*seminars*

Jun 23. - 25., 05 — *Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement* (3 days)
Prof. Dr. Günter Franke, Universität Konstanz
Prof. Dr. Dirk J. F. Nonnenmacher, DZ BANK AG

Sep 8./9. & Sep 29./30., 05 — *Finanzökonometrie und Prognosemodelle I: Statistische Grundlagen* (4 days)
Prof. Dr. Walter Krämer, Universität Dortmund

Oct 20./21. & Nov 3./4., 05 — *Zinsprodukte: Analyse und Bewertung* (4 days)
Prof. Dr. Wolfgang Bühler, Universität Mannheim
Prof. Dr. Wolfgang Schmidt, Hochschule für Bankwirtschaft

Nov 17./18., 05 — *Bilanzierung von Finanzinstrumenten nach HGB, IAS und US-GAAP* (2 days)
Prof. Dr. Martin Glaum, Universität Gießen
Volker Thier, KPMG

Nov 24 - 26., 05 — *Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement* (3 days)
Prof. Dr. Günter Franke, Universität Konstanz
Prof. Dr. Dirk J. F. Nonnenmacher, DZ BANK AG

For further information and registration on all CFSseminars please contact Birgit Pässler, Tel.: +49-(0)69-242941-14, Fax: +49-(0)69-24941-77, email: paessler@ifk-cfs.de

CFS*research conferences*

May 20/21, 05 — *International Research Forum on Monetary Policy in Frankfurt*
Organization: Ignazio Angeloni (ECB), Matthew Canzoneri (Center for German and European Studies at Georgetown University), Dale Henderson (The Federal Reserve Board) Volker Wieland (Goethe University Frankfurt and CFS)

May 23/24, 05 — *International Conference on Competition, Stability and Integration in European Banking in Brussels*
Organization: ECB/CFS/CEPR

June 3, 05 — *The ECB and Its Watchers VII in Frankfurt*
Organization: Volker Wieland (Goethe University Frankfurt and CFS)

June 10-11, 05 — *Risk Transfer between (Re-)Insurers, Banks and Markets in Frankfurt*
Organization: Christian Laux (Goethe University Frankfurt and CFS), Achim Wambach(Universität Erlangen-Nürnberg and CFS)

June 15, 05 — *Fair Valuations – Moderne Grundsätze zur Durchführung von Unternehmensbewertungen*
Organization: Schutzgemeinschaft der Kapitalanleger e.V., CFS, Die Aktiengesellschaft – Zeitschrift für das gesamte Aktienwesen

Aug 15-22, 05 — *Summer School Monetary Economics at the Training Centre of Deutsche Bundesbank in Eltville*
Organization: Volker Wieland (Goethe University Frankfurt and CFS)

Aug 15-22, 05 — *Summer School Finance at the Training Centre of Deutsche Bundesbank in Eltville*
Organization: Jan Krahnen (Goethe University Frankfurt and CFS)

Oct 06, 05 — *CFSsymposium of the Deutsche Bank Prize in Financial Economics in Frankfurt*
Organization: Goethe University Frankfurt and CFS

Oct 13/14, 05 — *New Perspectives on Fiscal Sustainability in Frankfurt*
Organization: ECB, ZEI, Volker Wieland (Goethe University Frankfurt and CFS), Ludger Schuknecht (ECB), Jürgen von Hagen (ZEI)

For further information and registration please consult www.ifk-cfs.de.

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