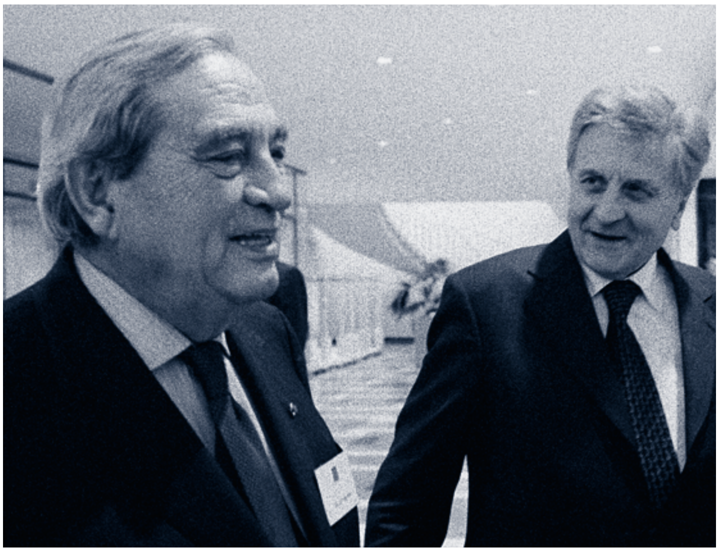
NEWS

CENTER FOR FINANCIAL STUDIES

1/04



Karl Otto Pöhl (President CFS) and Jean-Claude Trichet (President ECB) at the CFS Key Event 2003 in Frankfurt. See article on page 5

editorial

"The Financial Industry under Pressure"

Dear Members, Collegues and Interested Parties,

This edition of the Newsletter once again gives us the opportunity to highlight the principal topics which play a role in the current projects and events of the CFS.

The subject of the colloquium series during the last two semesters, namely "The Financial Industry under Pressure" is certain to continue influencing the work of CFS. The emphasis here is on the word "pressure", then it is the view of most observers that without far reaching structural changes the German financial industry will not be in a position to maintain its current role in the German and European markets.

The details of this need for reform affect many areas and are by no means restricted to legal and tax policy issues. In particular, it is the case that unimpeded competition must be allowed and the resulting market processes must be accepted. Here there is a decided backlog, as the debate on early ratings for the Landesbanks not so long ago clearly demonstrated. In this context, as in repeated cases of actual or feared corporate takeovers, we are witnesses to a questionable involvement by public authorities, professional associations and high-ranking politicians. It may be assumed that this undoubtedly well-meant intervention causes more damage than good. The damage results above all from the fact that Germany's financial market once again appears to be a difficult and isolated terrain.

There is clear evidence supporting this notion to be found in the fact that, despite the prolonged difficulties experienced by banks and insurances in Germany, there have still been no significant takeovers by foreign institutions.

The impressive success of Eurex in the U.S. has plainly shown what effects a foreign competitor, even before he has actually taken up the job in hand, can achieve amongst the old top dogs. The previously lethargic options and futures market in the USA is currently experiencing a renaissance and a modernization surge that is unrivalled. There is a lesson to be learned: an intruder and mischief-maker entering the local financial market from abroad might actually be a blessing, enhancing innovation and recovery at home.

On this note we wish us all an eventful and successful 2004.

Best greetings,

Jan P. Krahnen *Antje Becker* *Volker Wieland*

Contents

CFS*colloquium series*

"Finanzindustrie unter Reformzwang – Financial Industry under Pressure"

Banks and Stock Exchanges - Partners in difficult times?

(original German title: „Banken und Börsen: Partner in schwierigen Zeiten? Rollenverteilung im Wandel")

Lutz Raettig, Chairman of the Board of Management Morgan Stanley AG and Chairman of the Frankfurter Wertpapierbörse (FWB) Exchange Council, presented in October 2003 his views the changing nature of the role to be played by the banks and stock exchanges in the global field. According to Raettig, the financial industry is only just at the beginning of an extensive consolidation process during which amalgamations in the most diverse fields will occur.

The trend in securities settlement, in particular, is clearly towards concentration and a global oligopoly structure. The German Stock Exchange has improved its position in this field with the acquisition of Clearstream. Securities settlement represents a significant cost factor to the banks. For years the frequently debated common settlements platform has failed to emerge owing to a lack of consensus on the best approach to be taken. Consolidation in the field of securities settlements is driven above all by the potentially large economies of scale effects and reduced risks to be gained from a broader netting of individual positions.

Structural problems have long been ignored by the banks. In particular, cost structures have not been well tended and the processes involved have not been analyzed, adjusted and optimized enough. The banks' situation is still one of strong inward orientation. However, from now on the pressure to reorganize in the wake of Basle II will become increasingly stronger. Basle II has fundamentally changed the opportunities for companies to procure outside capital, amongst other things in the direction of public capital markets. In part this has happened directly, but also to some extent indirectly. In Germany it has been above all the indirect pressure resulting from the banks' balance sheets which has played a decisive role. In order to create growth potential, i.e. in order to be able to increase the volume of loans, there has to be more securitization. This process, according to Raettig, is currently underestimated, although various activities such as the True Sale Initiative under the auspices of the KfW point to the need for it.

With a view to the domestic banking sector, Raettig emphasized that above all those banks that on the size scale register closely after Deutsche Bank are being called upon to evaluate their market position and to initiate a reorientation. It is foreseeable that there will be several takeovers, whereby Raettig initially envisages this consolidation occurring predominantly at the national level. As he notes, even during periods when German banks were to be had really cheaply, little interest was shown by foreign institutions because even then there was little confidence on their part that they would be capable of seeing through the necessary reorganization. Takeovers in Germany are not so much a question of price, but rather tend to depend mainly on the extent to which the acquiring company considers itself to be capable of completing the task of reorganization, and furthermore has the willpower to unite two different corporate cultures.

