NEWS 1/02

CENTER FOR FINANCIAL STUDIES

The "Euro starter kit"

editorial

Dear Members, Colleagues and Interested Parties,

The introduction of the euro as the means of payment within the European Currency Union has brought some movement to the financial market structure. In Germany the revised version of the Bundesbank Law and the Law on Creating a Single Financial Market Supervision Authority have entered their crucial phase. Thus, it is highly likely that the terms of reference for institutions such as the Bundesbank and the financial market supervision authority will change. We assume that in the future both of these institutions, more so than in the past, will be required to make formative contributions to the discussion on the international financial architecture and on the framework conditions for monetary policy and competition in financial markets. The institutional and statistical knowledge gathered by the central bank and the supervision authority over the course of several decades will therefore in future need to be more oriented towards scientific methodology and means of analysis in order to secure its place in the debate. The discussion on the new equity principles (Basle II) has already provided an exemplary demonstration of this competition of ideas between the research departments of various central banks and academic institutions. CFS intends to be prepared for this development on a long term basis, contributing at the same time to strengthening the financial market debate within Europe. In this context – in collaboration with the European Central Bank (ECB) we are preparing a network initiative entitled "Capital Markets and Financial Integration in Europe" which is scheduled to begin at the start of 2002.

Researchers from the ECB, the system of European central banks as well as academics from universities and research institutions from throughout Europe will be participating in this network initiative. Initially work will be concentrated on acquiring a better understanding of the external capital markets and banking systems of the European financial markets. Later on comparative analysis of shareholders' equity markets will be carried out. In this way a basis should be established for improving the framework conditions of European capital markets and for facilitating the integration of financial markets. Further reports on the ECB-CFS initiative will be published from Spring 2002 onwards in editions of CFSnewsletter.

We are looking forward with enthusiasm to further developments in the CFSprogramme and would like to take this opportunity to wish all members, sponsors and friends a healthy and successful 2002.

Best greetings,

Jan P. Krahnen　*Antje Becker*　*Axel A. Weber*

Contents

CFS*colloquium*

Post-Merger Integration: A Progress Report

(original German title: Post-Merger Integration: Ein Erfahrungsbericht)

On 26th September, 2001 as part of the present CFS*colloquium* series "Cross Border Financial Integration – Trends, Strategies and Lessons Learned" Rolf-E. Breuer, Spokesman of the Board of Managing Directors of Deutsche Bank AG, talked about "Post-Merger Integration: A Progress Report" in which he outlined the integration of Bankers Trust in Deutsche Bank. As a starting point he first of all described the ongoing trends in the financial markets, then went on to discuss key factors for the success or the failure of a merger, before finally reporting on the experiences of Deutsche Bank with the integration of Bankers Trust.

The changes occurring in the financial markets are complex. For one thing the banks, thanks to progress in communication technology, now operate in a global market. Gathering information is no longer the main concern, instead evaluating the importance of pieces of information is what counts. Customers expect that they will increasingly be able to communicate with their bank via different media (multi-channel distribution). This requires investment in new means of distribution, which will not necessarily generate corresponding returns. At the same time companies so far unrelated to banking are pressing their way into the financial business sector and thus are increasing the degree of competition. Real net output in the financial sector, which has traditionally rested in one hand, is being increasingly segmented. Competitors are now only dealing with single elements in the value chain, such as the production or distribution of financial products.

What role do the banks play in this scenario and what will be their future position? According to Breuer the answer is to be found in the original motivation behind banking. This includes counselling and research and the experience to accompany them. A further fundamental segment is the processing of transactions, not so much however the technical procedure, but rather the management of the risks involved, and finally the transformation of risk and the accompanying development of financial products. Banks form the point of intersection for market participants; they assume risks and compose them to new products, which investors are then prepared to purchase.

In this market environment different reasons exist for bank mergers. It is by no means the urge towards greater dimensions, although larger markets such as that created by the introduction of the euro imply a greater volume of business. In general the main reason for a merger in the financial sector is the realisation of cost synergies owing to increasing returns to scale. Experience with mergers show that costs may be reduced by approximately 10%. Furthermore, it is usually easier to improve the operational efficiency of a firm by cost saving than by procuring additional returns. A merger, however, carries with it potential synergies of return. The retail business, in particular, can be run more profitably given an increase in customers, and the geographical expansion as well as an increase in products and know-how means that synergies of return can be expected. Finally, a merger makes it possible to buy in expertise in certain fields of business. In addition to synergy effects an important role is also played by the geographical or business area-related risk diversification of the company concerned.

Reservations with respect to mergers are usually based on their low rate of success; more than half of all mergers are unsuccessful. Breuer puts forward several reasons for this situation. On the one hand false hopes are raised with regard to the development of costs and returns. Then the lack of commitment and an integration strategy on the part of the management with a view to creating a new and better company gives rise to uncertainty amongst employees. On the basis of these insights Breuer deduces those factors which are decisive for success. The choice of personnel must be transparent and conducted in accordance with some general criteria; all decisions associated with the merger must be made at top speed in order to produce certainty as quickly as possible for all those involved; communication and information for staff, customers and suppliers must be maintained throughout all the merger phases.

Breuer finished by discussing the example of the integration of Bankers Trust. For Deutsche Bank the transatlantic platform as well as the position in investment banking were the major reasons for deciding to aquire Bankers Trust. In this way existing customers could be accompanied throughout their business deals on the other side of the Atlantic and new ones could be won over. At the same time increased presence in investment banking, asset management and private banking could be quickly achieved. And cost synergies could be realised by the reduction of overlaps.

Although the merger was only legally closed after 7 months, the new organisation and choice of personnel began directly after the decision to merge had been signed. An integration steering committee chaired by Rolf-E. Breuer was the highest body and was supported by the integration office composed equally of staff from both partners. Business plans were drawn up in which was stipulated down to the very last detail who would supervise which business transactions where and according to what strategy. Thus, directly after the closing, a merged company with common positions was able to operate on the market. The integration review committee, which has then been set up under Breuer's chairmanship, was monitoring the adherence to the integration plan and the realisation of synergies. The successful integration of Bankers Trust has contributed towards making the year 2000 the most successful in its history for Deutsche Bank.

Bernd Kaltenhäuser (CFS research staff)

We asked Rolf-E. Breuer about

the biggest plus point of ECB Monetary Policy

and he answered: ***"The biggest plus of the ECB is its strict commitment to price stability. Until summer this was an uphill-battle due to surging oil prices and the epidemic-related jump in food prices. The recent deceleration in the yoy rate (EuroStat estimate for Nov. 2.1%) however, makes me confident that the ECB is pursuing the right policy and will be successful in pushing the inflation rate clearly below 2% in 2002."***

the biggest minus point of ECB Monetary Policy

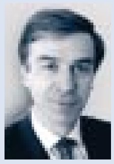
and he answered: ***"One area for improvement is the ECB's communication policy. This is partly related to its two-pillar strategy. This broad approach may be justified in the ECB's internal policy analysis given the uncertainties the ECB has been confronted with, but due to its complexity and vagueness, e.g. the relative weight and interaction of the two pillars, it sometimes tends to be a rather awkward communication vehicle, which occasionally tends to blur the transparency of monetary policy instead of improving it."***

Rolf-E. Breuer

Cross-Border Financial Integration from the point of view of an industrial company group: Global Corporate Finance?

(original German title: Cross-Border Financial Integration aus der Sicht eines Konzerns: Global Corporate Finance?)

On 24th October, 2001 as a "premiere" at the CFS*colloquium*, for the first time a colloquium topic was presented from the point of view of an industrial company group. Heinz-Joachim Neubürger, a member of the central board of Siemens AG and Head of the Corporate Finance Section, discussed the role of "global corporate finance" for his company. Corporate finance is not a business transaction as such, but is geared towards the requirements of the operative business. In the case of Siemens AG this is organised globally as the shares in total turnover of 19% for Germany, 24% for the rest of Europe, 21% for America and 10% for Asia and the Pacific Rim countries clearly signify.



Heinz-Joachim Neubürger

In accordance with the subdivision (referred to as "slicing") of the group's activities according to the different types of transaction, the scope for action by the group's treasury is determined by not only the operational business but also by the transactions of Infineon Technologies AG (an autonomous firm) and the (legally independent) Pensions Trust e.V.

By way of example Neubürger explained the global cash-management policy of Siemens AG, which is characterised primarily by the aggregation of incoming and outgoing payment transactions. For each currency the attempt is made to concentrate these transactions on one bank in the country of the currency in question. Owing to the resulting group internal liquidity equalisation and the central payment system, volume and time benefits can be utilised. It also becomes possible to present a united and consistent front in dealings with the banks and investors. In conclusion it can be said that the decentralised implementation of tasks deriving from centralised control form the necessary requirement for successful financial management.

The Treasury has access to a large toolbox for achieving defined goals and objectives, that is the strengthening of internal financing and the adjustment of refinancing positions. Among other things, Siemens AG is the only industrial company in Europe which, via its own company established precisely for this purpose, can issue securitisation of proprietary and external equity (so-called ABS). This instrument is used in order to demonstrate to rating agencies the legitimacy of the Siemens concept of an independent financial services and real estate company. It is run in accordance with banking standards and is therefore permitted in the medium term to operate with a lower equity capital share of the balance sheet total than that currently stipulated for operative businesses. This gives rise to the opportunity for a possible equity redemption by way of share repurchasing.

In addition to the management of financial risks Neubürger also discussed the pension sector management via the corporate finance function. When, in addition to the tax deductible interest payments of 6%, imputed incurring costs such as an adjustment for inflation expectations and biometric risks are taken into account, company pension reserves do not provide an convenient, attractive internal financing source. For this reason Siemens AG has spun off pension obligations (and the accompanying pension assets) to a pension trust.

The alignment of financial activities to the requirements of the investment community ensues, for example, via the NYSE listing, the efforts towards an intensive dialogue with investors, share investors and managers of bond funds alike, an appealing organisation of the balance sheet structure, (via Bloomberg), transparent commercial paper rates and a strived-for AA quality rating. Neubürger illustrated the discrepancy with respect to capital charges between the theoretical analysis and practical implementation.

Siemens AG takes active advantage of the opportunities arising from the development of global corporate finance and cross border integration and intends to continue being actively involved in the building up these infrastructures.

With a view to the current debate in Germany Neubürger criticises, amongst other things, what he regards as being the inadequate consideration of such global aspects in take-over legislation (he calls for a liberal formulation of guidelines on the European level) and the lack of critical acknowledgement of the German corporate legal structure in the comparative recommendations of the Baums Commission.

Anke Leiser (CFS research staff)

International Banking Strategies: Is Globalization Really the Answer?

On 7th November, 2001 Hessel Lindenbergh expounded from the viewpoint of a diversified global financial services company on the CFS*colloquium*. Hessel Lindenbergh is a Member of the Executive Board of ING Bank/ING Group, a leading bank, insurance company and asset manager in Europe, a top 5 insurer in the US, the largest international life insurer in Latin America and the second largest in Asia and the Pacific.

How can the notion "global company" be more precisely defined? If the largest companies listed in Fortune 500 ranking were to be scrutinised under a magnifying glass then it would be ascertained that for the majority their business can be described as global in the sense of being not exclusively focused on its domestic market. Thus being big and being global seem to be closely correlated.

Furthermore, it can be observed that the top 20 companies of the Fortune 500 are all rooted in large economies. The growth of international sales in comparison to local sales, or the market share within the specific world market may also be used to gauge whether a company can be considered to be global. For those companies which do business all over the world, the degree of globalisation can be defined in terms of the share of international sales to total sales. This leads to the observation of another characteristic feature, notably that there is no global size without local clout.

Going on to look at the top 20 (ranked according to market capitalisation) global financial services companies it becomes apparent that

… firms which strongly emphasise globalisation in their rhetoric are not necessarily the ones with a 50 percent ratio of foreign premiums to total premiums (cf. Citigroup, Morgan Stanley Dean Winter),

… that a higher share of foreign premiums does not necessarily lead to global business (Allianz, for example, operates mainly in the European market),

… that global size is not the same as global spread and

… that the most globalised companies are not as global as they would have us believe.

Despite the difficulties involved in trying to define globalisation precisely, the notion of globalisation plays a major role in strategic planning. The strategic starting point of ING with respect to retail strategy is the click-call-face concept. The customer should be given the opportunity through the integration of all marketing channels in a single effective and efficient distribution system to choose his or her preferred interface with ING. ING, as far as the market cap is concerned, belongs to the world-wide largest financial services companies with, according to Lindenbergh, a satisfactory positioning except for in Europe. Here ING may be regarded as big in today's small domestic market and small in tomorrow's domestic market.

