

# NEWS

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STUDIES

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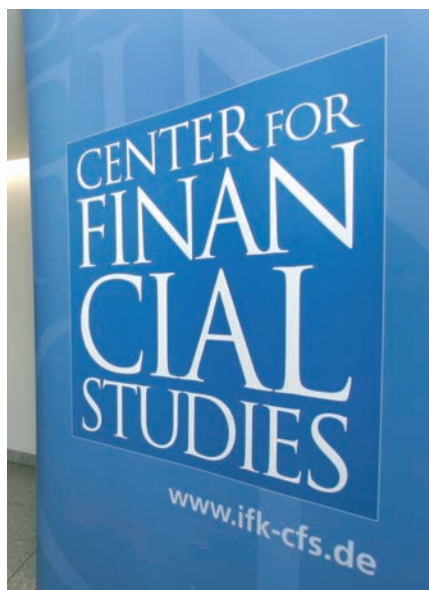
## Editorial

### CFS – Moving Forward in Times of Change

*It is now ten years ago that the Center for Financial Studies was launched. It was 1996 and Germany's financial community had set about achieving greater international visibility. On the one hand, there were ambitious plans for developing the local financial center with the aim of narrowing the gap to London, the market leader. On the other hand, in view of the rapidly developing European Monetary Institute, it was deemed essential to establish an internationally-oriented research environment. To this end, the Institut für Kapitalmarktforschung, founded in 1967, was expanded to include several new fields of action. These included a research program, additional presentations, a compact executive development program focusing on financial economics, and numerous international conferences. At the same time, the name Center for Financial Studies (CFS) was introduced.*

*With the active support of Karl Otto Pöhl, the first President of the CFS (appointed in 1996), the Institute quickly succeeded in attracting attention and becoming part of the scientific community in Europe. At the*

*very beginning, Alan Greenspan gave a widely heeded speech at the CFS. Subsequently this was followed by international conferences and the first - 'clinical' - research results, relating to the credit and risk management of German banks among other things, both of which enjoyed growing attention.*



*The collaboration with the ECB was intensified under Axel Weber, who joined CFS as a Director in 1998. The now widely-known conference that he initiated on "The ECB and Its Watchers" was taken over by CFS Director Volker Wieland in 2003. It recently took place for the 8th time and is now a firmly established event in the CFS annual calendar. Furthermore, CFS also works closely together on a regular basis with the ECB and the European System of Central Banks*

*via the creation of the Research Network on "Capital Markets and Financial Integration in Europe". These developments have been accompanied by a considerable broadening of the spectrum of research topics at CFS.*

*After ten years as the head of CFS, Dr. Pöhl stepped down as President on 28 June. Pöhl's dedication to the Institute contributed significantly to the success of its expansion. At a CFS event on 28 June 2006, tribute was paid to his services to the Institute.*

*His successor as President is Professor Otmar Issing, until recently Member of the Executive Board of the European Central Bank. Thus, the path has been ideally laid for CFS to become a think tank of the financial community. Under Issing's guidance we expect there to be an even stronger orientation towards policy-relevant research programs that will also take into account issues related to regulatory policy.*

*President Issing's term of office will certainly be characterized by increased efforts on the part of financial market participants in Germany to ensure that no ground is lost in terms of competitiveness within Europe. And to the very best of our ability, we at CFS will contribute to the necessary accompanying research. The current prospects are by any standard unusually favorable, so let us get to work!*

*Jan Krahn, CFS Director*

# A New President at CFS: an Interview with Otmar Issing and Karl Otto Pöhl



On 28 June 2006 the CFS Board of Trustees elected **Otmar Issing** as the new president of the Center for Financial Studies. Thus, the former Executive Board Member of the European Central Bank will succeed **Karl Otto Pöhl**, who held this office for ten years.

At this occasion the *Frankfurter Allgemeine Zeitung* held an interview which was published on 14 July 2006 (\*).

**Question:** Mr. Pöhl, Mr. Issing, in former times monetary policy deliberately made use of surprises, sometimes even shocked markets. Today central banks often announce rises in its interest rates weeks in advance and change its rate usually only in very small steps. Why is this the case?

**Pöhl:** I am not so sure that we used to work with shocks, although decisions did sometimes come as a surprise. However, we did not deliberately set out to shock the markets, but we did less to prepare the markets for changes.

**Issing:** And sometimes it was also the case that a central bank wanted to demonstrate to the markets who was in charge. I have never thought that this was a very good idea. As financial markets have developed, the role of expectations has become increasingly important. Financial markets are driven by expectations.

**Question:** Have the financial markets therefore increased in importance for monetary policy?

**Issing:** The financial markets today are a decisive transmission belt for monetary policy. Consequently, the steering of expectations is a central task for

monetary policy. If the central banks do not wish to accept or even engineer erratic changes in expectations, they must take great care, and this has been recognized by all central banks around the world. It is important to steer and anchor expectations such that the financial markets take the central bank and its objective seriously, i.e. the bank will do whatever it takes to keep the rate of inflation low.

**Pöhl:** At the Bundesbank we also tried to influence expectations; ‘steer’ is the wrong expression. It had more to do with exerting influence in general than with respect to individual measures. Perhaps there was not as much awareness at that time.

**Question:** Raising the rate by 25 basis points does not have a particularly strong influence on the real economy, on firms’ investment activities, but it does significantly affect the financial markets where basis points are calculated in fractions. Is this the reason for the tendency towards taking small steps in interest rate changes?

**Issing:** When central banks take decisions that are totally unexpected then inevitably some investors will suffer a loss

because they have planned differently. And then immediately there is an enormous wave of public criticism. And it does not matter so much anymore who is right but that damage has been done. In the end this leads to volatility in the financial markets and this is expensive for the economy as a whole.

**Question:** Is monetary policy being increasingly influenced by academic research?

**Pöhl:** Axel Weber is the first academic to head the Bundesbank and this is an indication of this tendency. But it is understandable. Monetary policy has become much more complicated, for example on account of flexible exchange rates. Exchange rates must always be taken into account when making decisions. In recent times we have been experiencing astonishing exchange rate stability, and this is almost certainly because the central banks have become more cautious with respect to interest rate decisions, i.e. taking smaller steps but, as in America’s case, doing so 17 times in succession.

**Question:** Is this a fundamental change?

**Pöhl:** This, of course, does not mean that monetary policy is no longer policy-

making as such and that considerations other than those relating to economics and scientific research are left aside. Central bank policymaking is also an art. Alan Greenspan, the former governor of the US central bank, was indeed an artist. For example, his manner of speaking was highly artificial and I admired that. Thus there is plenty of leeway for aspects other than scientific.

**Issing:** The role of science has generally increased. It is important for monetary policy that nowadays most central banks are independent. From the viewpoint of science, this means that research based results can more easily be adopted in policy decisions. Each policy decision should thus be based on research. Politicians, however, in many instances say, “we cannot do that, we do not want to...”

**Pöhl:** ... we have to think about the effects it will have on the voters...

**Issing:** ...these things play a big role in politics. But as Mr. Pöhl has already said, monetary policy will never be policy that simply follows models to which there are no alternatives. For me, monetary policy will always be applied research, but it remains to a great extent a process of weighing – leaving aside whether or not it should be called art.

**Question:** Increasingly academics are being appointed to the central bank committees that take the decisions on monetary policy.

**Issing:** Entire bodies decide on the monetary policy of the European Central Bank, the American Fed and the Bank of

England. I would find it rather alarming if only professors would be members...

**Pöhl:** ...yes...

**Issing:** ...but I would also find it disastrous if there were no academics in these decision bodies, or only those who have no relevant role to play.

**Pöhl:** I view the problem more as being related to the adherence to strict rules. I have always said, well we could install an obedient civil servant and he would then announce whether the money supply objective is achieved or not. But nowadays I'm much more skeptical about a monetary growth target. I am not saying that it is irrelevant, but it is only one criterion amongst many and thus at the end of the day you still have to weigh up which decision is the right one.

## Price Stability, Inflation Dispersion and Convergence in EMU: Does One Size Fit All?

by CFS Research Fellow Guenter W. Beck (Frankfurt University)



The establishment of the European Monetary Union (EMU) has been accompanied by heavy criticism from some economists and the success of the new currency has been doubted for a

variety of reasons. Feldstein (1997) and Obstfeld (1997), e.g., argue that the EMU is not an optimum currency area in the sense of Mundell (1961). Referring to Friedman (1953), they think that – in the presence of market rigidities as in the case of European countries – nominal exchange rate adjustments across European countries would be required to achieve necessary changes in real exchange rates in response to asymmetric adverse shocks. Critics have considerable doubts that a single monetary policy can adequately meet the requirements of the various member countries (“Does one size fit all?”). One issue that was discussed in this

context are the implications of the existing large heterogeneities in economic conditions across member countries on the adequacy of the ECB's inflation target of an EMU-wide average inflation rate of less than 2%. Sinn and Reutter (2001) argue that due to Balassa-Samuelson effects in less developed countries such as Ireland or Portugal, inflation rates in these countries will be relatively high. As a consequence, price dispersion across the member countries will be large and some more developed countries such as Germany might be threatened by deflation when the ECB strictly sticks to its target. Therefore, the two authors call for an increase in the ECB's upper

inflation bound by at least 0.5%. Another issue of concern is that countries' efforts to follow a strict stability policy as prescribed by the Maastricht Treaty have been weakened after joining the EMU and - as a consequence - inflation rates will no longer converge but might even diverge in the near future.

Given the importance of the topic it is surprising that only few attempts have been made to deal with it systematically thus far. In Weber and Beck (2005) we provide a contribution to close this gap. We approach the topic of inflation dispersion and convergence in the euro area in three different ways. All results are based on a broad sample of regional inflation rates from EMU member countries. To illustrate the importance and extent of regional inflation rate dispersion, Figure 1 plots inflation rates for our European 'core sample'. As one can see, regional dispersion is considerable, spanning a band of around 4% width.

In the first part of our formal analysis, we examine the existence and degree of mean reverting behavior ( $\beta$ -convergence) in EMU regional inflation rates. We find evidence in favor of significant mean reversion of inflation rates throughout the sample period. However, the speed at which this convergence occurs is relatively slow. In the second step of our analysis, we examine whether  $\sigma$ -convergence across EMU inflation rates is taking place. The results of this analysis are presented in Figure 2 where we plot the dynamics of regional inflation dispersion (as measured by the standard deviation) for EMU regions, U.S. states and Japanese prefectures (taken from Beck and Weber (2005)). The graphs show that there was a significant reduction in EMU-wide inflation dispersion at the beginning of the 1990s but also that this process came to an end in recent years. On the contrary, we find a slight increase in dispersion after 1998. Moreover, we can see that the degree of overall

**Table 1: Transition Probabilities (Annual Transitions) for Deviations from the Cross-Regional Mean**

Transition Probabilities for EMU					
Dev. in t	Dev. in t + 1				
	< -0.7	-0.2	0.2	0.7	> 0.7
< -0.7	0.61	0.25	0.11	0.02	0.01
-0.2	0.34	0.35	0.17	0.06	0.09
0.2	0.05	0.3	0.23	0.25	0.17
0.7	0.03	0.1	0.19	0.34	0.34
> 0.7	0.01	0.04	0.11	0.3	0.54

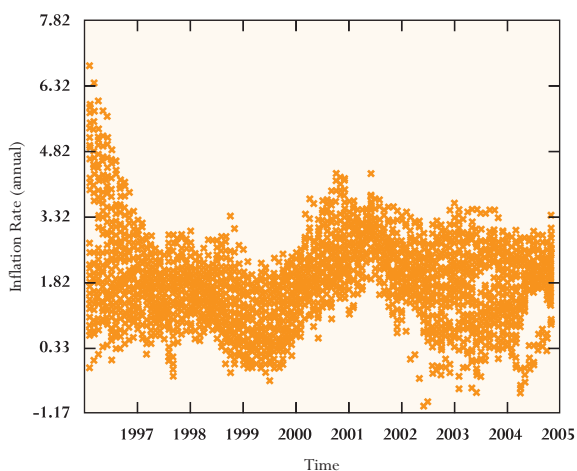
Transition Probabilities for the U.S.A					
Dev. in t	Dev. in t + 1				
	< -0.7	-0.2	0.2	0.7	> 0.7
< -0.7	0.42	0.24	0.14	0.14	0.07
-0.2	0.24	0.28	0.24	0.17	0.07
0.2	0.18	0.32	0.2	0.21	0.1
0.7	0.05	0.19	0.3	0.33	0.12
> 0.7	0.02	0.09	0.1	0.22	0.57

Transition Probabilities for Japan					
Dev. in t	Dev. in t + 1				
	< -0.3	-0.1	0.1	0.3	> 0.3
< -0.3	0.28	0.27	0.26	0.12	0.07
-0.1	0.19	0.28	0.21	0.2	0.13
0.1	0.19	0.21	0.25	0.23	0.11
0.3	0.13	0.17	0.22	0.28	0.19
> 0.3	0.07	0.22	0.19	0.21	0.32

**Note:** Table entries report conditional probabilities for the event that an observation which is in period t in the state indicated in column one moves to one of the states indicated in columns two to six in period t + 1. The variable under consideration is the deviation of a certain region's inflation rate from the cross-sectional mean of inflation rates. Each state includes all inflation rate deviations that lie within the indicated range. The state -0.20, e.g., comprises all inflation rate deviations that lie in the range [-0.70, -0.20]. States were chosen such that each state has approximately the same number of observations.

**Figure 1: Regional European Inflation Rates: All Items**



**Note:** Figure 1 plots cross-sectional inflation rates('All Items') for Germany, Austria, Finland, Italy, Spain and Portugal. Inflation rates are computed as annual percentage changes in the underlying price index.

