CENTER OF EXCELLENCE SAFE
Sustainable Architecture for Finance in Europe

# Newsletter

AT THE HOUSE OF FINANCE

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# About SAFE

The Center of Excellence SAFE – "Sustainable Architecture for Finance in Europe" – is a cooperation of the Center for Financial Studies and Goethe University Frankfurt. It is funded by the LOEWE initiative of the State of Hessen (Landes-Offensive zur Entwicklung wissenschaftlich-ökonomischer Exzellenz). SAFE brings together more than 40 professors and just as many junior researchers who are all dedicated to conducting research in support of a sustainable financial architecture. The Center has two main pillars: excellent research on all important topics related to finance; and policy advice, including the dissemination of relevant research findings to European decision makers from the realms of politics, regulation and administration.

In order to promote a fruitful exchange with interested parties from politics, academia, business and the media, SAFE issues a newsletter on a quarterly basis. This aims to provide an overview of the Center's ongoing research and policy activities. The SAFE Newsletter succeeds the House of Finance Newsletter, which was published between 2009 and 2012.

SAFE is based at Goethe University's House of Finance, however extends beyond by drawing on scholars from other parts of Goethe University as well as from fellow research institutions. The Center builds on the reputation of the House of Finance institutions, serving as an interdisciplinary think tank on the issue of finance.

## Content



# Editorial

Uwe Walz
Director
Center of Excellence SAFE

Almost a year has passed since we launched SAFE in January 2013. One issue that has kept us busy from the beginning was the search for outstanding, highly motivated researchers to fill our new positions: six professorships, six junior professorships, nine post-doc positions and numerous research assistant jobs. We have been very active in the international academic job market, which is not only an important new step for SAFE but also for the internationalization process within Goethe University's Faculty of Economics and Business Administration. And one thing has made this search even more challenging: as part of the SAFE concept, the new professors should each build a bridge between their different areas of research in order to overcome traditional boundaries and, thus, to secure our comprehensive research approach.

By now, we have succeeded in filling all of the junior positions as well as four of the six professorships (with the sixth having only been advertised during the summer). It speaks for the SAFE concept, the reputation of Goethe University and the House of Finance as well as for the attractiveness of the location Frankfurt that we were able to win some internationally experienced, highly talented and promising new colleagues to join the SAFE faculty.

Already in October Loriana Pelizzon took over the SAFE Professorship for Law and Finance and also the SAFE research lab on systemic risk as a Program Director. Coming from the University of Venice, Loriana has largely dedicated herself to issues related to the financial crisis, such as systemic risks, risk management, credit derivatives and risks, or contagion. Since the beginning of December, we have had Christine Zulehner on board, holding the SAFE Professorship for Industrial Organization and Financial Markets. Christine, who joins us from the University of Linz, conducts research in the area of industrial and competition economics that is focused on the strategic behavior of market players in oligopolies or auctions (see page 12). And we are looking forward to welcoming Rüdiger Bachmann in April 2014. Rüdiger, who is currently at the RWTH Aachen University, will be taking over the SAFE Professorship for Behavioral Economics and Finance. His research in microeconomics focuses on the behavior of heterogeneous agents, and the implications of uncertainty and expectations formation for macroeconomic outcomes.

Beyond these three, Tobias Tröger, Professor of Law (Chair of Private Law, Trade and Business Law, and Jurisprudence) at Goethe University since 2011, joined the SAFE team in October. With a special focus on corporate finance, banking law and contract law, Tobias' research is strengthening the important link between law and finance within SAFE.

For more information on our new junior researchers, please visit the SAFE website – and have a look at page 6 of this newsletter where Nathanael Vellekoop, who joined us as Junior Professor in August from the University of Tilburg, provides an outline of his recent work on risk and religion.

I hope that you will enjoy reading this issue of the SAFE Newsletter.
Yours sincerely,
Uwe Walz

# Rational Inattention and Business Cycles

Mirko Wiederholt
Goethe University

**The United States and Europe have recently experienced major recessions. These recessions have forcefully reminded us how important it is to understand business cycles. Which shocks cause recessions? How are these shocks propagated through the economy? What are the right policy responses?**

The conventional view of business cycles is one where all agents process perfectly all available information at each point in time. Both the Real Business Cycle theory and the New Keynesian theory share this perspective. In recent years, my co-authors and I have developed an alternative view of business cycles, building on the work on rational inattention by Christopher A. Sims (2003). Under this new view, agents have a limited ability to process information, and they decide which features of the economy to pay attention to and which features of the economy to ignore. In our existing work, we show that this new view can explain important aspects of how shocks are propagated through the economy.

### Optimal Sticky Prices under Rational Inattention

In the article "Optimal Sticky Prices under Rational Inattention", we study price setting by firms when decision-makers in firms have limited attention and allocate their attention optimally. Following Sims (2003), we model the limited attention of an agent as a constraint on the total amount of information that the agent can process. Subject to this constraint, agents decide which information they process. Since idiosyncratic conditions are more volatile than aggregate conditions, price setters choose to pay more attention to idiosyncratic conditions than to aggregate conditions. As a result, prices respond quickly to idiosyncratic shocks, but slowly to aggregate shocks. This can explain the combination of micro and macro evidence on prices that, on the one hand, individual prices change frequently and by large amounts, and on the other hand, the aggregate price level responds slowly to monetary policy shocks. We show that this model can generate strong and persistent real effects of monetary policy shocks, even though prices respond very quickly to idiosyncratic shocks.

### Business Cycle Dynamics under Rational Inattention

In the paper "Business Cycle Dynamics under Rational Inattention", we develop and solve a dynamic stochastic general equilibrium (DSGE) model with rational inattention. Households and decision-makers in firms have limited attention and allocate their attention optimally. Rational inattention is the only source of slow adjustment. In contrast, in the conventional DSGE models currently used for the analysis of monetary policy, there are multiple sources of slow adjustment (e.g. Calvo price stickiness, habit formation in consumption, Calvo wage stickiness). Nevertheless, we find that the rational inattention DSGE model matches macroeconomic data about as well as the conventional DSGE models. This finding is important because one of the main arguments in favor of the conventional DSGE models has been their success in matching data.

