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30 June 2015

Dear Sir or Madam,

The discussion on the future of cash has finally reached Germany. Kenneth Rogoff, Professor at Harvard University, former Chief Economist of the International Monetary Fund (IMF) and winner of the Deutsche Bank Prize in Financial Economics (2011), was one of the first and the most prominent to request the abolition of cash in 1998. Initially, he had argued against the high denomination of the 500 euro note as it would foster crime and drug trafficking. For me, at that time (1998), his argument was more the expression of American concerns that they might lose seigniorage from printing US dollar notes to the Eurozone via the use of euros instead of US dollars.

Otmar Issing
CFS President

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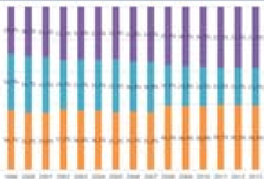
Persistently Low Interest Rates in Germany



In a recent study, **Volker Brühl** and **Uwe Walz** describe the consequences of the low interest environment for private households and selected institutional investors in Germany.

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Comments on the EU Commission's Capital Markets Union Project

In a SAFE White Paper, **SAFE and CFS researchers** discuss a Green Paper published by the European Commission that outlines possible measures to create a single market for capital in Europe.

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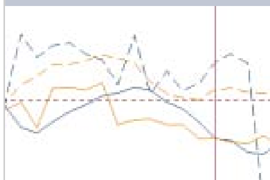
Interest Rate Elasticity of Bank Loans: The Case for Sector-Specific Capital Requirements



In a CFS Working Paper, **Florian Hense** analyses if the interest rate elasticity of bank loans differs across borrowers.

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Workshop on Financial Crises

On 26 January, the CFS organized a workshop on financial crises under the auspices of the Deutsche Bank Prize in Financial Economics where **Guillermo Calvo** and **Nobuhiro Kiyotaki** talked about their latest research.

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CFS Presidential Lecture: Jens Weidmann

On 19 February, **Jens Weidmann**, President of the Deutsche Bundesbank, gave a CFS Presidential Lecture on innovations in the financial sector.

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The ECB and Its Watchers XVI

On 11 March, the CFS and the Institute for Monetary and Financial Stability (IMFS) jointly organized the sixteenth edition of the conference "**The ECB and Its Watchers**".

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CFS Conference on Operational Risk

On 19 March, the **CFS Conference on Operational Risk** took place where academics and practitioners discussed current research on this topic.

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CFS Colloquium: Hyun Song Shin

On 23 March, **Hyun Song Shin** gave a talk at the CFS Colloquium series about "Financial markets in an interconnected world".

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6th Bundesbank-CFS-ECB Workshop on Macro and Finance

On 17 April 2015, the **6th Bundesbank-CFS-ECB Workshop on Macro and Finance** took place at the House of Finance.

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Editorial

No Future for Cash?

The discussion on the future of cash has finally reached Germany. Kenneth Rogoff, Professor at Harvard University, former Chief Economist of the International Monetary Fund (IMF) and winner of the Deutsche Bank Prize in Financial Economics (2011), was one of the first and the most prominent to request the abolition of cash in 1998. Initially, he had argued against the high denomination of the 500 euro note as it would foster crime and drug trafficking. For me, at that time (1998), his argument was more the expression of American concerns that they might lose seigniorage from printing US dollar notes to the Eurozone via the use of euros instead of US dollars.

In the meantime, it is cash as such which is seen as an instrument for fostering socially harmful activities, crime of all kind, black market activities, and tax evasion. The limits of the zero lower bound have led to a new argument: Without the option of holding cash the central bank could reduce its interest rate well below zero into negative territory, thereby giving powerful incentives for taking credit to finance investments.

As a means of payment cash is seen as costly and cumbersome compared to technologically advanced instruments. There are, indeed, forms of electronic money which are or will be extremely convenient. There is no reason to deny this. The question is whether payment with cash should actually be forbidden by law and whether banknotes and coins should be withdrawn from circulation to achieve the goals mentioned before.

Enforcement of cashless payments would imply that every citizen must dispose of substitutes in form of electronic money. This will not be easy to achieve. Also, old and/or poor people might still prefer to pay in cash. Anyway, to force people to use one means of payment or the other against their preferences is an exorbitant act of legal enforcement. Against this background, it needs to be questioned whether the arguments in favor of this enforcement, such as substantial advances in social welfare, are really convincing.

Take the case of Sweden which is together with other Scandinavian countries the most advanced economy in using electronic devices for payments. Cash is not anymore accepted for buying bus tickets or paying a museum's entrance fee. At the bakery, even small amounts of cash are often refused. At the cathedral in Uppsala, you will not find a box for inserting notes and coins anymore. Instead, there is an electronic terminal which accepts payments by your credit card. The industry, including credit card companies, praises this development as a great progress for society. However, different groups of opponents are forming. When banks close their branches and get rid of ATMs to cut costs, it should be the obligation of the government to ensure that everybody has access to cash. We might see comparable discussions in many countries.

In Germany, people still have a strong preference for paying in cash, especially small amounts. For 80% of all transactions notes and coins are used and, on average, every German carries about 100€ in his or her purse – this has not changed for years. Over time, electronic money will certainly become more popular also in Germany. But this will and should be, first and foremost, driven by the preferences of the people.

Having reduced nominal interest rates to extremely low levels has already had a strong impact on the financial system. The banking sector is confronted with a huge challenge to adapt business models to this new environment – and for life insurance companies,

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pension funds etc. it is an existential threat. Giving the central bank the option to go substantially below the zero bound would have dramatic effects on the financial system. Taking into account the options available at the zero bound, especially quantitative easing, the question arises whether there is a powerful argument to put the financial system at risk or at least enforcing deep changes by widening the negative territory for central bank interest rates.