Figure 2: Cross-Regional Inflation Rate Dispersion: EMU, USA, and Japan

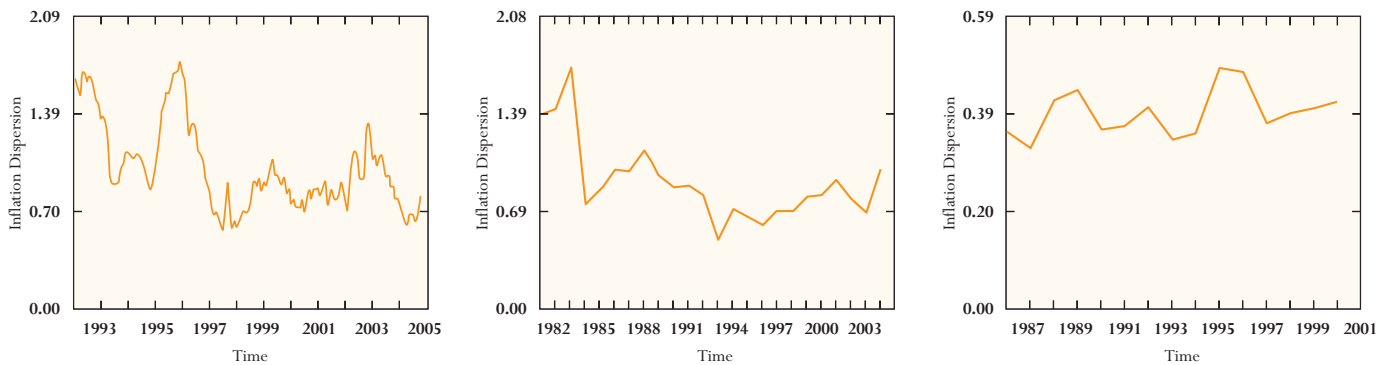
**Note:**

Figure 2 plots the standard deviation of the regional inflation rates (total index) of European (left), U.S. (middle) and Japanese regions. Inflation rates are computed as annual percentage changes in the underlying price index. All figures are multiplied by 100.

inflation dispersion in EMU is very close to that of the U.S. sample. Together with our findings on  $\beta$ -convergence these findings suggest that the ECB should not expect that regions/countries with relatively low/high inflation rates will revert towards the mean very quickly. This result is confirmed when we turn to the third part of our analysis where we perform ‘distribution dynamics’. Distribution dynamics is a methodology that is extensively used in the empirical growth literature. Its main advantage is that it allows simultaneous studying of the dynamics of an overall distribution and the within-distribution dynamics. The results from applying distribution dynamics to regional EMU inflation rates are presented in Table 1 and confirm the above described findings from  $\beta$  - and  $\sigma$ -convergence: Although European regional inflation rates tend to revert towards the cross-regional mean, the speed at which this occurs is relatively modest. The numbers also show that in Japan mean inflation rate deviations are basically expected to disappear within one year. For the U.S. case the expected duration of mean inflation rate deviations is larger than for Japan but considerably smaller than for EMU. In the last part of the chapter, we approximate the empirical distribution of

European inflation rates by a theoretical equivalent to examine the relationship between the average EMU-wide inflation rate (that is the base for the ECB’s decisions) and the portion of regions (5%, 10%, 25%) with negative inflation rates. We find that below a ‘critical value’ of around 1% a significant portion of regions faces deflationary threats. In total, our results show that heterogeneities in the EMU are far more pronounced than in either Japan or the USA. Given the potentially negative consequences of large and persistent inflation differentials cited above, the ECB should look very carefully at the future development of these differentials. This necessity is aggravated by the fact that in the near future some of the Central and East European countries are likely to join the EMU. This accession will increase the anyway large inflation rate dispersion across EMU member countries even further. In this context, a better understanding of the sources of inflation dispersion and thus potential measures against it would be desirable. Unfortunately, there exists only few literature on this subject by now. The same is true for the important questions of potential welfare costs of prevailing inflation differentials. All these issues will be dealt with in future work.

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# Structures of Risk Transfer

by CFS Program Director Christian Laux (Frankfurt University and CFS)



The trading and sharing of risks play an important role in the capital market. Even though stock corporations have already transferred their risk to the capital market, they still use insurance and derivatives (futures and options) contracts to transfer specific risks.

What can be gained if the risk of a fire in a plant is borne by the investors of an insurer rather than the firm's investors? If investors hold well-diversified portfolios, as they should, and most do, then they will end up bearing the risk in both cases.

Capital market frictions provide a rationale for corporate risk transfer. Owing to information and incentive problems, a firm might find it costly or impossible to recapitalize once the debt ratio exceeds a critical level. This can result in distorted investments, inefficient liquidation, and adverse reactions by stakeholders (customers, suppliers, employees) as well as competitors. These distortions are often referred to as indirect bankruptcy costs. Thus, a potential role of risk transfer is to reduce the expected costs of financial distress, for example, by reducing the likelihood of excessive debt stemming from large losses. It might also be difficult and costly to raise equity to finance new ventures. In this case, the role of risk management is to ensure that sufficient internal funds are available for financing new, profitable projects, which otherwise might not be carried out.

Clearly, risk transfer can create value for shareholders, but information and incentive problems generally also make it difficult and costly to transfer risk. For example, consider an insurance contract under which the insurer commits to cover any shortfall of internal funds below the level of funds required to finance all

profitable investment opportunities. The problem with such a contract is that a firm will always claim – in the shareholders' interest – that it has insufficient internal funds and high financing needs.

Risk management has to trade off the costs and benefits of risk transfer and retention (holding equity), where the trade-off depends on the available risk transfer instruments. Recent years have witnessed the development of new contracts, instruments, and solutions to transferring risk. An important prerequisite for choosing between risk transfer instruments is to understand the potential problems and how to deal with them. In this analysis these problems are examined and related to the characteristics of risk transfer instruments. The interrelation between characteristics is discussed for catastrophe bonds and securitization.

## Problems and Design of Risk Transfer

There are four potential information and incentive problems that shape the design of risk transfer instruments. (1) Risk transfer can affect the protection

buyer's decisions and therefore the risk exposure that is borne by the protection seller. For example, a firm may invest less in quality control if it has insured the losses from recalling its products or product liability claims. (2) There may be a dispute about the realized loss and the level of coverage. For example, the protection buyer might exaggerate the loss or the protection seller might argue that the loss is lower or not covered. (1) and (2) are examples of moral hazard. (3) Asymmetric information about the expected loss can result in difficulties in pricing the risk transfer contract. This can result in adverse selection where only those with high expected losses want to transfer their risk. (4) The possibility that the protection seller may not be able to pay when the loss occurs results in counterparty or credit risk.

The art of risk management is to design instruments that allow a low cost and effective risk transfer. Design elements include the choice of (a) trigger: indemnity versus exogenous, (b) organizational structure: intermediary versus direct, (c) contractual structure: retaining and bundling risks, (d) funding: unfunded versus funded.

### Trigger

Moral hazard and adverse selection problems arise when the payoff of the protection instrument depends on the true realized loss of the protection buyer and the protection buyer is able to influence the loss distribution, or has private information about it. One objective may therefore be to reduce the contract's sensitivity to the buyer's actions and information. For example, the protection instrument can depend on an exogenous trigger such as the price of commodities, interest rates, or exchange rates. This is a major difference between insurance and derivatives contracts. While insurance contracts are usually indemnity contracts where the claim depends on the protection buyer's actual loss, the payoff of derivatives depends on exogenous parameters. Certainly, moral hazard and adverse selection problems are very limited for derivatives. Exogenous triggers are usually observable and verifiable and therefore easier to enforce. The benefits are obtained at the cost of basis risk, since the payoff of the derivative may not perfectly hedge the loss of the firm. For some risks, no suitable exogenous triggers are available, e.g., losses from fire in a plant. In these cases indemnity triggers are the only alternative.

### Organizational Structure

Monitoring can reduce problems of adverse selection and moral hazard. For example, the protection seller can obtain information to estimate the expected loss, to ensure that the protection buyer continues to invest in loss control, and to estimate the size of a realized loss. Monitoring is costly and requires great expertise. This implies that the risk cannot be transferred directly to a large and dispersed group of counterparties. Instead, an intermediary monitors on behalf of its owners, the ultimate protection sellers. Moreover, instead of negotiating with many dispersed parties,

the protection buyer has to deal only with the intermediary, who puts his reputation at risk and therefore has higher incentives to honor his obligations.

With an exogenous trigger, a contract's payoff realization is straightforward to determine, and information and incentive problems are held to a minimum. Therefore, there is less need for an intermediary and the contracts can be directly traded in the market.

### Contractual Structure

To reduce problems of moral hazard and asymmetric information, the protection buyer usually retains part of the risk. For example, insurance contracts generally have deductibles and upper limits. The retention can be contingent on individual risks or a bundle of risks. Multi-line insurance policies bundle different risk exposures to be covered by one contract with a common aggregate deductible and policy limit. One advantage is that a common aggregate deductible on a portfolio of risks allows the total insurance coverage to be reduced, subject to some maximum aggregate risk that the firm is willing to retain. This can reduce the transaction costs of insurance. It can also reduce moral hazard and adverse selection, but in this case, the optimal retention structure is very sensitive to the underlying risk and the risk management objective. Indeed, a common aggregate deductible may also increase moral hazard problems.

### Funding

An important issue in risk transfer is counterparty risk, in particular, when risk is to be transferred directly to dispersed and anonymous investors. In a funded system, the contractual parties have to make an up-front payment to ensure that funds are sufficient to cover the claim with a certain level of confidence. The required funds may vary from a fraction of the expected loss to the maximum

possible loss. An example for the first alternative is the use of margin accounts for derivatives. Insurance contracts are usually unfunded in that no specific funds are assigned to particular risks. Instead, the insurer's total funds are available to cover all potential claims. Thus, the counterparty risk depends on the financial strength and the reputation of the insurer.

### Cat Bonds

Cat bonds are bonds with forgiveness provisions after a catastrophic loss, where the interest or the principal are reduced, depending on the size of the loss. These bonds have evolved as an alternative to reinsurance to hedge insurers' risk from catastrophic events. Instead of directly issuing the cat bond, an insurer typically uses a special purpose vehicle (SPV), which is a firm that is set up for the purpose of this transaction. The insurer writes a reinsurance contract with the SPV, which backs the transaction by raising capital through issuing bonds. The level of insurance payment or, equivalently, debt forgiveness, usually depends on an exogenous trigger such as a composite index of insurer losses or a parametric measure of the event. Therefore, an important feature of a cat bond is the trigger's correlation with the insurer's loss. The higher the correlation, the lower is the basis risk. This basis risk has to be traded off against the benefits of reduced moral hazard and adverse selection.

The SPV can be interpreted as a focused insurer whose only purpose it is to write one insurance contract. In contrast, a general insurer engages in many different activities and has many different risks on its balance sheet. A SPV helps to segregate the claims of different policyholders and a sufficiently high endowment of the SPV eliminates the counterparty risk. The risk that funds may be diverted to other uses

is also minimized. This can considerably reduce the costs of raising and holding capital and increases the confidence of the protection buyer that the funds will be available when needed. These benefits are particularly pronounced when low frequency and high severity risks are involved with a high correlation of losses between policyholders as in the case of catastrophe risk.

With an index or parametric trigger, monitoring and claims settlement become less important. No traditional insurer is needed to offer a funded index-triggered product. Instead, a SPV can be set up that raises funds in the capital market. While a traditional insurer or reinsurer also raises funds in the capital market, these funds are not restricted to one particular risk. In this sense the cat bond can be interpreted as a capital market alternative to reinsurance that transfers one particular risk “directly” to the capital market.

### Cat Bonds and Competition

It is often argued that because of cat bonds, the reinsurance market has become more contested, thereby also decreasing premiums for traditional reinsurance. One potential reason is asymmetric information between reinsurers that can stem from incumbents having inside information or different capabilities for evaluating an insurer’s expected loss. Asymmetric information allows reinsurers to extract an information rent, as reinsurers fear adverse selection and bid less aggressively than they would with symmetric information. Cat bonds with index or parametric triggers are not subject to adverse selection. The availability of cat bonds therefore reduces the rent that can be extracted from asymmetric information and thus also the costs of traditional reinsurance. Interestingly, the mere possibility that a cat bond can be issued is sufficient to reap this benefit; actually issuing the cat bond is not required.

### Securitization

Related to cat bonds is securitization. From the perspective of risk transfer, securitization involves bundling the risks from a pool of assets that a firm (the originator) transfers to a SPV, which has been created specifically for this purpose. The SPV issues tranches of financial securities on its cash flow with different seniority: super senior, senior, subordinate, mezzanine and equity.

The transfer of risk to the SPV can be arranged as a true sale transaction where the asset pool is segregated from the originator and transferred to the SPV, which purchases the assets from the originating institution. Alternatively, only the risk is transferred in a synthetic transaction, e.g., through a credit default swap, which is written between the originator and the SPV. A synthetic securitization can be funded or unfunded. In the first case, the SPV holds the money to make the payment to the originating bank if a loss (default) occurs. In the second case, funds are raised after the loss.

The difficulty in securitization lies in the transfer of risk. The transfer of credit risk in a synthetic transaction is akin to buying credit insurance from the SPV. Thus, the structure of securitization resembles the structure of cat bonds. Again, the SPV’s purpose is focused and limited, which is particularly beneficial for highly correlated low frequency and high severity risks. Consider a well-diversified credit portfolio. A huge market downturn, where many creditors default, is a very low probability event, but results in very large losses for many banks. Systematic risk in banking is similar to catastrophic risk in insurance. One difference is that it may be more difficult to obtain an exogenous trigger that is highly correlated with the loss of the credit portfolio. In any case, exogenous triggers are usually not used

in securitization. Instead, the true cash flow risk is transferred, which gives rise to potential problems. For example, what is the quality of the underlying portfolio, will the underlying assets be serviced (claims collection, extension of credit for a revolving pool)? These problems are usually addressed through tranching in combination with monitoring, risk retention, and reputation.

### Tranching

Through tranching, different risk classes can be created with different sensitivities to the underlying asset value. Senior tranches default only if there are strong adverse movements in the market or large exogenous shocks (systematic risk). Mezzanine tranches have a higher probability of default and the equity tranche captures the expected loss. Dealing with incentive problems is therefore more important for those tranches that involve a large part of the unsystematic risk. Through tranching it is possible to target investors with different degrees of sophistication in evaluating and monitoring risk. Moreover, some investors may only be allowed to invest in investment-grade bonds. Tranching thus makes it possible for these investors to participate in risk transfer by holding senior tranches.

The tranches as well as the SPV are rated by rating agencies, which monitor the process during the life of the financial assets and the SPV. In addition, an external credit enhancer may provide guarantees and an external servicer of the assets may be used. An external credit enhancer has incentives to monitor also the transaction, and the use of an external servicer can reduce conflicts of interest when a bank has strong relations to its creditors above and beyond the credit. Often, the originator retains a high fraction of the risk. Retaining the equity tranche is akin to a deductible in an insurance contract.



For the mezzanine tranche, the analogy to insurance is a combination of an insurance contract that indemnifies losses up to an upper limit and a second insurance contract with a deductible that insures losses exceeding the limit. Retaining the senior tranche is akin to an upper limit in an insurance contract.

Furthermore, an originator, who regularly securitizes assets, puts his reputation at risk. This is particularly true for a transaction where the risk is directly transferred to the market, which observes the payoffs through the performance of the issued securities.

### Conclusion

Risk transfer can increase shareholder value because of capital market frictions that stem from information and incentive

problems. Because of these frictions, risk transfer has an effect on operating decisions and therefore on firm value.

Financing decisions involve risk transfer decisions and are subject to many of the same problems. For example, when a firm is raising equity capital to hold cash as a buffer against potential losses, adverse selection (how much is the equity claim worth?) as well as moral hazard (how are the funds used if no loss occurs?) arise. The art of risk management is to decide which instruments are most effective in transferring certain risks: financial structure, insurance, derivatives, or alternative risk transfer? This implies trading off the costs and benefits of risk transfer and retention, where the trade-off depends on the available instruments.