In addition, we find that the rational inattention DSGE model yields very different counterfactuals than the conventional DSGE models. Therefore, it matters which model one uses for policy analysis. It matters for policy whether slow propagation of shocks is due to rational inattention by decision-makers or various forms of adjustment costs (as in the conventional DSGE models). For example, if times become more turbulent, the rational inattention DSGE model predicts that agents will pay more attention to the aggregate economy and thus the propagation of shocks will change, whereas the conventional DSGE models predict that the propagation of shocks will not change. Thus, the models yield very different conclusions about the effects of monetary and fiscal policy in turbulent times.

### Exogenous Information, Endogenous Information, and Optimal Monetary Policy

In the article "Exogenous Information, Endogenous Information, and Optimal Monetary Policy", we study optimal monetary policy when decision-makers in firms can choose how much attention they devote to the aggregate economy. When decision-makers in firms devote a fixed amount of attention to the aggregate economy, complete price stabilization is optimal only in response to shocks that cause efficient fluctuations under perfect information and flexible prices. In contrast, when agents in firms can choose how much attention they devote to the aggregate economy, complete price stabilization is optimal also in response to shocks that cause inefficient fluctuations under perfect information and flexible prices. Hence, recognizing that decision-makers in firms can choose how much attention they devote to the aggregate economy has major implications for optimal monetary policy. The optimality of complete price level stabilization becomes a much more general result.

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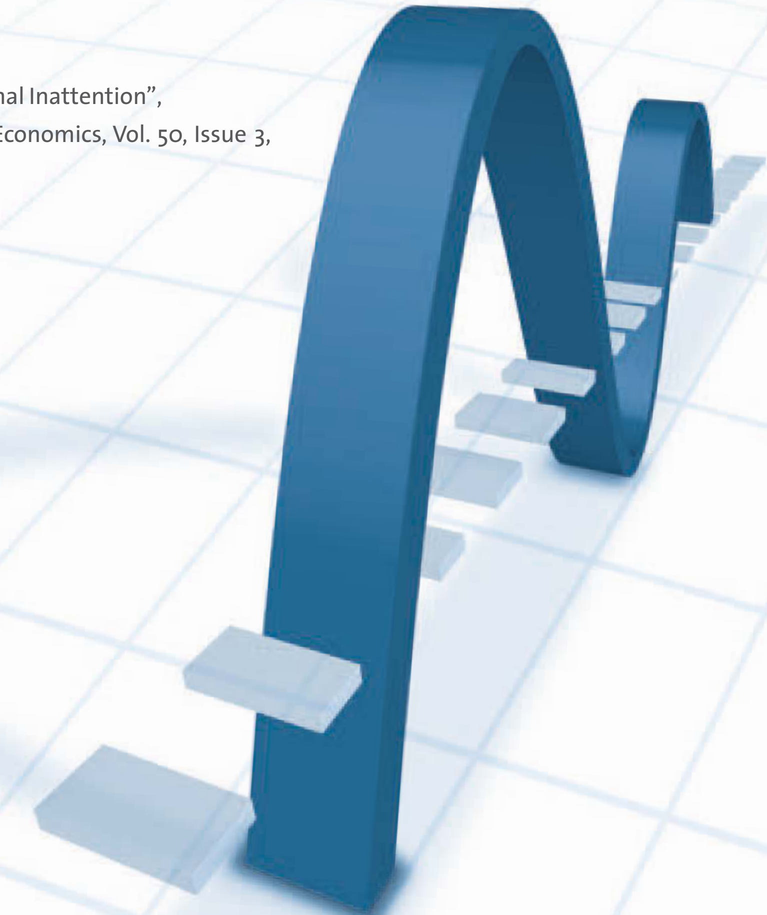

# Risk Aversion and Religion


Charles Noussair
Tilburg University

Stefan Trautmann
Tilburg University

Gijs van de Kuilen
Tilburg University

Nathanael Vellekoop
Goethe University and SAFE


We study how financial risk and religion are correlated. We find strong confirmatory evidence that more religious people, as measured by church membership or attendance, are more risk averse with regard to financial risks. Furthermore, we obtain some evidence that Protestants are more risk averse than Catholics in this respect. Finally, our data suggest that the link between risk aversion and religion is driven by the social aspects of church membership, rather than by religious beliefs themselves.

Recent research has revealed some strong relationships between religion and economic behavior. Measures of religiosity and religious affiliation exhibit correlations with investment and managerial decisions, organizational behavior, and financial market outcomes (Hillary and Hui, 2009). These studies provide a microeconomic foundation for macroeconomic cross-country research that finds evidence of an important role of religion in economic development and institutional structure. One potential mechanism that could generate a relationship between religion and economic behavior is a correlation between religious belief, or practice, and risk attitudes. Identifying the nature of this connection might clarify the link between religion and financial market behavior. The results with respect to differences in risk aversion between Christian denominations are mixed. Some find that Protestants are more risk averse, and that Protestants make safer financial investments than Catholics, while others observe the opposite.

In this study, we report new evidence of a relationship between religion and risk aversion in a demographically representative sample of the Dutch population. Our work differs from previous studies in two main respects. First, our data provide the first evidence for a link between an incentivized risk aversion measure and church membership at the individual level. Second, apart from a person's church membership, we also have access to an extensive set of variables concerning religious background and practice.