ING is responding to this situation by integrating those business units which have to date exhibited a large degree of operational independence into shared service centres for various back- and mid-office processes. The transition of ING to a fully web-enabled organisation and the implementation of the click-call-face concept, means the company is on course towards becoming a highly integrated company.

ING's European wholesale strategy provides, amongst other things, for the accelerated integration of ING Bank, BBL, BHF and ING Barings, all dedicated providers of corporate and investment banking services in their countries, and the strong corporate banking network in the emerging markets of Asia, Latin America and Europe. This integrated organisation will then be in a position to provide seamless service to corporate clients locally, regionally and globally. The wholesale business model is to be a pan-European one-stop, selling a broad range of products. In this model structured services are the mainstay of a wholesale operation like ING's. Owing to a range of specialisations ING can make a considerable difference to the client, for example, in the area of employee benefits. Here ING can fall back upon its long-standing domestic experience in pension schemes and can thus offer corporate clients and their employees services with a wide selection of non-wage benefits ranging from healthcare to stock options, chief amongst which are the pension schemes.

ING's top priority currently is to meet its potential in becoming a strong pan-European player. This together with the continued consolidation of market positions in the Americas and Asia, will allow ING to attain the balanced global spread of revenues, risk and profit that a company at the top of the global player ranking should have.

Lindenbergh's conclusion: Without secure sustainable positions in the markets that count, being "global" is just a word.

Anke Leiser (CFS research staff)

We asked Hessel Lindenbergh about

the biggest plus point of ECB Monetary Policy

and he answered:

"The ECB has one of the clearest policy goals of all central banks, namely price stability defined as an inflation rate between 0 and 2%. This main goal of monetary policy enables the ECB to keep inflation expectations in check, thereby contributing to low long-term interest rates in the euro-zone."

the biggest minus point of ECB Monetary Policy

and he answered:

"The transparency and communication. The ECB speaks with to many mouths about monetary policy causing a lot of unrest in the financial markets. I think the ECB's decision to discuss interest rates only once a month instead of twice is a wise decision. This puts an end to speculation on interest rate moves every two weeks, thereby reducing volatility in financial markets."

Hessel Lindenbergh

CFS*forum*

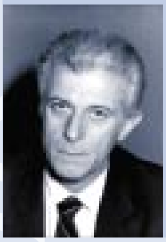
Estimating Equilibrium Exchange Rates

On 5th July, 2001, Giancarlo Gandolfo (University 'La Sapienza', Rome) presented his joint paper with Daniela Federici on "Endogenous Growth in an Open Economy and the Real Exchange Rate: A NATREX Approach". The paper aims at the estimation and quantification of a possible under- or overvaluation of the real exchange rate between the Italian lira and the US dollar. Firstly, a nonlinear system of differential equations for the Italian economy is estimated. Secondly, the appropriate conditions for determining the natural real exchange rate (NATREX), which is the rate that would prevail if the current account were balanced and output at its capacity level, are imposed on the model. A comparison of the NATREX and the actual real exchange rate give an estimate of the over or undervaluation of the currency. According to the model, the lira was overvalued by 5 to 10% for most of the time it was a member of the European Monetary System. In a further step, Gandolfo intends to apply this method to the real euro-dollar rate.

Bernd Kaltenhäuser (CFS research staff)

We asked Giancarlo Gandolfo about

the biggest plus point of ECB Monetary Policy
and he answered: ***"The ECB consistently pursues the anti-inflationary goal."***



Giancarlo Gandolfo

the biggest minus point of ECB Monetary Policy
and he answered: ***"On the international side, the ECB lacks a clear idea of what should be an equilibrium REAL exchange rate between the euro and the dollar."***

The World Economy from a Central Banker's Perspective

Rt. Hon. Sir Edward George

At the CFS*forum* on 13th September, 2001 the Rt. Hon. Sir Edward George (Governor of the Bank of England) spoke about "The World Economy from a Central Banker's Perspective". Referring to the different monetary policy approaches applied by important central banks, he explained that there is no unique best way for a central bank to fulfil its mandate. He stressed that monetary policy operates on the demand side of the economy and there is very little that monetary policy can do for the supply side. In practice central banks have to keep aggregate demand growing consistently over time, broadly in line with the underlying sustainable rate of growth of supply. Consistently low inflation is essentially the measure of their success in achieving this objective. Aiming for effective price stability is not simply a doctrinaire end in itself, but a reflection of the broader aim of achieving macro-economic stability in the much wider sense of a sustainable balance between aggregate demand and underlying supply. By succeeding in this aim cyclical fluctuations will be moderated and much of the nominal uncertainty removed from the economy, thereby indirectly helping to improve the supply side performance of the economy. Against this background he explained what can and what cannot reasonably be expected of monetary policy in the present economic situation in the US, Japan, the euro area and the United Kingdom.

Elke Hahn (CFS research staff)

Operational Risk

On 2nd November, 2001 the first meeting was held of the CFS*forum* "Operational Risk". This series of lectures organised in collaboration with Commerzbank AG, Deutsche Bank AG, Dresdner Bank AG, the financial studies research group of the J. W. Goethe-University of Frankfurt and CFS offers presentations on qualitative and quantitative issues related to operational risks. Leading practitioners are lecturing once a fortnight on the various aspects of this subject thus creating a platform for the dialogue between the business world, the university and public bodies.

In place of Thomas Fischer, Member of the Board of Deutsche Bank AG, who had unfortunately been taken ill, Fred A. Peemöller, also from Deutsche Bank AG, spoke on the subject "Development of Operational Risk in the Regulatory Debate". In his talk Peemöller outlined the central issues of the debate on operational risks and the associated capital adequacy ratio and demonstrated, using some well-known examples of dramatic losses incurred by the banks in credit transactions and derivatives, the difficulty of distinguishing between operational risks and business risks or other traditional types of risk. He then explained the different methods currently under consideration for calculating the capital adequacy ratio and how these methods differ from one another in terms of their complexity. A central problem from the bankers' point of view are the incentives to actually use the more sophisticated calculation methods for operational risks, which need to result in a greatly reduced capital adequacy obligation in order to justify the high degree of resource employment. Peemöller emphasised that although methods for analysing operational risks have only just begun to be developed, the Basle II Treaty timetable calls for efforts in this field to be intensified immediately. In the ensuing discussion it became clear that on the one hand the availability of data and on the other hand the question which banks to involve (only those active internationally or all institutions) are two of the main open issues still to be settled. The meeting provided a successful start to the lecture series and the active audience participation showed that the topic of operational risk will in future lead to a greater demand for information and debate.

The CFS*forum* is intended to provide an opportunity for discussing problems, raising questions and deriving solutions together with leading representatives from both business and academia. For more information on the CFS*forum* "Operational Risk" please visit our CFS web site at http://www.ifk-cfs.de.

Christian Schlag (J.W. Goethe-University Frankfurt)

(For information on our CFS*seminar* "Operational Risk – Von der Begriffsbestimmung zu zukünftigen Entwicklungen – Anforderungen an Quantifizierung und Management von Operationalen Risiken", see article on page 24 and on our "Dates of Events" overleaf.)

CFS*research lectures*

Joint Lunchtime Seminars

The Joint Lunchtime Seminars, introduced as a new series of research lectures in January 2001, continued throughout the year. The seminars, jointly organized by Frank Smets (ECB), Heinz Herrmann (Deutsche Bundesbank) and Axel A. Weber (CFS/J. W. Goethe-University Frankfurt), present recent research in the fields of Monetary Economics, International Macroeconomics, Financial Economics, and Econometrics.

On 13th June, 2001 Matteo Ciccarelli (University of Alicante and Bank of Spain) gave his paper "The Transmission Mechanism of European Monetary Policy: Is there Heterogeneity? Is it Changing over Time?", jointly written with Alessandro Rebucci (International Monetary Fund). They investigate the transmission mechanism of monetary policy in core European countries by means of dynamic heterogenous models estimated in a Bayesian fashion. Based on pre-EMU evidence from Germany, France, Italy, and Spain, they show that: (i) there are differences in the timing of the effects of monetary policy on economic activity, but their cumulative impact after two years is quite homogeneous across these countries; (ii) the transmission mechanism seems to have changed over time in the run up to the EMU, but its degree of heterogeneity has not decreased; (iii) the European-wide effects of monetary policy on economic activity might have taken hold more rapidly in the second half of the 1990s, appearing within 6-7 months, peaking after 12-16 months, and disappearing within 18-24 months.

On 22nd August, 2001 Lutz Kilian (University of Michigan) asked, "Why is it so Difficult to Beat the Random Walk Forecast of Exchange Rates?" and presented his joint research with Mark P. Taylor (University of Warwick). According to them, the answer to the question is a nonlinear adjustment process of the nominal exchange rate to its fundamental value. In particular, if the nominal exchange rate is close to its fundamental value, which is approximated by purchasing power parity, it can be well described by a random walk. The strength of the link between the nominal exchange rate and its equilibrium increases nonlinearly with the distance between both. They estimated an exponential, smooth threshold autoregressive (ESTAR) model for several exchange rates, which takes these nonlinearities in the adjustment process into account. The ESTAR model is able to beat the random walk predictions over longer time horizons.

Mark P. Taylor

On 10th October, 2001 Marco Hoeberichts (currently as RTN-fellow at CFS; see article on page 20) presented his paper "Central Bank Announcements and Productivity Shocks". In this paper, he investigates the possibility and desirability for a central bank to make announcements revealing its private forecasts of productivity growth. The central bank wants to push output above its potential level and therefore faces a credibility problem. For this reason, precise announcements regarding shocks are not credible. Instead, the central bank may announce a range in which its forecast falls. It is possible to derive conditions under which the central bank is willing and able to announce such a range. It turns out that this condition can only be satisfied if productivity shocks have a sufficiently large effect on aggregate demand.

International Macroeconomics

06 June, 2001	**Pierre-Oliver Gourinchas** (Princeton University) "Lending Booms: Latin America and the World" (joint paper with **Rodrigo Valdes**, Ministry of Finance, Chile) and Oscar Landerretche (MIT)
20 June, 2001	**Martín Uribe** (University of Pennsylvania) "Stabilization Policy and the Cost of Dollarization"
15 August, 2001	**Oved Yosha** (Tel Aviv University) "Risk Sharing and Industrial Specialization: Regional and International Evidence" (joint paper with **Sebnem Kalemli-Ozcan**, Brown University and **Bent Sorensen**, Brown University)
22 August, 2001	**Lutz Kilian** (European Central Bank and University of Michigan) "Why is it so Difficult to Beat the Random Walk Forecast of Exchange Rates?" (joint paper with **Mark P. Taylor**, University of Warwick)
05 September, 2001	**Cédric Tille** (Federal Reserve Bank of New York) "On the Distributional Effects of Exchange Rate Fluctuations"
14 November, 2001	**Alan Sutherland** (University of St. Andrews) „Incomplete Pass-Through and the Welfare Effects of Exchange Rate Variability"
21 November, 2001	**Katrin Wesche** (Institute for International Economics, Bonn) "Forecasting Output with Information from Business Cycle Turning Points: A Qualitative Variable VAR"

Monetary Economics

13 June, 2001	**Matteo Ciccarelli** (University of Alicante and Bank of Spain) "The Transmission Mechanism of European Monetary Policy: Is there Heterogeneity? Is it Changing over Time?" (joint paper with Alessandro Rebucci, International Monetary Fund)
27 June, 2001	**Stephanie Schmitt-Grohé** (Rutgers, The State University of New Jersey) "Optimal Fiscal and Monetary Policy under Sticky Prices"
04 July, 2001	**Andreas Hornstein** (Federal Reserve Bank of Richmond) "Optimal Time-Consistent Monetary Policy with State-Dependent Pricing" (joint paper together with Michael Dotsey, Federal Reserve Bank of Richmond)
10 October, 2001	**Marco Hoebrichts** (CFS) "Central Bank Announcements and Productivity Shocks"
31 October, 2001	**Marcel Fratzscher** (European Central Bank) "The Euro Bloc, the Dollar Bloc, and the Yen Bloc: How much Monetary Policy Independence can Exchange Rate Flexibility Buy in an Interdependent World?"
7 November, 2001	**Paul Söderlind** (Stockholm School of Economics) "Inflation Uncertainty"
12 December, 2001	**Andrea Gerali** (Bank of Italy, Rome) "On the 'Conquest' of Inflation"
19 December, 2001	**Neil Rankin** (University of Warwick) "Time Consistency and Optimal Inflation-Tax Smoothing: Is There Really a Deflation Bias?"