### FURTHER READING

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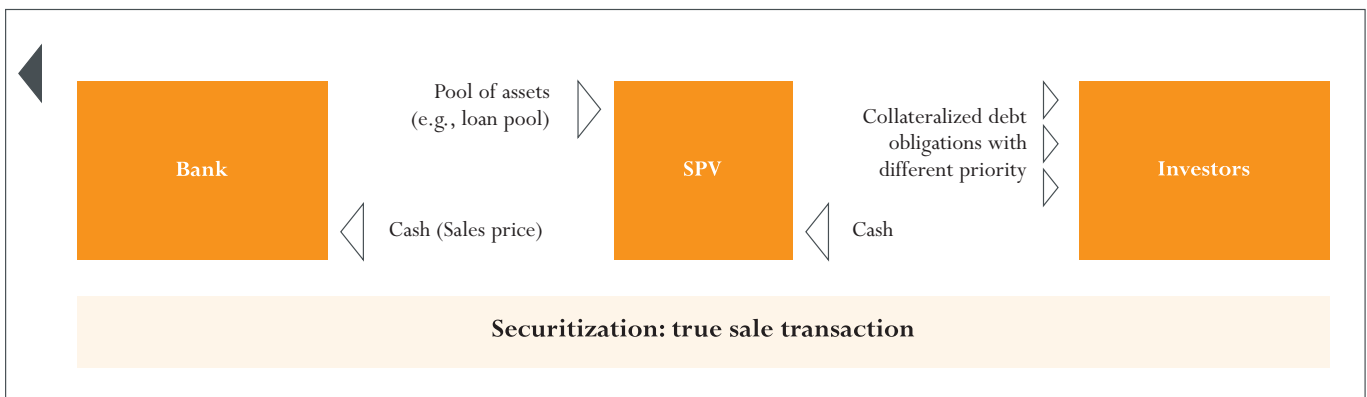
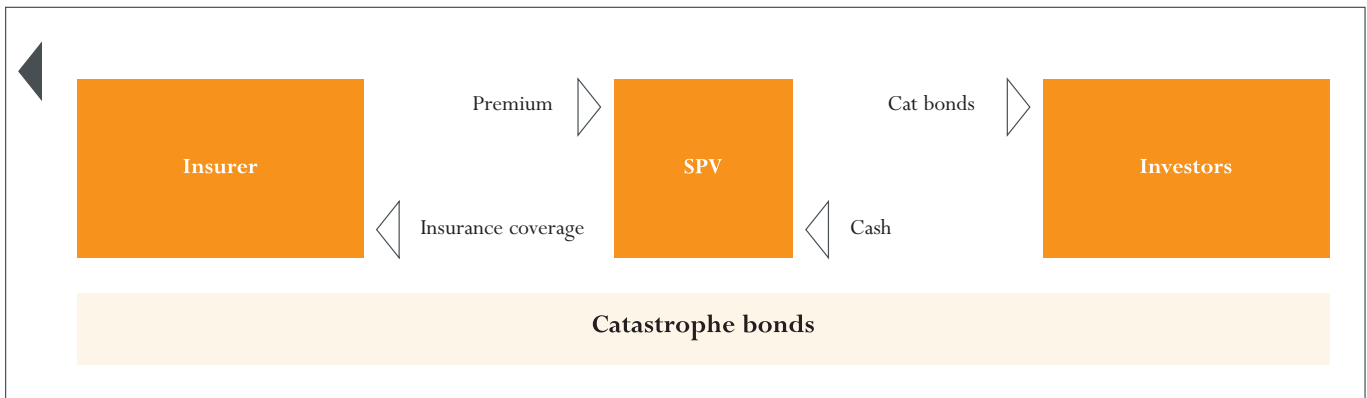
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# Corporate Governance in Entrepreneurial Firms: Evidence from VC Contracts

by CFS Program Director Uwe Walz (Frankfurt University and CFS)



Corporate governance is an important topic that is discussed intensively both by the general public as well as in the academic literature. These discussions rest on the premise that corporate insiders do not always act in the best interests of the providers of funds. The separation of ownership and control can lead to situations in which management does not necessarily act in the best interests of the investors; such situations include the degree of dedication on the part of management, the exploitation of control benefits, and the misdirection of funds to name but a few. Corporate governance concerns the means by which the suppliers of finance to firms seek to ensure proper returns on their investment.

The relation between venture capitalists (VCs) and their portfolio firms has for a number of reasons proved to be a particularly interesting field for analyzing corporate governance mechanisms and for comparing them over time as well as across countries. First, young entrepreneurial firms are crucial in the process of innovation and economic growth. Second, the degree of informational asymmetries is very pronounced, thus rendering corporate governance mechanisms potentially very valuable. Third, VCs very often use explicit contracts that provide particular insights into the relationship between the investor and the management of the firm. The main questions in this context are concerned with determining which observable governance mechanisms may be considered the most important, why explicit contracts are used and whether there is any added value to be gained.

**Professor Dr. Uwe Walz (University of Frankfurt and CFS) CFS Program Director of the area “Entrepreneurial Finance”**

## VCs and contracts

Venture capitalists are specialized financial intermediaries who channel funds from their investors to young entrepreneurial firms. They add value by acting as hands-on investors who are actively engaged in their portfolio firms. In order to overcome informational problems vis-à-vis their own investors, they typically supply closed-end funds with a lifetime of 10-13 years

duration. This in turn implies that they engage in their portfolio firms for a limited period only. Disinvesting their firms in public or private markets is hence crucial to the success of these intermediaries. Owing to the limited period of engagement in the firms, VCs have to rely on explicit contracts in order to address the multitude of informational problems associated with entrepreneurial firms. Given the conventional assumption underlying economic theory that individuals only engage in time and resource-consuming activities when they expect to receive the proper returns, the sheer size and detail of these contracts throughout the world provide a strong indication that they do indeed add value.

## Venture Capital Contracting

There is a vast body of theoretical studies that focuses on the principal agent relationship between the investor and management. An analysis of the relationship between the VC and the entrepreneur is therefore an obvious choice when it comes to trying to shed some empirical light on this issue.

The most immediate finding is that VCs can separate cash flow and control rights. This is reflected by the very widespread usage of control rights, such as veto and voting rights, liquidation as well as exit rights. In most cases observed these rights are made contingent on some kind of verifiable performance measure.

## Financial securities

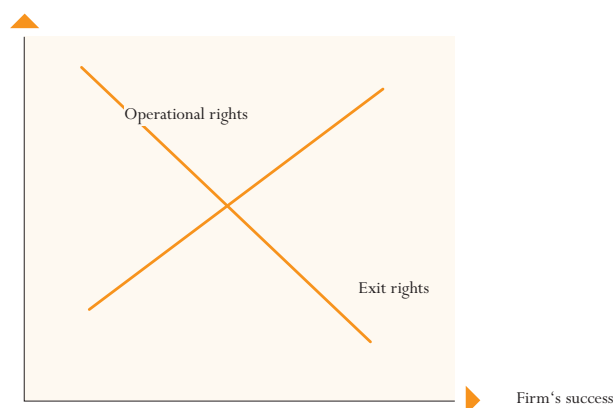
Convertible stocks are the dominant financing instruments, at least in the US. It is there that this type of security is used – depending on the data sample - in 70%-90% of all contracts.

Convertible (preferred) stocks imply that the compensation function of the entrepreneur will be convex (i.e. increase overproportionally with success), thereby allowing the contracting parties to address the double moral hazard problem prevalent in the relationship between the active VC investor and the entrepreneur in an efficient manner. Outside the US, convertible stocks are much less common (e.g. in Germany they only appear in approximately 10% of all contracts), but we observe on the one hand financial securities that have similar incentive effects (such as Debt-Equity mixes) and, on the other hand (and more importantly), there seems to be a strong tendency, especially among more experienced VCs, towards such financial securities. VCs outside the US seem to learn and adapt US style financial securities.

### Decision and Control rights

Decision and control rights give one of the parties the right to choose among different actions under certain circumstances in the firm's future. This reflects the incompleteness of the contracting problem. The numerous different decision control rights can be grouped in three categories: operative rights (such as veto rights against changes in the business plan or in the firm's capital structure, or board seat rights, which allow the VC to interfere in management decisions in normal times), liquidation rights (such as put options and staged financing), and exit rights (which aim to resolve potential conflicts of interest in the event of exit and mitigate potential hold-up problems). These control rights are often complements rather than substitutes: in contracts where put options are observed, staged financing as well as debt financing is also often found. One particularly interesting observation is the development of these rights over time (i.e. calendar time as well as the firm's lifetime and its success). The relationship between the firm's success and the operational control rights in the hand of the VC is depicted in Figure 1; it declines over time.

Figure 1  
Control rights with VC



Informational asymmetries become less important over the lifetime of the firm and the firm accumulates more pledgeable income making operative control rights as substitutes for cash flow rights less important. Hence, it is efficient, given the fact that the VC typically does not experience any control benefit (in contrast to the entrepreneur), to hand these rights back to the firm. In a sample of German VC contracts, it can be observed that the VCs veto rights against a specific business plan changes diminishes from 58% in the second financing round to 35% (of all contracts in which the VC has this right) in the third round. At the same time, however, we observe also a significant increase of exit rights in the hand of the VC. The percentage of all contracts that do contain exit rights doubles between the first and the third financing round. Hence, we observe a change in the structure but not in the level of the VC's control rights. While venture capitalists return superfluous operational rights to entrepreneurs, they also gain (valuable) exit rights during the course of the relationship.

As with financial securities, we observe for the German VC market significant learning processes involving the usage of decision and control rights (which allow mitigating incentives and control problems).

### Staged financing

Staged financing is another important mechanism by which to resolve information asymmetries as well as hold-up problems. Staging can be both implicit and explicit. An explicit definition centers on milestones that, if reached, trigger the release of new capital. However, these milestones have to be defined ex-ante. Thus they are unable to take into account new information produced during the relationship. On the other hand, by only using an implicit contract, the entrepreneur may face the risk of being expropriated by the VC, thus reducing his incentives to work hard. Research suggests that VCs take this trade-off into account when designing contracts.

### VC type and contracts

A crucial question in this domain is obvious: do all VCs aim to impose the same governance mechanisms on their firms, or are there crucial differences? Disentangling firm selection effects, i.e. to control for the fact that different VCs finance different firms, significant differences in corporate governance approaches do indeed emerge for different types of VCs. For the German VC market, it turns out that independent VCs use significantly more contract mechanisms that induce active intervention than do bank-dependent VCs, which in turn use significantly more of these mechanisms than do public VCs. As far as direct control mechanisms are concerned, the differences are less pronounced for veto rights and even less for liquidation rights.

## Conclusion

What are the main lessons to be learned here? First, the empirical evidence shows that very detailed explicit contracts play a crucial role in VC governance. Second, the data reveals that these contracts allow VCs to separate cash flow and control rights and that they make use of this in very many cases.

Third, we observe a huge universe of different control rights in operation. It turns out that these control rights change their structure but not their level over the lifetime of the portfolio firm. Finally, for young maturing markets, such as the German VC market, strong learning processes and a convergence towards US style contracts (at least for independent VCs) can be detected.

## LITERATURE:

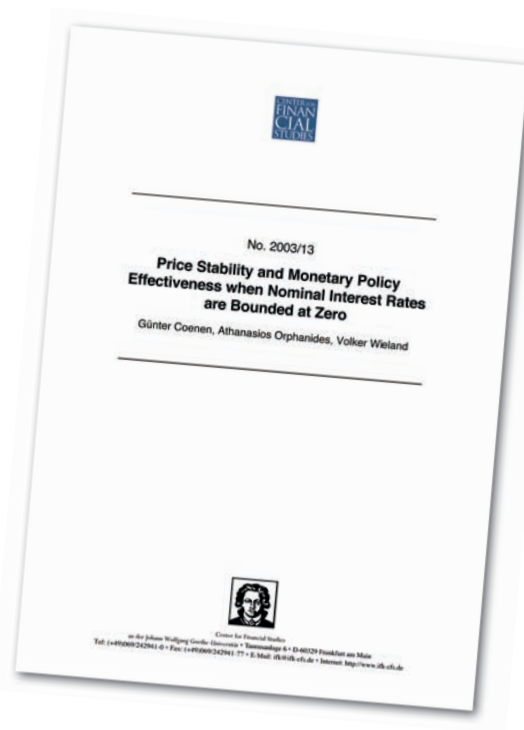
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## CFSworking paper in Focus: The current debate on an inflation target for the U.S. economy

Since Ben Bernanke has become Chairman of the U.S. Federal Reserve the public debate on the choice of an explicit target for U.S. inflation has intensified. Agreeing on a target would require picking a number and a time horizon by which such a number should be met. In a recent Wall Street Journal article by Greg Ip that also appeared on the front page of Wall Street Journal Europe joint research by CFS, ECB and the Federal Reserve was referred to as a basis for picking an appropriate numerical target.

The Wall Street Journal wrote „the closer some officials look, the more they believe a 1% to 2% range is too low. At 1% inflation, there is a greater risk a shock could tip the economy into deflation, or generally falling prices. Because nominal interest rates can't go below zero, an inflation rate of 1% or less gives the Fed little room to make the kind of interest rate cuts that might be needed to remedy severe economic weakness.

Research by Fed economist Athanasios Orphanides, Günter Coenen of the European Central Bank and Volker Wieland of Frankfurt University concludes the Fed would encounter this “zero nominal bound” on interest rates once every 20 years with a 2% target, every 10 years with a 1% target; and every five years with a target of zero. This implies a significant deterioration in economic performance with an inflation target of 1% or lower, they conclude. Their research finds these risks are insignificant with a 2% target. The ECB's stated target is “below, but close to 2%.”



For further information on this research see the CFSworking paper 2003/13 “Price Stability and Monetary Policy Effectiveness when Nominal Interest Rates are Bounded at Zero”, which is available in PDF format from the CFS website at [www.ifk-cfs.de](http://www.ifk-cfs.de) and can be requested as hardcopy from CFS.



## CFSworking papers

The *CFSworking paper* series presents the result of scientific research on selected topics in the field of money, banking and finance. The authors are either participants in the Center's Research Fellow Program or members of one of the Center's Program Areas. Around 200 Working Papers are currently available and can be downloaded from our website: [www.ifk-cfs.de](http://www.ifk-cfs.de)

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2006/18	<b>Dirk Krueger, Alexander Ludwig</b> On the Consequences of Demographic Change for Rates of Returns to Capital, and the Distribution of Wealth and Welfare		

## CFSconference readers

We still have a limited number of the following conference readers that we can send out for free:

The *CFSconference reader* "Open Forum on Germany's Banking System" with excerpts from all the contributions to the conference, that took place on 7 March 2005.

The *CFSconference reader* „Capital Markets in the Long Term: Demography, Economic Development and Funded Pension Systems“ with contributions from the conference, organized by the Allianz Group and CFS on 23 September 2004.