### Survey and lottery evidence from The Netherlands

In a previous study (Noussair et al., forthcoming) risk attitudes were measured by playing a lottery with real payoffs under the Longitudinal Internet Studies for the Social Sciences (LISS) panel, a representative sample of the Dutch population. Each participant chose, in five trials, between a lottery that paid €65 or €5 with equal probability and thus had an expected value of €35, and a sure payoff that differed with each trial (see Figure 1). The sure payoff varied from €20 to €40 in steps of €5. Our measure of individual risk aversion is the number of instances in which a subject chose the sure payoff. A risk neutral agent would make either one or two safe choices out of the five choices, and more than two safe choices would indicate risk aversion. In one case, the lottery was played for real cash and the subjects had a chance of getting paid while, in another case, the payoffs were hypothetical.

Next to an incentivized risk measure, we have a rich set of data on religious behavior and beliefs. These include parents' church membership, own and parents' church attendance, own and parents' denomination, own frequency of prayer, and own specific religious beliefs in God and core Christian theological concepts. Using our measure of aversion to financial risk, we test whether there are differences in risk aversion between church members and non-members, as well as between Protestants and Catholics. We also study the role of parental religious activity, religious beliefs, prayer, and church attendance as correlates of risk attitudes.

We have three main findings. First, we confirm the previously obtained result that religious people, as measured by church membership or attendance, are more risk averse. We document the new finding that risk aversion correlates strongly with current religiosity, and only weakly, if at all, with whether one had a religious upbringing. This either suggests that relatively risk-tolerant individuals opt out of the church, or that leaving the church makes one less risk averse. It is tempting to speculate that, as religious membership has been declining in Europe over the last few decades, there may also have been a corresponding decline in the degree of risk aversion of the average individual. This could be the case as either a cause or as a consequence (or both) of the decline in religious affiliation. In our view, this is an interesting line of inquiry for future research to consider.

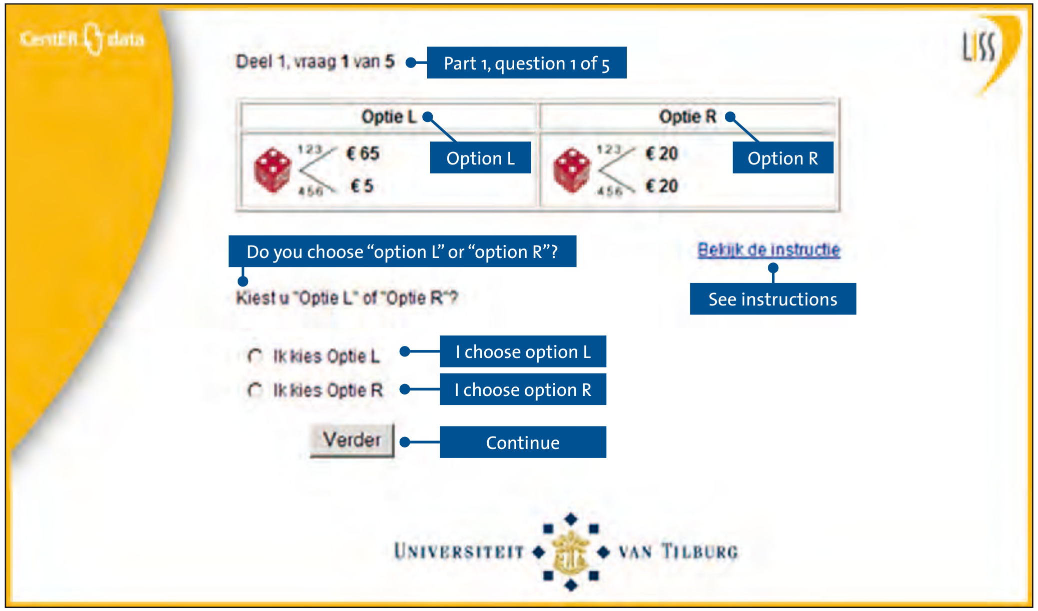


**Figure 1:** Lottery question to measure risk attitudes

### Catholics and Protestants are not so different (in their risk attitudes)

Second, we obtain some evidence that there are differences in risk aversion between major Christian denominations. Our data suggest that Protestants are more risk averse than Catholics when risk attitudes are measured with a real cash payoff gamble. However, this result may not be that robust as we observe that, for hypothetical decisions, Catholics are sometimes more risk averse under some specifications. These findings do reconcile some previous results, as they suggest that Protestants might not be more risk averse than Catholics, but are rather more averse to lotteries where the risks are positively skewed; a feature of many types of gambling that Protestant churches discourage (see Kumar et al., 2011).

Third, our data suggest that the link between risk aversion and religion is driven by social aspects of church membership, rather than by beliefs in religious teachings. We find clear evidence of active religious practice, i.e. church attendance and prayer outside church, correlating with greater risk aversion. These activities are likely to expose the individual to the specific doctrine and institutions of his/her church, which is not the case for those individuals who are strong believers, but practice their faith mostly in private. We also show that religious activities and church membership have a different impact on risk aversion than membership in other social organizations that may potentially serve as risk-sharing institutions. That is, religious groups and organizations are likely to socialize their members according to certain doctrines that relate to risk aversion, or as discussed above, avoidance of gambling and skewed risks.

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# The European System of Financial Supervision – Stillborn or About to Grow Out of the Cradle?

Jens Gal
Goethe University & ICIR

The establishment of the European (Financial) Supervisory Authorities (ESAs) represents a new peak in the process of agencification of the administration of the European Union (EU). The European legislator has granted the newly founded ESAs numerous far-reaching powers in relation to national supervisory authorities and market participants. In this regard, the question arises if the European Union was duly empowered by primary law to found these supervisory authorities. It has, hitherto, also remained unclear if the extent of the powers entrusted to them is in conformity with other founding principles of European primary law and the case law of the European Court of Justice (ECJ).