Financial Economics, Econometrics, and others

11 July, 2001	**Ben Craig** (Federal Reserve Bank of Cleveland)/ **Joachim Keller** (Deutsche Bundesbank, Frankfurt) "The Empirical Performance of Option Based Densities of Foreign Exchange"
29 August, 2001	**Bruno Amable** (University of Lille II and CEPREMAP) "Product Market Competition and Employment Protection: A Case for Policy Complementarity" (joint paper with Donatella Gatti, Social Science Research Center Berlin)
12 September, 2001	**Joachim Winter** (University of Mannheim) "Empirical Analysis of Household Behavior with Survey Data: Opportunities and Challenges"
19 September, 2001	**Helmut Herwartz** (Humboldt-University, Berlin) "Stability, Autocorrelation and Conditional Leptokurtosis of Return Processes – Empirical Results and Implications for Option Prices"
26 September, 2001	**Thomas Lux** (University of Kiel) "Artificial Financial Markets and the Stylized Facts"
17 October, 2001	**Paola Rota** (Università degli Studie di Modena e Reggio Emilia) "Capital Heterogeneity: Does it Matter? Fundamental Q and Investment on a Panel of Italian Firms"
24 October, 2001	**Axel Ockenfels** (Otto von Guericke-University, Magdeburg) "Sniping' and the Rules for Ending Second Price Auctions: Theory and Evidence"
28 November, 2001	**Lucio Sarno** (Warwick Business School) "The Out-of-sample Success of the Term Structure of Forward Premia as Exchange Rate Predictor: A Step Beyond"
5 December, 2001	**Andreas Fischer** (Swiss National Bank, Zurich) "Understanding Labor Market Fluctuations in the Presence of Time-Varying Depreciation"

Elke Hahn, Marco Hoeberichts, Bernd Kaltenhäuser (CFS research staff)

The Political Economy of Unions/What Does the European Union Do?

At a research seminar on 29th June, 2001, organised jointly by the ECB and CFS, Alberto Alesina (Harvard University) and Ignazio Angeloni (ECB) gave a presentation of their two recent papers "The Political Economy of Unions", co-authored by Federico G. Etro (Harvard University), and "What does the European Union do?", co-authored by Ludger Schuknecht (ECB). In their first paper they presented a theoretical model of a union as a heterogeneous group of countries deciding together on the provisions of certain common goods or policies, which affect them all. Their model captures key features of all unions, in particular the tensions between heterogeneity of tastes and the advantage of taking decisions in common. It provides useful insights on issues now at the top of the European agenda, such as subsidiarity, "enhanced cooperation", voting mechanisms and enlargement. Alesina and Angeloni show that under majority rule, the equilibrium size of a union is inversely related to the dispersions of country preferences and to the spectrum of common goods, and directly related to the strength of externalities. They argue that "flexible" unions, where only some goods are centralised while others are left to the discretion of members, are more efficient than rigid ones and are unanimously supported. New members tend to be accepted only if their preferences are close to the status quo. However, if a union were to have a redistributive role, then poorer applicant countries would tend to be rejected. As to voting mechanisms, moves from unanimity to a qualified majority tend to favour centralisation, whereas assigning a greater weight to population size is likely to have the opposite effect.

In their paper entitled "What Does the European Union Do?" Alesina and Angeloni construct a set of indicators to measure the policy-making role of the European Union in a selected number of policy domains. Their data confirm that the extent and the intensity of policy-making by the EU have increased sharply over the last thirty years. They show that such an increase has taken place at different speeds and to different degrees across policy domains. In recent times the areas that have expanded most are those which are furthest away from the EEC's original mission of establishing a free market zone with a common external trade policy. However, they conjecture that the resulting allocation may be partly inconsistent with normative criteria concerning the assignment of policies at different government levels, as laid out in the recent theoretical literature.

Roman Kräussl (former CFS research staff)

We asked Alberto Alesina about

the biggest plus point of ECB Monetary Policy

and he answered: ***"The ECB has pursued a steady course in monetary policy. It has built a credible low inflation environment for Europe allowing for a certain amount of flexibility to let inflation go above the 2 per cent target when necessary because of the weakening of the Euro. This was the correct course of action, and it was not easy to follow since the ECB started operating in a difficult moment for the world economy.***

This young institution showed maturity and strength in order to withstand political pressures from various European governments and ministers who tried to blame the ECB for a downturn that had nothing to do with monetary policy. Contrary to common views, the ECB has not followed an unnecessary tight policy. Comparing the ECB with the Fed ignores the very different nature of the cycle in Europe and in the US.

With only a few lapses the ECB also showed calm and restraint in the wake of the weakening of the Euro."

the biggest minus point of ECB Monetary Policy

and he answered: ***"I think that there is relatively little that the ECB can be blamed for. One issue is that the ECB has often not been particularly good at communicating with the public and the markets. For instance the ECB maintains its confusing strategy of the "two pillars", money and inflation. It should abandon the first and simply say that it is targeting inflation. This is essentially what the ECB does, and the money pillar simply introduces confusion."***

Alberto Alesina

Monetary Policy Analysis in Models without Money

It has recently become common practice for monetary policy analysis to be conducted in models that include no reference to any monetary aggregate. Although there have been a few exceptions, this general tendency is true of research conducted by both central bank and academic economists. The purpose of the CFS*research lecture* by Bennett T. McCallum, Carnegie Mellon University, on 19 June, 2001 was to consider whether there is anything fundamentally misguided about this practice. According to McCallum's paper on "Monetary Policy Analysis in Models Without Money", this does not seem to be the case.

In his lecture McCallum developed the following arguments. Firstly, models without monetary aggregates do not imply that inflation is a non-monetary phenomenon and are not necessarily non-monetary models. Secondly, theoretical considerations suggest that such models are misspecified, but the quantitative significance of this misspecification seems to be very small. McCallum went on to say that arguments based on "indeterminacy" findings, for example, claims that policy rules respond strongly to expected future inflation rates, are of dubious merit; there are various reasons for believing that findings of solution multiplicity are theoretical curiosities, which have little or no real world significance. In connection with this issue, McCallum looked at the type of indeterminacy implied by a rule that does not respect the Taylor principle (i.e., that interest rates should be made to increase more than simply point-for-point with inflation). He argued that the nature of the problem in this case is different and of genuine importance.

In summary, McCallum stated that these points are mostly supportive of the notion that policy analysis in models without money, based on interest rate policy rules, is not fundamentally misguided. In his opinion, therefore, it is important to mention explicitly that these arguments do not imply that policy rules with an interest rate instrument are necessarily preferable to those based on a controllable monetary aggregate, such as total reserves or the monetary base. His own preference, McCallum concluded, has been, for many years, for base instrument rules.

Stefanie Franzke (CFS research staff)

We asked Benett McCallum about

the biggest plus point of ECB Monetary Policy
and he answered: *"The best feature of ECB policy to date is that it has concentrated on the inflation target, as intended by the Maastricht treaty. In particular, it has not paid too much attention to the depreciation of the euro."*

the biggest minus point of ECB Monetary Policy
and he answered: *"Although I believe that monetary aggregates are very important – especially the monetary base – I do find the "twin pillars" approach to policy implementation to be somewhat unclear. This should not be interpreted as implying that the ECB has been non-transparent in other ways."*


Benett McCallum

International Dimensions of Optimal Monetary Policy

On 10th July, 2001 Giancarlo Corsetti (University of Rome III, Yale University and CEPR) gave a CFS*lecture* on the "International Dimensions of Optimal Monetary Policy". He analysed a baseline general-equilibrium model of Optimal Monetary Policy among independent economies with monopolistic firms that set prices one period in advance. Strict adherence to inward-looking policy objectives such as the stabilization of domestic output cannot be optimal when firms` markups are exposed to currency fluctuations. Such policies induce excessive volatility in exchange rates and foreign sales revenue, leading exporters to set higher prices in response to higher profit risk. In general, optimal rules trade off a larger domestic output gap against lower import prices. Monetary rules in a world Nash equilibrium lead to less exchange rate volatility relative to both inward-looking rules and discretionary policies, even when the latter do not suffer from any inflationary (or deflationary) bias. Gains from international monetary cooperation are related in a non-monotonic way to the degree of exchange rate pass-through.

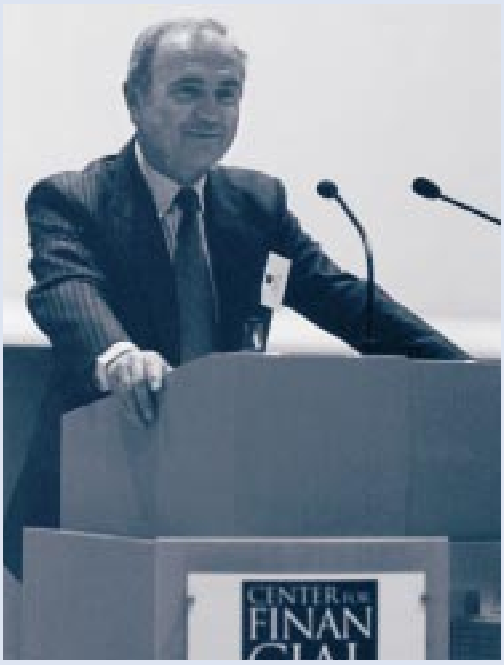
Elke Hahn (CFS research staff)

CFS*research conferences*

The ECB and its Watchers III

The CFS*research conference* "The ECB and its Watchers III", organised by Axel A. Weber (CFS/J.W. Goethe-University Frankfurt), took place on 18th June, 2001. The third conference of this series provided in four panels a platform for discussions between ECB Watchers and policy makers in change of european monetary affairs on the topics of "The Monetary Transmission and EMU", "The Transformation of Financial Markets in Europe" and "Price Stability and Macro Adjustment in EMU".

The opening statement was given by Otmar Issing (Member of the Executive Board of the ECB) and was followed by a statement from Christa Randzio-Plath (President of the Economic and Monetary Committee of the European Parliament, Brussels). Otmar Issing discussed the conduct of monetary policy and its interaction with the financial markets, which is a subject of major interest since the financial markets are a key part of the transmission mechanism. He concentrated on three main aspects. Firstly, he addressed the question of whether the financial markets should react to the monetary authority or vice versa. He argued that leadership by the monetary authority is vital to ensuring price stability over the medium term. Secondly, reviewing evidence from the financial markets on the predictability and credibility of the ECB policy since the start of stage 3, Issing concluded that the ECB policy has not only been credible throughout but for the most part predictable as well. Finally, as an interesting example of when surprising the markets is unavoidable, he discussed the ECB interest rate cut on 10th May, 2001.



Otmar Issing

In her statement referring to a comparative study by Daniel Gros (Centre for European Policy Studies, Brussels), Christa Randzio-Plath explained that the ECB was more transparent than any other central bank in the world, but not as well understood as other central banks. She stressed the difficult situation of the ECB by comparison to that of other central banks, in facing not one single but rather 12 political counterparts and their respective publics. With regard to ECB policy making, she said that the ECB continued to fulfil its mandate despite failing to keep the inflation rate below 2 percent because of extraordinary factors and exceptional circumstances. However, she complained about a lack of transparency in the secondary target of the ECB. Criticising the ECB's explanation of the interest rate cut in May 2001 with statistical corrections of M3, she stressed that the European Parliament would prefer the ECB to pursue a strategy of direct inflation targeting.

Christa Randzio-Plath

The first panel, chaired by Axel A. Weber (CFS/J.W. Goethe-University Frankfurt), brought together representatives of all major ECB-Watching groups from academia. Among the panelists were Daniel Gros (Center for European Policy Studies, Brussels), Jürgen von Hagen (Zentrum für Europäische Integrationsforschung and CEPR), and Lars E.O. Svensson (Institute for International Economics, Stockholm and CEPR).
Harald Uhlig (Humboldt University, Berlin and CEPR) opened the discussion with his presentation of the main points made in the most recent CEPR-Report on the ECB. After acknowledging that the ECB has done a good job to date, he emphasised two points. Firstly, he called for a formalised procedure for the interaction of the ECB with the finance ministers of the EMU countries (Euro 12) to replace informal meetings. Secondly, he addressed an issue, which is increasingly a topic for discussion, namely the divergence of inflation rates across EMU countries. He argued that the ECB should not worry about this because it may reflect necessary relative price adjustments.
Daniel Gros presented the main conclusions drawn in the latest CEPS-Report on EMU. After denying that Europe shows any signs of being a "New Economy" since productivity growth has not accelerated, he discussed in depth labour market developments over the last years. Given that progress in labour market reforms remains slow, he argued that slight improvements in employment are almost solely due to structural changes in the workforce and sectoral changes in the European economy. Therefore the need to reform the labour market remains undiminished. With respect to the monetary policy of the ECB, he said that interest rates have the right level, given that the rate of growth in Europe has not increased, the euro remains weak, and some inflationary pressures persist.