Please mail your request to: [media\\_contact@ifk-cfs.de](mailto:media_contact@ifk-cfs.de)



## CFS*monographs*

### Essays on Inflation in the Euro Area

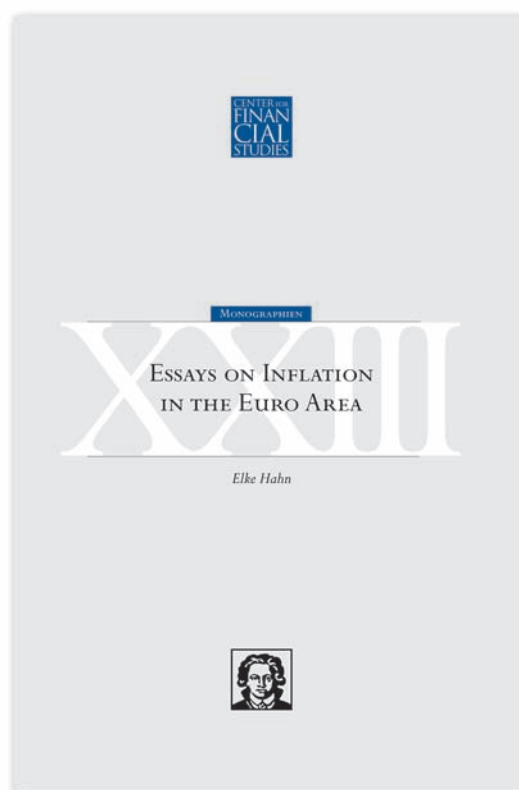
Elke Hahn's dissertation comprises three essays that deal with the topic of inflation in the euro area. The first two essays focus on the methodology of measuring the core inflation rate in the euro area. Different estimation approaches are applied. The third essay investigates the impact of external shocks on the euro area inflation rate.

The first essay presents a core inflation indicator for the euro area that is based on the structural vector autoregressive (VAR) approach. The specialty of this core inflation approach is its foundation in economic theory. The derived core inflation measure indicates a decline in the underlying inflation in the euro area over the 1990s, which is followed by an increase in trend inflation since the mid-1999. Some periods of occasionally quite substantial deviations between core and HICP inflation are identified.

In the second essay core inflation is analyzed by means of the generalized dynamic factor model. This approach features the favorable properties of summarizing the information on the price trend contained in a large number of heterogeneous variables and to directly address different kinds of distortions that may cover the price trend. The results derived with this approach widely corroborate those of the structural VAR approach. The decline in core inflation over the year 1998 is reversed in the course of 1999 and stabilizes in the midyear of 2000. Also the estimated pattern of deviation between HICP and core inflation is similar.

The third essay provides a comprehensive empirical analysis of the pass-through of external shocks (oil price, exchange rate, and import price shocks) to euro area inflation at different stages of the pricing chain (import, producer, and consumer prices). The analysis is based on a VAR model. Identification is achieved both by applying a Choleski decomposition and a structural identification scheme. The results indicate that the pass-through is largest and fastest for import price shocks followed by exchange rate and oil price shocks. The size and speed of the pass-through of these shocks decline along the pricing chain. External shocks explain a large fraction of the variance of all price indices. Moreover, external shocks have been strong positive contributors to inflation in the euro area since 1999.

**As a doctoral student Elke Hahn was a research assistant at the Center for Financial Studies from 2000 till 2003. She studied under the guidance of Professor Axel Weber, then CFS Director responsible for the Monetary and International Economics areas. She also worked at the ifo Institut für Wirtschaftsforschung. Since 2003, Elke Hahn has been working at the European Central Bank, in the business area "Euro Area Macroeconomic Developments".**



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Frankfurt am Main

## CFScolloquium series

# Unternehmensverfassung im Wandel/ Corporate Governance in Transition

## Corporate Governance and Banks – National and International Developments

At the CFScolloquium on 28 June 2006 Klaus-Peter Müller, CEO of Commerzbank AG, presented his views on the topic “Corporate Governance and Banks – National and International Developments”. Müller divided his speech into two parts; he first discussed the current situation in Germany of corporate governance in general and then went on to consider specific aspects of the banking sector.



Müller started his speech by giving an overview of the general trend in the implementation of corporate governance rules in Germany. In his view, Germany has developed a corporate governance system that is “in the upper bracket of the league” by implementing a wide range of regulations during recent years. He now called for a regulatory break in order to be able to assess the results of these past efforts, saying that too much governance activism is counterproductive as it only leads to uncertainty for firms and investors. Secondly, he pointed out that due to corporate governance rules, the work of the advisory board has become more professional over the last years.

Meetings take place more frequently and a stringent information and communication policy has improved the quality of the work. His third argument centered on the internal self-regulation approach of the Codex. In his view, the public debate suffers from a lack of confidence in regulation via market forces. Instead, the demand for the legislator prevails. Within this context, he recommended making it easier for shareholders to exercise their rights, although he said he knew that active participation cannot be dictated.

In the second part of his speech, Müller highlighted the importance of corporate governance rules for banks since they play a central role in the stability of national economies and financial systems. Bank crises prove to be very expensive as experiences in Japan, Norway and the savings and loans crisis in the USA have shown. This is the reason why banks belong to one of the most strictly regulated branches. Banking supervision has spread to almost all areas of the banking process. Thus, Müller concluded that good and efficient internal risk management is the sign of

a good corporate governance structure. Furthermore, Müller said he considers the implementation of Basel II to be one of the most important projects for the future development and improvement of banking governance. He also mentioned the corporate governance of banks, i.e. the governance of debtors through their credit institutions. In particular with respect to Basel II, banks are pursuing a constant dialog with their credit users which has led to a rise in transparency and is thus enhancing corporate governance structures.

Müller is of the opinion that the subject of corporate governance is just one dimension of corporate responsibility and is closely related to other fields such as the dialog with all shareholders, sustainability, and corporate citizenship. He completed his presentation by pointing out that only a considerate and critical public is the real guarantor for a permanent improvement in the field of corporate governance in Germany.

*Michael Winands, Radomir Todorov (CFS staff)*

## Joint Lunchtime Seminars

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

Originally started in January 2001, the weekly presentations have become a fixed entry in the diary of many members of research institutions and central banks located in Frankfurt. As a result, seminars are usually accompanied by lively debates and subsequent discussions.

The Joint Lunchtime Seminars are organized by Klaus Adam (European Central Bank), Heinz Herrmann/Sandra Eickmeier (Deutsche Bundesbank) and Volker Wieland (Frankfurt University and CFS)/Günter Beck (Frankfurt University).

28 Nov. 2006	<b>Inflation and Welfare: A Search Approach</b> <b>Ben Craig</b> (Federal Reserve Bank of Cleveland)
21 Nov. 2006	<b>What Determines the Saving Behavior of German Households? An Examination of Saving Motives and Saving Decisions</b> <b>Daniel Schunk</b> (University of Mannheim)
14 Nov. 2006	<b>Bank Ownership, Market Structure and Risk</b> <b>Gianni De Nicolò</b> (International Monetary Fund)
7 Nov. 2006	<b>Firm Size and Monetary Policy Transmission: A Theoretical Model on the Role of Capital Investment Expenditures</b> <b>Clemens Kool</b> (University of Utrecht)
31 Oct. 2006	<b>Dissecting FDI</b> <b>Farid Toubal</b> (University of Paris I)
24 Oct. 2006	<b>Labor Markets and Business Cycles</b> <b>Morten Overgaard Ravn</b> (European University Institute)
17 Oct. 2006	<b>Determinants of Relative Productivity Performance among OECD Countries</b> <b>Gernot Doppelhofer</b> (University of Cambridge)
10 Oct. 2006	<b>Model Confidence Sets for Forecasting Models</b> <b>Peter Reinhard Hansen</b> (Stanford University)
26 Sept. 2006	<b>Term Structure Estimation with Survey Data on Interest Rate Forecasts</b> <b>Don Kim</b> (Board of Governors of the Federal Reserve System)
19 Sept. 2006	<b>Asymmetric Wholesale Price Adjustment: Theory and Evidence</b> <b>Daniel Levy</b> (Bar-Ilan University)

12 Sept. 2006	<b>Model Averaging and Value-at-Risk based Evaluation of Large Multi Asset Volatility Models for Risk Management</b> <b>Paolo Zaffaroni</b> (Imperial College London)
5 Sept. 2006	<b>The Financial Structure of Private Equity Funds</b> <b>Per Strömberg</b> (Swedish Institute for Financial Research)
29 Aug. 2006	<b>On-the-Job Search and Precautionary Savings: Theory and Empirics of Earnings and Wealth Inequality</b> <b>Jeremy Lise</b> (University College London & Institute for Fiscal Studies)
22 Aug. 2006	<b>When is a Central Bank Governor Fired? Evidence Based on a New Data Set</b> <b>Jakob de Haan</b> (University of Groningen)
15 Aug. 2006	<b>Monetary Policy and the Rejections of the Expectations Hypothesis</b> <b>Juha Seppälä</b> (University of Illinois)
8 Aug. 2006	<b>Networks as Entry Deterrence and the Competitive Supply of Venture Capital</b> <b>Yael Hochberg</b> (Northwestern University)
1 Aug. 2006	<b>Basel Accord and Financial Intermediation: The Impact of Policy</b> <b>Christian Zimmermann</b> (University of Connecticut)
25 Jul. 2006	<b>Forecasting Euro Area Variables with German Pre-EMU Data</b> <b>Ralf Brüggemann</b> (Humboldt University Berlin)
11 Jul. 2006	<b>Consolidation and Competitions in Stock Exchange Economics</b> <b>Paul Bennett</b> (New York Stock Exchange)
4 Jul. 2006	<b>Welfare-maximizing Monetary Policy Under Parameter Uncertainty</b> <b>Thomas Laubach</b> (Federal Reserve Board)
27 Jun. 2006	<b>In Search of a Theory of Debt Management</b> <b>Andrew Scott</b> (London Business School)
20 Jun. 2006	<b>Pricing-to-market, Trade Costs, and International Relative Prices</b> <b>Ariel Burstein</b> (University of California Los Angeles)
13 Jun. 2006	<b>Panel Data Models with Interactive Fixed Effects</b> <b>Jushan Bai</b> (New York University)
6 Jun. 2006	<b>Information Acquisition and Portfolio Under-Diversification</b> <b>Laura Veldkamp</b> (Stern School of Business, NYU)



## CFSresearch conferences

### International Research Forum on Monetary Policy



**Venue:** Federal Reserve Board

**Date:** 1-2 December 2006

On 1 and 2 December 2006 the fourth conference organized by the International Research Forum on Monetary Policy was held at the Federal Reserve Board in Washington D.C.



Ten papers by well-known academics were featured within four sessions:

- DSGE Interpretations of Historical Episodes
- Job Search, Wage Setting, and Microeconomics
- Investment in Housing and the Business Cycle
- Expectation Formation, Learning, and Policymaking

Among the topics examined were the following: Three Great American Disinflations; The Mistake of 1937:

A General Equilibrium Analysis; Unemployment Fluctuations with Staggered Nash Wage Bargaining and Robustly Optimal Monetary Policy with Near-Rational Expectations.

The forum's organizers were able to gain renowned discussants such as Lars Svensson, Wouter den Haan, Christopher Sims and Mark Watson.

Since its creation in 2002 by the European Central Bank (ECB), the Federal Reserve Board (FRB), the BMW Center for German and European studies at Georgetown University (CGES) and the Center for Financial Studies (CFS) in Frankfurt, the Research Forum's goal has been to encourage research on monetary policy issues that are relevant for monetary policy making in independent economies. It regularly organizes conferences that are held alternately in the euro area and the United States.

This year's conference was organized by **Matthew Canzoneri** (CGES), **Dale Henderson** (FRB), **Lucrezia Reichlin** (ECB) and **Volker Wieland** (Frankfurt University and CFS).

The complete conference program can be found at [www.ifk-cfs.de](http://www.ifk-cfs.de) Events >> CFSconferences



## The ECB and Its Watchers VIII Frankfurt, 5 May 2006

The 8th meeting of the CFS trademark conference series ‘The ECB and Its Watchers’ organized by Volker Wieland (Frankfurt University and CFS) brought together 22 distinguished speakers from private sector financial institutions, think tanks, central banks, and academia to discuss various issues with ECB representatives. The record number of registered conference participants comprised almost 250 professionals from the financial community, central banks and academia, including close to 50 media representatives.



In his welcoming address, Volker Wieland emphasized the uniqueness of the “ECB and Its Watchers” conference series as an example of openness and transparency in central banking. As in previous years, central bank critics and central bank decision-makers used this forum as

an opportunity for both an open and public exchange of opinions and to derive suggestions for future policy conduct. The conference began with a panel of short presentations by professional and academic ECB watchers on current ECB policy and strategy, followed by

a response from Otmar Issing (ECB). Axel Weber (Deutsche Bundesbank), who initiated the conference series in 1999 as CFS Director, reviewed its history and praised Otmar Issing for his readiness to confront criticism in this forum over the last eight years. Two further panels addressed the performance of the revised stability and growth pact and the problems and prospects facing the new EU member states on the road to the euro. Otmar Issing concluded the conference by commenting on the ECB’s policy strategy.

### Current Performance and New Challenges

The first session, chaired by **Volker Wieland**, started with a presentation by **Elga Bartsch** (Morgan Stanley). She warned the ECB of overdoing transparency. The ECB, in her view, should not give too much direct guidance regarding future interest rate decisions. Not meeting its own predictions in the face of unexpected macroeconomic developments could seriously undermine its credibility in the future. Instead, Bartsch argued that the ECB should use its communication process to educate the public better on the risks of inflation and to improve the debate about the macroeconomic outlook.

**Giancarlo Corsetti** (European University Institute) proposed raising the ECB’s long-run inflation target if GDP trend



Giancarlo Corsetti, Volker Wieland, Elga Bartsch

growth in Europe continues to remain low, and if the stability and growth pact is not to be altered. He argued that a budget deficit (including debt service costs) at 3% of GDP would only be consistent with a 60% debt to GDP ratio if nominal GDP were to grow at 5% per year. With potential real growth in Europe revised down to 2%, nominal output can grow by 5% each year only if inflation reaches 3%, rather than the 'close to but below 2%' objective of the ECB. In addition, Corsetti argued that a greater inflation buffer would be needed to avoid hitting the zero-lower bound on nominal interest rates in a world with lower trend growth and equilibrium real interest rates.

**Peter Hooper** (Deutsche Bank) suggested that the recent labor productivity slow-down in Europe might generate substantial political pressure for the ECB. In terms of global current account imbalances, Hooper argued that Europe needs to make significant progress in structural reforms in order to attract more capital. Capital inflows in turn would lead to an appreciation of the euro vis-à-vis the US dollar and thus help in balancing international current accounts.

**Angel Ubide** (Tudor Investment) argued that a substantial part of the US trade deficit is accounted for by the European Union. He argued the case that ECB policy has not responded sufficiently to low European growth rates. Instead, he proposed adopting an opportunistic approach to the resolution of global imbalances, namely by increasing European domestic demand in order to accommodate the US dollar's ultimate depreciation. Ubide also asked for ECB policy to support structural reforms and stressed that, in his view, a key structural reform in Europe would be to foster financial integration of European mortgage markets; otherwise a monetary tightening or easing might have a differential effect on member countries.