Since 2011 the European Union has been endowed with a new framework for the supervision of the financial sector. The newly created European System of Financial Supervision (ESFS) rests on two pillars: on the one hand, the pillar of macro-prudential supervision represented by the European Systemic Risk Board (ESRB) and, on the other, the pillar of micro-prudential supervision. Concerning the latter pillar, the ESFS is subdivided into three independent ESAs and a joint committee. The three ESAs being the European Banking Authority (EBA) based in London, the European Securities and Markets Authority (ESMA) in Paris and the European Insurance and Occupational Pensions Authority (EIOPA) established in Frankfurt. These ESAs, however, form but the upper level of the European micro-prudential supervisory system. Responsibility for the day-to-day supervision of the financial markets will remain vested in the national supervisory authorities.

The newly founded ESAs remain, to most intents and purposes, the “supervisors of the supervisors”. This should, however, not obscure the fact that all ESAs have been entrusted with tasks and granted powers vis-à-vis the national supervisory authorities and, in some instances, even vis-à-vis market participants, that have resulted in an unprecedented shift in power in the field of financial supervision from the national to the European level. At the same time, the ESAs have been granted powers that were hitherto thought to be vested in the European Commission, thereby resulting in a second shift in power at the European level itself. The European Commission has seemed quite inclined not to accept such a transfer of

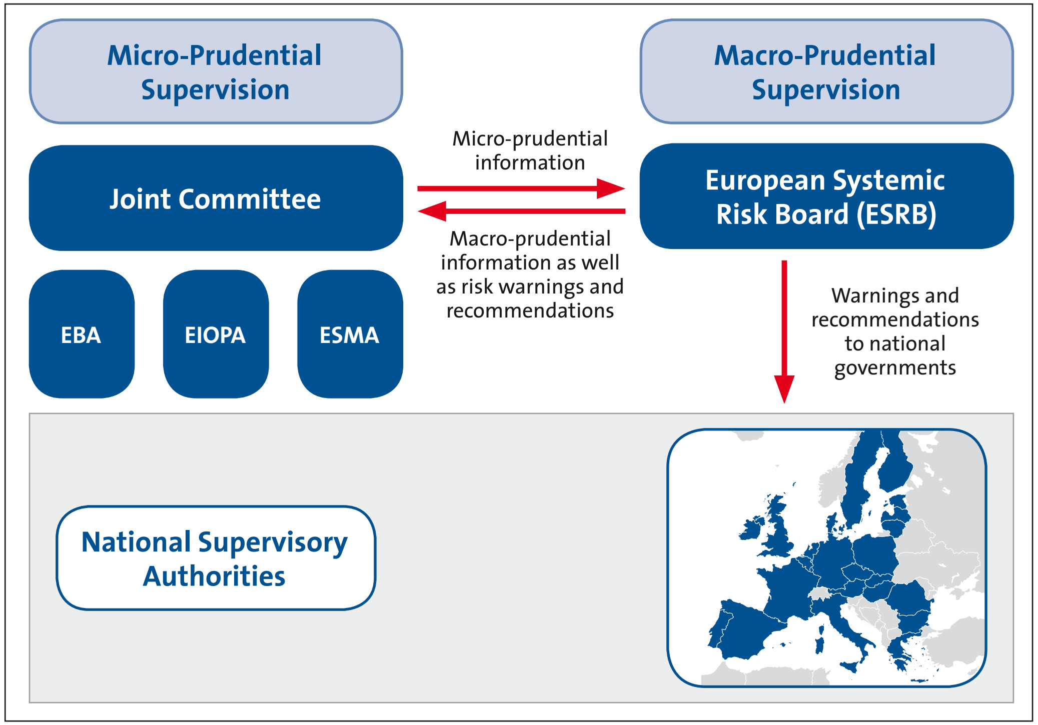


**Figure 1:** Architecture of the European System of Financial Supervision

power to its detriment, and some Member States have also followed suit. In the so-called "ESMA case", the United Kingdom has instituted legal proceedings against the transferral of certain powers to ESMA on the grounds that such a transferral would violate principles of primary law.

**Meroni revisited**

The discussion raised by this case, which is still before the European Court of Justice (ECJ), is on the European delegation issue, i.e. the legal requirements which must be met for a transferral of specific powers to specific actors. Unfortunately, this discussion is very often complicated by too strict an adherence to the letter of the leading case law by the ECJ. In the two "Meroni" decisions of 1958, the Court, by invoking the European principle of the "balance of powers", took the very severe stance that a delegation of sovereign powers was impermissible and only the European institutions could be granted powers with a margin of discretion. As such, the delegation of powers to external entities could only involve powers in respect of the preparation, or the execution, of the decisions of these institutions.

If one were to apply the strict standards of the Meroni doctrine, the delegation of powers to the ESAs, in particular powers to adopt binding decisions, would be impermissible, since these would not involve the preparation or mere execution of decisions by European institutions, but rather fully discretionary powers. However, in view of the dramatically changed context, the Meroni decisions – and also the follow-up "van der Vecht" and "Romano" decisions – cannot apply directly. The Community law of the 1950s has only little in common with today's EU law. The continued process of economic, social and, also, political integration has effected such a shift that both are hardly comparable. Hence, an excessively undiscerning application of the Meroni ruling to the present question of to which extent powers may be delegated to European agencies seems rather out of place. Still, these rulings by the ECJ are only good law insofar as one extracts from them their underlying legal rationale: the legality of a delegation of powers must today meet the requirements of the democratic principle and the institutional balance as they are understood under modern primary law.

**Implications**

The examination of the ESA regulations and the applicable primary law leaves a disquieting feeling. Even if one takes the position that Article 114 of the Treaty on the Functioning of the European Union (TFEU) offers a workable legal basis, considerable concerns remain as to whether the delegation of certain powers conforms with primary law. Conformity with the founding principles of the EU may, for the most part, be affirmed – at least when applying a restrictive interpretation of these powers in conformity with primary law – with regard to powers in the context of the enactment of technical standards, the issuance of guidelines and recommendations, and of numerous other tasks. The same is not necessarily true for the power to adopt binding decisions. In view of the interplay between such a power and the independence of ESAs and their organs, the assumption of a breach of the democratic principle is not fully implausible.