Raettig considers there to be a potential for transactions owing, amongst other things, to the abolition of the liability authority's guarantee from 2005, especially with respect to institutions under public law and in particular the "Landesbanks". Given that the owners of institutions subject to public law are no longer willing to make additional capital available in order to generate more growth, changes in the legal form and in corporate governance as well as the introduction of minority interest partners might occur.

Overall, Raettig expects there to be a change away from a totally "bank-dependant society" to a "public capital market society" with all the consequences that accompany the public capital market. Above all, in view of the fact that the German economy and in particular the small and medium size business sector urgently requires more equity capital, it would be essential to establish suitable markets for creating equity capital. *Stefanie Franzke (CFSresearch staff)*

Long Term Investment and Return guarantees

In November 2003, as part of the present colloquium series, Joachim Faber, Member of the Board of Management of Allianz AG Dresdner Asset Management gave a talk entitled "Long Term Investment and Return Guarantees". Faber explained that under uncertainty and in an environment of low interest rates, it becomes harder to offer guarantees to investors. Insurances and Reinsurances have felt the pressure, basically, due to the type of obligations they have (life obligations).

Joachim Faber

Two different types of guarantees can be offered, either legal or economic guarantees. The former are infrequent as it is hard to be allowed to give legal guarantees. Economic guarantees are those that do not represent any legal obligation on the part of the manager. They provide confidence level and are used to keep the expected shortfalls to a minimum and reduce the volatility in returns of assets. Life insurance companies and pension funds are the main users of economic guarantees. Regulatory pressures, a raising number of retirees compared to the number of beneficiaries, downgrades by rating agencies due to the unfounded pension obligations, or the changing of international accounting rules that challenge the pension schemes, have created a growing appetite towards guarantees. However, the question that arises is why investing in guarantees when dealing with long term investment? On the one hand, volatility of average returns decreases as investment horizon increases. Also, shortfall probability is lower in the long run. On the other hand, the expected magnitude of shortfall increases over time and the return compromise from protection can be compensated by ability to invest in more aggressive assets, thus increasing expected returns.

Several approaches are used to address the question of long-term investments, mainly either static or dynamic strategies. While static strategies create more stable portfolios, they are also strongly exposed to shortfalls. With dynamic strategies there is a higher flexibility to invest in broader range of assets and also the risk control is more reliable even for long-term investments. The speaker came to the conclusion that long term investments require dynamic strategies because they mean a high participation rate on long-term premium while also taking into consideration short-term constraints.

The concluding remarks that can be extracted are that market development has fundamentally altered long term investing. Investors are more focused on wealth protection and are evermore demanding of the asset manager. Successful asset managers should be able to provide absolute performance, better risk management, a customized service and also higher transparency. Finally, economic guarantees of dynamic nature can give the long-term investors the ability to control downside risk, participate in the market returns and protect portfolios from shortfalls.

Marc Escrihuela-Villar (CFSresearch staff)

"Consolidate Public Finances – Reform the Tax System":

Financial Market Aspects of the German Council of Economic Experts' annual report

(original German title: "Staatsfinanzen konsolidieren - Steuersystem reformieren: Finanzmarktrelevante Aspekte des Jahresgutachtens des Sachverständigenrates")

On December 11, 2003, Axel A. Weber, a former Director of CFS, who is currently a Member of the German Council of Economic Experts as well as Professor for International Economics at the University of Cologne, gave a presentation based the Council's annual report for 2003/04, which is entitled "Consolidate Public Finances - Reform the Tax System". Given that the report comprises nearly 700 pages and the presentation time allowed was just an hour, it was clear that the focus would be on the salient aspects only.

The starting point of the presentation was the Council's forecast for the German economy for 2004. The central prognosis (as of November 2003) was the expected growth rate for GDP of 1.5%, owed largely to foreign trade. The tax reform, which at this point was not certain to be moved forward, would increase the rate of growth slightly to 1.7%, but in view of other reforms that were first passed in December, even this small increase is likely to turn out to be weaker than expected. Owing to the current economic uncertainty, the forecasts of the Council are, of course, also uncertain. One of the biggest risks, according to Weber, is the burden to the world economy resulting from the US twin deficits (i.e. the current account deficit and the fiscal deficit) and the consequences for the US dollar exchange rate.

Further corner stones of the Council's prognosis for Germany include a deficit of 3.4% (and thus the renewed violation of the Stability and Growth Pact), a stable unemployment rate of 10.6% (with a slight reduction for the second half of the year) and an inflation rate of 1.2%. Weber referred to the inflation statistics as the only area for which the economic policy objective would to a large extent be achieved.

Weber was equally forthright in his evaluation of the budgetary policy situation in Germany. He detects a political renaissance of fiscal dogma that accepts short run positive effects and risks a loss of credibility with respect to the long-run consolidation of the public budget. At the same time, however, it is once again unlikely that a disturbance of aggregate economic equilibrium will be announced in

2004 in order to justify the high level of new borrowing. Weber said that the European Stabilty and Growth Pact is already dead, even if the politicians did not share this view.

The central concern of the Council's current annual report is the creation of a basis which will lead Germany onto a higher growth path that is influenced not so much by international than by domestic developments. In this context, Weber focussed particularly on the tax system and the labor markets.

Weber criticized the German tax system in particular for not being systematic enough, and for the persistently high level of the tax burden in Germany in international comparison. The Council proposes the introduction of a dual income tax system that would not only increase the attractiveness of Germany as an economic location, but would also lead to more systematic and therefore more efficient taxation. The nub of this dual income tax is the neutrality of corporation tax via an adjustment of the tax rate for corporation profits and private capital income to a uniform rate, as well as the accompanying separation of tax from capital and labor income.

Looking at the labor market, Weber warned that increasing flexibility of labor market law as well as improved incentive structures are necessary. Thus, the Council has called for more flexible protection against dismissal regulations and wage agreement laws. In order to improve the willingness to accept employment by the unemployed a degressive development for unemployment benefits is suggested. And additionally, in order to finally achieve a higher rate of employment, a fundamental reform of social benefits and unemployment benefit respectively are required, together with further diversification of the wage structure in the field of low-skilled employment.