Daniel Gros

Jürgen von Hagen highlighted the importance of the first pillar (money growth) of the ECB's monetary policy strategy. The link between future inflation and present money growth as well as between money growth and official interest rates proved to be stable. Against this background, he criticised the revision of M3 growth and the related, widely unexpected cut in official interest rates in May 2001 as a result of holdings of money market instruments by non-euro residents. It remains unclear which data the revision relied upon. If it is based on information about the first buyer, it could be imprecise because of trading on secondary markets.

Lars E.O. Svensson, on the other hand, called for an explicit inflation target of the ECB. The actual reference value for money growth implies an inflation target of 1.5%, while price stability is defined by the ECB as an inflation rate between zero and two percent. This creates uncertainty for two reasons. One is, the asymmetry of the implicit inflation target within the defined range, and the other is the undetermined preferences of the ECB with respect to the upper and the lower bound of the range of the definition for price stability. Furthermore, because of the time lag with which monetary policy can affect the rate of inflation, interest rates should be set according to the inflation forecast. Along these lines Svensson called for comprehensive publication and a discussion on inflation forecasts, on inputs for deriving the forecasts, and on the uncertainty connected with the forecasts. Whilst acknowledging some movement by the ECB in this direction, he suggested that improvements could be made by increasing the frequency of published forecasts to every three months and linking the forecasts more closely to policy actions.

The second panel, chaired by Hermann Remsperger (Deutsche Bundesbank), concentrated on "Monetary Transmission and EMU". Members of the panel were Paul de Grauwe (Catholic University of Leuven), Juan J.

Hermann Remsperger

Dolado (Universidad Carlos III de Madrid), Sylvester Eijffinger (CentER, Tilburg University), and Carlo Monticelli (Deutsche Bank).

Ignazio Angeloni (ECB) delivered the opening statement for this session. He differentiated between two aspects of monetary transmission: first, the aggregate effect of the single monetary policy on prices and output, and second, the distribution of the effects of monetary policy across countries and sectors. The former is the most important for the ECB, given its mandate of maintaining price stability, whilst the latter is helpful for understanding the channels through which monetary policy operates. In addition, he presented some results of recent research on the effects of a monetary tightening in Euroland and the US. The responses of prices and output are very similar in both currency areas, that is output contracts temporarily and inflation rates fall with a time lag. Since the financial sector is crucial to the transmission mechanism he also reported the reaction of key monetary aggregates and credit in search of a „lending channel" in the Euroarea. A monetary restriction will lead to a rapid fall in M1. However, substitution effects between different monetary aggregates leave the broadest aggregate, M3, mainly unchanged for about 2 years. The decline in credit is also very slow and statistically not very significant. This gives rise to the conclusion that for the Euroarea on the wholeaggregate the lending channel is not very important because banks have access to alternative sources of finance. The fact that banking markets are still largely national, or even regional, may open a role for the lending channel for certain sectors or areas. The Eurosystem project on monetary policy transmission is addressing these issues using micro-data on bank balance sheets. With respect to the impact of monetary policy on non-financial firms, evidence is also limited. Whilst the average firm size, investment ratio, or debt maturity is similar at least across large EMU-countries, standard deviations of the cash flow and investment ratio within each country are sometimes substantial and differ across countries. This indicates a large degree of variability within each country and across countries. How this impacts on the transmission mechanism is also the focus of current research in the Eurosystem.

Ignazio Angeloni

Paul deGrauwe concentrated in his statement on the divergence, which has come as a surprise to many observers, of inflation rates in the Euroarea. Different inflation rates imply different real interest rates. In addition, past interest rate hikes by the ECB have had a very varied impact on national real interest rates, with inflation rates rising in some countries and dropping in others. He argued that this fact combined with nonlinear economic relations, such as credit rationing, capacity constraints, or the Philips curve make the monetary transmission process and the economic outcome unpredictable.

Sylvester Eijffinger pointed out that financial market structures across EMU-countries are different, but likely to converge in the long run. Carlo Monticelli argued that the analysis of the difference in the transmission mechanism across countries is interesting and informative, but has only limited impact on the conduct of monetary policy over and above what can be said for the Euroarea as a whole. One size fits all, that is "a fact of life, the ECB has to live with."

In the discussion Bennet Mc Callum (Carnegie Mellon University) doubted the suitability of so-called Vector-Autoregressive-models (VAR) for the analysis of monetary policy. Impulse response functions to monetary shocks give the reaction of the system to the unsystematic part of monetary policy. But more importantly, the focus should be on the effects of the systematic part of monetary policy and this can be done with structural models for the economy and feedback rules for monetary policy.

The third panel, chaired by Thomas Mayer (Goldman Sachs), discussed "The Transformation of Financial Markets in Euroland". Among the panelists were Giancarlo Corsetti (Yale University, New Haven and University of Rome III), André Sapir (European Commission), Niels Thygesen (EPRU, Copenhagen University), and Norbert Walter (Chief Economist, Deutsche Bank Research).

The panel started with an opening statement by Tommaso Padoa-Schioppa, a Member of the Board of the ECB. According to Padoa-Schioppa the transformation of financial markets is a highly topical issue. For monetary policy in particular the ongoing transformation will be a big challenge as the conduct of monetary policy depends crucially on the structure of the financial markets. Padoa-Schioppa asked what is meant by financial markets? In his view there are two definitions, one is broad and the other narrow. The broad definition includes all financial assets such as loans and non-negotiables, whilst the narrow definition includes only marketable instruments. In order to achieve the best possible policy a central bank should look at the broad definition. Hence, the ECB follows the broad definition of financial markets. For the ECB the transformation of European financial markets is governed by deregulation and the advent of the single currency. Four points are crucial as far as the transformation of financial markets is concerned. Firstly, the transformation is proceeding at a fast pace. Secondly, there are still significant obstacles in the development of a single currency. Thirdly, the formation of a single currency is desirable, and fourthly, the ECB takes a neutral stance on the modality of a single European financial market. From the ECB's point of view the development of a single European financial market is a desirable trend, as the monetary transmission mechanism is more easily understood under such circumstances. The neutrality of the ECB in this development is to be considered with respect to the issue of which financial centre and what financial instruments will prevail.

Tommaso Padoa-Schioppa

In his statement Giancarlo Corsetti linked the question of the exchange rate of the US dollar and the euro to the transformation of the European financial markets. He noted that within Euroland markets for goods and services are not perfectly integrated. While economists had problems in explaining the recent developments in the US dollar/euro exchange rate, there seems to be a clear link between the smooth working of the financial system and the exchange rate variability. Hence, in order to reduce the variability of the exchange rate, a further integration of financial markets would be desirable.

Niels Thygesen welcomed the development of further financial market integration within the euro zone. However, he believes the question of regulation will pose problems in the near future, as the regulation of the financial system is still done on the national level, while the European markets are becoming more and more supranational. In his view the single currency puts pressure on the member countries to establish a European-wide regulatory body. The main obstacle towards this European regulatory authority will be national jealousies.

Andre Sapir pointed out that the integration of European financial markets is far from being complete. He would have expected that the introduction of the Euro would have had wide spread implications. Judging from the number of cross border M&A activities in the uro zone, not much has changed since 1999. These activities also reveal that the insurance sector is much more globalised than the banking sector. The main impediments to further integration are differences in the legal tradition between the member countries, differences in taxation, and differences in the regulatory environment. Sapir expects consolidation to be achieved first in taxation and regulation. Differences in the legal system are much more likely to persist.

Norbert Walter reported on his work at the Lamfalussy group. He stressed the fact that financial integration has indeed made great progress. However, there has been too much patience in Europe for too long. It would be more relevant to ask what has not been achieved in Europe, instead of being satisfied with the goals reached so far. Walter urged private players to look upon themselves as being European. Research at universities should focus more on regulatory questions and national regulatory authorities should stop jealously defending their national role. Not having developed a fully integrated financial market implies huge costs for EMU member countries.

Panel four, chaired by Jürgen Pfister (Commerzbank AG), was entitled "Price Stability and Macro Adjustment in EMU". Other panel members included Matthew B. Canzoneri (Georgetown University, Washington DC), Francesco Giavazzi (Bocconi University, Milano), Bennet T. McCallum (Carnegie Mellon University, Pittsburgh), Hans-Werner Sinn (University of Munich, CESifo), and Axel A. Weber (J.W. Goethe-University and CFS).

The panel started with an opening statement by Vitor Gaspar (European Central Bank) who expressed his own views and not necessarily the view taken by the ECB. The current developments within the euro zone reflect strong structural adjustments. These adjustment processes should lead to an adjustment of the relative prices between countries, that is the real exchange rate. In Gaspar's view the concept of the real exchange rate has a different meaning for a small open economy than for a single currency area. For a small open economy the real exchange rate is the relative price of non-tradeable goods,

Vitor Gaspar

whereas inside a monetary union the real exchange rate concerns the internal and external balance. Inflation differentials calculated with the help of the Balassa-Samuelson effect are only limited. Gaspar drew four conclusions from this finding. Relative prices should change when strong structural adjustments are taking place. This may lead to inflationary implications. If inflation differentials were to develop, national policy makers would have to counterbalance them, for example with further deregulation. Finally the possibilities of monetary policy for countering inflation differentials are limited since the ECB has only one instrument at its command.

Matthew Canzoneri reported the findings from his latest research on the subject. According to Canzoneri the so-called Samuelson-Balassa effect is only partly responsible for the inflation differentials between the countries he considered. Therefore, the crucial question for an assessment of inflation differentials in Euroland is how much a percentage of the observable difference is due to long-run effects, which can be explained by the Samuelson-Balassa effect, and how much is due to short-run effects.

Matthew B. Canzoneri

In his statement Francesco Giavazzi raised the question whether member countries should have the same inflation rates? While Giavazzi thought this to be necessary in the long run, short-term deviations may be a desirable phenomenon, in the sense that inflation differentials between countries within a currency union are the only way left for adjustment.

In Bennett McCallum's view inflation differentials within the eurozone are not something that the ECB should be taking into account when considering its monetary policy actions, as there is little the ECB can do to mitigate the differentials. Furthermore, the ECB should not develop its own stance towards fiscal policy. McCallum considers this to be a dangerous development because it may lead to some degree of fiscal policy co-ordination, which could in the end endanger the ECB's independence.

In an assessment of the current inflation in Euroland Hans-Werner Sinn could not find any worrisome developments. Core inflation remains subdued. The high inflation rate can be explained by special factors, the effects of which will fade out after a while. Sinn pointed out that despite the current higher level of inflation in Euroland. deflation may be the bigger problem in the coming years. If the ECB were to achieve its inflation goal of 1.5% for the whole Euro area this would translate into a deflation in Germany, given the inflation differentials within the Eurozone. Hence, Sinn suggested that a discussion about deflation in Euroland should be started. As the example of Japan shows deflation is a serious threat to growth.

AXEL A. WEBER presented new evidence about inflation diversity and convergence in EMU. He finds that inflation convergence takes a specific form: inflation rates are mean-reverting in the sense that European regions with initially high (above average) rates on inflation tend to have subsequently lower (below average) inflation rates. He also finds that the cross-sectional variance of regional inflation rates in Europe significantly declines over time. Such regional diversity in inflation can be shown to also exist in other industrialised countries (i.e. the U.S. and Japan). Weber argues that inflation diversity should not be of concern for the ECB since a 2% area-wide inflation ceiling is sufficiently flexible to allow for European national and even regional inflation diversity without exposing European regions to sizeable deflationary risks.

Elke Hahn, Bernd Kaltenhäuser, Dirk Schumacher (CFS research staff)

CFS Summer School in Finance and Monetary Economics

This year in August a joint summer school was held by CFS in Eltville for both finance and monetary economics. Participants from universities, central banks and other research institutions were taught over the course of a week by a high ranking faculty and were also given the chance to present results from their own research.

In the finance part of the summer school the courses were taught by OVED YOSHA from the University of Tel-Aviv, JEAN-CHARLES ROCHET from the University of Toulouse, and ALBERT KYLE from Duke University.

Oved Yosha

Yosha dealt in his lecture with the question of risk spreading among individuals, regions and countries. First of all, the empirical implications were derived from a theory of optimal risk spreading with the focus here on the role of capital markets in particular. Then, using micro and macroeconomic data, the validity of these implications was tested.