The above also raises serious doubts about the EU's ability to create a banking union and to establish a single supervisory mechanism or a single resolution mechanism for winding up failed banks without an alteration of the Treaty – as this would imply a transferral of powers to a European entity that would also run the risk of being regarded as "unlawful" by the ECJ (a transferral of such powers to the ECB, the most likely solution, would also create difficulties, albeit different ones, as this would have to take place under a different provision of primary law, i.e. Article 127 (6) TFEU). For the time being, one has to await the judgement of the Court in the ESMA case with great anticipation and equal concern, and hope for a pragmatic decision that will not hinder future steps towards more enhanced European financial supervision.

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# The Bail-In Proposal: A Game Changer in Banking Markets

Jan Pieter Krahnen
Goethe University & SAFE

Towards the end of 2013, the European Commission is expected to respond officially to the so-called Liikanen Report which was handed in one year ago. The High Level Expert Group, headed by Erkki Liikanen, was established by EU-Commissioner Michel Barnier to examine the need for reforms in the structure of the European banking sector. One key recommendation of the Liikanen Report was the mandatory issuing of subordinated bank debt thought to be liable (the "Bail-in Proposal") which aims for a revitalization of market discipline in financial markets. This proposal has often been misunderstood in recent months, so clarification in some points seems necessary.

In the years preceding the financial crisis, the risk of a systemic banking breakdown grew almost imperceptibly. The nature of this systemic risk can be attributed to the substantially increased level of interconnection between financial institutions, as compared with banking in earlier decades. Over the past 25 years, the rapid growth of derivatives markets, the increasing role of secured and unsecured interbank lending and the heightened dependency on refinancing funds borrowed short-term on the capital market, have significantly increased interdependencies amongst financial institutions. Indirect relationships, such as the correlation of the mark to market valued assets on bank balance sheets and liquidity-sensitive market prices in the event of the fire sale of exactly these assets, have further reinforced these interdependencies. Direct and indirect bank interdependencies, in turn, have fueled the risk that difficulties encountered by individual institutions or price slumps on individual product markets will "infect" other markets and be transferred to other institutions.

The anticipation of a collapse of this nature is referred to as systemic risk. Should this occur, government intervention and creditor bailout is almost always required to avoid the anticipated significant costs to the real economy. Given the current circumstances, this unavoidable, almost compulsory, government rescue of individual institutions or entire groups of institutions in the event of a crisis, has a significant ex-ante impact on the behavior of the key players in the market and on the market prices observed. This line of argument thus ends in a self-reinforcing cycle, a vicious circle, in which existing systemic risks lead to expectations of rescue, and these, in turn, to indirect subsidies to the owners of banks (via subsidized refinancing costs).

### Breaking through the Vicious Circle

Against the background of this crisis explanation the core idea of the Liikanen Report is to reinforce the processing capability of individual institutions and, at the same time, to eliminate the contagion effects between banks, at least at the level of subordinated debt.

The simple yet fundamental contribution of the Bail-in Proposal laid out in the Liikanen Report is to ask for holding restrictions for bail-in bonds in order to limit the identity of their buyers. The restriction called for is a simple one: banks should be prohibited to hold bail-in bonds issued by other financial institutions on their balance sheet. The justification for this: if the supervisory authorities can assume that the owners of bail-in bonds are not themselves banks, they can initiate a write down (or a debt-equity swap) without having to fear contagion or immediate systemic consequences. And as this is the case, their announcement of a bail-in will also be credible ex-ante. It is precisely this credibility that is called into question, if, at a moment of crisis, there is uncertainty on the part of the supervisory authorities concerning the identity of the holders.

This Bail-in Proposal therefore addresses the reason for the dysfunctionality of the bank refinancing market. Requiring banks to issue a minimum amount of unsecured bonds is, by itself, not unusual, as most financial institutions already have a host of junior or hybrid tier-2 instruments outstanding. It should be stressed, to avoid misunderstandings, that even after the creation of special bail-in bonds, all items on the liabilities side of a bank will fundamentally continue to be subject to private liability, that is to say will be bail-in-able. Thus, the special feature of this new class of subordinated bonds is not in the loss absorption capacity but rather in the credibility of the liability announcement.

### Resurrecting the Market's Disciplinary Effect

The essential innovation in the Liikanen Proposal is the explicit holding restriction as a bond covenant. Only institutions outside of the banking sector may hold subordinated debt. These should be long-term investors, such as pension funds, life insurance companies, and sovereign wealth funds. Importantly, a retrocession i.e. the transfer of the default risk of this subordinated debt back into the banking system, through the purchase of credit default swaps (CDS), where a bank acts as protection seller, needs to be systematically ruled out.

In this way, a supervisory authority considering a bail-in can be confident that its decision will not trigger the next systemic crisis in the banking sector. As a consequence, this situation should encourage it to involve creditors in the rescue. In turn, creditors will know from the very start, i. e. from the date of issue, that the threat of losing part or all of their capital is a very real possibility. Accordingly, the actual default risk of any particular bank – subject to market efficiency – will be reflected properly in market prices of debt as well, and the disciplinary effect of these markets will be resurrected. Bail-in, thus, will be a game changer. It will allow banks to fail. Banks will be like any other industrial corporation: an entity investing freely and taking risks at the owners' discretion, making profits in good times, and absorbing losses in bad times – no intervention of the taxpayer needed.