Patrick Herbst (CFSresearch staff)

CFS*lecture* – CFS*forum*

Preventing and Overcoming Banking Crises

(original German title: "Bankenkrisen: Prävention und Bewältigung")

"The majority of crises within market economies are banking crises sector". With these words, Hans Gersbach, Professor of Economic Policy at the University of Heidelberg, began his CFS*lecture* in October 2003, in which he focussed primarily on the macroeconomic effects of crises in banking. Since 1980 130 of the 180 IMF countrieshave experienced problems in the banking sector, and since 1977 there have been 112 banking crises, i.e. situations in which the majority of banks have no longer been able to comply with equity capital regulations. These crises have not only involved developing countries and emerging markets, but have also included modern industrial and service-sector countries such as the USA, Scandinavia, and Japan as well..

Banking crises lead to high costs for the economy as a whole. On average these costs amount to 12% of GDP, and in individual cases can rise to more than 40%. Furthermore, the economy is also burdened by considerable redistribution effects. A banking crisis leads to a fall in GDP of between 10% and 12% for the country concerned; investment projects are cancelled, lending becomes more restrictive, or the economy even faces a credit squeeze.

Hans Gersbach

However, by taking macroeconomic relationships systematically into account, the chances for overcoming and preventing banking crises could indeed be improved. Since banking crises frequently go hand in hand with other financial crises (e.g. a downturn in share and property prices), or balance of payments and exchange rate crises arise, these macroeconomic data (i.e. interest rate shocks, exchange rate shocks, business cycle shocks at home and abroad) should feature in the models of bank regulation and insurance systems. Gersbach therefore recommends that macroeconomic risks be better captured in the banks' own portfolio models and in the calculation of risk premiums. In the long run new instruments can be devised for reducing macroeconomic risks by indexing loan agreements (dependant on the state of the economy), or by creating new hedging instruments. Even equity capital should be organized on a more business cycle oriented, anticyclical basis such that higher levels of equity capital during boom periods and lower levels during economic troughs than at present would be tolerated by the banking supervisory authorities.

It can be seen empirically that in the beginning indications of crisis are frequently obscured, and in the case of a clear crisis eruption crisis management is often ad hoc. Moreover, an implicit state guarantee to bail out nearly all banks gives the wrong incentives. According to Gersbach, it would be preferable to strictly enforce equity regulations during the good periods, whilst exercising more lenience in critical times. In crises which pose a threat to stability the insolvency of some banks should be accepted in favor of rescuing the banking system as a whole.

Ulrike Lexis (CFSresearch management)

Chief Risk Officer at a Big German Bank: Experiences and Challenges

(original German title: "Chief Risk Officer in einer deutschen Großbank: Erfahrungen und Herausforderungen")

"Challenging times" was how Wolfgang Hartmann, Member of the Board of Managing Directors and Chief Risk Officer of Commerzbank AG, at a CFSforum in November 2003, described the current situation on the German banking market.

According to Hartmann, the banks' operative profits are currently being to a large extent devoured by greatly increased risk provision measures. And the banks, not least in view of these circumstances, are focussing on cost management strategies and the dismissal of thousands of bank employees.

Hartmann underlined that the German financial industry will for years to come be undergoing a restructuring process, and for this reason will not be in a position to play an active role in the forging together of Europe as a financial center. The challenges facing risk management on the road to achieving sustainability are evident.

He went on to describe the structure of the risk management department at Commerzbank.

A central element in risk management is the processing of information. The regular monitoring across the group of all types of risk is based on the so-called "risk map", which quantifies the different risks in the individual areas of business. Besides credit, market and liquidity risks, it also covers in particular the operational risks (including legal risk). Not included on the other hand, because they are not quantifiable, are reputation risk and strategic risk. The basis for a meaningful mathematical and statistical quantification of risk is an optimization of the underlying processes, data quality and the infrastructure.

As always credit risk represents the greatest source of risk. Referring to the loan loss provisions as a percentage of total lending, Hartmann emphasized in particular the excellent position of Commerzbank among international banks. At the same time, however, he conceded that, as the example of Citibank showed, a large degree of risk provision is not necessarily bad per se. He stated that in the long run good credit risk results are based on a group of factors, such as the structural differences between the national markets, the individual quality of a bank portfolio, the work-out and write-off policy, the coverage ratio of problem loans, the effectiveness of internal steering systems, and the presence of skilled staff for dealing with credit risk and the bulk risk limitations.

The life of a Chief Risk Officer is determined to a particularly large extent by the requirements of the regulations, namely the minimum requirements imposed on commercial business operations ("Mindestanforderungen an das Handelsgeschäft"), the minimum requirements imposed on lending business operations ("Mindestanforderungen an das Kreditgeschäft") and Basle II. The implementation of MaH, i.e. the prompt monitoring and limiting of risk positions and thus the preventive risk defense, is the responsibility of the general management. The MaK serve the integrated view of the lending business and thus provide important impulses for risk management. When these regulations come into effect in July 2004, the Board of Directors will be faced with a greater responsibility for credit risk controlling within the context of corporate governance. Finally, according to Hartmann, Basle II will create a new credit category. This is something of which not many people are sufficiently aware. On the basis of Basle II, the securitization of a credit transaction with shareholders' equity will depend on the individual risk of default and the underlying model. This implies that long-run fixed term interest rate contracts will inevitably become less popular.

What ultimately counts is the aggregation of all risk positions and thus the quantification of "economic capital" at the overall bank level. This specifies the size of the operational capital that a bank must hold in reserve for the risks assumed. The calculation of "economic capital" alone does not however, according to Hartmann, confer any benefit in itself, rather it is the integration in the control systems of the bank that primarily creates competitive advantages.