Jean-Charles Rochet

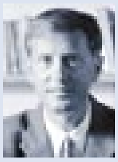
Rochet's lecture looked at the topic of bank risk contagion across borders, as well as the role played by central banks in such a process. The so-called Asian Crisis at the end of the nineties was a prime example of this type of contagion case. First of all, Rochet presented from a theoretical viewpoint the apparent reasons for the particular fragility of the banking sector. He then discussed the role of state supervision of banking as well as the role of the central bank as the lender of last resort.

Albert Kyle

Kyle examined the question of data processing in financial markets. To this end he presented a dynamic model he had developed of the trading activities of a financial market. Under the assumption of different degrees of knowledge amongst market participants, the distribution of information was analysed. The results of the model were then checked using computer simulations.

The lectures in the field of monetary economics were given by Matthew Canzoneri from Georgetown University, Richard Clarida from Columbia University and Ilian Mihov from Insead.

Canzoneri introduced the participants to the technical details of modelling new macroeconomic models. The focus of attention thereby was on the concept of monopolistic competition. This concept is nowadays part of the standard approach to modelling macroeconomic phenomena such as business cycles and inflation.



Richard Clarida

Clarida dealt in his lecture with the topic of monetary policymaking in an open economy. Recent research uses so-called monetary policy rules to describe central bank behaviour. Prof. Clarida presented both the theoretical derivation of such a rule in terms of an open economy and its empirical content.

Ilian Mihov

Mihov looked at a selection of new empirical methods for analysing macroeconomic phenomena. He focussed primarily on the vector autoregression of time series, explaining possible fields of application as well as the limitations involved and presenting numerous empirical examples.

Dirk Schumacher (CFS research staff)

How to Pave the Road to E(M)U: The Monetary Side of the Enlargement Process (and its Fiscal Support)

"How to pave the road to E(M)U: The Monetary Side of the Enlargement Process (and its Fiscal Support)" was the title of a joint Deutsche Bundesbank, National Bank of Hungary and Center for Financial Studies conference which took place on 25th October, 2001. The conference opened with a lecture by Jean Lemierre (President of the European Bank for Reconstruction and Development) about "The Transition Process after 10 Years: Achievements and Challenges ahead". In his opinion the transition countries have made tremendous achievements in the last 10 years. Among the lessons to be learned from the experience of the last 10 years, he emphasized that the success of macroeconomic policies in these countries has not been a question of the adopted regime but of the macroeconomic skills of the policy makers. With respect to the challenges ahead he stressed the huge need for investment in these countries.

Jean Lemierre

On 26th October, the introductory remarks were made by Ernst Welteke (President of the Deutsche Bundesbank) and Zsigmond Járai (President of the National Bank of Hungary), who described the conference as an attempt to contribute to an exchange of views between representatives of the Eurosystem, the accession countries and academics before the Berlin Seminar.

Hermann Remsperger (Deutsche Bundesbank) chaired the first session on "Exchange Rates: which Regime for Transition Countries and Consequences for the

EURO". JÜRGEN VON HAGEN (University of Bonn) presented the results of the CEPR report "SUSTAINABLE REGIMES OF CAPITAL MOVEMENTS IN ACCESSION COUNTRIES". The most important factors when trying to minimise the risk of a financial crisis, are the exchange rate regime, the degree of capital mobility, and the soundness of the banking sector. In the presence of fully liberalised capital accounts intermediate exchange rate regimes have proven more vulnerable than flexible or fixed rate regimes. Indeed, transition countries have moved to the "corner solutions" over time. Consequently, the report calls for a fast, unilateral "euroisation" of the accession countries in order to minimise the risk of a crisis. The EU forces the candidates into risky territory when it requires a two-year membership in the European Exchange Rate Mechanism II (ERM II) before the introduction of the euro. BEATRICE WEDER (University of Mainz) agreed with this assessment and added that "euroisation" would be best not only in the interests of accession countries but from the EU's point of view as well.

HOLGER WOLF (George Washington University) argued in his paper "EXCHANGE RATE REGIME CHOICE AND CONSEQUENCES" that after EU accession the earliest entry into EMU is appropriate only for Estonia (which has a currency board), while for the other first round accession countries the situation is less clear. Continued trend movements in the real exchange rate make the case against an early entry into EMU, while lower risk premia, the elimination of possible speculative attacks, and an enhanced voice in decision making are arguments in favour of an early entry.

JEROME STEIN (Brown University) used a NATREX model to evaluate the impact of EU enlargement on the equilibrium value of the euro under different scenarios for the investment and savings ratio. Palle Andersen (Bank for International Settlements) remarked that the paper, while using an EU sample, is in fact discussing the impact of the entry into EMU rather than into EU. This then raises the question of the treatment of the British pound.

The first part of the second session "FINANCIAL SYSTEMS FOR THE ENLARGEMENT PROCESS", chaired by JEROME STEIN (Brown University), started with the presentation by THORSTEN BECK (World Bank). The paper, which summarises the World Bank Policy Research Report entitled "FINANCE FOR GROWTH: POLICY CHOICES IN A VOLATILE WORLD", argues that a strong relationship exists between financial depth and economic growth. Establishing a legal infrastructure and making timely and accurate information available are essential for the development of financial markets. As this cannot be left entirely to the market, the government has an important role to play in building legal and informational foundations. Once these are in place, the government should make sure that rules and contracts are enforced. Regulation of financial markets should be done in co-operation with the markets themselves, for example by limiting safety nets and looking more to markets and owners for monitoring banks. Evidence on deposit insurance suggests that the combination of such a scheme with weak institutions not only makes a crisis more likely, but also decreases monitoring by markets and reduces financial sector development. Discussant CHARLES WYPLOSZ (Graduate Institute of International Studies) sees the bigger role for governments in the "NEW WASHINGTON-CONSENSUS" as being a step in the right direction.

The second presentation was by SERGIO SCHMUKLER (World Bank) entitled "ON BOOMS AND CRASHES: FINANCIAL LIBERALISATION AND STOCK MARKET CYCLES". Using a sample of 28 countries, the paper studies the process of financial liberalisation since the 1970s. The booms and busts in stock markets generated by actual data are more pronounced than the ones generated by a random walk process. It is also shown that cycles from emerging economies are more protracted than those from mature markets, confirming the hypothesis that imperfections in capital markets are more pronounced in emerging economies. Perhaps surprisingly, stock market prices do not become more volatile after financial liberalisation, but even tend to become more stable over time. However, in the short run, within three years after opening up the financial system, markets do tend to become more volatile.

The second part of the session, chaired by RICHARD PORTES (London Business School, CEPR), started with a presentation by THOMAS REINIGER and MARTIN SUMMER (both Österreichische Nationalbank) on "THE FINANCIAL SYSTEM IN THE CZECH REPUBLIC, HUNGARY AND POLAND AFTER THE FIRST DECADE OF TRANSITION". The presentation began with an analysis of the banking sector in the three countries. Recapitalisation, privatisation and consolidation have been successfully completed. There are however problems with the amount of non-performing loans and the low profitability of the banks. The financial sector shows a high degree of international integration, with foreign ownership in the bank sector's equity over 50% in all three countries. In the field of corporate financing, domestic bank loans are still the most important external source of capital. The level of equity-based financing is still very low. Finally, the legal environment was considered. The legal protection of creditor and shareholder rights are in line with the EU average. The weak spot seems to be in the field of law enforcement.

The final presentation in this second session was made by Claudia Buch (Kiel University) and dealt with "Short-Term Capital, Economic Transformation, and EU Accession". This paper focuses on the determinants of short-term capital flows. Short-term bank lending appears to increase with the degree of development within a country, the size of its population, the importance of the interbank market and whether the country hosts an international financial centre. Using parameter estimates, a prediction is made about the share of short-term bank lending in total international bank finance in the accession countries. The predicted share for the accession countries is higher than its actual share, suggesting that there is scope for increasing the importance of short-term bank lending in these countries. The results for domestic and international short-term debt securities seem to point in the same direction, but are less clear.

The third session chaired by György Szapáry (National Bank of Hungary) covered the topic "Monetary Policy for Transition Countries". The first paper in this session "Central Banking and the Choice of Currency Regime in Accession Countries" was presented by Clemens Grafe (European Bank of Reconstruction and Development) and jointly written with Willem Buiter (European Bank of Reconstruction and Development). This paper analyses the design of the appropriate central banking arrangements and exchange rate regimes for those formerly centrally-planned Central and Eastern European countries that are candidates for full membership in the European Union. They come to the conclusion that the accession criteria do not necessarily favour a particular monetary regime. Analysing the pros and cons of the two regimes widely believed to be most stable – currency boards and inflation targeting – they find that under both regime tensions are likely to arise from the attempt to meet the accession criteria of a low inflation rate and a stable exchange rate.

Helmut Wagner (University of Hagen) talked about "Pitfalls in the European Enlargement Process – Challenges for Monetary Policy". He investigated the pitfalls associated with the choice of an exchange rate regime in the run-up to E(M)U and also the pitfalls involved in the premature adoption of the euro. He explained that candidate countries pegging their exchange rate face the danger of financial instability, while those adopting flexible exchange rates need an anchor to stabilise inflation expectations. Frequently, inflation targeting is suggested.

Transition economies, however, are likely to have problems in practising inflation targeting. He warned that if EMU enlargement comes too hastily, then firstly the danger of real divergence may arise and secondly, when financial markets assess the scenario of the occurrence of real divergence, an anticipatory recession may arise in the EU. Bail-out actions of the core countries would immediately lead to an increase in interests rates, which would put the ECB under pressure.

Lucjan T. Orlowski (Sacred Heart University) presented his paper "Monetary Convergence of the EU Candidates to the Euro: Theoretical Framework and Policy Implications". A flexible approach to direct inflation targeting is a viable monetary policy choice for transition economies and is believed to facilitate both the economic transition and the monetary convergence to the euro. Following this assumption, Orlowski puts forward an analytical model investigating the link between the inflation process and monetary variables in transition economies. The empirical testing is conducted for Poland, the Czech Republic and Hungary. The analysis recommends that monetary convergence begins with inflation targeting and concludes with fully-fledged euroisation.

The fourth session, chaired by Heinz Herrmann (Deutsche Bundesbank), emphasised "Fiscal Challenges" of the accession process. Maxwell Watson (International Monetary Fund) recommended a path for public expenditures rather than the public deficit to avoid a procyclical fiscal policy. In addition he called for the highest possible degree of transparency to further anchor market expectations. Laszlo Halpern (Hungarian Academy of Sciences) pointed out that the interest burden of the public debt of the accession countries might be underestimated. Restructuring and an increase in transparency is likely to raise the level of debt significantly. He argued that a primary surplus of 1 percent is sufficient to service the debt over the medium run.

The conference ended with a panel discussion chaired by Axel A. Weber (CFS/J. W. Goethe-University Frankfurt). The panel members were Jürgen Stark (Deputy Governor, Deutsche Bundesbank), Mitja Gaspari (Governor, The Bank of Slovenia), Zdenek Tuma (Governor, Czech National Bank), György Szapary (Deputy Governor, National Bank of Hungary), and Klaus Regling (Director General, European Commission).

Jürgen Stark underlined several preconditions for the accession of transition economies to the European Union and the euro area. First, the compliance with the acquis communautaire of the EU is indispensable. Further, nominal and real convergence is of absolute priority before entering the euro area. The nominal convergence criteria defined in the Maastricht treaty have to be strictly met. The membership in ERM II should increase nominal and real convergence with the euro area. Currently, the financial sectors of the transition countries seem to be underdeveloped with respect to size, depth, and the degree of intermediation. And finally, the independence of the central bank, that is legal, personal, financial, and policy independence, is still insufficient in some countries.

Mitja Gaspari described the situation of Slovenia. The policy objective, that is membership of EU and EMU, is clear but there is still some discussion on how it should be achieved. With respect to the discussion during the conference about the choice of the exchange rate regime, he pointed out that Slovenia is successfully pursuing a managed float of the exchange rate and will not change that system until it enters into ERM II. He expressed some concerns about fiscal policy, where the level and the structure of expenditures may create problems.

Zdenek Tuma argued that the exchange rate regime is not important, if the structures of the economy and the domestic financial sector are sound. In this respect, the ERM II would not be of any additional benefit. If price stability is achieved, the exchange rate will prove to be stable too. Further, he questioned the link between nominal and real convergence, saying that the ERM II will ensure nominal but not real convergence. For these reasons, the CNB adopted a long-term monetary policy strategy with a gradual approach to the inflation target of 2% at the end of 2005.

György Szapary regards Hungary and the other transition countries to be as eligible for EU and EMU as were earlier accession countries. The transition countries are already constrained in their flexibility and want to gain some stability by entering into EU and later on into EMU. He underlined the psychological impact of the accession process on politics and financial markets and suggested that everybody should stick to the rules spelled out in the treaty and their interpretation in 1998.