And on the argument of crime: Does electronic money not open new forms of crime via cyber attacks? We have already seen this happening. Who could ensure people that their electronic account is safe against criminal attacks?

So far, banknotes (and to some extent coins) have been the only legal means of payment. How can this legality be achieved in a cashless society?

And, finally and most important: Payments with any kind of electronic money will unavoidably leave traces stored in computers. Most of our personal activities are accompanied by payments. Is it not an Orwellian nightmare to imagine a world where no payment and thus no personal activity is left unrecorded? Who will trust the assertion that this knowledge will not be used – or misused – by public authorities and protected against illegal intrusions?

From his experience in a prison camp, Fjodor Dostojewski once coined the term: "Money is printed liberty." It is only cash which can provide this liberty.

Yours sincerely,
Otmar Issing

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Persistently Low Interest Rates in Germany

by Volker Brühl and Uwe Walz, both CFS

The consequences of the currently low level of interest rates in Germany have been the subject of discussions by policy-makers and the general public for quite some time now. Interest rates of German government bonds with short and medium maturities (10-, 5- and 1-year) have reached historical lows – especially since the outbreak of the financial crisis in 2007, a downward tendency can be observed (see figure 1). In January 2015, the yields for German government bonds with a remaining period to maturity of up to 5 years were negative for the first time and 10-year government bonds yields reached only slightly positive values. Because of the low but still positive inflation rate, real interest rates have become negative. Also, real interest rates on savings deposits (one of the main asset class of German households) have been negative since early 2010. Hence, real wealth accumulation (taking into account the inflation rate) is hardly possible with savings deposits in the long run. In general, highly liquid and relatively low-risk products have only generated low real returns during the last decades.

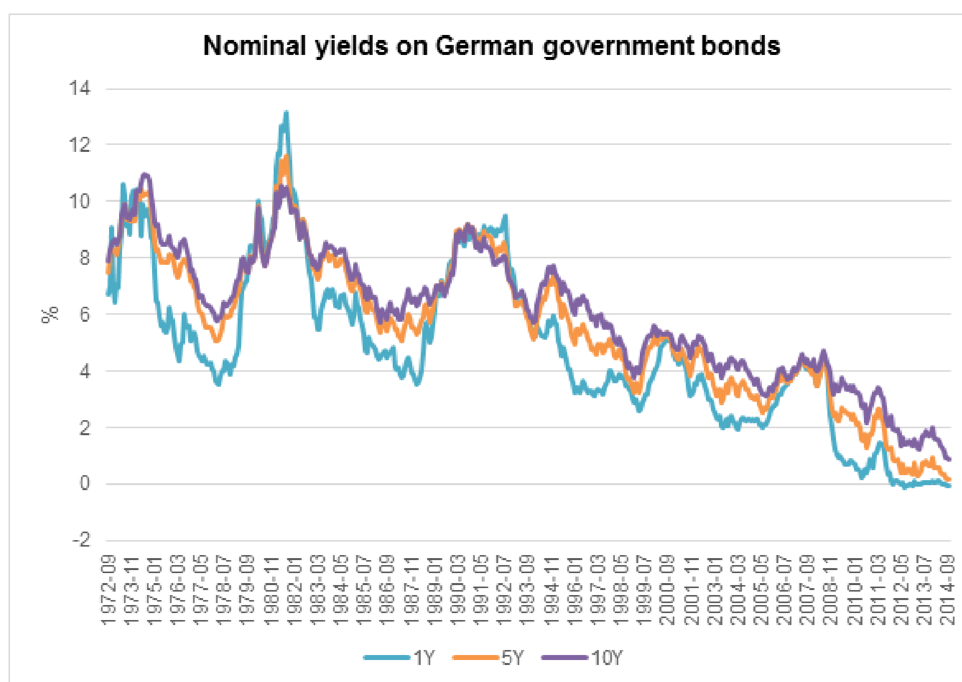

Figure 1: Yields, derived from the term structure of interest rates, on listed Federal securities with annual coupon payments of 1, 5 and 10 years, 1972-2014. *Source: Deutsche Bundesbank Statistics, 2014*

The cause for the currently low interest rate environment is the loose monetary policy of the European Central Bank (ECB) since the outbreak of the financial crisis, which has significantly influenced short-term interest rates on money and capital markets. Given that economic growth is still low and growth expectations are only modest for the euro area, we expect that the ECB's strategy will not change in the foreseeable future. Hence, we have to prepare for a long-lasting period of low interest rates at the short and medium end of the interest rate curve.

Implications for private households

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In our study, we analyze the consequences of the low interest rate environment on the savings and consumption behavior and the financial asset allocation of private households in Germany. We find that the value of financial assets held by private households has overall increased during the last 15 years – despite some intermediate drops. At the end of 2013, they reached a value of 5,000 billion euro for the first time.

Next, we examine how the financial asset allocation of private households has developed between the outbreak of the financial crisis in 2007 and the year 2013 by looking at three different asset categories: cash and deposits, securities and insurance claims. Our results show that the share of cash and deposits held by private households increased during this period from about 35% to 39% and the share of insurance claims went up from 34% to over 37%, while the share of securities decreased from about 30% to 23% despite positive valuation effects (see figure 2). This means that private households have mainly invested in less risky products in spite of their low returns. We also find that private households in Germany invest increasingly less in shares despite the rising share prices. The average return on a broadly diversified share portfolio would be about 6-7% p.a. higher than an alternative investment in safe short-term bonds.