Stefanie Franzke (CFSresearch staff)

Slides of this presentation are available on request. Please contact: paessler@ifk-cfs.de.

CFS Key Event 2003

"The ECB's Monetary Policy Strategy after the Evaluation and Clarification of May 2003"

On November 20, 2003 Jean-Claude Trichet held one of his first public speeches as President of the European Central Bank on invitation of the CFS. This 2003 CFS Key Event was warmly welcomed by an audience of 700 in Frankfurt, and broadcasted world wide. Trichet was introduced by the President of the CFS, Karl Otto Pöhl,

events

who stressed the successful cooperation of the ECB and the CFS. Both institutions cooperate in a number of fields (such as the Joint Lunchtime Seminars, see page 7; the ECB-CFS research network, see page 14, or the International Research Forum on Monetary Policy, see page 10 of this issue). However, Pöhl foresees a difficult time for the ECB, as deflation is no issue any more but interest rates will have to be raised soon, which will be an unpopular task for the Governing Council of the ECB who will have to withstand strong political pressure in the near future.

In his speech on "The ECB's Monetary Policy Strategy after the Evaluation and Clarification of May 2003" Trichet made it clear that the euro is a success story so far. The introduction of the euro was not simple but was nevertheless smoothly carried out. The shocks to the euro area economy during the last years were met with pragmatism and determination. Inflation and inflation expectations were kept low.

Referring to the review of the ECB's strategy conducted in the first half of 2003, Trichet emphasized that the result of this evaluation demonstrated that the ECB's monetary policy is based on a sound, robust fundament. He pointed out that the primary objective of the ECB's monetary policy is to maintain price stability and he highlighted the importance of price stability for economic growth and welfare. Trichet regards the announcement of the quantitative definition of price stability (i.e., a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) of below but close to 2 % in the euro area) as an extremely valuable element of the ECB's strategy.

Within the two-pillar framework, the ECB carries out an economic as well as a monetary analysis, in which a variety of tools and theoretical models are used in order to come to an overall judgement on the risks to price stability. In the context of its strategy evaluation, the Governing Council of the ECB decided in May to discontinue its earlier practice of reviewing the reference value for M3 on an annual – a decision in line with the medium term orientation of the ECB's monetary policy strategy.

Trichet did not stop here; he made clear that the ECB will not be complacent about its past achievements. He emphasized that it recognises that new and important challenges are constantly emerging, and that credibility and confidence are assets that central banks can develop only gradually but that can be lost rapidly if the central banks are not vigilant at all times. He pointed out that what the euro area economy really needs is a higher long-term sustainable growth rate. To achieve this goal, structural reforms in the labour and product markets as well as in the social security systems have to be undertaken by the national states. The prerequisite for new jobs is improved confidence in fiscal policy by the economic agents. The nations have to abide by the rules of the Stability and Growth Pact in order to build confidence. The ECB's role, ensuring price stability, confidence in the euro and its purchasing power is less difficult when governments and social partners contribute their share.

Ulrike Lexis (CFSresearch management)

Does Economic Growth Leads to Higher Equity Returns

Jay Ritter

Jay Ritter, Cordell Professor of Finance at the University of Florida, answered the question raised above in the CFS*forum* in January, 2004 with "no". As he showed, the cross-country correlation of real stock returns and per capital GDP growth over the period 1900-2002 is negative. Thus, he argued that although consumers and workers may benefit from economics growth, the owners of capital do not necessarily benefit. Equity holders receive dividends on the shares they own today. Economic growth occurs from high personal savings rates and increased labor force participation, and from technological changes. If increases in capital and labor inputs go into new corporations, these do not boost the present value of dividends on existing corporations. Ritter continued arguing, that the technological change does not increase profits unless firms have lasting monopolies, a condition that rarely occurs.

Thus, according to Ritter, countries with high growth potential do not offer good equity investment opportunities unless valuations are low. *Stefanie Franzke (CFSresearch staff)*

For further reports on "Have Value-at-Risk models proved themselves in turbulent times? Empirical results from Germany" and "Risk management with weather derivatives" please refer to our website www.ifk-cfs.de
Admission to all research lectures is free of charge. Please refer to the registration form or contact Birgit Pässler, Tel.: +49-(0)69-242941-14, Email: paessler@ifk-cfs.de

Joint Lunchtime Seminars

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

They are organized by Carsten Detken (European Central Bank), Heinz Herrmann (Deutsche Bundesbank), Volker Wieland and Klaus Adam (both Goethe-University, Frankfurt and CFS). *For further information and personal registration please contact Birgit Pässler, Tel. +49-(0)69-242941-14, Email paessler@ifk-cfs.de.*

Presentations held in Monetary Economics, International Macroeconomics, Financial Economic and Econometrics:

Jun 25, 03	**Etienne Wasmer** (ECARES, Brussels) **"Interpreting Europe and US Labor Markets Differences: the Specificity of Human Capital Investments"**
Jul 02, 03	**Philippe Bacchetta** (Study Center Gerzensee) **"Can Information Heterogeneity Explain the Exchange Rate Determination Puzzle?"**
Jul 09, 03	**Paul Schure** (University of Victoria, Canada) **"A Model of the Angel Capital Market"**
Jul 16, 03	**Bartosz Mackowiak** (Humboldt University, Berlin) **"Structural VAR Evidence on the Effects of External Shocks on Emerging Markets"**
Jul 23, 03	**Leo Kaas** (University of Vienna) **"Deregulation of Banking Markets and Loan Competition"**
Jul 30, 03	**Jean Imbs** (London Business School) **"Trade, Finance, Specialization and Synchronization"**
Aug 06, 03	**Mathias Hoffmann** (University of Dortmund) **"Home Bias and the Structure of International and Regional Business Cycles"** (Co-Author: Michael J. Artis, European University Institute, Florence)
Aug 13, 03	**Erwan Quintin** (Federal Reserve Bank of Dallas) **"Financial Crises and Total Factor Productivity"** (Co-Author: Felipe Meza, Federal Reserve Bank of Dallas)
Aug 20, 03	**Marco Cipriani** (George Washington University, Washington D.C.) **"Herding and Price Convergence in a Laboratory Financial Market)**
Aug 27, 03	**Kai Christoffel** (Goethe University, Frankfurt) **"Habit Formation in Consumption in an Estimated Model for the Euro Area"**
Sep 03, 03	**Yigal Newman** (Stanford University) **"The Volume of New Issuance and Its Impact on Market-Wide Credit Spreads"**
Sep 10, 03	**Guilherme Carmona** (Universidade Nova de Lisboa) **"Reciprocative Behavior in Repeated Relationships: 1. Optimality of Monetary Trading and 2. Correlation between Current Consumption and Current and Lagged Income"**
Sept 17, 03	**Francesco Lippi** (Bank of Italy) **"Monetary Union with Voluntary Participation"**
Sept 24, 03	**Harald Uhlig** (Humboldt University, Berlin) **"Do Technology Shocks Lead to a Decline in Labor?"**
Oct 1, 03	**Roel Beetsma** (University of Amsterdam) **"Reconciling Stability and Growth: Smart Pacts and Structural Reforms"**
Oct 8, 03	**Jan Egbert Sturm** (University of Munich & Ifo Institute for Economic Research) **"IMF Credit: How Important are Political Factors"** (Co-Authors: Helge Berger, CESifo, Munich; Jakob de Haan, University of Groningen & CESifo, Munich)

Oct 15, 03	**Philipp Maier** (De Nederlandsche Bank & Tinbergen Institute) **"The Role of Regional Information in the Optimal Composition of a Committee"** (Co-Authors: Beata K. Bierut & Robert-Paul Berben, both: De Nederlandsche Bank)
Oct 22, 03	**Jean Boivin** (Columbia Business School, New York) **"Measuring the Effects of Monetary Policy: A Factor-Augmented Vector Autoregessive (FAVAR) Approach"**
Oct 29, 03	**Tim Mennel** (Center for European Integration Studies (ZEI b), University of Bonn) **"An Adverse Selection Model of Optimal Unemployment Insurance"**
Nov 5, 03	**Vasso Ioannidou** (University of Tilburg) **"Does Monetary Policy Affect the Central Bank's Role in Bank Supervision?"**
Nov 12, 03	**Luca Benati** (Bank of England) **"Evolving Post-World War II UK Economic Performance"**
Nov 19, 03	**Albrecht Ritschl** (Humboldt University, Berlin) **"Endogeneity of Currency Areas and Trade Blocs: Evidence from the Inter-War Period"** (Co-Author: Nikolaus Wolf, London School of Economics)
Nov 26, 03	**Bond** (Oxford University) **"The Roles of Tobin's Q, Cash Flow and Expected Profitability in Econometric Models of Company Investment"** (Co-Authors: Alex Klemm, Institute for Fiscal Studies; Rain Newton-Smith, Murtaza Syed and Gertjan Vlieghe, all Bank of England)
Dec 03, 03	**Chryssi Giannitsarou** (Universidade Nova de Lisboa) **"Balanced Budget Rules and Aggregate Instability: The Role of Consumption Taxes"**
Dec 10, 03	**Hyun Shin** (London School of Economics) **"Public and Private Information in Monetary Policy Models"** (Co-Author: Jeffery Amato, Bank for International Settlements, Basle)
Dec 17, 03	**Hans Peter Grüner** (University of Mannheim) **"Committees and Special Interests"** (Co-Author: Mike Felgenhauer, University of Mannheim)
Jan 21, 04	**Luca Guerrieri** (Federal Reserve Board, Washington) **"Can Long-Run Restrictions Identify Technology Shocks?"** (Co-Author: Christopher J. Erceg and Christopher Gust, both Federal Reserve Board)
Jan 28, 04	**Michael Ehrmann/Marcel Fratzscher** (European Central Bank) **"Exchange Rates and Fundamentals: New Evidence from Real-Time Data"**
Feb 04, 04	**Charles Grant** (European University Institute, Florence) **"Redistributive Policy through Taxation: Theory and Evidence"** (Co-Authors: Christos Koulovatianos, University of Cyprus; Alexander Michaelides, LSE & CEPR; Mario Padula, CSEF, University of Salerno)
Feb 11, 04	**Martin Krause** (Tilburg University & CentER) **"The (Ir)relevance of Real Wage Rigidity in the New Keynesian Model with Search Frictions"** (Co-Author: Thomas A. Lubik, The Johns Hopkins University, Baltimore)
Feb18, 04	**Leopold von Thadden** (Deutsche Bundesbank/ European Central Bank) **"The Taylor-principle in a new Keynesian model with capital accumulation, government debt dynamics and non-Ricardian consumers"** (Co-Author: Campbell Leith, University of Glasgow)
Feb 25, 04	**Holger Bonin** (Institute for the Study of Labor – IZA, Bonn) **"Real and Nominal Wage Rigidities and the Rate of Inflation: Evidence from West German Micro Data"** (Co-Authors: Thomas Bauer, University of Bochum, CEPR & IZA; Uwe Sunde, IZA)

CFS*research conferences*

CFS Summer Schools, 2003

Last year's CFS Summer Schools took place from August 11-18. Classes on finance and macroeconomics were held concurrently. Once again, CFS and the organizers were successful in recruiting a renowned faculty. The finance summer school, organized by Christian Schlag and Jan P. Krahnen (both Goethe University, Frankfurt and CFS) comprised Stefan Mittnik (University of Munich, Ifo and CFS), Claus Munk (Odense University), and Carsten Sorensen (Copenhagen Business School). The participants of the finance class on "Financial Economics and Financial Econometrics" came from banks and universities in Germany and abroad. The chosen topics centered on asset pricing theory, real options and investment, financial econometrics, models of the term structure of interest rates and asset allocation. Five student papers were presented that focussed on topics ranging from futures markets and the microstructure of financial markets to credit spreads.