Klaus Regling agreed on the objective of EU accession of the Central and Eastern European countries. He emphasiszed the importance of the Copenhagen criteria, transformation to a market based economy and the ability to withstand competitive pressures, as preconditions for EU accession. Currently no transition country meets the Copenhagen criteria, but some are close to doing so. Further difficulties may arise in two dimensions: bearing the cost of real appreciation without an exchange rate tool and balancing public budgets. The EU itself is ready for the entry of new countries.

Elke Hahn, Marco Hoeberichts, Bernd Kaltenhäuser (CFS research staff)

CFS*research activities*

Research Project "Venture Capital and the New Markets in Europe"

The joint research project "Venture Capital and the New Markets in Europe", supervised by Mark Wahrenburg in co-operation with researchers from the Johann Wolfgang Goethe-University Frankfurt/Main (Stefan Feinendegen, Eric Nowak, Daniel Schmidt, Alexander Swoboda) and CFS (Stefanie Franzke), can now report preliminary results.

Mark Wahrenburg

In collaboration with VCM Venture Capital Management GmbH (www.vcm.de), one of the largest and oldest Venture Capital Fund-of-Funds firms in Europe, the foundations for extensive, empirical research studies in the field of private equity have been created. Within the framework of the long term research co-operation the project "The Analysis of Contractual Relations between European Venture Capital Funds and Investors" is developing very successfully. In connection with the project a data base has been established which is unique within Europe. It draws on data from 110 private placement memoranda and 43 partnership agreements of European venture capital funds. The analysis utilised the indemnity structure and the use of covenants respectively as instruments for solving emerging principle agent problems.

The initial results of both descriptive and multivariate analysis illustrate the relationships between company-specific, or in turn macroeconomic, factors and the contractual arrangements. Thus, for example, it is shown to what extent the competence and experience (reflected in different measurable variables) of the fund management companies affects their contractual claims with respect to payments and self-imposed restrictions on their own operations through covenants. The effects on contract arrangements of a venture capital market currently in the process of establishing itself in Europe are also observable. The dynamics of contractual relations captured in descriptive statistical analysis can also be confirmed using multivariate methods. In this context significant dependencies have come to light, particularly with respect to the analysis of covenants. For example, a more efficient contract design has derived over the years in which investment principles have been stipulated in more concrete terms, thus denying venture capital companies the freedom to behave opportunistically. This leads the conclusion to be drawn that the field of venture capital is becoming more professional.

Mark Wahrenburg (J. W. Goethe-University Frankfurt)

Research Training Network (RTN)

Understanding Financial Architecture: Legal and Political Frameworks and Economic Efficiency

On 26th/27th October, 2001 the second meeting of the Research Training Network (RTN) took place, hosted by CEMFI, Madrid. (article on the first meeting see CFS*newsletter* 1/01)

The workshop focused on topics in the area of corporate governance. In particular papers analysing the origins and consequences of individually-adopted corporate governance mechanisms and economy-wide corporate governance systems were invited for presentation. The programme put together by the organisers Marco Becht (ECARES, Université Libre de Bruxelles), Erik Berglöf (SITE, Stockholm School of Economics), Colin Mayer (Said Business School, University of Oxford), Rafael Repullo (CEMFI, Madrid) and Howard Rosenthal (Princeton University) comprised ten papers, which are available for downloading at CEPR web site: http://www.cepr.org/meets/wkcn/5/575/papers/.

Among these is, for example, that of Ernst-Ludwig von Thadden (University of Lausanne) and Enrico Perotti (University of Amsterdam) on the "Political Economy of Bank- and Market Dominance", which was presented in the opening session. The paper deals with the effects of legislation on corporate governance and the protection of stake-holder versus investor claims. In their model the authors illustrate under what conditions the political majority will support bank over equity dominance and in what circumstances the dominance structure will switch towards favouring equity markets with riskier corporate strategies and higher profits.

The second day of the workshop centred mainly on topics in the area of venture capital financing. In their paper, Colin Mayer (Said Business School, University of Oxford), Koen Schoors (University of Gent, Belgium and University of Oxford) and Yishai Yafeh (University of Oxford and Hebrew University of Jerusalem) analyse the "Sources of Funds and Investment Strategies of Venture Funds: Evidence from Germany, Israel, Japan and the UK". Their main finding suggests that although financial institutional factors account for some of the differences in investment patterns across countries, other considerations (such as the supply of entrepreneurs) are of greater significance.

Stefanie Franzke

Focusing on Germany`s Neuer Markt, Stefanie Franzke (CFS) presented her paper "The Underpricing of Venture and Non Venture-Backed IPOs". Her findings that IPOs backed by prestigious venture capitalist are on average significantly more underpriced gave rise to lively discussion. After the conference Franzke emphazised that for up-and-coming academics the opportunity to discuss at length with a top ranking, international audience the results of their own research is an extremely valuable experience and a special feature of this workshop.

Stefanie Franzke (CFS research staff)

The Analysis of International Capital Markets

The other RTN-project in which the CFS participates is called "The Analysis of International Capital Markets: Understanding Europe's Role in the Global Economy."

(see article on the first workshop in the CFS*newsletter* 1/01) The network deals with questions concerning international capital markets, the implications for macroeconomic behavior, challenges for financial regulation and taxation policies. The analysis will be based on micro-underpinned theoretical models of international financial markets accompanied by empirical tests. In this EU-sponsored project, the CFS cooperates with CEPR and universities in Copenhagen, Dublin, London, Rome, Tel Aviv and Tilburg. Every six months a workshop is organised by one of the participating institutions. During these events research papers are presented and discussed. Moreover, CFS is pleased to be able to invite foreign researchers to join the CFS staff for a period of time.

Portrait

Marco Hoeberichts joined the academic staff at CFS in May, 2001. As a post-doc researcher he is working on the RTN-project mentioned above, that analyses Europe's role in international capital markets.

In 1998, Hoeberichts received his Ph.D. from Tilburg University. His dissertation deals with the institutional design of central banks, more specifically with the independence, transparency and accountability of central banks. For two years after completing his Ph.D., he remained in Tilburg as an assistant professor. He was involved in teaching and the supervision of Master's theses in the area of monetary and macroeconomics. During this period parts of his thesis were published in international journals such as *The Journal of Money, Credit, and Banking* and *Oxford Economic Papers.* After these two years, he felt that it was time for him to widen his horizons and look for an interesting research position abroad. First of all, he spent a few months at the Research Department of the Bank of Spain, taking part in their Visiting Researchers programme. He worked on a project analysing the incentives and constraints a central bank faces when it announces private information. In May, he packed his suitcase again and moved to Frankfurt. For him, Frankfurt is an outstanding place for doing economic research, especially for someone interested in monetary affairs. The concentration of important financial institutions and the conferences and seminars they organise means that many academic visitors come to Frankfurt. The opportunities available for meeting and talking to these people is making Hoeberichts' stay in Frankfurt very valuable.

Marco Hoeberichts

CFS*research staff* at (inter)national research conferences

International conferences

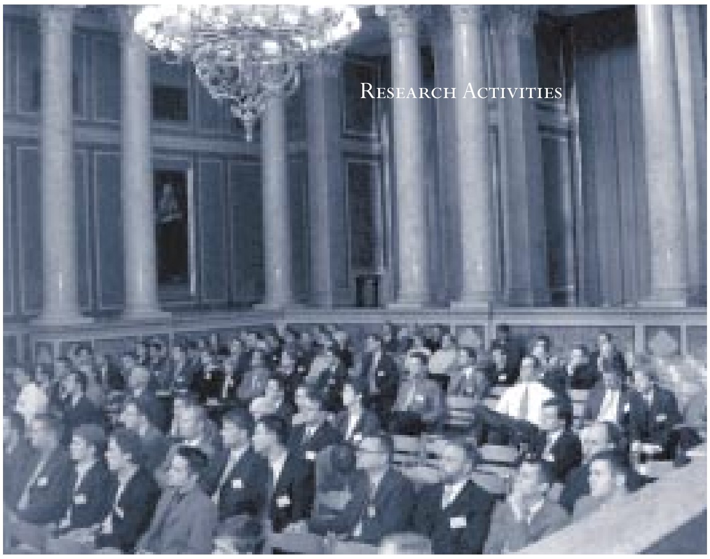
Axel A. Weber (J.W. Goethe-University Frankfurt/ CFS) and Günter Beck (J.W. Goethe-University Frankfurt) have presented their joint research on "The Integration Effects of Monetary Unions" at various international conferences, such as the 16th Annual Congress of the European Economic Association in Lausanne, the European Congress of the World Econometric Society at Lausanne, the Annual Conference of the Verein für Socialpolitik in Magdeburg and at two research seminars at the European Central Bank. A more recent study on "Economic Integration and the Exchange Rate Regime: How Damaging are Currency Crisis?" was presented at the Second Annual Research Conference of the International Monetary Fund in Washington D.C. and will be published in a Special Volume of the IMF Staff Papers in mid-2002. Weber and Beck are currently working on a new research project which analyses "Price Stability, Inflation Convergence and Diversity in EMU: Does a One Size Monetary Policy Fit All?".

Axel A. Weber

Annual conference of the Verein für Socialpolitik

The annual conference of the Verein für Socialpolitik took place on 25th – 28th September, 2001 at the Otto von Guericke University of Magdeburg. A highlight of the conference was the lecture given by Mario Monti (European Commissioner for Competition, Brussels) on the subject "Germany and the European Competition Policy". Incidentally, the overwhelming number of papers presented at this conference was very impressive. More than 200 papers, divided into 7 topic blocks, represented work from the most diverse fields. The areas covered included banking and finance, insurance, taxation competition, growth and employment, globalisation, monetary policy, economic history as well as environmental policy, health and sport.

Several researchers from CFS were there to present their work. In addition to Antje Brunner (c.f. meeting of the GFA) and Stefanie Franzke, (c.f. RTN meeting), Dirk



Schumacher talked about his paper entitled "Testing Co-ordination Failure". In his work Schumacher tries to find evidence for the existence of co-ordination failure as a central feature for business cycle movements. Starting out from a dynamic model of co-ordination failure following Cooper (1994), he derives two necessary conditions which must be fulfilled by the data. Firstly, the activity of two industrial sectors should switch simultaneously from different regimes of activity. Secondly, this switch should not be caused by a common shock. However, the author finds only a few industrial sectors in the US exhibiting behaviour which could be explained by co-ordination failure. *For more information on the programme and work presented please visit the web site http://www.uni-magdeburg.de/vfs2001/.*

8th Meeting of the German Finance Association

On 5th and 6th October, 2001 the eighth annual congress of the German Finance Association (GFA) convened in Vienna. For the first time a foreign university, that is the University of Vienna, hosted the congress. In the venerable surroundings of the great banqueting hall the Nobel Laureate William F. Sharpe (Stanford University) in an opening speech presented the results hot from the press of his paper on the subject of "Individual Risk and Return Preferences: A Preliminary Study". In this study questionnaire data are evaluated, which provide information on the individual preferences of investors with respect to investment decisions over a long time horizon and in the presence of uncertainty.