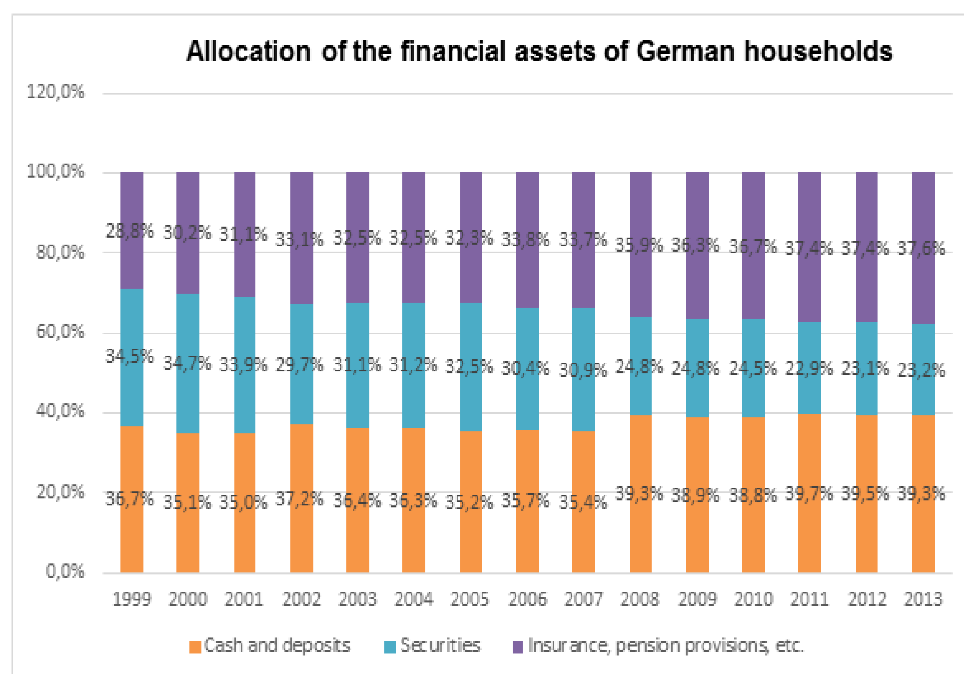

Figure 2 *Source: Federal Statistical Office, Deutsche Bundesbank Statistics, 1999-2013, own calculations*

In our next step, we analyze in a simulation model how strongly the old-age provision of private households in Germany is affected by long-term low interest rates. In the model a standard investor concludes an additional retirement savings plan at the age of 20, he saves 9.2% of his net income (which increases by 3% each year), the inflation rate is 1.64%, the retirement age is 64 and his life expectancy is 85 years. The standard investor will receive 27% of his last net income as an additional annuity if the real interest rate is 2%. If the real interest rate is 0%, he will only get 14%. For example, if the standard investor's average last net income is 2,000 euro, he will only receive 280 euro per month instead of 540 euro. Thus, a prolonged low interest environment could cause a significant pension gap.

Also, in different scenarios, we examine the cumulative effect of low interest rates on the asset accumulation of private households. The magnitude of the effect depends on the duration of the low interest phase, on the interest rate gap between the low interest rate level and an alternative "normalized" interest rate level as well as on the amount of cash and deposits held by households and their development over time. Furthermore, the level and development of debts of private households have to be taken into account because indebted household will actually benefit from the low interest rate level. We calculate different scenarios and find that, for example, German households will lose around 59 billion euro of net assets (taking into account household debts) and around 224 billion euro of gross assets (without considering household debts), if the low interest rate phase lasts for five years and the average interest rate gap is 2%.

Implications for institutional investors

Persistently low interest rates could, especially in the medium run, have negative effects on the profitability and also on the stability of institutional investors. For example, the solvency of life insurers in Germany could become at risk. These companies usually provide guaranteed interest rates on the savings component of the capital paid in. Risks could arise, if it gets more and more difficult for life insurers to generate sufficient returns to pay the guaranteed interest rates because of a difficult situation in the capital markets. Not only the low interest rate environment could endanger life insurers, but also the fact that they have invested large parts of their capital in low-risk fixed-interest

rate assets.

German banks also suffer from the persistently low interest rate level. Especially large German banks have lower margins since the outbreak of the financial crisis. This is mostly due to the ECB's loose monetary policy which has led to high liquidity in the German and European banking system and also due to the fact that credit demand of companies and private households is still low despite a high willingness of banks to provide credits. In conjunction with a structural overcapacity in the European banking sector, this market situation leads to a high pressure on margins in the lending business. This effect is partly weakened because of German savers' preferences for highly liquid assets. The German savings banks ("Sparkassen") have suffered much lower losses. This is probably due to the fact that they have more favorable refinancing costs as well as a comparatively lower risk business model.

The paper was published as CFS Working Paper No. 506 and is available for download ***here***.

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Comments on the EU Commission's Capital Markets Union Project

by Volker Brühl, Helmut Gründl, Andreas Hackethal, Hans-Helmut Kotz, Jan Pieter Krahnen, Tobias Tröger

The EU Commission has launched an ambitious project for deepening financial market integration amongst its 28 member states: the Capital Markets Union (CMU). This market completion is not only in line with the philosophy of European integration. By enhancing the choice set of consumers as well as of providers of financial services, it should also foster medium-run growth and employment. In the wake of the financial crisis, efforts were initially focused on implementing a Banking Union. The Capital Markets Union project now aims at enhancing the non-bank dimension of financial intermediation as stated in the corresponding Green Paper: "capital markets need to play a larger role in channeling financing to the economy" (EU COM 2015).

It is difficult to take issue with this project. In fact, we essentially share the objectives. Questions, however, arise from the diagnosis. In the Green Paper (EU COM 2015), it is held that Europe's recovery from the Great Financial (and the ensuing European Sovereign Debt) Crisis is slow as compared to the U.S. This is seen as a consequence of the structure of Europe's financial markets that rely too heavily on bank intermediation in the external funding of non-financial firms, in particular, the most dynamic medium-sized ones. Reducing hurdles standing between ultimate savers and final investors (in non-financial assets or real capital) is expected to foster potential growth. This might be the case. However, a more detailed analysis is necessary to produce conclusive evidence on the reasons why economic growth in Europe is lagging behind growth in the U.S. since the financial crisis. This requires more than just comparing differences in the financial market structures of these two countries.