As usual the program consisted of a mix of lectures by the faculty, student paper presentations, reading, discussion and exercises.

The macro class, organized by Volker Wieland and Klaus Adam (both Goethe University, Frankfurt and CFS) concentrated on empirical methods for building macroeconomic models. The participants, mostly from universities and central banks, discussed the design, calibration, estimation and testing of models and the effects of various shocks (e.g., exchange-rate shocks, technology and fiscal policy shock). The teaching faculty consisted of Fabio Canova (University of Barcelona), Martin S. Eichenbaum (Northwestern University, Illinois) and John Williams (Federal Reserve Bank of San Francisco).

The macro class included lectures by the faculty and 12 presentations by students, in which questions such as "Does the Euro follow the DM?" were discussed, and the international liquidity constraints in emerging market economies as well as the ECB's monetary policy with reference to the Taylor rule were also discussed.

Ulrike Lexis (CFSresearch management

Expectation, Learning and Monetary Policy

On August 30 and 31, 2003, the Deutsche Bundesbank, the CFS and the Journal of Economic Dynamics and Control (JEDC) jointly held a research conference on the subject of "Expectations, Learning and Monetary Policy". The conference was organized by Heinz Herrmann (Deutsche Bundesbank), Athanasios Orphanides (Federal Reserve Board), Volker Wieland and John C. Williams (Federal Reserve Bank of San Francisco). In his welcome address, Volker Wieland emphasized that the organizers were highly pleased by the fact that they were able to bring together leading researchers who have developed and employed alternative models of expectations formation and learning. He pointed out that one of the conference's major objects was to advance the exploration of the role of learning and expectations formation in understanding macroeconomic and financial phenomena and in policy design. In his opening remarks, Hans Georg Fabritius (Deutsche Bundesbank) stressed that expectations played a pivotal role in monetary policy making and in economic policy making in general. He emphasized that it was a generally recognized fact that learning also plays an important role in these areas. He also expressed his satisfaction to see that the discourse between central banks and university researchers in Europe had intensified in the past few years and considered this conference to be a sign of such progress. In the first contribution, George Evans (University of Oregon) and Bruce McGough (Oregon State University) presented their paper "Monetary Policy, Indeterminacy and Learning" in which they examine the question of whether macroeconomic fluctuations, taking the form of coordination on extraneous exogenous variables, are likely to emerge under adaptive learning when the economy is characterized by New Keynesian IS-AS equations and monetary policy follows a form of Taylor rule. James Bullard from the Federal Reserve Bank of St. Louis presented joint work with In-Koo Cho (University of Illinois) in which the two develop a theory of near-zero nominal interest rates, as observed in Japan in 1990s and in the U.S. in the 1930s. Seppo Honkapohja (University of Helsinki) and Kaushik Mitra (Royal Holloway College) presented work in which they examine the twin questions of determinacy and stability under adaptive learning for constant interest rate projections rules using the standard New Keynesian model. Athanasios Orphanides and John C. Williams investigated in their contribution the role that imperfect knowledge about the structure of the economy plays in the formation of expectations, macroeconomic dynamics, and the efficient formulation of monetary policy. Sharon Kozicki (Federal Reserve Bank of Kansas City) and Peter A. Tinsley (University of Cambridge) showed how imperfect policy credibility can affect transition to a new inflation target. In his presentation "The Role of Expectations in Economic Fluctuations and the Efficacy of Monetary Policy", Mordecai Kurz (Stanford University) showed that diversity of beliefs is an important propagation mechanism of economic fluctuations where investment and other forward looking decisions are the channels for such amplification. Steven Durlauf (University of Wisconsin) presented joint work with William A. Brock (University of Wisconsin) and Kenneth West (University of Wisconsin) in which they describe some approaches to macroeconomic policy evaluation in the presence of uncertainty about the structure of the environment under study. In the last presentation of the conference, Timothy Cogley (University of California, Davis) presented results from the paper "Bayesian Fan Charts for U.K. Inflation: Forecasting and Sources of Uncertainty in an Evolving Monetary System" in which he and his co-authors Sergei Morozov (Stanford University) and Thomas Sargent (New York University) develop and estimate a Bayesian vector autoregression with drifting coefficients and stochastic volatilities to characterize posterior densities for several objects that are of interest for designing and evaluating monetary policy. In his after-dinner speech Charles Goodhart (London School of Economics) emphasized that understanding and discussions between economic analysts and central bank practitioners has become much closer in recent decades than it was at the beginning of the 1960s when I started doing economics. He emphasized that since then in the field of monetary policy, analyses and practice have become much more closely interactive and supportive of each other.

Günter Beck (CFSresearch staff)