*The full article is available at:*
http://safe-frankfurt.de/policy-publications

### Selected Policy Center Publications

**Böcking, H.-J., Gros, M., Worret, D.** (2013)
"Commentary on ESMA Guidelines on enforcement of financial information",
White Paper No. 5/2013, SAFE Policy Center

**Issing, O.** (2013)
"Challenges for Monetary Policy",
White Paper No. 7/2013, SAFE Policy Center

**König, E.** (2013)
"Gesprächsreihe zu Strukturreformen im europäischen Bankensektor: Wiederherstellung privater Haftung und die zukünftige Rolle der Aufsicht",
Policy Letter No. 13/2013, SAFE Policy Center

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"Der einheitliche Abwicklungsmechanismus – Europäisches Allheilmittel oder weiße Salbe?",
Policy Letter No. 14/2013, SAFE Policy Center

## SAFE Celebrates its Inauguration

On 12 September 2013, a ceremony was held to mark the official inauguration of the Center of Excellence SAFE. Opening remarks were made by Werner Müller-Esterl, the President of Goethe University, Luise Hölscher, by then State Secretary in the Hessian Ministry of Finance, and Jan Pieter Krahnen, Academic Director of SAFE. They all emphasized the importance of SAFE's focus for the coming years, namely research and policy advice aimed at building a sustainable financial architecture in Europe – an objective to be met with financial support from the Hessian LOEWE program. Hölscher stressed that researchers not only need to find new solutions for the current problems, but must also learn to ask new questions.

In his keynote address, Michel Barnier (see photo), European Commissioner for Internal Market and Services, stressed the multi-facetted, interdisciplinary approach of SAFE, noting that this was a good starting point for the analysis of the complex world of finance. The Center's name is not insignificant: "We all need the financial sector to be safe", Barnier said. And, for this, a framework is needed that is robust, yet leaves room for innovation and new ideas. The Commissioner said that he was looking forward to building a financial framework that supports the real economy together with SAFE. Subsequently, Richard Blundell, Ricardo Professor of Political Economy at University College London, outlined the importance of and the challenges associated with combining empirical research and policy analysis: "Policy analysis provides key new ideas for research, and research provides credibility and a long-term foundation for policy analysis", he stated.

## Two new Professors Strengthen SAFE Research Team

Loriana Pelizzon, 46, took over the SAFE Professorhip for Law and Finance in October. Currently, she focuses on systemic risk, risk management, credit derivatives and risks, and contagion. Coming from the University of Venice, Pelizzon has also conducted research in other places, including the MIT Sloan School of Management and the London Business School, where she also earned her PhD in finance in 2002. She is a coordinator of the Doctoral Tutorial of the European Finance Association (EFA) and a member of BSI GAMMA Foundation's Executive Committee. Furthermore, Pelizzon has been involved in NBER and FDIC projects, as well as in European Union (EU), Europlace and Inquire Europe projects. In addition, she frequently advises banks, pension funds and government agencies on risk measurement and risk management strategies.

Christine Zulehner, 45, became the SAFE Professor for Industrial Organization and Financial Markets in December. She conducts research in the area of industrial and competition economics that is focused on the strategic behavior of market players in oligopolies or auctions. Zulehner holds a doctoral degree from Humboldt-Universität in Berlin and completed her habilitation at the University of Vienna in 2008. Besides having worked as a professor at the University of Linz, she is a research staff member at the Austrian Institute of Economic Research and a member of the Scientific Advisory Council of the Centre for European Economic Research (ZEW) in Mannheim.

## Orphanides Criticizes Crisis Management of EU Member States

On 13 September, Athanasios Orphanides, Professor of the Practice of Global Economics and Management at the MIT Sloan School of Management, contributed to the SAFE Policy Center Lecture Series with a presentation on "The Politics of the Euro Area Crisis". He warned that Eurozone economies have been heading towards disintegration since the emergence of the financial crisis – something which would threaten the EU project itself in the long run. According to the former President of the Central Bank of Cyprus, EU Member States had exacerbated this situation by standing in the way of an efficient fight against the crisis.

The Eurozone was clearly lacking a supranational institution with the authority to make decisions independently from national governments in case of crisis, Orpanides said. The European Central Bank (ECB) has only been able to buy governments more time to solve the crisis and to prevent an immediate crash of the Eurozone by purchasing Greek government bonds and promising to purchase the bonds of other crisis countries under the Outright Monetary Transactions (OMT) program. But it could not solve the political problems of the Eurozone by itself. However, European governments have not made use of the breathing space secured by the ECB, but have continued to delay necessary decisions. This has only led to higher crisis costs for the whole Eurozone. Orphanides called upon European governments to make more courageous efforts for an integrated Europe and give up part of their sovereignty in order to overcome the current crisis. If not, in particular private households will continue to suffer from the effects of the crisis.

## Liability Scheme of German Savings Banks Finance Group Seen Threatened

On 7 November, Karl-Peter Schackmann-Fallis, Member of the Executive Board of the German Savings Banks Association (DSGV), presented the perspective of the Savings Banks Finance Group on proposals for a European deposit guarantee scheme. The lecture was part of the SAFE Policy Center Lecture Series. Since the start of the Group's Joint Liability Scheme in 1973, not a single member institute has experienced difficulties in servicing its liabilities, Schackmann-Fallis highlighted. By regularly monitoring the risk of all associated institutes, the scheme has successfully averted a situation in which institutes require additional funding. As it limits risk-taking and moral hazard problems within the Group, the confidence of customers and markets in the member institutes is strengthened.

However, according to Schackmann-Fallis, the EU Directive on Deposit Guarantee Schemes and planned bank resolution regulations put the Group's guarantee system into question. The options now being discussed at the political level are: a) the replacement of all national systems by a pan-European system (a one-stage scheme); b) the extension of national systems by a downstream European component (a two-stage scheme); and c) national systems with mutual liability under credit facilities. Schackmann-Fallis underlined the DSGV's assertion that any European system has to secure that the funds accumulated can also be used for prevention purposes. He concluded that a two-stage scheme would be a reasonable compromise, but stressed that moral hazard has to be avoided in all cases and that incentives to take on responsibility at the national level will be essential.