Starting from a functional finance perspective, therefore being basically agnostic about the optimal structure of providers of services, we focus on the comparative efficacy with which particular functions are discharged. In particular, we highlight that loans to small and medium-sized companies (SMEs) are difficult to standardize because these firms are usually quite heterogeneous. Therefore, lenders need to have more specific knowledge about the individual company to assess credit risks properly. Here, banks might have an advantage compared with non-banks as they traditionally offer more individualized financing solutions while non-banks usually focus on more standardized products. Addressing those issues, as far as possible, should potentially ease the scope of banking beyond banks. But what ultimately counts is, if this translates into more employment and growth, as the EU Commission rightly calls for. Moreover, in addition to efficiency of intermediation services, the financial stability dimension is essential. And this has much to do with the adequate pricing of risks as a mispricing could lead to excess supply of credit and foster the boom and bust cycle in availability of funds.

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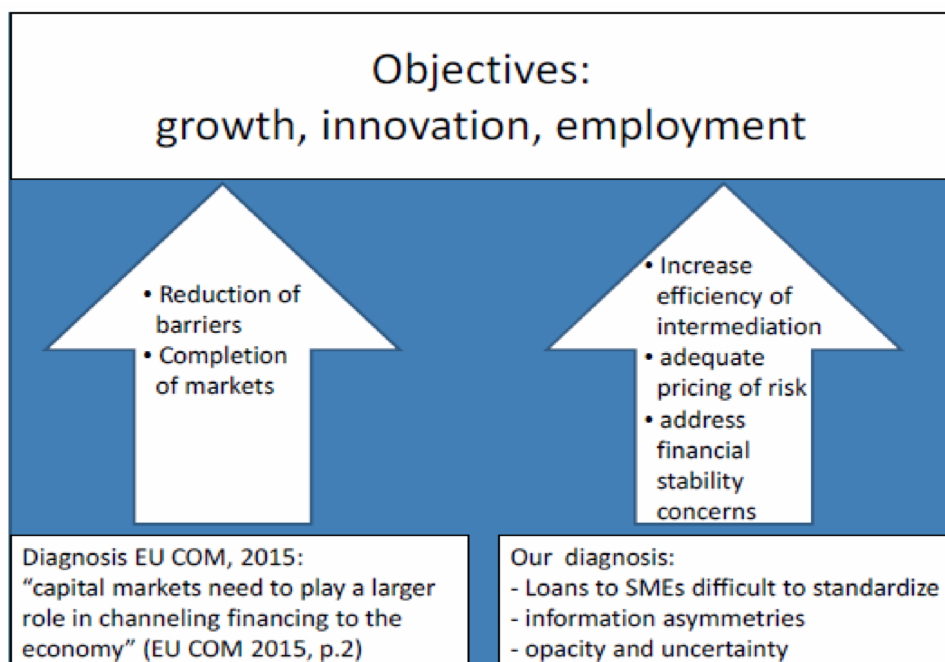

Figure 1: Capital Markets Union: Objectives and different diagnosis approaches

To assess institutional innovations, most of them in effect endogenous, we start from a basic principle. Policy intervention is only called for, when there are externalities or other issues of market imperfection (large economies of scale, scope, network externalities) and an appropriate public sector solution is available. Policies, according to the functional finance perspective, should be essentially neutral in terms of institutions (level playing field). Our main angle, from which we assess proposals, are information asymmetries and the agency problems (screening, monitoring) which arise as a result.

Within this perspective, we make a number of more specific proposals on how to create an environment which allows for a reduction of frictions with regard to the treatment of default risk. For example, we suggest a special European regime for restructuring corporate bonds outside of the 28 distinct insolvency proceedings in each of the European member countries – a 29th insolvency regime. Mitigating information asymmetries is also important to allow for robust access to risk capital for SMEs and start-ups. Also, a reassessment of asset allocation strategies for old-age insurance seems necessary. Supporting financial literacy would be conducive to increase financial market participation of households in European countries which is much lower as in the U.S. We also make suggestions on retention ambiguity, hampering the resilience of securitization markets. Finally, we raise issues with regard to the infrastructure of markets: its minimum required liquidity and the resulting efficiency in price discovery.

*The paper was published as SAFE White Paper No. 27 and is available for download **here**.*

- Deutsche Bank Prize in Financial Economics 2015

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Interest Rate Elasticity of Bank Loans: The Case for Sector-Specific Capital Requirements

by Florian Hense, CFS

The financial crisis has refocused attention on the interplay of financial and macroeconomic conditions. This concerns, among other things, the role of credit developments. The enormous credit boom during the period before the financial crisis resulted in a collapse in 2008, followed by a period of low to negative growth of both output and credit which lasts until today. A large number of policy measures have been introduced since then. There is, however, an ongoing debate about how to design monetary and macro-prudential policy (more) effectively.

One question is how to design policies and tools to impinge upon the demand for credit. Various factors have an impact on credit demand such as output, house prices, and interest rates. Especially interest rates are very relevant from a policy perspective. If, for example, central banks raise interest rates, the costs of taking out a loan rise and the demand for credit weakens. Changing interest rates may, however, not only affect the level of credit demand but also have an impact on the distribution of credit demand across various sectors. In other words, credit demand analysis undertaken at the aggregate level may obscure potential behavioral heterogeneity between various borrowers.

Borrowers react differently to interest rate changes

The heterogeneity arises from the fact that borrowers might be affected by varying macroeconomic and financial conditions very differently. One reason is that borrowers have different objectives that motivate them to take out a loan. For example, companies and households tend to have different reasons such as investing in commercial real estate on one side and fulfilling consumptions purposes on the other side. While an interest rate hike might render the investment of one borrower unprofitable, and therefore this borrower will not take out a loan, another borrower may see his business model relatively less affected and will continue to borrow money. In essence, the heterogeneous behavior translates into different levels of interest rate elasticity of credit demand across borrowers.