Angel Ubide

**Manfred Neumann** (University of Bonn) wondered why the ECB was reluctant to increase nominal rates significantly in the face of strong M3 and credit growth. He requested that the ECB publishes detailed statistics regarding the distribution of cash among different denominations in order to enable analysis on determining the sources of the strong growth in cash holdings. But even when adjusting for growth in cash holdings, Neumann estimated the current monetary overhang to be 8.9% of projected trend money supply. Consequently, he warned of inflationary risks, asking the ECB to commit to raising nominal rates to 3.25% by the end of the year.

### ECB Watch - Review of the ECB's Strategy and Alternative Approaches

**Huw Pill**, head of the Monetary Policy Stance Division of the ECB, provided an account of how monetary analysis is used at the ECB to inform monetary policy decisions. He showed that long-term trends in monetary growth are systematically related to long-term trends in inflation, while such a relationship appears to be absent in the very short-run. A key practical challenge for monetary analysis would thus be to extract the information on underlying price trends from real time data on monetary developments. Currently, monetary analysis at the

ECB is based on an eclectic and partly judgmental approach to extracting this information.

**Jan Qvigstad** (Norges Bank) discussed the publication of policy rate forecasts as practiced at the Central Bank of Norway. Starting in 2003, the Central Bank of Norway has gradually established its current practice of publishing forecasts for the interest rate three years ahead. The published path of interest rates, according to Qvigstad, is what the bank perceives as the appropriate policy for stabilizing inflation near target within a reasonable time horizon. The main rationale for publishing this path is that monetary policy should be more effective in managing expectations as a result. However, the announced interest rate path should be understood by the private sector as a forecast conditional on current knowledge rather than as a promise on future policies.

**Richard Clarida** (Global Strategy Advisor Pimco and Columbia University) commented on central bank transparency. In this context, he presented a comparative perspective of the Federal Reserve Board, the ECB and the Bank of Japan. He expected the Federal Reserve to become more transparent under Chairman Bernanke, but also hoped that the ECB as a relatively young institution will act to further enhance transparency, and likewise the Bank of Japan.

Transparency, according to Clarida, is critical for the relationship between central banks and financial markets, as market expectations regarding the further course of policy play a key role in the determination of long-term interest rates. Notwithstanding the recent success of monetary policy in keeping inflation low, it will be critical for monetary policy to signal its intentions clearly in order to keep inflation expectations in check.



Athanasios Orphanides

**Athanasios Orphanides** from the Federal Reserve Board discussed the consequences of limited knowledge and imperfect measurement for the conduct of monetary policy. In his view, these issues are more controversial than other elements of good policymaking such as giving primacy to the objective of price stability. Orphanides stressed that in the face of informational constraints, simple rule-based policies have a clear advantage over policies based on optimal control experiments. While the latter use theoretically appealing concepts, these are often impractical owing to a lack of measurable empirical counterparts.

In his response to the panel, **Otmar Issing** noted that the exposition of Huw Pill helped to clarify the role of monetary analysis in informing day-to-day policy decisions within the ECB. With respect to the low trend growth rates in Europe, he suggested that they should be the focus of appropriate structural policies, but would have to be taken as given for current monetary policymaking. He shared the concern for global imbalances and stressed that they are likely to be the result of a variety of factors. Finally, regarding central bank communication, Otmar Issing emphasized that the general public's understanding of the ECB's strategy and policy intentions has advanced over the years, although room for improvement still remains. Issing pointed to the difficulty

of communicating with an audience like that of the ECB, which is heterogeneous with respect to not only professional backgrounds but also to language and cultural idiosyncrasies.

Frank Smets (ECB) asked to what extent the European labor productivity slow-down might merely reflect a composition effect following reforms in European labor markets. Vitor Gaspar (Banco de Portugal) remarked that the evidence on a permanent reduction in the natural rate of interest is weak and does not justify a change in the inflation objective.

In response, Giancarlo Corsetti argued that the productivity slow-down is likely to reduce average real interest rates and would suggest an upward revision of the inflation objective to be advisable in order to off-set the increased probability for the lower-bound to become binding. Otmar Issing, in turn, stressed that the lower bound, albeit a problem in periods of zero inflation or deflation, should not be considered a problem in the current, more typical times with inflation around two percent. Appropriate action would not require increasing the inflation objective and thus average inflation beyond the ECB's target rate.

### The ECB and Its Watchers: 1999- 2006

After the first panel, the President of the Deutsche Bundesbank, **Axel Weber**, reviewed seven years of 'The ECB and Its Watchers'. After starting this conference series in 1999, Weber was responsible for organizing it until 2003. From the beginning the conference series has provided professional ECB watchers with a platform for communicating their views directly to policymakers. In turn, it also gave ECB representatives the opportunity to respond directly to the watchers' assessment. Weber summarized that within the last seven years the conference

has generated intellectual competition among the various monitoring groups. He pointed out that the topics of the first conferences continue to be of interest for today's policymaking as witnessed by the close relation of topics covered throughout the years, i.e. issues of monetary policy strategy, monetary and fiscal policy coordination, communication, financial integration, and global imbalances.

On this occasion, Axel Weber praised Otmar Issing, who participated in all eight conferences, for his pragmatic approach to policymaking. His emphasis on stable money, the medium-term policy perspective, and on challenging theories



Axel Weber

with real world data had been successful. Specifically, Otmar Issing's focus on an explicit monetary policy strategy had to some degree led to a "depersonalization" of monetary policy in the euro area. Weber said that these policy principles would remain the anchor of ECB decision-making in the coming years.

### The Revised Stability and Growth Pact – Is it working?

A second panel, chaired by **Wolfgang Schill** (ECB), discussed the effectiveness of the revised Stability and Growth Pact (SGP). Speakers at the 7th "ECB and Its Watchers" conference in 2005 had concluded that the success of the SGP



Wolfgang Schill, José Manuel González-Páramo, Michael Hüther

would ultimately depend on its actual implementation. Now, one year later, the panel was asked for a first assessment.

**José Manuel González-Páramo** (ECB) argued that the SGP reform represents a step towards more flexibility and better economic judgment. At the same time, however, it introduced the risk of higher and more persistent deficits. The 2005 fiscal outcomes, according to González-Páramo, had been better than expected. Yet, he cautioned the audience against viewing this as a confirmation of the revisions to the pact, not least because the 2005 budgets were adopted before the SGP was reformed. Furthermore, he

characterized the speed of consolidation as minimalist. González-Páramo also expressed his concern that the extension of deadlines for reducing deficits due to special circumstances might become the norm rather than the exception.

**Michael Hüther** (Institut der Deutschen Wirtschaft) stressed that Germany and France account for more than 46% of the public debt outstanding in the European Monetary Union. He was concerned with possible free-riding by these two large economies. Hüther concluded his talk by calling for a stronger SGP to prevent fiscal authorities from borrowing excessively.

**Lars Calmfors** (Stockholm University) judged that the pact was working in general, although some of the revisions had weakened fiscal discipline in some countries. Nevertheless the legitimacy of the pact had increased by allowing for more sensible judgment. He expressed his concern that the widened scope for discretionary fiscal policymaking at the national level may lead the SGP to lose credibility. The SGP might be further weakened in response to violations by some of the large member countries. Calmfors stressed that in order to overcome these problems, member states should be given more incentives to tighten their fiscal policy stance. In turn monetary policy should become more expansionary to ease the economic burden of fiscal adjustment.



Servaas Deroose

**Servaas Deroose** (European Commission) pointed out that the concerns with regard to the SGP might be exaggerated. Over the last year, most countries respected the 0.5% adjustment benchmark and employed realistic budgetary projections. Over and above these achievements, he demanded that national fiscal policies should focus more on the long term, with an aim to ensuring fiscal consolidation in good times. Improving fiscal governance is likely to become a key issue. To this end he urged that the European statistical system also be strengthened.



Lucrezia Reichlin, Volker Wieland, Lucas Papademos

## On the Road to the Euro? Progress and Prospects of New EU Members

The third panel, chaired by **Lucrezia Reichlin** (ECB), reviewed the progress that the new EU member countries have made towards joining the euro zone.

**Willem Buiter** (London School of Economics) focused on the five central and eastern European economies aiming to join the Exchange Rate Mechanism within the next three years (the Baltic States, Slovenia and Slovakia). Since these countries are small and very open, there is a strong case in favor of them joining the single currency. The costs of admitting these countries to the euro area would be mild due to their sustainable fiscal stance and their limited size. Apart from Slovakia, which has a fiscal deficit slightly above 3%, all of the countries would meet the Maastricht criteria regarding fiscal balances. In terms of the inflation limit, Buiter proposed applying the ECB's target of 'close to but below 2%' plus 1.5%. He also argued that allowance should be made for the Balassa-Samuelson effect inflation, increasing the benchmark inflation rate to around 5.2%.



Willem Buiter

**Lucas Papademos** (ECB) assessed the progress in convergence of all new member states. He stressed the need to differentiate between structural measures

with a permanent effect on the economy and short-term measures. In addition to nominal convergence, real convergence is also of great importance. He singled out two issues of particular significance for the decision-makers in the euro zone, i.e. the reliability of the statistical base and legal convergence, particularly with regard to central bank independence. In addition, public deficits may remain a major source of concern for these countries even after having joined the euro zone.



Lucas Papademos

Next, **György Szapáry** (Magyar Nemzeti Bank) highlighted two challenges that Hungary and the other new EU member states face on the road to the euro: a boom in credit and concerns about fiscal policy. The former socialist countries tended to start from a low base of private credit. With the advent of the market economy, private credit consequently has grown rapidly. Since a large part of the new credit is denominated in foreign currency, Szapáry pointed out that the credit expansion adds a strong exchange rate channel to the monetary transmission process, which may counteract the usual interest rate channel. In particular, a rise in domestic interest rates, accompanied by an appreciation of the domestic currency would reduce the debt burden for foreign-currency denominated credit, and consequently fuel demand. In the event of a depreciation, financial stability might also be at stake. The second challenge

he focused on was the improvement in fiscal balances. For the case of Hungary he attributed the deficit to the historically high social spending, which needs to be cut by stepwise reform.



György Szapáry

**Daniel Gros** (CEPS) expressed satisfaction with the overall convergence progress of the new EU member countries. In his opinion, most of the new members should be able to fulfill the Maastricht criteria. However, an obstacle might be the unduly restrictive inflation criterion. Gros pointed out that statistical effects arising during the EU enlargement were not taken into account when the low criterion was constructed. Following Buiter, he proposed that the current inflation benchmark should be replaced by the euro area average inflation rate plus the margin of 1.5%.

## Concluding Remarks by Otmar Issing



Otmar Issing

In his concluding remarks, **Otmar Issing** emphasized that long-run inflation trends were quite accurately predicted by the real-time analysis of monetary developments. Thus, monetary aggregates should not be ignored in monetary policymaking. Furthermore, he addressed the question why more than one pillar was needed for successful monetary policy. Here, Issing drew attention to the different time horizons for monetary policy.

The two pillars stand for two different perspectives from which the ECB looks at the underlying data. While monetary analysis is used to extract information about longer-term trends in inflation, economic analysis is mostly concerned with the correct assessment of shorter-term risks to price stability. Thus, he concluded that as long as there is no satisfactory model, which incorporates both elements, monetary policy should continue to rest on two separate pillars.



Finally, Issing addressed questions raised by the panels and the audience asking whether the ECB had engaged in too much or, indeed, too little stabilization policy in the face of recent economic shocks. He strongly rejected the criticism that the ECB had not given enough stimulus to demand, but also ruled out the notion that the ECB had been excessively gradualist in raising rates. In addition,

addressing criticism also raised in the conference, he referred to the differences in the economic structure of the euro area and the US. These differences needed to be considered when comparing the ECB's monetary policy strategy and stance with that of the Federal Reserve Board.

*Keith Küster, Gernot Müller, Ulrike Busch, Maxim Ulrich (Frankfurt University)*

## 2nd German Workshop in Macroeconomics

On Friday 14 July and Saturday 15 July 2006 the 2nd German Workshop in Macroeconomics took place at the Frankfurt University. The organizers, Dirk Krüger (Frankfurt University and CFS), Salvador Ortigueira (European University Institute Florence) and Klaus Wälde (University of Würzburg) welcomed a total of 14 young speakers from the US (5 speakers), Germany (3 speakers) and the rest of Europe (6 speakers). As with the first edition of the workshop last year, the explicit goal of the workshop was to provide constructive criticism and intense discussion on the research of these young scientists. For the first time we could also welcome senior researchers from outside Frankfurt, such as Prof. Michael Burda from Humboldt University Berlin, Prof. Matthias Döpke from UCLA, Prof. Tom Krebs from the University of Mannheim, and Prof. Christian Zimmermann from the University of Connecticut, whose attendance and comments made the event even more successful.

The first speaker, **Mathias Trabandt** (Humboldt University Berlin), in his paper *Optimal pre-announced tax reforms under valuable and productive government spending* argued that pre-announcing a capital- and labor income tax reform may result in substantial welfare gains, relative to implementing the reform immediately, at least if the government cannot levy confiscatory capital income taxes. In the second presentation *Dynamic contracting, persistent shocks and optimal taxation* **Yuzhe**

**Zhang** (University of Minnesota) developed a method to solve dynamic principal agent problems (such as long-term relationships between firms and their employees) in continuous time. Previously these models could only be solved under the unrealistic assumption that the productivity of the agent is uncorrelated over time, whereas Zhang's method allows for arbitrary autocorrelation of productivity. In the last presentation of the Friday morning session **Michael Waugh** (University of



Dirk Krüger, Klaus Wälde, Salvador Ortigueira

Iowa) demonstrated in his paper *International Trade and Income Differences* that a significant fraction, possibly up to 40%, of cross-country income differences may be explained by trade costs that reduce the extent to which goods flow across countries below their optimal levels.

The afternoon session shifted focus to the analysis of financial markets. **Katharina Greulich** from the Universitat Pompeu Fabra in Barcelona showed, in her work on *Asset prices and interest rates with heterogeneous portfolios* that when financial markets are populated by investors with different portfolio shares in stocks and bonds, a change in the nominal interest rate (triggered say by a change in monetary policy) may have an effect on asset prices that goes beyond the standard impact due to a change in the market time discount rate, and stems from a wealth effect for the marginal investor. In his work on *Diffusion of scale effects between European and US regions* **Jürgen Antony** (University of Augsburg) argued that if technology-intensive goods are traded among regions or countries, one region's growth rate is positive affected by the scale (size) of its trading partners. Using data from US and EU regions he finds some empirical support for his hypothesis.