Contracts and Institutions in Models with Heterogeneous Agents

On November 7 and 8, 2003, a joint JEDC-CFS research conference on the topic of "Contracts and Institutions in Models with Heterogeneous Agents" was held. This conference was organized by Wouter J. Den Haan (London Business School and University of California, San Diego), Kenneth L. Judd (Hoover Institute, Stanford University), Michel Juillard (CEPREMAP, Paris) and Volker Wieland. At the centre of the conference was the discussion of macroeconomic and financial models that take into account heterogeneity on the side of market participants. In his welcome address, Volker Wieland stressed that the incorporation of heterogeneities into economic models makes these models considerably more realistic but also drastically complicates the model framework and therefore various techniques of solving these models had to be developed. He pointed out that for this reason one of the major emphasis of the conference would lie on possible ways to solve such models. In the first contribution of the conference, Kartik Athreya (Federal Reserve Bank of Richmond) presented results from a paper, in which he evaluates uniform exemption policy primarily within the context of the recent congressional proposal H.R. 975. David Marshall (Federal Reserve Bank of Chicago) presented joint work with Edward S. Prescott (Federal Reserve Bank of Richmond) in which they study two models of bank capital regulation under deposit insurance. In this work the two authors confirm previous results that were based on a more limited framework and that showed that it was optimal to impose fines on banks that produce high returns. In his contribution on "Uninsurable Investment Risks" which is joint work with Cesaire Meh (Bank of Canada), Vincenzo Quadrini (New York University) showed that the presence of investment risks that cannot be fully insured might lead to under-accumulation of capital relative to an economy where idiosyncratic shocks can be fully insured. In his contribution, Torsten Koeppl (European Central Bank) provided an assessment of the degree of risk sharing that can be achieved through financial markets when enforcement is based on the threat of exclusion from future trading as well as on costly enforcement intermediaries. Dirk Krueger (Stanford University) and Harald Uhlig (Humboldt University) analyzed dynamic equilibrium risk sharing contracts between profit-maximizing intermediaries and a large pool of ex-ante identical agents that face idiosyncratic income uncertainty that makes them heterogeneous ex-post. Gian-Luca Clementi (New York University) presented results from joint work with Tom Cooley (New York University) and Cheng Wang (Iowa State University) in which the three authors develop a dynamic model of managerial compensation where neither the firm nor the manager can commit to long-term contracts. In two round table discussions leading scholars in the field of computational economics such as Kenneth Judd, Michel Juillard, Michael Reiter (Universitat Pompeu Fabra) or Jesus Fernandez-Villaverde (University of Pennsylvania) presented several numerical solution algorithms and discussed their respective advantages and drawbacks. The presented papers will be published in a special issue of the Journal of Economic Dynamics and Control. *Günter Beck (CFSresearch staff)*

International Research Forum on Monetary Policy

Alan Greenspan

The second annual conference organized by the International Research Forum on Monetary Policy was held on November 14-15, 2003 at the Federal Reserve Board, Washington D.C. The Forum is sponsored by the European Central Bank (ECB), the Federal Reserve Board (FRB), the Center for German and European Studies (CGES) at Georgetown University, and the CFS. Its purpose is to encourage research on monetary policy issues that are relevant from a global perspective. The organizers of the 2003 conference were Ignazio Angeloni (ECB), Matthew Canzoneri (CGES), Dale Henderson (FRB), and Volker Wieland (Goethe University Frankfurt and CFS).

Otmar Issing

The conference was opened by Alan Greenspan. Luncheon and Dinner speakers included Otmar Issing from the ECB and Ben Bernanke from the Federal Reserve Board. Conference participants included researchers from leading universities, international organisations and central banks, as well as financial market observers from private sector firms and financial press representatives.

The following is a short summary of the research contributions presented at the Forum:

Fabrice Collard (University of Toulouse) and Harris Dellas (University of Bern) employ a New Neoclassical Synthesis model, assuming policymakers commit to following a standard Henderson-McKibbin-Taylor rule, and enquire whether the great inflation of the 1970s was likely due to incomplete information or rather is an indication of the degree of policy activism. The authors suggest that imperfect information and learning played an important role.

Athanasios Orphanides (Federal Reserve Board) and John C. Williams (Federal Reserve Bank of San Francisco) highlight that the interaction of policy errors with an endogenous expectations formation process turned what could have been a relatively mild inflationary episode into the stagflation of the 1970s. They argue that the adoption of policies that downplay the activist pursuit of employment and output gaps would have avoided this outcome.

Pierpaolo Benigno (New York University) and Michael Woodford (Princeton University) propose an integrated treatment of the problems of optimal monetary and fiscal policy, for an economy in which prices are sticky and the only available sources of government revenue are distorting taxes. A linear-quadratic policy problem and optimal targeting rules are then derived through which the monetary and fiscal authorities may implement the optimal equilibrium.

Susan Athey (Stanford University), Andrew Atkeson (University of California, Los Angeles) and Patrick J. Kehoe (Federal Reserve Bank of Minneapolis) study the trade-off between giving the monetary authority discretion to react to its private information and the need to guard against the standard time inconsistency problem arising from the temptation to stimulate the economy with unexpected inflation. This tension may be solved by legislating an inflation cap, that ought to be the tighter the more severe the time inconsistency problem is.

Jordi Gali (Centre de Recerca en Economia Internacional), J. David López-Salido and Javier Vallés (both Banco de España) stress that recent evidence on the effect of government spending shocks on consumption cannot be easily reconciled with existing optimizing business cycle models. However, as the authors clarify, extending the standard New Keynesian model to allow for the presence of rule-of-thumb consumers can better explain existing evidence on the effects of government spending.

Nicoletta Batini (Bank of England), Paul Levine (University of Surrey) and Joseph Pearlman (London Metropolitan University) examine the performance of forward-looking inflation-forecast-based rules in open economies, in the context of a New Keynesian sticky-price two-bloc model. They point out that the problem of indeterminacy can be intrinsically more serious in the open economy, even more so when central banks respond to expected consumer, rather than producer price inflation.

Tamim Bayoumi, Douglas Laxton (both International Monetary Fund) and Paolo Pesenti (Federal Reserve Bank of New York) estimate the macroeconomic benefits and international spillovers of an increase in competition in the Euro Area by using a variant of the IMF's Global Economy Model (GEM) that features nominal rigidities and monopolistic competition in product and labor markets. Their estimates suggest that greater competition can have large effects on standard measures of macroeconomic performance.

Michael Ehrmann and Marcel Fratzscher (both European Central Bank) investigate whether economic and monetary policy interdependence between the United States and the Euro Area has changed with the advent of EMU. Using real-time data to analyse the effects of announcements on daily interest rates, they find that in recent years U.S. macroeconomic news have become good leading indicators for economic developments in the Euro Area, suggesting that there has been an increase in real economic integration.