In order to investigate whether different borrowers actually have different interest rate elasticities of credit demand (and different elasticities with respect to output and house prices), I perform panel models based on euro area quarterly data from 2003-2013 for each borrower with credit as the dependent variable and with interest rates, output and house prices as determinants. For simplicity and data availability reasons, borrowers are grouped and the analysis focuses on the comparison of four borrowing sectors: non-financial companies (NFC), financial companies (FC), households which use the loans for consumption purposes (HHcon) and households which take out loans for house purchases (HHhp). While the traditional approach is to compare corporate with household sectors, I focus on comparing non-financial companies with financial companies and households which use the loans for consumption with households that use it for house purchases. The rationale for this comparison is that while NFC vs. FC and HHcon vs. HHhp are characterized by very different investment objectives NFC and HHCon have similar investment objectives as much as credit demand by FC and HHhp show parallels. While borrowers who intend to repay their loan out of cash flows of the investment may be very sensitive to minor variations in interest rates, other borrowers who invest in projects where asset or property price inflation expectations are more important for the investment objective could be less affected by changing refinancing conditions.

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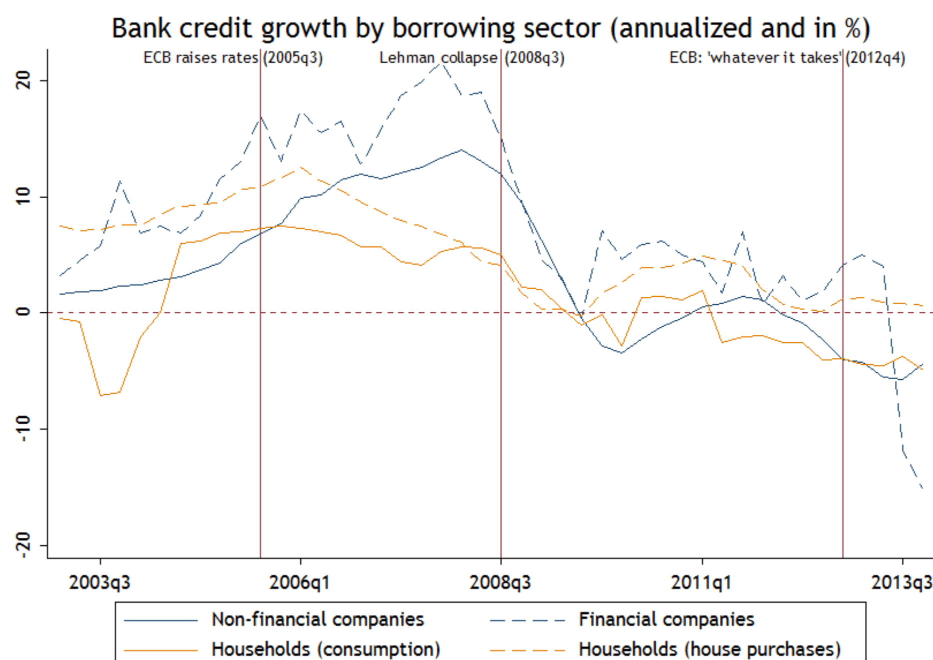

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Figure 1

Empirical findings and implications for monetary policy

Looking at the annualized growth rates of bank credit as shown in figure 1, the borrowing behavior seems to vary across sectors and the business cycle. The empirical findings of the regressions with respect to the determinants of credit demand confirm the graphical evidence. Indeed, the results suggest that loans to NFC and HHcon react stronger to economic growth than credit demand by FC and HHhp, respectively, while FC and HHhp seem to be more sensitive to the ups and downs of house prices than loans to NFC and HHcon. With respect to interest rates, the results lead to higher elasticities for credit demand of FC and HHhp than for NFC and HHcon. In other words, the countercyclical effect of interest rates seems to be stronger in the case of loans to FC and HHhp than for NFC and HHcon.

In times of high economic volatility, such as during the booming phase between 2005 and 2008 or the severe recession between 2008 and 2012, the interest rate's countercyclical effect is, however, undermined. This is especially the case for FC and HHhp, but less for NFC and HHcon. In periods where self-reinforcing dynamics of thriving economic growth, ever rising house prices and lax credit supply develop (or fire sales, weakening house prices and tightened credit conditions interfere with each together), interest rates turn out to be less effective as a countercyclical instrument, in particular when you want to push credit demand of FC and HHhp in the other direction.

To conclude, the way a borrower reacts to changing interest rates depends on its borrowing objective and the state of the economy as well as on macroeconomic and financial conditions. The interplay with house prices and credit demand reveals the non-universal effect of interest rates on various borrowers. A monetary policy which relies exclusively on the interest rate as a policy instrument will affect borrowers in different ways. Preemptive interest rate policy is a necessary but not a sufficient condition for financial stability. Hence, there is a strong case for macro-prudential tools that are both counter-cyclical and sector-specific.

*The paper was published as CFS Working Paper No. 504 and is available for download **here**.*

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CENTER FOR FINANCIAL STUDIES

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Workshop on Financial Crises

On 26 January, the Center for Financial Studies organized a workshop on financial crises under the auspices of the Deutsche Bank Prize in Financial Economics. Guillermo Calvo, Professor of Economics, International and Public Affairs at Columbia University, and Nobuhiro Kiyotaki, Professor of Economics at Princeton University, talked about their latest research. Mirko Wiederholt, Professor of Macroeconomics at Goethe University Frankfurt, opened the workshop and welcomed speakers and audience.