Subsequently, the participants were spoilt for choice and had to make a decision in favour of one of the five parallel presentations. The fields covered included, amongst others, capital structure and corporate governance, banking, bond and option pricing, empirical microstructure, behavioural finance, and credit and market risk. The sessions were very varied, particularly since both theoretical and empirical work was presented within the course of one session. Also worth mentioning is the large number of qualitatively high standard papers from which the organizers had to choose the ones to be presented. Those chosen under the heading Credit Risk included the paper by Antje Brunner (CFS/Humboldt University of Berlin) and Jan P. Krahnen (CFS/J.W. Goethe-University of Frankfurt) entitled "Corporate Debt Restructuring: Evidence on Lender Co-ordination in Financial Distress". Using a unique data set the problem of co-ordinating several lenders in the event of financial distress was analysed. The study arrives at the conclusion that the existence of banking pools increases the success probability of a workout, whereby a significant influence on the organisation of the pools is exerted by the number of lending banks, the distribution of loans across individual lenders and the extent of the distress shock. *This paper together with all the other papers presented at the congress is available for downloading from the web site http://dgf.univie.ac.at/*

The congress was rounded off by a panel discussion on "Technological and Institutional Changes in Financial Intermediation" with contributions by Matthew Elderfield (Financial Services Authority), Lynthon Jones (Jiway), Erich Obersteiner (Wiener Börse AG), William F. Sharpe (Stanford University) and René Stulz (Ohio State University). *All papers by CFS research staff are of course available at http://www.ifk-cfs.de*

Stefanie Franzke/Anke Leiser (CFS research staff)

CFS*working papers*

2001/01	**Stefanie Franzke** Underpricing of Venture-Backed and Non Venture-Backed IPOs: Germany's Neuer Markt
2001/02	**Roland Beck** Do Country Fundamentals Explain Emerging Market Bond Spreads?
2001/03	**Markus Kern / Bernd Rudolph** Comparative Analysis of Alternative Credit Risk Models – an Application on German Middle Market Loan Portfolios
2001/04	**Antje Brunner / Jan Pieter Krahnen** Corporate Debt Restructuring: Evidence on Lender Coordination in Financial Distress
2001/05	**Ralf Ewert / Andrea Szczesny** Countdown for the New Basle Capital Accord. Are German Banks Ready for the Internal Ratings-Based Approach?
2001/06	**Bernd Kaltenhäuser** Explaining the Dollar-Euro Rate: Do Stock Market Returns Matter?
2001/07	**Guenter Beck / Axel A. Weber** How wide are European borders? – New Evidence on the Integration Effects of Monetary Unions –
2001/08	**Yunus Aksoy / Tomasz Piskorski** Domestic Money and US Output and Inflation
2001/09	**Elke Hahn** Core Inflation in the Euro Area: Evidence from the Structural VAR Approach
2001/10	**Olaf Ehrhardt/Eric Nowak** Private Benefits and Minority Shareholder Expropriation – Empirical Evidence from IPOs of German Family-Owned Firms

Available for download from the CFS homepage via http://www.ifk-cfs.de

CFS*executive development*

Moving Ahead with Knowledge

Being well qualified can only be achieved by ensuring a continual update of knowledge. The CFS*seminars* and *executive conferences* for specialist and executive personnel as well as interested researchers provide an important basis for efficiently putting into practice at work what has been learnt and they also cover many fields ranging from equity research and the balancing of financial instruments to the evaluation of interest rate products or derivatives. Owing to the close links between research and executive development at CFS and the intensive collaboration with researchers from home and abroad, the most recent insights from financial market research are incorporated directly in the seminars. During the first half of 2002 CFS is offering amongst other things the opportunity to acquire qualifications in the following subjects (the complete timetable see on the overleaf of this CFS*newsletter*):

CFS*executive conferences*

Advances in Behavioral Finance II 22nd April, 2002

(Conference language will be German)

During the past twelve months financial markets have become more of a riddle to their participants than ever before. For the first time in a long while the stock markets have undergone a slump which cannot be explained by fundamental factors alone. In particular it is the younger market participants who lack the experience necessary for dealing with rapidly faling prices. Analysts and consultants alike have been at a loss to explain to clients that, which they themselves have frequently not been able to understand.

In these difficult times more than one person has been forced to take leave of the financial market. For some it was because of real financial dire straits, for others it was because they had lost faith in the stock exchange. Irrespective of these decisions, the world will continue to turn and it is precisely during an economic tailspin that it becomes all the more important to prepare yourself and your clients for better times ahead and to offer sound advice to those seeking it. This will not happen by sticking to traditional economic arguments. Investors, wishing to continue unperturbed in investing their money in the stock exchange, want to know what really influences the markets. They often feel let down by their consultants who, by nature of their profession, are not inclined to talk about losses.

Although most market participants are convinced of their own rational behavior, the results of their decisions are frequently not what you would call optimal. However, at the end of the day as long as substantial profits are realised, there are no problems. It is when losses are incurred that systematic mistakes start being painfully obvious. It is then that it becomes apparent for the first time, whether investors have earned sufficiently well during the good times to be able to do more than simply survive the bad years.

The Center for Financial Studies (CFS) has responded to the rapidly growing interest on the part of business practioners in behavioral-oriented Financial Market Research by organising various events. These one-day conferences are part of this initiative.

Just as last year Joachim Goldberg (cognitrend GmbH) and Martin Weber (University of Mannheim) will be in the chair. Both have made a name for themselves with their CFS*seminars* on Behavioral Finance and regular publications are due evidence of their leading position in this field in Germany. Other experts from theory and practice will also speak on the latest research findings and we shall be devoting particular attention to the implementation of the Behavioral Finance approach in routine investment practice. As the opening speaker in 2002 we shall be pleased to welcome Dr. Norbert Juchem from Bayerische Hypo- und Vereinsbank AG.

Towards an Evaluation of Internal Rating Systems: Certification and Validation – 6th June, 2002

(Conference language will be English)

The estimation of credit risk is a central part of modern credit management. These days most banks and supervisory agencies acknowledge that internal rating systems should be used to perform this task, especially with respect to corporate exposures. Internal rating can be regarded as the key instrument for estimating the probability of default by a creditor. External ratings and data from other sources can be used to complement the internal data.

Internal ratings serve a variety of purposes. They form the basis of risk-adequate pricing of loans and may be used to monitor loans. Recently, the Basle Committee on Banking Supervision has recognised the importance and quality of internal ratings and is willing to base its capital requirements on this data. Besides the simple standard approach, the New Basle Capital Accord (Basle II) proposes a standard as well an advanced internal-rating based approach for determining the capital requirement.

Given the importance of internal rating systems, it is obvious that they should be correct, that is, indeed able to provide an unbiased estimate of the probability of a creditor defaulting. This validation is needed for the credit management process and will be part of the certification requirements of any supervisory authority. After the general discussions about estimating credit risk, and independently of the current political debate about Basle II, we think it is necessary to move on and devise an appropriate risk estimation for credits.

For this reason CFS has decided organise this executive conference entitled the title "Towards an Evaluation of Internal Rating Systems". The goal of this conference is to bring together the parties involved in this process. We have invited four groups, namely bankers, consultants, academics and regulators, to share their views on the evaluations. The bankers will be presenting their current practices, the consultants are to discuss how they can contribute to the validation process, the academics will present current research and, last but not least, the regulators are going to discuss the requirements for the certification process. We have invited speakers and panellists from various European countries as well as from the US, which should enable us to discuss aspects of the evaluation of internal rating systems from a truly international perspective.

For further information, please visit us at www.ifk-cfs.de

CFS*seminars*

Aktien: Renditen, Modelle, Anomalien – 8th-9th March 2002

(Course language will be German)

Well-founded knowledge of the stochastic properties of stock yields, the relevant models and current empirical studies are vital requirements for forecasts of stock yields, the development and evaluation of investment strategies, portfolio management, performance measurement, the development of performance-oriented payment methods as well as the estimation of equity costs. The anomalies, that is the deviations of actual yields from the forecasts of standard models, are of particular interest and it is the presentation and explaining of these anomalies together with the a discussion on their implications in practice, which form the focus of this event.

Richard Stehle

With this seminar on "Aktien: Renditen, Modelle, Anomalien" CFS is responding to the need for more qualification in this area by offering in-depth information on the relevant insights from research, particularly with regard to the theoretical foundations, concepts of analysis, data problems, the results of traditional studies and new developments. The focus of attention will be on the German and US American markets and the seminar will be led by Richard Stehle (Humboldt University, Berlin), who is an acknowledged expert in the field. *For further information please visit us at www.ifk-cfs.de.*

Operational Risk

– Von der Begriffsbestimmung zu zukünftigen Entwicklungen – Anforderungen an Quantifizierung und Management von Operationalen Risiken

7th-8th June 2002

(Course language will be German)

Operational risks have become a core topic in the risk management of banks. Although it is part of routine banking control and thus not a new concept, operational risk is rapidly becoming established as a discipline with its own management structures, instruments and procedures. The controlling and management of these risks is already to be found in many banks as an independent section along side those of credit and market risk management.

This subject has received greater attention since the Basle Committee on Banking Supervision referred explicitly to operational risks in a consultation paper on new capital resources agreements. The initial consultation paper, published in June 1999, on the new regulation relating to the equity-backed securities provision of banks called for the first time for equity securitisation backing with respect to ”other risks, principally operational risk“. In the course of the subsequent dialogue between the banking supervision authorities and the banks, equity-backed securitisation in a second consultation paper from January 2000 and in its accompanying supplement on operational risks was limited to operational risks as the most important and measurable component of "other risks". In September 2001 a working paper with new suggestions on this topic was published.

Further publications in the form of the repeatedly postponed paper on "Sound Practices for Operational Risk Management“ as well as a new consultation paper, which aims to integrate the main elements of the voting process, have been announced for October/November 2001 and March 2002.

The Basle Committee and the banks are well aware of the dimensions and consequences of the new rules on capital, which were initially underestimated with respect to their complexity, as well as the extent of tasks still to be accomplished. In the near future the topic of operational risks is highly likely to undergo an intensive development process.

The implementation of the new standards will present the banks with a considerable challenge, with respect to both staff capacity and the necessary investment in structures and instruments.

CFS is responding to the growing interest in the practice of operational risk management with the seminar entitled "Operational Risk – Von der Begriffsbestimmung zu zukünftigen Entwicklungen – Anforderungen an Quantifizierung und Management von Operationalen Risiken", which will introduce the latest scientific insights into the transposition of methods from market and credit risk together with concrete examples of the practice-oriented implementation approaches of the three largest Frankfurt banks.

The main focal points of the seminar are:

- An understanding of operational risk and how it differs from other types of risk
- The analysis of effects on current management concepts and structures in financial institutions
- The presentation of current methods and the technical requirements for measuring operational risk
- The presentation of the relevant data and their sources
- Reports based on previous experiences about the anticipated opposition and hindrances to implementation
- Clarification of actual trends from Basle and Brussels and their implications

The two-day seminar will thus deliver fundamental, topical and comprehensive information on the current developments and requirements in policy, research and practice. The seminar is to be headed by Robert Hübner (Deutsche Bank AG) and Christian Schlag (J. W. Goethe-University Frankfurt/Main). Further speakers include Gerrit van den Brink (Dresdner Bank AG) and Thomas Kaiser (Commerzbank AG).

More information on this and other events can be found under www.ifk-cfs.de or call us and speak to either Christiane Bauder or Barbara Kleiner, Tel.: +49-(0)69-242941-30 or -25, Fax: +49-(0)69-242941-33, Email: bauder@ifk-cfs.de and kleiner@ifk-cfs.de

Special: Executive Development at CFS

Interview with Dr. Antje Becker, General Manager of CFS

Antje Becker graduated in Business Management and Economics at the Universities of Marburg and Hamburg. She was awarded a Ph.D. degree in 1995. She then worked for three years as Executive Search Consultant for Heidrich & Struggles Mülder & Partner. From 1998 to 1999 she was employed by Thomson Financial as Sales and Marketing Executive for Germany and Austria. In December 1999 she moved to the Center for Financial Studies and took up the position Head of Executive Development. In October 2000 she became General Manager of the Center for Financial Studies.

When did the Executive Development programme start at CFS?

Becker: It was on October, 1997 that CFS first began its Executive Development programme for specialist and management personnel from the field of finance. The seminar in question was lead by the renowned New York professors Martin Gruber and Edwin Elton on the subject of ”Managing Institutional Asset Portfolios: Pension Funds and Mutual Funds” and was also the starting point for the collaboration in Research and Executive Development training with the Salomon Center of the New York University.

How does CFS organise its Executive Development programme?

Becker: The Programme Advisory Council of the Gesellschaft für Kapitalmarktforschung e.V. advises CFS with respect to activities in the context of Executive Development. It comprises top ranking representatives from the personnel departments and specialist units for capital market issues of our members. Twice a year the programme advisory council nominees meet with the Directors and Head of Executive Development to discuss in detail what changes in direction the Executive Development programme will need to take in order to meet the requirements of the financial community.

The conclusions drawn, together with continual guidance from the market gleaned from talks with market participants and our own participation in financial market forums go towards constituting the Executive Development programme of CFS.

And of course the regular dialogue with both the Managing Board and the Board of Trustees as well as representatives from our member firms ensures the quality and innovative nature of the programme on offer. I would like to take this opportunity to say a special thank you for the support given by our members of the Managing Board, the Board of Trustees and the Programme Advisory Council!

What is so special about the CFS-seminars?

Becker: The close links between Research and Executive Development activities as well as the collaborations on a national and international level allow up-to-the-minute insights to be incorporated in the seminars.

The faculty at CFS*seminars* includes both academics and practitioners. In this way we can guarantee that in our seminars “both languages” will be spoken, whilst ensuring nonetheless that the latest scientific findings can be brought to bear in practice.

In what form does the Executive Development programme at CFS appear as whole?

Becker: Within the framework of the Executive Development programme CFS takes up current issues and imparts the latest findings, associated in-depth concepts as well as the predominant relationships.