International trade in goods and services also played a key role in the international transmission of technology shocks, according to **Zeno Enders'** (European University Institute, Florence) paper *The role of the terms of trade and the trade balance in the transmission of technology shocks*. Finally, the last paper of the first day, given by **Viktor Tsyrennickov** from New York University provided an attempt to quantify the main determinants of international capital flows. In his paper *Quantitative Analysis of International Lending Under Asymmetric Information* he argued that while the inability of banks to legally enforce repayment of credit to developing countries by itself is unlikely to explain size and direction of capital flows, the inability of banks to monitor the use of funds in the borrowing countries is a crucial ingredient of his model to explain these credit flows.

The second day of the conference began with an investigation of the quantitative importance of the lumpy nature of investment in its response to aggregate shocks. **Rüdiger Bachmann** (Yale University) argued, in his paper *Lumpy investment in dynamic general equilibrium*, that lumpy adjustment of investment on the firm level can account for a large fraction of the smooth response of investment to aggregate shocks. The conference proceeded with the theme that understanding behavior on the micro-firm level is crucial for macroeconomic dynamics. **Vivien Lewis** (Catholic University Leuven) analyzed, in her work *Macroeconomic fluctuations and firm entry: theory and evidence*,



the main determinants of the entry of new firms in an industry. In terms of macroeconomic influences, she singled out aggregate demand shocks as an important driving force of firm entry. The final paper of the morning shifted back to a more aggregate perspective. **Alexandra Ferreira Lopes** from ISGEG in Lisbon attempted to quantify the *The costs of EMU for transition countries*, more specifically the Czech Republic, Hungary and Poland. The main cost of these countries potentially joining the EMU was attributed to the loss of monetary flexibility in these countries, and was found, in the context of a fully articulated open economy dynamic general equilibrium model, to be potentially large.

The final session of the conference started with the presentation *Foreign Direct Investment and the nature of the imitation process* by **Hélène Latzer** from Université Catholique Louvain-la-Neuve. In her work she asked whether it is optimal for a developing country to obtain access to new technologies via foreign direct investment or via direct trade and imitation. The paper showed that both strategies are substitutes and characterized the conditions under which each strategy is preferable. In the paper *Financial intermediation and economic development: A quantitative assessment* **Erwan Quintin** (Federal Reserve Bank of Dallas) attempted to quantify the importance of financial intermediation for economic development. He showed that poor enforcement of financial contracts reduce both the capital



employed in a country as well as the efficiency with which it is used, therefore generating substantially lower output than would be obtained without contract enforcement problems.

In his theoretical study *Tax rate variability and public spending as sources of indeterminacy* **Thomas Seegmuller** (Centre National de la Recherche Scientifique Paris) derived conditions under which variable tax rates may lead to indeterminacy of equilibrium and thus to endogenous economic fluctuations in a model without any extrinsic shocks. The conference was concluded by a presentation by **Almuth Scholl** (Frankfurt



University) who analyzed foreign aid policy in a world with a conflict of interest between the aid donor and the recipient country. Her paper *Aid effectiveness and limited enforceable conditionality* argued that imposing conditions on the recipient government under which aid will be paid can be an effective tool to provide good incentives for governments of poor countries to enact good policies. However, her model also implied that less democratic regimes may receive permanently larger aid funds.

In addition to the formal presentation ample time for informal discussions about the research presented at the conference was available, not least at the conference dinner on the evening of the first conference day. This dinner, as well as the local organization of the workshop in general, was superbly conducted by Elisabeth Greifenstein and Mario Koturic. The organizers wish to thank the Center for Financial Studies in Frankfurt, the Johann Wolfgang Goethe-University Frankfurt and the Bayerische Julius-Maximilians-University of Würzburg for generous financial support that made this event possible in the first place.

*Dirk Krüger (Frankfurt University and CFS)*

Information about Future Workshops or past events can be found at: [www.ifk-cfs.de](http://www.ifk-cfs.de) or at [www.wifak.uni-wuerzburg.de/vw12/forschung/macroworkshop.htm](http://www.wifak.uni-wuerzburg.de/vw12/forschung/macroworkshop.htm)



## European Corporate Governance Training Network (ECGTN) “Foundations of Corporate Governance”

The First ECGTN Summer School “Foundations of Corporate Governance” supported by the European Commission and hosted by CIFRA-University of Amsterdam took place between 12-21 June 2006 in Amsterdam, the Netherlands.

The First Summer School was organized by the Centre for Economic Policy Research (CEPR) and the Amsterdam Center for Research in International Finance (CIFRA) as part of the ECGTN Research Training Network, funded under the EU’s Sixth Framework Programme. Focusing on

corporate governance from an economic, legal and political perspective, the school featured **Bruno Biais** (University of Toulouse), **Katharina Pistor** (Columbia Law School), **Stephen Haber** (Stanford University), **Stijn Claessens** (World Bank), **Enrico Perotti** (University

of Amsterdam), **Joe McCahery** (University of Amsterdam) and **Jaap Winter** (University of Amsterdam), a group of distinguished scholars with influential work on corporate governance. The program consisted of three courses, namely ‘Corporate Finance’, ‘Governance



Systems and Investor Protection’ and ‘Corporate Governance Law’. The lectures took place at the Tinbergen Institute and the University of Amsterdam. Sixteen participants including ECGTN ‘Early Stage Researchers’ also had the opportunity to attend the conference “Large Shareholder Involvement in Corporate Governance” at the Anton Philips Center in Gruenendaal.

The first lecturer, **Bruno Biais**, provided a review of financial contracting theory and corporate governance mechanisms that can mitigate the moral hazard problem. He analyzed models on investor activism, distinguishing between disciplinary activism (monitoring, corporate control and project choice) and advisory activism. Interactions between corporate governance and social responsibility were also discussed in the lectures. In the second part of the Corporate Finance course, **Stijn Claessens** reviewed “A Reader

in International Corporate Finance” edited jointly with Luc Laeven. The book includes the most influential articles on international corporate finance of recent years and covers the following areas: law and finance, corporate governance, banking, capital markets, capital structure and financing constraints, and the political economy of finance. Claessens summarized and discussed these important studies of corporate finance.

**Katharina Pistor** taught the first part of the ‘Corporate Governance Law’ course, which mainly analyzed comparative corporate law, focusing on fiduciary duties and agency relations in the corporations, executive compensation and takeovers. Selected cases were discussed in a very interactive environment by comparing the possible outcomes for different legal systems. Pistor’s lectures provided the participants with a new approach to analyzing issues in corporate governance.

**Jaap Winter** continued by surveying legal issues related to corporate governance, bringing his practical insight into the discussion. He introduced the European Corporate Governance Forum, showed the differences between the various governance codes of European countries and stressed the importance of having standardized procedures by giving examples of the double application of codes. Winter also explained the concept of ‘social networks’ and how approaches differ in countries. The final lecture in Corporate Governance Law was given by **Joe McCahery**. McCahery reviewed a study exploring the costs and benefits of the Sarbanes-Oxley Act, and he analyzed the Enron case in detail.

The next day **Enrico Perotti** started with the classification of governance systems. He discussed the differences in legal origins and their implications for investor protection in relation to financial development and corporate governance.

**Stephen Haber** reviewed the literature on related lending and discussed its impact whilst focusing on developing countries. He also discussed the common indices used in corporate governance and the choice of legal origin. In addition to the lectures, the summer school provided a stimulating environment for participants to discuss their research with other PhD students as well as to socialize while enjoying beautiful Amsterdam.

*Günseli Tümer-Alkan (CFS research staff)*



In September 2005 CFS recruited Günseli Tümer-Alkan as an early stage researcher in the European Corporate Governance Training Network (ECGTN). The ECGTN project was launched in June 2004 and is funded by the European Commission under the Marie Curie Research Actions.

Further information can be found at <http://www.ifk-cfs.de> under Research >> Research Networks >> European Corporate Governance Training Network (ECGTN)



13-20 August 2006 – Training Center of the Deutsche Bundesbank, Eltville

## CFS Macro Summer School 2006 “Empirical Macroeconomic Modeling”

The CFS Macro Summer School, generously supported by the “Stiftung Geld und Wahrung”, took place from 13 till 20 August, 2006 at the Training Center of the Deutsche Bundesbank in Eltville/Rheingau.



This year the CFS Macro Summer School on “Empirical Macroeconomic Modeling” provided thirty-eight international students with the opportunity to learn about the latest developments in the field of empirical macroeconomics from outstanding international faculty including **Kenneth D. West** (University of Wisconsin), **Philip Lane** (Trinity College Dublin), **Michael Binder** (Frankfurt University), and **Charles M. Engel** (University of Wisconsin). The School focused on evaluating forecasts based on time series models, modeling external balances and exchange rates, and dynamic panel modeling in macroeconomics.

During the first two days of classes, **Kenneth West**, drawing in part on his landmark research in this field, addressed the issue of evaluating forecasts based on a variety of time series models. He described the aim of his lectures as “discussing how one might put confidence

intervals or construct test statistics around measures of out-of-sample predictive accuracy”. After analyzing four examples from the applied literature and reviewing standard results, West went on to consider different approaches to comparing the forecasting performance of both nested and non-nested models. His lectures gave special consideration to the issue as to whether forecasters need to make special provisions when entering estimated parameters in their forecasts. West made the case that asymptotic irrelevance, which implies that “asymptotically, the fact that predictions rely on estimated parameters is irrelevant for inference”, applies in a variety of leading cases.

The next speaker was **Philip Lane**, one of the pioneers of the recent literature on financial globalization, who gave an overview on the modeling of external balances, paying particular attention to the effects of financial globalization on the so-called valuation channel.

Supporting his theoretical insights with empirical evidence, Lane showed how cross-holdings of foreign assets and liabilities have substantially increased the importance of the exchange rate adjustment channel relative to the traditional trade balance channel for current account adjustments. Turning to exchange rates and global imbalances, his lectures shed much light on the ongoing debate about the large current account deficit of the U.S. Lane presented both the perspective of those who maintain that the U.S. current account position is unsustainable, as well as the perspective of those in favor of the argument that the large U.S. current account deficit can be explained by optimizing behavior if the rest of the world expects a continued robust growth performance of the U.S. economy.

The third series of lectures was given by **Michael Binder**, who was also responsible for the overall organization of the CFS Macro Summer School this year. His lectures conveyed to students state-of-the-art dynamic panel modeling, and placed considerable emphasis on the practical illustration of econometric considerations at the end of every course section. After introducing the subject matter with a primer on static panel data models, Binder illustrated in the context of an analysis of cross-country savings how misleading results may be obtained if cross-country heterogeneity in the underlying data is not accounted for properly. He then focused on dynamic panel data models with homogenous

slopes, presenting joint work with Cheng Hsiao and Hashem Pesaran on estimation and inference in short panel autoregressions with unit roots and cointegration. The last section of his module was devoted to dynamic panel data models with heterogeneous slopes and offered (inter alia) new cross-country empirical evidence on the relation between investment and economic growth. By moving beyond the traditional modeling framework of the empirical growth literature, he made the case that the notion of a long-run causal relation between investment in physical capital and output is strongly refuted.

During the last two days of lectures, **Charles Engel** gave a stimulating overview of the different approaches to modeling exchange rates, drawing on some of his highly distinguished work in this area. After deriving the monetary theory of exchange rate determination in a new open-economy macroeconomic model, he scrutinized the argument that considering the out-of-sample fit, modern exchange rate models cannot consistently outperform random walk models. He showed that this is not surprising as monetary theory implies that the exchange rate should be indistinguishable from a random walk. In fact, Engel also showed that this result would effectively carry over to sticky-price models. Concluding that “genuine out-of-sample forecasting is not all that useful for assessing exchange rate models”, Engel turned to the question of whether exchange rates contain information that is useful for forecasting future observed fundamentals and showed evidence that for a set of industrialized countries exchange rates indeed do carry such information.

The overall high quality of the Summer School lectures was reflected in the



anonymous feedback from students, many of whom labeled the lectures “amazing”.

A significant aspect of the CFS Summer School is the fact that the students are invited to present their own research in front of an inquisitive audience featuring eminent faculty. This year almost half of the students took advantage of this opportunity. After presenting his work, one of the students working for a renowned central bank stated that, “this was a most valuable experience in the course of advancing my own research and a perfect preparation for presenting at international conferences”.

Also worth mentioning are three exciting social events that took place during the week. At the beginning of the week there was a guided tour of the manor house Johannisberg which is located in the midst of the oldest Riesling growing vineyard in the world. The participants particularly enjoyed a visit to a unique wine cellar where they got to taste some of the wines produced at the vineyard. The second social event was a get-together at a cozy inn located in Eltville. The final lecture of the CFS Macro Summer School was followed by a trip to a medieval castle that scenically situated overlooks the

river Rhine. Following a guided tour of the castle, the participants were divided into three groups and invited to take part in a knights’ tournament to demonstrate how well they would have mastered life in the Rheingau region in centuries past. Afterwards there were rumors that the winning group was not only talented in archery, throwing the iron, fencing and crossbow but also in concealing measurement error!

Summing up the week, the CFS Macro Summer School offered participants the opportunity to learn about state-of-the-art empirical macroeconomic modeling from an internationally renowned faculty. Complemented by the manifold opportunities to exchange research ideas and socialize the CFS Macro Summer School was an enormous success that without any doubt will add momentum to the future research work of the participants.

*Marcel Bluhm (CFS Research Staff)*

13-20 August 2006 – Training Center of the Deutsche Bundesbank, Eltville

## Sprinting onto the stock exchange - looking at the speed with which new information makes an impact on asset prices

### CFS Finance Summer School 2006 “Empirical Asset Pricing” revolved around the prize winner of the Deutsche Bank Prize in Financial Economics 2005 (\*)

From 13 to 20 August 2006, the CFS gave 34 postgraduates and Ph.D. students the opportunity to discuss with internationally renowned researchers the most recent findings in empirical asset pricing. The CFS Finance Summer School 2006 thus focused on an area of research that is closely associated with Eugene F. Fama. The Professor of Finance at the University of Chicago Graduate School of Business was last year’s winner of the Deutsche Bank Prize in Financial Economics, which was awarded for the first time in 2005 by CFS and Frankfurt University and sponsored by the “Stiftungsfonds Deutsche Bank”.



The lectures by **Erik Theissen** from the University of Bonn, **Joachim Grammig** from the University of Tübingen together with **Lubos Pastor**, who is a colleague of Fama from Chicago, provided the basis of the weeklong CFS Finance Summer School that took place at the Bundesbank Training Center in Eltville. The postgraduate participants also had the chance to present and discuss their own projects in relation to Fama’s research.



Erik Theissen, Joachim Grammig, Lubos Pastor

With Eugene F. Fama as the prize recipient, the Deutsche Bank Prize in Financial Economics 2005 was awarded last year to an academic scholar whose market efficiency hypothesis has played an influential role for many years in the work of financial economists, bankers, brokers and financial policymakers everywhere. “His concept has contributed decisively to the understanding and analysis of information processing and price movements on the capital markets”, explained Jan Pieter Krahen, CFS Director and Chairman of the jury 2005 responsible for selecting Fama.