At first, Kiyotaki talked about his recent paper "Banking, Liquidity and Bank Runs in an Infinite Horizon Economy" (joint with Mark Gertler). Kiyotaki presented a macroeconomic model of banking crises that allows for bank runs. Whether a bank run is feasible in the model depends on the bank's leverage ratio and the liquidation price for bank assets, he explained. Kiyotaki showed how values such as output develop in the model in different simulation scenarios of recessions: without a bank run, with an unanticipated bank run and with an anticipated bank run. Finally, Kiyotaki named some policy implications of the model. For example, he said that higher capital requirements would reduce bank's risk-taking and the probability of a bank run. However, at the same time, these could increase the financial intermediation costs if capital is costly to raise.

Secondly, Calvo gave a presentation entitled "Liquidity: Puzzles and Challenges". He explained his Price Theory of Money which states that fiat money that has no intrinsic value gets valuable in terms of output because prices are sticky and, thus, will not be modified in the short run (money's output anchor). This would help to sustain fiat money's liquidity premium and would lower the risk of a liquidity meltdown, he said. For example, mortgage-backed securities would not have melted down in the subprime crisis to the extent they did if wages and prices had been quoted in terms of mortgage-backed securities instead of dollars, Calvo explained. Furthermore, he named factors that debilitate the money's output anchor such as floating exchange rates, currency substitutions or high inflation. These factors would make economies more vulnerable to global financial shocks, he said.

In the second part of his presentation, Calvo showed an analysis of recession episodes. He explained that he had used a sample of advanced and emerging economies in order to find out how labor markets recovered after crisis situations. One of his main results is that inflation can help to get unemployment back to pre-crisis levels but, at the same time, usually leads to lower real wages in the labor market.

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Nobuhiro Kiyotaki, Mirko Wiederholt, Guillermo Calvo (from left)

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CFS Presidential Lecture: Jens Weidmann

"Innovations in the financial sector"

On 19 February, Jens Weidmann, President of the Deutsche Bundesbank, gave a speech at the Center for Financial Studies following an invitation from CFS President Otmar Issing. Weidmann talked about innovations in the financial sector, especially cyber money, and their consequences for monetary policy.

There have been several innovations in payment systems and currencies in the financial sector in recent years, for example PayPal and Apply Pay or the new regional currency "Chiemgauer", Weidmann said. Cyber money, such as Bitcoins, includes both aspects: it is a new currency as well as a new payment system. Digital currencies are decentralized systems which do not need a central currency issuer that guarantees the authenticity of the currency, Weidmann explained. Electronic encryption systems that are managed by decentralized databases are used in order to ensure that a person wanting to pay with the digital currency actually owns it. Cyber money thus constitutes an alternative to state-managed currencies and aims at replacing the financial intermediation function of banks by a decentralized system.

According to Weidmann, Bitcoins have no intrinsic value, but money supply is limited to a maximum amount and thereby the currency becomes valuable. Moreover, new Bitcoins can only be produced by solving mathematical equations that become more and more complex. The increasing computing effort, for which more and more powerful computers are needed, ensures that the growth rate of the currency is decreasing. In general, Bitcoins are mostly used as an object of speculation or as a store of value but are not suitable for everyday shopping. The currency is very volatile which constitutes a risk for investors, Weidmann warned. In case of a loss, there is no deposit insurance for Bitcoins, no competent central bank that could counteract currency fluctuations, and no regulatory authority that could intervene if necessary.

In Weidmann's view, digital currencies are currently not posing a risk for financial stability because they are not widespread enough. Further, he does not assume that in the future cyber money will prevail over currencies issued by an independent, stability-oriented central bank.

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The ECB and Its Watchers XVI

The sixteenth edition of the conference "The ECB and Its Watchers" on March 11, 2015 set new records with more than 450 participants. As **Mario Draghi**, President of the European Central Bank, said in his speech, euro area developments are "pointing in the right direction". The ECB buying government bonds and other debt "may be shielding other euro area countries from contagion" from Greece, Draghi told the conference organized by the Center for Financial Studies (CFS) and the Institute for Monetary and Financial Stability (IMFS) at Goethe University Frankfurt. Two days earlier the ECB had started its quantitative easing (QE) program, which will induce monthly purchases of up to 60 billion euros of eurozone government debt, along with private sector assets and the debt of eurozone institutions.

After welcome remarks by organizer **Günter Beck**, Research Fellow of both the CFS and the IMFS, and the President's Address, the first session chaired by CFS President **Otmar Issing** questioned the effectiveness of non-standard monetary policy measures. ECB Board Member **Peter Praet** pointed out in his speech that thanks to policy measures taken by the ECB since the summer the nominal cost of bank borrowing for euro area companies went down sharply. **Jordi Gali** of the Barcelona-based research institute CREI considered the non-standard measures positive but likely insufficient to jumpstart growth of the euro area economy. According to **Volker Wieland**, Director of the IMFS and longtime organizer of the conference series, the impact of earlier measures by the ECB were already sufficient given the outlook. "The ECB needs to take into account the reactions of governments to ECB actions in estimating the impact of the actions on growth and inflation," Wieland argued.

With the ECB taking up the responsibility of banking supervision last November, in the second session Bank of Finland Governor **Erkki Liikanen**, **Stephen Cecchetti** of Brandeis University and **Casper de Vries**, member of the Dutch Council of Economic Advisors, discussed the challenges resulting from the ECB's double role. Against this background, Liikanen acknowledged risks like insufficient macroprudential tools. In his view, however, the new regulatory framework has contributed to growth in financial intermediation. De Vries pointed out that "empirical research shows that the main effect of QE is through the exchange rate". As proposed by de Vries, an "official intervention without sterilization would have been perfectly in line with the European Treaties". Cecchetti, former chief economist of the Bank for International Settlements (BIS), regarded time-varying policies unlikely to be effective.