# Selected Publications

**Andres, C., Betzer, A., Haesner, C., Theissen, E., van den Bongard, I.** (2013)
"The Information Content of Dividend Surprises: Evidence from Germany",
Journal of Business Finance and Accounting, Vol. 40, pp. 620-645.

**Baums, T.** (2013)
"Corporate Governance und Anlegerschutz",
Mohr Siebeck, Tübingen.

**Campolmi, A., Faia, E.** (2013)
"Rethinking Optimal Exchange Rate Regimes with Frictional Labour Market",
forthcoming in Macroeconomic Dynamics.

**Gal, J., Sehrbrock, D.** (2013)
"Taking Stock of the Solvency II Reform Project – Towards a new European Insurance Supervisory Framework",
European Public Law (EPL), Vol. 19, Issue 2, pp. 295-316.

**Haar, B.** (2013)
"Neues zur Haftung von Ratingagenturen im Zuge der zweiten Novelle der Rating-Verordnung (CRA III)?",
Der Betrieb [DB], Vol. 66, pp. 2489-2496.

**Ignatyeva, E., Rauch, C., Wahrenburg, M.** (2013)
"Analyzing European SPACs",
forthcoming in The Journal of Private Equity.

**Kraft, H., Seifried, F.** (2013)
"Stochastic differential utility as the continuous-time limit of recursive utility",
forthcoming in Journal of Economic Theory.

**Kumar, V., Chattaraman, V., Neghina, C., Skiera, B., Aksoy, L., Buoye, A., Henseler, J.** (2013)
"Data-Driven Services Marketing in a Connected World",
Journal of Service Management, Vol. 24, Issue 3, pp. 330-352.

**Langenbucher, K.** (2013)
"Anlegerschutz – Ein Bericht zu theoretischen Prämissen und legislativen Instrumenten",
Zeitschrift für das gesamte Handels- und Wirtschaftsrecht, Vol. 177, pp. 679 ff.

**Loranth, G., Castiglionesi, F., Pelizzon, L., Feriozzi, F.** (2013)
"Liquidity Coinsurance and Bank Capital",
forthcoming in Journal of Money, Credit and Banking.

**Siekmann, H.** (2013)
"Eine stabile Geld-, Währungs- und Finanzordnung",
Berlin Duncker & Hublot, 2013.

**Tröger T., Pfaffinger L.** (2013)
"Partnerschaftsgesellschaft mit beschränkter Berufshaftung",
Juristenzeitung, Vol. 68, pp. 812-821.

**Wahrenburg, M.** (2013)
"Bad Banks – Good Bank Resolution?",
Zeitschrift für betriebswirtschaftliche Forschung, Vol. 67, pp. 42-71.

**Wandt, M.** (2013)
"Gedanken zur Serienschadenklausel Ziff. 6.3 AHB 2008",
Festschrift für Attila Fenyves, Wien, pp. 781-802.

## Recent SAFE Working Papers

**No. 33** **Camera, G., Chien, Y.**
"Two Monetary Models with Alternating Markets"

**No. 32** **Camera, G., Gioffré, A.**
"Game-Theoretic Foundations of Monetary Equilibrium"

**No. 31** **Bursian, D., Fürth, S.**
"Trust Me! I am a European Central Banker"

**No. 30** **Bursian, D., Roth, M.**
"Optimal Policy and Taylor Rule Cross-Checking Under Parameter Uncertainty"

# The Role of Empirical Research in Policy Design

Richard Blundell
University College London
and Institute for
Fiscal Studies (IFS)

The ethos of SAFE is one that is very close to my heart – the desire to place policy analysis and rigorous research on an equal footing. The two go hand in hand: policy analysis providing key new ideas for research, while research providing a credible long-term foundation for policy analysis. But how can we make the best use of empirical evidence in policy analysis? How should evidence be used? What is the appropriate balance between theory and empirics? I will answer to these central questions by reflecting the important stages in any rigorous research-based policy analysis in economics and by taking the Mirrlees Review as a concrete example of the successful interplay between policy and research. The Review, published by IFS in 2010, was an attempt to build a base for tax reform from the large body of economic theory and empirical evidence.

### 1. Key margins of adjustment

First, we need to establish empirical facts about key aspects of the behaviour under study. This is a 'descriptive' analysis, it does not reflect 'causality' just the correlations in the data, expressing the important facts. Where is it that individuals, firms and governments are most likely to respond? In the context of earnings tax design we might examine the different margins of labour market adjustment. A key piece of evidence we used in the Review was on employment across three different economies. Noticeable was the similarity of the average employment rates for men between the age of 30 and 50 – for three countries with very different tax and welfare systems. All the differences were at the beginning and the end of the working life. This suggests that, if we are looking for action in tax reform, it may be best to focus attention on the beginning and the end of the working life.

### 2. Measurement of effective tax rates

As a second step we considered the tax system as a whole. Precisely how is policy likely to impact on the incentives facing the key players? For example, what is the 'true' effective tax rate on labour earnings? There are taxes on earnings that operate through the employer, there are social insurance contributions that effectively act like taxes, and there are the taper rates in the withdrawal of welfare benefits. All of these make up the effective tax rate on earnings. To understand the incentive structure underlying a tax system we needed to examine all of these different taxes in a coherent way. What we saw is that there were huge differences with effective tax rates in excess of 80% for some family types. These are typically lower income families with children and reflect to an extent the withdrawal of welfare benefits. Without knowledge of these effective tax rates we would have had no idea of how the tax system really changes earnings incentives.