The one to four day seminars and conferences are designed to promote the systematic and scientifically sound dissemination of high quality knowledge. Participants

will be in a position to learn about methods and instruments mainly from the fields of finance and monetary economics and to master their application in practice.
Owing to the restricted number of participants we are able to guarantee intensive learning and we endeavour to ensure a comprehensive exchange of experiences. Individual supervision of participants in close collaboration with our specialist experts is certain to warrant the successful retention of acquired knowledge. Moreover the length of time spent away from the workplace is kept to a minimum owing to the partial weekend scheduling.

CFS-Team Executive Development

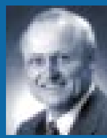
Christiane Bauder
Tel. +49-(0)69/24 29 41-30
Fax +49-(0)69/24 29 41-33
email: bauder@ifk-cfs.de

Barbara Kleiner
Tel. +49-(0)69/24 29 41-25
Fax +49-(0)69/24 29 41-33
email: kleiner@ifk-cfs.de

Sabine Lanius
Tel. +49-(0)69/24 29 41-30
Fax +49-(0)69/24 29 41-33
email: lanius@ifk-cfs.de

As a supplement to the comprehensive general Executive Development programme provided by the CFS*seminars* for specialist and management personnel as well as all those interested in advanced further education, we also meet the special requirements called for by specific training with our internal or firm-specific seminars respectively. On account of the orientation towards the prevailing conditions of an individual firm and its strategy, workplace-specific executive training means that knowledge relating to a specific firm and subject can be quickly and effectively imparted to a large number of management staff. Our CFS*inhouse-seminars* support the systematic development of both personnel and systems in specialist departments. The scientific expertise of CFS makes it possible for us to tailor development training programmes specifically to suit the needs of the client.
CFS has initiated a new series of events under the heading CFS*executive conferences*, which in general consist of single-day events. In the future we shall be using this forum for providing information about the latest developments and insights in both theory and practice. The main focus of these events is on summarising the most topical scientific trends in specific theories and will allow participants to accommodate these issues in their daily work routine immediately.

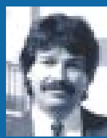
What makes the seminars particularly interesting for the members of CFS?
Becker: Our members are able to directly influence the structure of our Executive Development programme, since we maintain continuous contact with one another. Furthermore all participants from member firms are eligible for a 10% fee reduction for our seminars.



Wolfgang Bühler, ***University of Mannheim,*** **CFS*seminar***
"Zinsprodukte: Analyse und Bewertung"

Harald Eggerstedt, ***Commerz Asset Managers,*** **CFS*seminar***
"Emerging Markets: Risks and Opportunities for Banks and Investors"

Günter Franke, ***University of Konstanz,*** **CFS*seminar*** "Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement"



Walter Krämer, ***University of Dortmund,*** **CFS*seminar***
„Finanzökonometrie und Prognosemodelle I und II: Statistische Grundlagen & Moderne Zeitreihenverfahren"

Conrad Mattern, Deka Investment GmbH, **CFS*seminar*** "Euroland- und US-Wirtschaftsindikatoren als Market Movers"

We asked some of our CFS*seminar* faculty about:

CFS: ***In your opinion what are the immediate benefits of your seminar for the participants?***
Bühler: They receive a structured presentation of the principles of the fixed income concept in a form which to date is available neither in the literature nor in practice.
Eggerstedt: Economic risk measurement concepts are related to market events and thus become strategically utilisable. Systematic tools for evaluating emerging market exposures are introduced.
Franke: They become acquainted with new, highly practice-relevant forms of securitisation and the trading of loan loss risks.
Krämer: They will be able to understand other people's financial market analysis as well as to carry out their own empirical analysis.
Mattern: A connection is established between theoretical insights into economic relations and their effects on capital mar-

kets and the behaviour of capital market participants respectively.
Economic indicators are discussed and their influence on happenings in capital markets is explained by means of examples.

CFS: ***Why have you arranged your seminars in collaboration with CFS?***
Bühler: Out of solidarity with colleagues in Frankfurt.
Eggerstedt: CFS is currently the most accepted forum in the branch for Executive Development and the exchange of information.
Franke: Because of the very good planning and organisation of the seminars. I believe that in the meanwhile CFS has firmly established its position in the field of Executive Training.
Krämer: The participants are highly motivated.
Mattern: The reputation of CFS is one reason since it enables a target group to be reached with which it is possible to work without incurring too much frictional loss and in a goal-oriented manner. Furthermore the manageable group size and the professional organisation, which reacts flexibly to unforeseen events can be named.

CFS: ***What is necessary for forging a link between theory and practice?***
Bühler: People who speak both languages.
Eggerstedt: The involvement of experienced practitioners in organising the lecture and seminar programme.
Franke: Both sides must learn from one another. For this reason it is important that competent practitioners are involved, enabling new developments and evaluations from the world of practice to find recognition early on.
Krämer: A further step away for academia from its ivory tower.
Mattern: Both sides must move towards one another. As far as my seminar is concerned, economic theorists must come down from their ivory tower and realise that financial markets function only partially in accordance with commonly accepted theories. Practitioners for their part should concern themselves more with theoretical insights and not only act on "gut feeling".

CFS: ***How would you evaluate the general development of Executive Training in the financial market arena?***
Bühler: It is becoming increasingly more competitive. Frankfurt is suffering from the fact that in the long run foundation courses will no longer be required and the market for specialist seminars (such as those offered in London) is too small.
Eggerstedt: There is a large supply but major differences exist in the value-for-money factor.
Franke: Those courses dealing with new products and/or methods, which are important in the world of practice, will be successful. Courses on standard subjects will lose their appeal because many practitioners have already covered these issues during their university studies.
Krämer: Good approaches (c.f. CFS) More method and consistency must be introduced. A course just once a year is not sufficient and will not lead to much.
Mattern: In recent years there has been a glut of courses, which have not always delivered what they promised. A real gold digger's mentality has abounded. The changing financial market landscape will make it difficult for some courses to survive, particularly if the quality is not up to standard. Over the coming months it is likely that there will be a rapid separating of the wheat from the chaff.

Participants´ response to the question:

How would you comment on the CFS*seminars*?

- **Comparatively very good value for money**
- **Pleasant atmosphere, would in particular like to emphasise the splendid supervision by CFS**
- **Skilled moderation and practice-oriented exposition**
- **Optimal group size**
- **Professional organisation by CFS**
- **A successful blend of theory and practice**
- **In my view a sound basis for Executive Development**

Special compiled by Barbara Kleiner
(CFS*communications*)

Short Notice

We are pleased to be able to welcome as new members to the Gesellschaft für Kapitalmarktforschung e.V.*:

Sponsoring members:
KPMG Consulting AG and RWE Aktiengesellschaft.
Firm members:
Ashurst Morris Crisp, Berenberg Bank, Clifford Chance Pünder, Concord Effekten AG, Context Management Consulting Unternehmensberatungsgesellschaft mbH, Dr. Siegert & Partner, Falke Bank AG, Fraport AG, Freshfields Bruckhaus Deringer, Haarmann, Hemmelrath & Partner, Heidelberger Zement AG, McKinsey & Company, Inc., Palm Tresckow & Partner Consulting GmbH.
Individual members:
Stephen M. Illenberger, Georg Rankers, Dr. Peter Wilke
For membership information please contact Christiane Bauder, Tel: 069/24 29 41-30, Fax 069/24 29 41-33, email: bauder@ifk-cfs.de

*** The "Gesellschaft für Kapitalmarktforschung e.V." is the organisation which sponsors the CFS. Information on how to become a member of the "Gesellschaft für Kapitalmarktforschung e.V." please see CFS*newsletter* 2/01 or visit our homepage: www.ifk-cfs.de**

Dates of forthcoming Events

CFS*colloquium* series "Cross Border Financial Integration – Trends, Strategies and Lessons Learned"
Unfortunately the lecture "Strategies in International Asset Management and Insurance" with Pierre Richard (Chief Executive Officer of Dexia Group) needed to be postponed. A new date has not yet been fixed. We will keep you informed via our homepage (www.ifk-cfs.de) or by mail as soon as the new date has been fixed.
Our new CFS*colloquium* series "Globalization of Financial Markets – Risks and Opportunities" will start in April 2002.
We will keep you informed via our homepage (www.ifk-cfs.de) or by mail as soon as our lecture programme has been established and of course about all other CFS*research activities*.

Please note that admission to the lectures of the CFScolloquium is only possible with a valid ticket. Interested parties who do not receive tickets regularly may contact Birgit Pässler, Tel. +49-(0)69-242941-14, or use Fax: +49-(0)69-242941-77, or Email: paessler@ifk-cfs.de. For further information please consult our homepage: http://www.ifk-cfs.de.

Executive Development: I. Half Year 2002

CFS*seminars*

22./23. Feb
Finanzökonometrie und Prognosemodelle I: Statistische Grundlagen (Grundlagenseminar)
Walter Krämer, *University of Dortmund*
€ 1690 for member companies *,
€ 1790 for non-members

01./02. Mar
Corporate Valuation und Real Options
Ulrich Hommel, *European Business School*
Martin Scholich, *PricewaterhouseCoopers*
€ 1790 for member companies *
€ 1890 for non-members

08./09. Mar
Finanzökonometrie und Prognosemodelle II: Moderne Zeitreihenverfahren (Aufbauseminar)
Walter Krämer, *University of Dortmund*
€ 1690 for member companies *,
€ 1790 for non-members

22./23. Feb & 08./09. Mar
Finanzökonometrie und Prognosemodelle I und II: Statistische Grundlagen & Moderne Zeitreihenverfahren
Walter Krämer, *University of Dortmund*
€ 2790 for member companies*
€ 2990 for non-members

08./09. Mar
The New Techniques of Asset-Backed Securities
Ian Giddy, *New York University*
additional as speaker Martina Späth, *HypoVereinsbank*
€ 1990 for member companies *
€ 2140 for non-members
This seminar will be held in english.

08./09. Mar
Aktien: Renditen, Modelle, Anomalien
Richard Stehle, *Humboldt-University Berlin*
€ 1690 for member companies *
€ 1790 for non-members

12./13. Apr & 26./27. Apr
Zinsprodukte: Analyse und Bewertung
Wolfgang Bühler, *University of Mannheim*
Wolfgang M. Schmidt, *Deutsche Bank AG*
€ 2790 for member companies *
€ 2990 for non-members

24./25. May
Bilanzierung von Finanzinstrumenten nach HGB, IAS und US-GAAP
Martin Glaum, *University of Gießen*
Volker Thier, *KPMG*
€ 1790 for member companies *
€ 1890 for non-members

06./07./08. Jun
Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement
Günter Franke, *University of Konstanz*
Dirk J. Nonnenmacher, *Dresdner Bank*
€ 2390 for member companies *
€ 2540 for non-members

07./08. Jun
Operational Risk – Von der Begriffsbestimmung zu zukünftigen Entwicklungen – Anforderungen an Quantifizierung und Management von Operationalen Risiken
Christian Schlag, *University of Frankfurt*
Robert Hübner, *Deutsche Bank AG*
further speakers are: Gerrit van den Brink, *Dresdner Bank AG* and Thomas Kaiser, *Commerzbank AG*
€ 1790 for member companies *
€ 1890 for non-members

14./15. Jun
Euroland- und US-Wirtschaftsindikatoren als Market Movers
Conrad Mattern, *Deka Investment GmbH*
€ 1690 for member companies *
€ 1790 for non-members

14./15. Jun
Aktienbewertung und Style-Investing
Manfred Steiner, *University of Augsburg*
€ 1690 for member companies *
€ 1790 for non-members

CFS*executive conferences*

22. Apr
Advances in Behavioral Finance II
in co-operation with: Joachim Goldberg, *cognitrend GmbH*
Martin Weber, *University of Mannheim*
€ 590

06. Jun
Towards an Evaluation of Internal Rating Systems: Certification and Validation
Jan P. Krahnen, *University of Frankfurt and CFS*
Martin Weber, *University of Mannheim*
€ 590

For further information and registration with respect to all CFS-seminars and CFSexecutive conferences please contact Christiane Bauder or Barbara Kleiner, Tel.: +49-(0)69-242941-30 or -25, Fax: +49-(0)69-24941-33, Email bauder@ifk-cfs.de and kleiner@ifk-cfs.de.

Unless otherwise stated, the course language will be German. Fees include seminar fees, the costs for all seminar documents as well as board and lodgings.
(The discounts for member firms are limited to the annual membership fees.)*

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Center for Financial Studies
an der Johann Wolfgang
Goethe-Universität, Frankfurt
Taunusanlage 6
D-60329 Frankfurt/M.
Tel: +49-(0)69-242941-0
Fax: +49-(0)69-242941-77
http://www.ifk-cfs.de

Editor
Barbara Kleiner

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Center for Financial Studies
www.ifk-cfs.de