With a panel bringing in perspectives from Asia, South America and Europe, the international challenges for monetary policy were in the center of the conference's third session. While **Ewald Nowotny**, Governor of the Austrian central bank, declined to speak from a currency war with the ECB pushing the balance sheet back to early 2012 levels, former Brazilian central banker **Arminio Fraga Neto** stated that forward

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guidance and QE drove longer term interest rates down considering a "currency war as the next step". Comparing the situation in the United States with Japan 15 years ago, Nomura chief economist **Richard Koo** warned that in a situation like that "the government has to help until the private sector balance sheet is repaired". Referring to Japan, "the exit of QE is extremely difficult", he went on. "Once QE is removed in the United States, the budget deficit will not be 500 billion dollars but a trillion", Koo said. Andre Sapir, on the other hand, showed himself rater optimistic concerning QE in the euro area. "QE is going to have a significant impact on the southern countries of the euro area countries", he was convinced.

Natascha Lenz, IMFS

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CFS Conference on Operational Risk

"Management and Measurement"

On March 19th, a CFS conference on Operational Risk – Management and Measurement – took place in the House of Finance. The event, which has been organized by Thomas Kaiser (Goethe University and KPMG) and Mark Wahrenburg (Goethe University and CFS), has been attended by more than 80 participants. The idea was bringing together academics and practitioners active in the field of Operational Risk (in a wider sense, thus including governance and managerial aspects) to discuss which contributions academia already did make and is going to make in the future and which issues deserve further research from a practitioners' point of view.

Following a call for papers, four authors have been selected to present their current research on Operational Risk. The authors both included work performed by pure academics as well as applied research conducted by practitioners at banks and consulting firms. Topics included principle agent problems in banks' governance, the particularities of outsourcing risk as well as approaches to modeling Operational Risk and allocating the results to the business divisions.

Four practitioners from banks, asset management firms and stock exchanges presented their view on topics which the industry is tackling for resource reasons with more pragmatic solutions, but which might deserve in-depth research to eventually come up with more sophisticated solutions. These included recent regulatory developments, conduct risk/risk culture, the link between various subcategories of Operational Risk governed by different departments in banks as well as managerial aspects of Operational Risk capital.

The conference concluded with a panel discussion on potential ways forward. The audience engaged very actively both in the panel discussion as well as in reaction to the presentations.

All presentations released by the respective authors for this purpose are available for download **here**. Some of the papers which have been submitted for the conference will be published in a special edition of the Journal of Operational Risk in autumn 2015.

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Thomas Kaiser, Goethe University and KPMG

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CFS Colloquium: Hyun Song Shin

"Two phases of global liquidity"

On 23 March, Hyun Song Shin, Economic Adviser and Head of Research at the Bank for International Settlements, gave a talk at the CFS Colloquium series about "Financial markets in an interconnected world". In his lecture, Shin addressed two main topics: the changing pattern of financial intermediation since the financial crisis and the global nature of dollar-denominated corporate debt, including in the energy sector.

Shin defined two phases of global liquidity. During the first phase (2003-2008) credit growth was mostly driven by the banking sector with global banks intermediating credits denominated in U.S. dollars. The depreciation of the U.S. dollar coincided with a global lending boom until 2008 when the global financial crisis broke out and capital flows plunged worldwide. By 2010, liquidity flows were surging again but this time predominantly through capital markets. According to Shin, this is the second phase of global liquidity which is characterized by a bond market-led credit growth driven by extraordinarily low long-term yields. Since 2010, creditors are mostly long-term investors with a focus on corporate borrowers, especially from emerging markets.

Shin showed that lenders resident in the United States supplied only a small part of credits denominated in U.S. dollar to borrowers outside the U.S. A larger share was extended by lenders located outside the United States. In this way, depositors and investors outside the U.S. provided most of the credit volume denominated in U.S. dollar to non-U.S. borrowers. In general, there has been a large increase in credits denominated in U.S. dollar to non-banks outside the U.S. between 2000 and 2014, so that the non-financial sector now accounts for an increasingly large share of the credit issued, Shin said. He also showed that the highest increase in these credits can be observed in the emerging market economies.

Finally, Shin outlined that there has been a large increase in debt and leverage in the energy sector (oil and gas producers) during the last years. The stock of debt of energy firms has risen even faster than that of other sectors. A substantial part of the increased borrowing has been done by large oil firms from emerging market economies and by smaller U.S. oil companies. According to Shin, the recently low oil prices have reduced the value of oil assets that have been used to back the high debt, so that credit spreads in the energy sector have gone up since mid-2014. The low oil prices also reduce the

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cash flows associated with current production and increase the risk of liquidity shortfalls that would make firms temporarily unable to meet interest payments. Firms could respond by increasing their output or they might even be forced to sell assets. This could lead to a further decline in oil prices, Shin explained.

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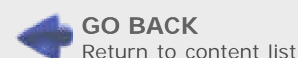
6th Bundesbank-CFS-ECB Workshop on Macro and Finance

On 17 April 2015, the 6th Bundesbank-CFS-ECB Workshop on Macro and Finance took place at the House of Finance. The workshop is organized regularly on a yearly basis to provide a platform for researchers of the three institutions (Bundesbank, ECB, and CFS/Goethe University) where they can present and discuss their current research.

This year, the keynote speech was held by Emanuel Mönch, Head of the Research Center of the Deutsche Bundesbank, who presented the paper "Fundamental Disagreement" that he has jointly written with Philippe Andrade (Banque de France), Richard K. Crump and Stefano Eusepi (both Federal Reserve Bank of New York). Here, the authors look at the term structure of disagreement of professional forecasters.

The rest of the workshop was organized in three academic sessions during which six research papers were presented and discussed. The sessions were chaired by Alexander Ludwig, SAFE Professor of Public Finance and Debt Management at Goethe University Frankfurt, Peter Karadi, Senior Economist at the European Central Bank, and Norbert Metiu, Economist at the Research Center of the Deutsche Bundesbank, respectively.