The professors and participants of the CFS Finance Summer School also confirmed just how fundamentally important Fama’s contribution to the development and study of the concept of market efficiency still remains today for the work of financial economists in academia, management, and the field of policy. Erik Theissen, who compiled the academic program for the Finance Summer School together with Jan Pieter Krahen, is certain that “if an opinion poll of the research community were to be conducted, asking who is the most renowned and influential researcher in the field of empirical asset pricing, the answer would be quite clear: Eugene F. Fama”. Theissen added, “One could even go so far as to say that without Fama’s groundbreaking work empirical asset pricing would not be where it is today”.

Like most professors of finance, Fama teaches that stock exchanges function efficiently and almost always reflect the value of the underlying companies. In his market efficiency hypothesis from 1971, he picked out as a central theme the speed with which new information is reflected in share prices. As long as

(\*) The text is based on Press Information distributed for the Deutsche Bank Prize in Economics



Erik Theissen

all available information is included in the price, investors can no longer systematically attain an excess return. According to Fama, without insider information even the best stock analysts cannot outperform an efficient market in the long run. Fama also went a step further. According to his random walk theory, prices do not follow a pattern or trend. Previous movements in prices cannot therefore be consulted to predict future prices. In numerous empirical studies the proponent of the rational choice approach was able to underpin his – sometimes controversial – theories. The assumption that all market participants behave completely rationally and on the basis of equal information has nevertheless revolutionized financial market research. The “homo oeconomicus“ model with its assumption of strictly rational behavior stands in contrast to the school of behavioral finance, which uses psychological insights in order to analyze human behavior on the financial markets.

**Erik Theissen** led the first two days of the Finance Summer School and familiarized the participants with the standard methodology of empirical asset pricing. This was a good starting point for many of the postgraduates because the prior knowledge of the subject varied greatly between individuals. As one participant from the research department of the Bundesbank said, “the survey character was very useful since I have not done any research to date in empirical asset pricing, but am very interested in becoming involved in this field.”

During the next two days **Joachim Grammig** presented recently developed alternative approaches. The models discussed by the econometrician Grammig under the heading of “The stochastic discount factor approach” were largely developed at the University of Chicago by, among others, John H. Cochrane, who is a son-in-law of Eugene Fama.

The third part of the Finance Summer School was taught by **Lubos Pastor**, who teaches together with Fama at the University of Chicago. The Bayesian approach presented by



Joachim Grammig

Pastor involves, in particular, a priori parameters and is regarded as a new and promising approach. “In each of the three course modules we have tried to present a different view of the subject of empirical asset pricing. The linking of these three models within one course and the opportunity in this context to present and discuss their own work has certainly been a great advantage for the students” said Pastor. The positive reaction from the students confirmed this view.

The participants were also in agreement that an equivalent to the CFS Finance Summer School 2006 as far as content is concerned was to be found nowhere else in Europe. A Ph.D student from the University of Barcelona, said: “The opinion shared by all my Summer School colleagues is that the evaluation of the three professors is very good indeed. Furthermore I have derived great benefit for my own research project and, in particular, have been able to intensify my networking here.”



Apart from its academic attractions, the CFS Finance Summer School of course offered much more. The idyllic surroundings of the Bundesbank Training Center, which is situated directly on the banks of the Rhine, and the numerous excursions to locations in the beautiful Rheingau area were appreciated by all participants. The program included a visit to Schloss Johannisberg and a trip to a vineyard including a wine tasting session. Towards the end of the week the weather even took a turn for the better, enabling the participants to enjoy a sunny stroll through Eltville.



# THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS

## 2007

### Nomination Procedure for the Deutsche Bank Prize in Financial Economics 2007 has begun

In 2007, the Center for Financial Studies (CFS) and Frankfurt University will award for the second time the Deutsche Bank Prize in Financial Economics. Since the end of September 2006, more than 2,700 university teachers and researcher from 24 countries, whose research focuses on this field of financial economic research, have been asked to take part in the nomination procedure.

On 4 October 2007 the prize, which is sponsored by the “Stiftungsfonds Deutsche Bank” and carries an endowment of 50,000 Euro will be presented by the Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG in Frankfurt. This prize is awarded every two years and according to Volker Wieland, CFS Director and Chairman of the jury 2007, it is well on the way to become the equivalent of a Nobel prize for financial economics. The 370 nominations from all over the world in 2005 are proof of the resounding response it has invoked.

The nomination procedure continues until 25 November 2006. Then in January 2007 a jury, whose members enjoy high international acclaim, will decide upon a prize winner. The jury comprises Günter Franke (University of Constance), Michael Haliassos (CFS Program Director and Frankfurt University), Otmar Issing (President of CFS), Jan P. Krahen (CFS Director and Frankfurt University), Patrick Lane (The Economist), Lucrezia Reichlin (Director General of Research at the European Central Bank), Reinhard H. Schmidt (Frankfurt University), Lars E.O. Svensson (Princeton University),

Norbert Walter (Managing Director of Deutsche Bank Research and Chief Economist of Deutsche Bank Group) and Volker Wieland (Chairman of the jury; CFS Director and Frankfurt University).

The requirements that must be met by the prize winner are very demanding. The jury is looking for someone whose research has left a decisive mark on the finance world – not only with respect to theory but also with regard to business practice and economic policy.

During the course of the award ceremony that will take place on 4 October 2007, a CFS*symposium* will be held at the Campus Westend that will focus on the research subject of the prize winner. The aim is to promote in Frankfurt as a prime location for research and finance.



## CFS-DAI Seminar – 16 May 2006

### “Wertschöpfung durch Risikotransfer” (Risk Transfer and Value Creation)

Efficient risk management is an important value driver for companies. This applies to the integrated treatment of processes as well as to the handling of transferable risks. In addition to the organization of requisite company-specific processes, the question concerning which risks are to be transferred and which are to be borne by the company itself plays a central role. For this reason, CFS together with the Deutschen Aktieninstitut e.V. organized a seminar on the topic “Risk Transfer and Value Creation – Risk Financing versus Risk Transfer”, which was held in Frankfurt on 16 May 2006. The seminar was part of the CFS program “Insurance and Risk Transfer”.

Leading experts accepted the invitation to appear as speakers, and care was taken to ensure that the choice of topics provided a balanced mix of fundamental concepts and concrete examples.

With respect to the issue of risk management, reference is nowadays usually made to the notion of “integrated risk management”. In his opening address, **Christian Laux** (Frankfurt University and Program Director at CFS) discussed the implications and limitations of integrated risk management. Rather than looking at individual risks in isolation, the focus of integrated risk management is on the analysis of total risk and the risk-bearing capacity of the company. It is only then that the company can consciously decide which risks it will transfer and which will be retained. The risk-bearing capacity depends on the financial, organizational, and operative measures of the company. It almost goes without saying that the management of a company must be fully aware of the risks involved in order to be able to take decisions about how they are to be treated. In practice, however, a series of concrete problems exists. In addition to the complexity of the process itself, these also include the consideration of alternative methods. Should, for example, a risk be covered by an insurance contract or a derivative contract, or should it be borne by the company?

**Walther Kiep** (Managing Director of Kiep Consulting GmbH) pointed out in his presentation that the industrial insurance market had changed greatly over the past few years and many industrial companies were not yet sufficiently prepared to face these changes. A lack of transparency with respect to risks could lead to an increase in insurance premiums and possibly even to serious limitations of insurance capacity. In addition, he estimated that approximately 50 % of the insurance premium is used to cover taxes, fees, and operation and administration expenses of the insurer. This underlines, in his opinion, the necessity for companies to look more specifically at ways and means to self-finance risks.

**Andreas Grabi** (Board Member of Protection Reinsurance Intermediaries AG) emphasized the importance of risk transparency. Protection Re is a subsidiary company of Talanx, to which HDI Industrie Versicherung and Gerling also belong; it has the task of advising the company’s clients on all topics connected with reinsurance and of optimizing the structure of insurance contracts and the level of the deductible. Grabi assumes that in the future there will be excess demand for capacity particularly in the market for major industrial risks.

The first three presentations therefore had identified the integration and

transparency of risk management as well as the decisions relating to the transfer or retention of risks as being the central challenges to risk management. The subsequent presentations looked at these issues in more detail.

**Karlheinz Hornung** (CFO of MAN AG) revealed in his contribution on “Value-oriented controlling” how the subject of integration is dealt with at MAN. Risk controlling and investment controlling form the basic elements of value-oriented controlling. Risk management is thus directly anchored in the company’s steering and control systems. The prerequisite for an integrated risk analysis is created via a transparent compilation of hierarchical and interfunctional risks. In the process a balanced chance & risk scorecard is used. Despite the professional and progressive approach adopted towards risks at MAN,



Andreas Grabi

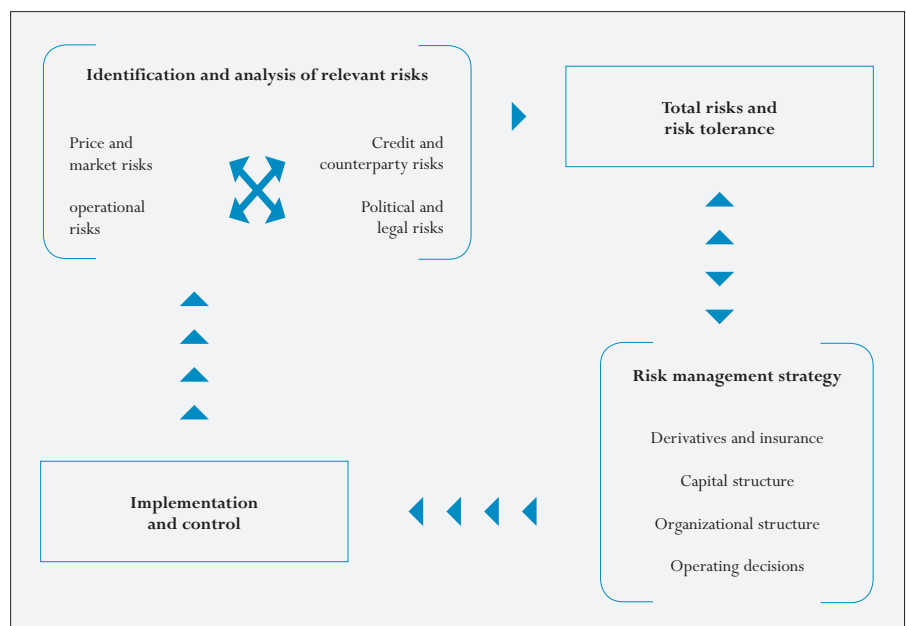
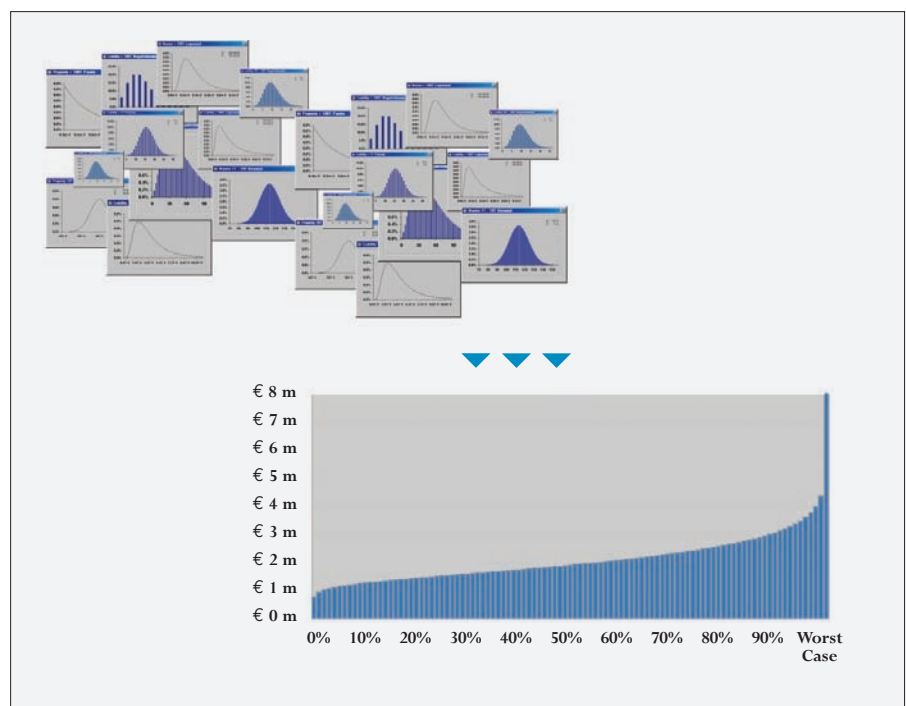
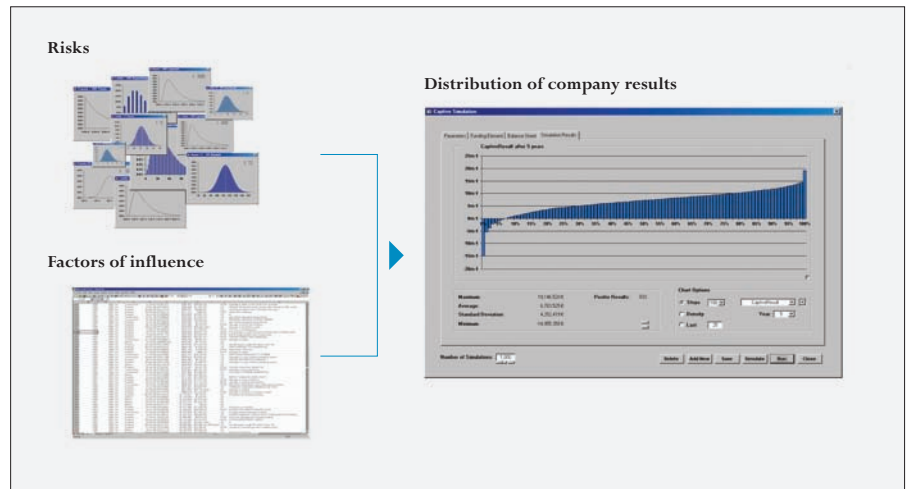


Hornung still perceived a great need for more research into the subject. In his view, research into the risk management of industrial companies as opposed to the risk management in financial institutions has been somewhat neglected.

The presentation of **Reiner Hoffmann** (Head of Corporate Solutions at Allianz Global Risk) focused on “the modeling of risk transfer decisions” as the precondition for the controlling of insurance risks. Hoffmann looked in particular at the general requirements, issues and objectives of a model of risk and discussed the necessary steps involved in risk modeling. Typical questions that arise in practice, and which are to be dealt with by the model, include the determination of the deductible and its associated consequences, the contribution of insurance solutions to firm value, the distribution of insurance premiums among individual profit centers, as well as the structure and deployment of captive insurance companies.

**Stefan Sigulla** (Director of Siemens Financial Services GmbH) and **Dieter Schmitt** (Head of adidas-Group Insurance) both demonstrated, using their companies by way of example, how two large international companies are coping with the challenges posed by changing insurance markets. In his presentation on “the new instruments of risk control”, Sigulla spoke about the insurance purchasing process practiced at Siemens. Transparency, stability, and cost efficiency are looked upon as the main objectives, whereby transparency with respect to risks, costs, and premium distribution constitutes a fundamental requirement for a cost-efficient approach to insurance purchasing.