### 3. The importance of information and complexity

The discussion of effective tax rates also naturally motivates the third step that relates to the understanding of the incentives implicit in the tax and benefit system. How do the individuals, households and firms themselves understand the system? What are the stigma, hassle and information costs involved in accessing the system? The degree of complexity can leave some individuals unwilling, unable or just too uniformed to access all the benefits and tax-credits to which they are eligible. It is difficult to argue against a policy reform that aims at more transparency.

### 4. Evidence on the size of responses

The core of any rigorous empirical analysis is the robust measurement of the causal impact of reforms. This is where the careful econometric analysis of structure and causality comes into play. It is clear (to some, at least) that an eclectic mix of structural and (quasi-) experimental approaches can deliver a powerful evidence base. Quasi-experimental studies provide robust estimates of particular policy contrasts while the structural models deliver simulations necessary for a more complete analysis of policy reform.

### 5. Implications from theory for tax design

Finally, these empirical relationships are brought together with the structure of mechanism design from economic theory to determine efficiency costs, overall optimality and improvements to tax design. There are three key ingredients to any optimal tax analysis: the accurate measurement of response elasticities, the detailed description of the distribution of income and, some view of social welfare weights. The first two of these are positive and can be learned from a careful evidence based analysis. The last is normative and therefore something where reasonable people may differ. The aim in the Mirrlees Review was to draw broad evidence based conclusions while making fairly weak assumptions on social welfare weights.

I know SAFE will have a flourishing future bringing together effective policy proposals based on rigorous empirically founded research. We will be SAFE in their hands!

*The author is a member of the Research Advisory Council of SAFE*

# Events

## January

Monday, 13th
4.15 – 6.00 pm
**LEMF Workshop**
**Risky Business: Competition, Compensation, and Risk-Taking**
Speaker: Charles K. Whitehead, Cornell University Law School

Monday, 13th
5.00 pm
**EFL Jour Fixe**
**Information Diffusion in Financial Markets – Evidence from Retail Investors**
Speaker: Steffen Meyer, E-Finance Lab

Tuesday, 14th
4.15 – 5.30 pm
**Finance Seminar – joint with SAFE**
Speaker: Mariassunta Gianetti, Stockholm School of Economics

Tuesday, 14th
7.00 – 8.30 pm
**GBS Information Session**
**Part-Time Master in Finance – Information Session**

Wednesday, 15th
2.00 – 3.00 pm
**Finance Brown Bag Seminar**
**The Causal Effect of Risk Management on Loan Quality**
Speaker: Tobias Berg, Bonn University

Monday, 20th
6.00 pm
**6th ICIR Seminar on Insurance and Regulation**
Speaker: Tom Wilson, Allianz SE

Tuesday, 21st
**SAFE Transparency Lab Presentation**
**EBRD Transition report**
Speaker: Jeromin Zettelmeyer, European Bank for Reconstruction and Development (EBRD)

Tuesday, 21st
2.15 pm – 3.45 pm
**Frankfurt Seminar in Macroeconomics – joint with SAFE**
Speaker: Sule Alan, University of Essex

Tuesday, 21st
4.15 pm – 5.30 pm
**Finance Seminar – joint with SAFE**
Speaker: Hannes Wagner, Bocconi University

Wednesday, 22nd
12.30 am – 2.00 pm
**CFS Lecture on the Order of Money**
**Parallelwährungen als Beitrag zur Lösung der Eurokrise**
Speaker: Roland Vaubel, University of Mannheim

Wednesday, 22nd
2.00 pm – 3.00 pm
**Finance Brown Bag Seminar**
**Delegation of Authority and Information Manipulation. Evidence from Bank Lending Decisions**
Speaker: Thomas Mosk, Goethe University & SAFE

Tuesday, 28th
4.15 pm – 5.30 pm
**Finance Seminar – joint with SAFE**
Speaker: Antonio Mele, University of Lugano

Tuesday, 28th
5.00 pm– 6.00 pm
**IMFS Distinguished Lecture**
Speaker: Andreas Dombret, Deutsche Bundesbank

Tuesday, 28th
2.15 pm – 3.45 pm
**Frankfurt Seminar in Macroeconomics – joint with SAFE**
Speaker: Pontus Rendahl, Cambridge University

Thursday, 30th
11.00 am – 18.30 pm
**E-Finance Lab Spring Conference 2014**
**Aspiration and Reality in Retail Banking – Which business and regulation models do (not) work out?**

## February

Monday, 3rd
5.00 pm
**EFL Jour Fixe**
**Social Trading**
Speaker: Florian Glaser, E-Finance Lab

Wednesday, 5th
2.00 – 3.00 pm
**Finance Brown Bag Seminar**
Speaker: Vicente Cunat, London School of Economics

Wednesday, 12th
2.00 – 3.00 pm
**Finance Brown Bag Seminar**
**Financial Integration and Business Cycle Synchronization: Evidence from U.S. States**
Speaker: Martin Goetz, Goethe University & SAFE

Wednesday, 26th
5.30 pm
**CFS Presidential Lecture**
Speaker: Hans-Werner Sinn, Ifo Institute

Wednesday, 26th
11.00 am – 12.30 am
**CFS Colloquium**
**Risikoverhalten in der Europäischen Wirtschaft: Finanzinstitute und Märkte**
Speaker: Markus Brunnermeier, Princeton University

## March

Wednesday, 5th
5.30 pm– 7.00 pm
**CFS Colloquium**
**Auswirkung der Finanzkrise und der Niedrigzinspolitik auf die Finanzierung in der Industrie**
Speaker: Joe Kaeser, Siemens AG

Wednesday, 12th
**CFS and IMFS Conference**
**ECB and Its Watchers XV**

Please note that for some events registration is compulsory.

CFS Center for Financial Studies
EFL E-Finance Lab
GBS Goethe Business School
ICIR International Center for Insurance Regulation
ILF Institute for Law and Finance
IMFS Institute for Monetary and Financial Stability
LEMF Doctorate/Ph.D. Program in Law and Economics of Money and Finance

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