More information about this year's workshop program is available here.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CFS Lecture: Stefan Krause

"How Digital Natives will Change the Financial Industry"

New technologies increasingly find their way into the financial industry and challenge the traditional business model of banks. On 1 June, in a lecture at the Center for Financial Studies at Goethe University Frankfurt, Stefan Krause, member of the management board of Deutsche Bank and President of the Schmalenbach-Gesellschaft, explained how banks could react to the growing digitalization and respond to the requirements of digital natives.

"The digitalization of the banking industry is still at its very beginning," Krause said. Profound changes across many areas are necessary to keep up with technological progress. Up to now, banks have been the most important players in the banking sector, Krause pointed out, but newly established FinTechs (financial technology firms) are increasingly competing with traditional banks. The business models of FinTechs have been digital-oriented right from the start, these firms understand how to effectively use the possibilities provided by the internet to translate the ideas and needs of digital natives into concrete solutions. This is an advantage because the new tech-savvy generation processes their banking transactions more and more online using mobile devices. Nevertheless, Krause believes that traditional banks will continue to play an important role in the financial sector, however not in their present form.

Krause requested from banks to adjust their business models and to make progress in the area of digitalization. Digital channels have to be used more efficiently and should be integrated in existing processes. It is foreseeable that, in the future, financial institutions have to make more use of individual data to get in touch with their customers and to offer them personalized solutions, he said. The bank of the future needs to actively contact its customers because fewer and fewer customers physically visit a bank's branch to inform themselves. According to Krause, traditional banks have an advantage compared with FinTechs in this context because customers trust traditional banks more when it comes to dealing with sensitive financial data.

The new digital banking industry will also provide new challenges for bank employees and managers, Krause explained. The classical bank employee will increasingly become a financial optimizer. Universities have to prepare their graduates for the changing work environment, he demanded.

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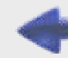
17 Jul 2015	CFS/Deutsche Börse Conference The Industrial Organisation of Securities and Derivatives Markets "High Frequency Trading"
21 Jul 2015	CFS Lecture Series "Risk & Regulation" **Korbinian Ibel**, *European Central Bank* "Der SSM-Ansatz zur bankaufsichtlichen Erfassung von Risiken"
09 Sep 2015	CFS FinTech Conference *in cooperation with Springer-Fachmedien*
24 Sep 2015	The Deutsche Bank Prize in Financial Economics Award Ceremony and CFS Symposium *in honor of the award winner of 2015 **Stephen A. Ross***
28 Sep 2015	CFS Lecture Series "Risk & Regulation" **Bernd Scherer**, *First Private Investment Management* "Wie gut managen Asset Manager ihre eigenen Risiken?"
07 Oct 2015	CFS Lecture Series "Risk & Regulation" **Carsten Schulze and Jochen Papenbrock**, *both PPI AG* "Moderne Entscheidungsunterstützungssysteme der Asset Allocation in Zeiten regulatorischen und ökonomischen Drucks"
08 Oct 2015	CFS Lecture **Mathew Szeto**, *Head Electronic Trading, RBC London* "High Frequency Trading"
29 Oct 2015	CFS Presidential Lecture **Martin Feldstein**, *Harvard University and National Bureau of Economic Research*



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Deutsche Bank Prize in Financial Economics 2015

The Center for Financial Studies has awarded the Deutsche Bank Prize 2015 to Stephen A. Ross. Jury Chairman and CFS Director Jan Pieter Krahnen explained the decision of the international Jury: "The Jury has chosen Professor Ross for his groundwork and fundamental contributions to the analytical development of financial economics. For more than 25 years major models developed by him have marked the economic world. His models relate to the theory of asset pricing, the analysis of the term structure of interest rates, understanding option prices, and the basic structure of the principal-agent problem. The work of Professor Ross has shaped today's thinking in financial innovation, practice, and policy."

Stephen A. Ross is the Franco Modigliani Professor of Financial Economics and Professor of Finance at the MIT (Massachusetts Institute of Technology) Sloan School of Management. Also, he is the author of more than 100 peer-reviewed articles in economics and finance and co-author of the best-selling textbook Corporate Finance. Furthermore, he has acted as advisor to the financial sector, major corporations, and government departments such as the U.S. Treasury, the Commerce Department, the Internal Revenue Service, and the Export-Import Bank of the United States.

Stephen A. Ross' wide range of research interests include the economics of uncertainty, corporate finance, decision theory, and financial econometrics. He is known for his fundamental contribution to modern financial economics. His models have changed and advanced practice profoundly. They are widely applied and standard in academia and the financial industry.

Most notably, Stephen A. Ross is the inventor of the Arbitrage Pricing Theory, a cornerstone of modern asset pricing theory and the Theory of Agency, which is omnipresent not just in corporate finance but also in many other spheres of economics. Furthermore, he is the co-creator of Risk-Neutral Pricing and of the Binomial Model for Pricing Derivatives. His work has been central for the development and the empirical analysis of the term structure models. He co-authored the Econometrica paper "A Theory of the Term Structure of Interest Rates" in 1985, which remains one of the most crucial contributions on the topic to this date.

In addition, recently Ross' Recovery Theory has opened up a huge potential for the analysis of household subjective expectations, rationality and financial literacy, but also financial advice. His theories provide standards for pricing in major securities trading firms, are useful for retirement accounts and for new financial products that may allow households to insure a wider range of risks.

The academic prize is sponsored by the Deutsche Bank Donation Fund and carries an endowment of €50,000. The CFS awards the prize biannually in partnership with Goethe University Frankfurt and in 2015 for the sixth time.

The award will be presented to Stephen A. Ross as part of an academic symposium in Frankfurt on 24 September 2015.

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