Owing to the growing complexity of the company risk landscape, the demands on management with respect to insurance



purchasing are increasing. Siemens has reacted to this by introducing an integrated risk model. All damage and risk information is consistently documented and thus not only provides a basis for objective risk-transfer decisions but also serves to improve communication about risk within the company. The information is also available to the insurers, who can make use of it as a basis for premium calculations. The resulting transparency of risks makes it easier for the insurer to assess risks, giving rise in turn to more favorable premiums. Schmitt in his presentation depicted the significance of captives when dealing with risks at Adidas. The initial decision taken at the end of 2002 to set up the captive, adidas-Group Insurance, was the result of, among other things, the deterioration of insurance conditions for industrial companies, cyclical fluctuations in industrial insurance premiums, a tendency to exclude unknown risks, and difficulties in finding sufficient capacities to insure special risks. The captive not only acts as an in-house insurer but also as a competence center with regard to the evaluation and handling of risks. In this context, the transparency of costs and damages together with the accumulation of risk capital and the uncovering of saving potential takes on a particular significance.

**Johannes Wedding** (Managing Director and Partner at Wedding & Partner) discussed in his presentation the legal and institutional framework. A large part of the discussion centered on the issue of to what extent and under which conditions, from a tax and insurance law perspective, companies are able to set up liability reserves within their own balance sheet instead of having to resort to a captive. Contrary to common belief, a company's room to maneuver would appear to be greater than previously thought. The possibility

that the parent company can assume a subsidiary's risk is regularly denied with reference to a German Reichsfinanzhof (Supreme Court of Fiscal Jurisdiction) report and decision from 1925 and 1937 respectively. According to Wedding, however, this involves a misinterpretation. The object of the report and the decision was not to establish whether an intra group self-insurance is admissible, but rather to establish whether a provision for insurance liabilities is admissible, which it clearly is not when the parent company is not an insurance company. While it is indeed correct that companies are not allowed to set aside provisions (or reserves) for unknown future risks, they are allowed to cover group-specific risks

that may arise from previous sales, such as for example product liability risks. This statement received some attention, since it means among other things that for part of the risks the detour via a captive is no longer necessary and the insurance tax of soon 19% can be saved. The Handelsblatt and the Financial Times Deutschland thus devoted considerable space to this statement.

*Christian Laux*

**Another seminar related to "Risk Transfer and Value Creation" is planned for the first half of 2007.**

#### **Insurance & Risk Transfer**

**Christian Laux (Frankfurt University and CFS) is CFS Program Director of the area "Insurance & Risk Transfer". The aim of this program area is to contribute to our understanding of the objectives and the implications of risk transfer between (re-)insurers, banks, corporations, and markets. The research mainly focuses on two areas: Alternative Risk Transfer and Integrated Risk Management**

#### **Fellows**

- **Alexander Mürmann (Wharton School, University of Pennsylvania)**
- **Achim Wambach (Universität Erlangen-Nürnberg)**

## Official Start of Construction for the House of Finance

On 17 August 2006, in the presence of the Finance Minister of the State of Hessen and about 80 guests, the official start of construction of the House of Finance took place at Frankfurt University's Campus Westend. From the spring of 2008 onwards, this new building will house 130 international researchers, who will teach and conduct research on financial issues. Many well-established institutions - the Center for Financial Studies, the E-Finance Lab, the Institute for Law and Finance, the Institute for Law and Insurance, the Institute for Monetary and Financial Stability, the Goethe Business School and the Frankfurt MathFinance Institute – together with several departments of the faculties of Law, Economics and Finance will be moving into the new premises. With the House of Finance all finance-related education and research activities connected to Frankfurt University will be located in one place. This European competence center for financial research will act as a link between theory and practice and will produce the highly qualified human capital needed by the financial community.



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The importance of the House of Finance has been recognized by the financial community and by politicians. This is reflected in the Board of the House of Finance. Members of the Advisory Board are the Federal Minister of Finance, the President of the Bundesbank, the Prime Minister of Hessen, the Minister of Finance of Hessen as well as CEOs of leading German and foreign financial institutions.

## CFS Fellow Frank Schmid awarded Hicks-Tinbergen Medal



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The 2006 Hicks-Tinbergen Medal was awarded to [Gary Gorton](#) and [Frank A. Schmid](#) for their paper "Capital, Labor and the Firm: A Study of German

Codetermination", *Journal of the European Economic Association* (JEEA) 2(5), pp. 862-905. This medal is sponsored by the European Economic Association (EEA) and was awarded during its 21st Congress in Vienna on Sunday 27 August 2006.

The paper by Gorton and Schmid provides a detailed empirical analysis of the German co-determination system. German co-determination is a significant institution in the European corporate governance landscape, due to its potential impact on the objective pursued by corporations (the "shareholder versus stakeholder" debate) and therefore on labor market and capital market outcomes. Determining the actual impact of such an institution is therefore a very

important empirical question. Their findings have already spurred further work and are a key input in the important debate on the advantages and limits of "shareholder value" in today's globalized marketplace.

The Hicks-Tinbergen Medal is to be awarded once every two years to the author(s) of an outstanding article published in the *Journal of the European Economic Association* during the two preceding years. It has been named the Hicks-Tinbergen medal to make clear that the EEA stands for both theoretical and empirical work in economics in Europe.

## Visiting Fellows



From April to July 2006 **Franklin Allen** – Nippon Life Professor of Finance and Professor of Economics at the Wharton School of the University of Pennsylvania - was the Metzler Visiting Professor of Finance at the Frankfurt University and Visiting Fellow at the Center for Financial Studies. During his stay at CFS he worked on a number of papers concerned with financial institutions and corporate finance. The first is entitled “Mark-to-Market Accounting and Liquidity Pricing” and is co-authored with Elena Carletti who is a Post-doctoral Research Fellow at the Center.

A second paper with Elena Carletti (CFS) and Robert Marquez (Arizona State University), is entitled “Credit Market Competition and Capital Regulation”. An important puzzle is why banks have significantly more capital than regulation requires them to have given that equity finance appears to be a relatively expensive form of finance. In this paper the authors argue that holding capital gives banks an incentive to monitor borrowers and this increases the probability of repayment of loans. In some cases it is shown that it can be optimal to hold more capital than regulators require.

A third paper, also with Elena Carletti and Robert Marquez, is “Stakeholder Capitalism, Corporate Governance and Firm Value”. Since scandals such as Enron, Worldcom, and Parmalat, there has been an intensive debate about corporate governance. Most of this debate is about firms that are shareholder-oriented. This is appropriate for Anglo-Saxon countries such as the US and UK. However, it is not appropriate for countries such as Germany where there is co-determination and workers are represented on the Supervisory Board. This paper develops a way of modeling stakeholder firms and shows that they can be more valuable than shareholder-oriented firms.



**Steven Ongena**, Professor in Empirical Banking at the Department of Finance at CentER-Tilburg University and a Research Fellow in Financial Economics at CEPR, visited the Center for Financial Studies from May to June 2006 and participated in two projects. Together with Elena Carletti, he worked on the economic impact of merger control looking at why the banking sector may have been affected differentially.

He also collaborated with Günseli Tümer-Alkan on a project investigating creditor concentration in Germany. Both projects were in cooperation with respective coauthors from the European Central Bank (Philipp Hartmann) and the Bundesbank (Natalja von Westernhagen). The results of this joint work have been compiled in the papers “The economic impact of merger control: What is special about banking?” (Carletti, Hartmann, Ongena) and “Creditor concentration: An empirical investigation” (Ongena, Tümer-Alkan, von Westernhagen). Steven Ongena taught a PhD course “Empirical Corporate Finance” at the Frankfurt University. He also participated in the 37th Konstanz Seminar on Monetary Theory and Monetary Policy and in a 2-day workshop on credit constraints organized by the European Central Bank.



**Andrea Zaghini** joined the Center for Financial Studies (CFS) in September 2006 as Visiting Fellow for the academic year 2006-2007. He is currently on leave from Banca d'Italia where he works at the Research Department.

He holds a Ph.D. in economics from “La Sapienza” University in Rome and an M.A. from University College London. He was at the Directorate Monetary Policy of the European Central Bank for two years working on Euro area money demand and the international transmission of shocks. Andrea’s research interests range from international macroeconomics to monetary policy issues.

## New Staff Portraits



**Sabine Neumann** joined the Center for Financial Studies (CFS) team in April 2006. Sabine's responsibilities include the „Deutsche Bank Prize in Financial Economics“ and the CFS Website. Before joining the CFS, Sabine completed an M.Sc. in Economics from the University of Munich and has worked for several international companies in the marketing area including Credit Suisse and Daewoo Automobile. She was also a consultant in the field of event management.

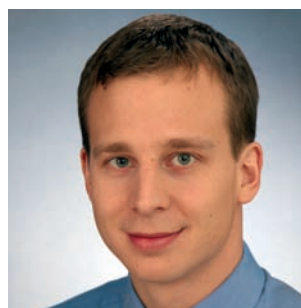


**Marcel Bluhm** joined the Center for Financial Studies (CFS) in October 2006 as an assistant to the President, Professor Otmar Issing. He is also working as researcher in the fields of monetary policy and international macroeconomic and financial linkages. In 2004, Marcel entered the Ph.D. Program in Economics at the Frankfurt University. Previously, Marcel has studied Economics at the University of Angers, France.



**Stephan Späthe** has been a member of the research team at the Center for Financial Studies (CFS) since October 2006. Prior to joining the CFS, he headed the Goethe Finance Association (GFA), which is the alumni and supporting association of the Finance Department at Frankfurt University. Since September 2003, Stephan has already enrolled as a Ph.D. candidate at the Finance Department, where he had graduated beforehand. He also holds a Financial Risk Manager (FRM) degree from GARP. Before his studies, he completed an apprenticeship at B. Metzler seel. Sohn

& Co. His research interests focus on the monitoring of financial centers and their developments. He acts as a coordinator of the new „CFS-Finanzplatzindex“ headed by Professor Jan Krahn. From 2007 on, this sentiment index will subsume the assessments and expectations of a panel of high-ranking managers from the Frankfurt financial community.



**Christian Knoll** joined the CFS research team in October 2006. For the last three years he has been working as a tutor and IT-system administrator at the Department of Microeconomics. Christian graduated in winter 2005 at Frankfurt University, majoring in finance. His research interests are in the field of corporate finance and game theory. Like Stephan Späthe, he works for the new „CFS-Finanzplatzindex“ project headed by Professor Jan Krahn.



**Sebastian Pfeil** graduated from Frankfurt University in 2005 and holds a degree in Finance specializing in „Management and applied Microeconomics“. His studies have included a stay at the Université Lumière Lyon 2 in France. After graduation, Sebastian enrolled in the newly established Ph.D. program in Economics at Frankfurt University and joined the Center for Financial Studies in October 2006. He is currently working as a research assistant to Professor Dr. Uwe Walz for the RICAPE II project (The Regional Comparative Advantage and Knowledge-Based Entrepreneurship research programme). His primary research focus is currently in the field of competition in the banking sector.

## CFScolloquium series 2006

### Unternehmensverfassung im Wandel/ Corporate Governance in Transition (All Lectures will be held in German)

23 Nov. 2006 **Dr. Gerhard Cromme**

(Vorsitzender des Aufsichtsrates,  
ThyssenKrupp AG)  
*Corporate Governance – ein europäischer Blick*

24 Jan. 2006 **Dr. Thomas R. Fischer**

(Vorsitzender des Vorstandes, WestLB AG)  
*Corporate Governance im Spannungsfeld zwischen  
Markt und Gesetz*

Admission to the lectures of the CFScolloquium is only possible after registration. Interested parties who do not receive Email information regularly may contact Birgit Pässler, Tel. +49 (0)69-798 30052 or Email: [paessler@ifk-cfs.de](mailto:paessler@ifk-cfs.de)



## CFSresearch conferences

30 Nov. –  
1 Dec. 2006

ECB-CFS Research Network  
*Eighth Conference of the ECB-CFS Research  
Network on Capital Markets and Financial  
Integration in Europe, hosted by the Bank of  
Spain in Madrid*

**Organization:** Fernando Restoy (Bank  
of Spain), Christian Laux (Frankfurt  
University and CFS), Philipp Hartmann  
(European Central Bank)

1–2 Dec. 2006 *International Research Forum  
on Monetary Policy*

**Organization:** Matthew Canzoneri  
(BMW Center for German and  
European Studies at Georgetown  
University), Dale Henderson (Federal  
Reserve Board), Lucrezia Reichlin  
(European Central Bank), Volker Wieland  
(Frankfurt University and CFS)

For further information and registration please consult  
[www.ifk-cfs.de](http://www.ifk-cfs.de).



**CFS executive education**

- 30 Nov. –  
1 Dec. 2006 *Bilanzierung von Finanzinstrumenten nach HGB, IFRS und US-GAAP*  
**Prof. Dr. Martin Glaum**  
(Universität Gießen)  
**Volker Thier** (KPMG Deutschland)
- 6–8 Dec. 2006 *Modernes Risikomanagement mit Kreditderivaten und Forderungsverbriefung*  
**Prof. Dr. Günter Franke**  
(University of Konstanz)  
**Prof. Dr. Dirk Jens F. Nonnenmacher** (DZ BANK AG)
- 31 May –  
1 Jun. 2007 *Zinsprodukte: Analyse und Bewertung: Teil I*  
**Prof. Dr. Wolfgang Bühler**  
(University of Mannheim)
- 14–15 Jun. 2007 *Zinsprodukte: Analyse und Bewertung: Teil II*  
**Prof. Dr. Wolfgang M. Schmidt**  
(Hochschule für Bankwirtschaft)

**CFS presidential lectures**

We are pleased to announce the start of a new CFS lecture series on European Integration under the auspices of our new president Prof. Dr. Dr. h.c. mult. Otmar Issing.

The series will be opened by the former German chancellor Dr. Helmut Kohl on 29 March 2007. More events with, inter alia, Lord Ralf D. Dahrendorf (House of Lords) and Prof. Dr. Dr. Udo di Fabio (Bundesverfassungsgericht), will follow. The dates for these lectures will be announced in due course.

For further information and registration please consult [www.ifk-cfs.de](http://www.ifk-cfs.de) or contact Birgit Pässler ([paessler@ifk-cfs.de](mailto:paessler@ifk-cfs.de), phone: +49 (0)69 798 30052)



For further information and registration on all CFS seminars please contact Birgit Pässler, Tel.: +49-(0)69-798 30052, Fax: +49-(0) (0)69-798 30077, email: [paessler@ifk-cfs.de](mailto:paessler@ifk-cfs.de)



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We are pleased to be able to welcome **IXIS Corporate & Investment Bank**  
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Furthermore, we are also pleased to welcome **Thomas Krahenen** and **Thomas Seidel** as new Members.  
As of 2007, **infoscore Forderungsmanagement** will join as member

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