Robert G. King (Boston University) and Alexander L. Wolman (Federal Reserve Bank of Richmond) demonstrate that in the New Keynesian model with two-period staggered price-setting, due to the complementarity of firms' pricing decisions, discretionary monetary policy leads to multiple equilibria and to the possibility of endogenous fluctuations in inflation and real activity that are not related to the economy's fundamentals. In a stochastic setting increased economic volatility, as well as higher inflation, may be an additional cost of discretion in monetary policy.

Ester Faia (Universitat Pompeu Fabra) and Tommaso Monacelli (Università Bocconi) analyze welfare maximizing monetary policy in a dynamic two-country model with price stickiness and imperfect competition, where a typical terms of trade externality affects policy competition between independent monetary authorities. Deriving a second order accurate solution to the policy functions, they characterize welfare gains from commitment as well as from international policy cooperation.

Roberto M. Billi/Marcus Pramor (both CFSresearch staff)

The complete program including papers can be found at http://www.federalreserve.gov/events/conferences/irfmp2003

Policy Conference: Venture Capital and the New Markets

On January 22, 2004, the CFS organized this conference jointly with the "Deutsches Aktieninstitut" in order to promote the discussion among policy makers, practitioners and academics on issues of venture capital financing and equity markets…

The complete report is available at www.ifk-cfs./content/veranstaltungen/data/20040122Ventur.htm

View of forthcoming events:

The ECB and Its Watchers VI

The sixth ECB Watcher conference will take place on July 2, 2004 in Frankfurt, organized by Volker Wieland. The conference will be made up of three sections. The first part will be devoted to the academic ECB watchers. The second part will cover the topic of European financial integration and the final part of the conference will be dedicated to the issue of continued and growing international imbalances, manifested in the large United States external deficit and matching surpluses in a handful of other economies.

For further information on the program please contact our website www.ifk-cfs.de or send an email to heeg@ifk-cfs.de.

CFS Summer Schools August 25-30, 2004

For Ph.D. students and young researchers it is of great importance to experience stimulating and thought provoking environments that expose them to the latest developments in their fields and that allow them to exchange research ideas and to discuss their latest research projects.

The objective of the CFS Summer Schools is to provide such an environment. There will be two CFS Summer Schools this year, one on "Corporate Finance, Corporate Governance, and Political Economy", and one on "International Macroeconomics".

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

The lectures in this school will cover recent research spanning the three areas of Corporate Finance, Corporate Governance, and Political Economy. By integrating Corporate Finance and Corporate Governance with Political Economy, one takes into account the political, social, and legal environment that shapes financing decisions. This is important to understand the differences between corporations' financing and governance across countries.

With Enrico Perotti and Antoine Faure-Grimaud we are very happy and proud that we were able to win great experts in their fields as faculty for this Summer School.

Enrico Perotti is at the Finance Department of the University of Amsterdam. He has a broad interest in Corporate Finance and International Finance. Current research projects include "Entrepreneurial Ideas" and "Political Economy of Bank Governance". His research has appeared in, e.g., American Economic Review, European Economic Review, Journal of Financial Economics, and Journal of Financial and Quantitative Analysis. Antoine Faure-Grimaud is at the Economics Department of the LONDON School of Economics. His research interests are in Corporate Finance and Contract Theory. He has published in, e.g., Review of Economic Studies, Review of Financial Studies, European Economic Review, and RAND Journal of Economics.

Summer School on "International Macroeconomics"

The lectures in this school will cover recent research in international macroeconomics, with an emphasis on empirical research using both time-series and (cross-country) panel data. Topics to be covered in the lectures will include growth empirics, determinants of international price and exchange rate dynamics, and current account dynamics and economic policy design under financial globalization.

We are most pleased to be able to announce Steven Durlauf and Mark Taylor as highly distinguished faculty members for this summer school. (A third faculty member is to be confirmed, and will be announced on the CFS website.)

Steven Durlauf is the Kenneth J. Arrow Professor of Economics at the University of Wisconsin-Madison. His research covers much of Macroeconomics and Econometrics. He has been or currently is on the editorial board of, inter alia, American Economic Review, Review of Economic Studies, Journal of Applied Econometrics, Journal of Economic Growth, and Macroeconomic Dynamics. Mark Taylor is Professor of Economics and Finance at Warwick University. His research interests span Macroeconomics, Econometrics, and International Finance. He has founded and is editor of International Journal of Finance and Economics, and is head of the Macroeconomics Research Program of the UK Economic and Social Research Council.

Michael Binder / Christian Laux (Goethe University, Frankfurt and CFS)

Further details are available on our website www.ifk-cfs.de.
A timetable about other forthcoming CFSresearch conferences can be found at the end of this Newsletter.

CFS*executive development*

With its seminars, conferences and inhouse meetings, which last between one and four days, the CFS makes its contribution to qualification training and executive development in designated fields. Renowned university lecturers, leading practitioners and important international partners provide top quality knowledge as well as the methods and instruments for practical application.

The complete overview of our forthcoming seminars can be found in the timetable at the end of this issue.

We are very pleased with the contribution to this newsletter from the CFS*seminar* faculty, Günter Franke, whom we had asked to report on current issues, including among others the topics under discussion in his respective seminar.

Tradability of Credit Risks is the Great Challenge

by Günter Franke
Professor of International Finance
University of Konstanz

During the last quarter of the 20th century about seventy countries experienced banking crises with high costs in terms of economic growth, unemployment and fiscal deficits. Japanese banks had to reduce their credit volume because they were and are still plagued by huge portfolios of bad loans. This has led to severe credit rationing in Japan reinforcing stagnation. The situation would be much better if the banks could sell their bad loans on a liquid market for credit risks. Therefore banks have started strong efforts worldwide to create such a market. Collateralized debt obligations (CDOs) and credit derivatives are the most important instruments for trading credit risks.

Günter Franke

Creating instruments and markets for trading credit risks is much more difficult than doing the same thing for standard market risks like interest rate, exchange rate and stock price risks. Information on credit risks of medium sized companies is not well dispersed in markets. Therefore trading such risks requires rather complex product structures to make sure that the investors buying those credit risks can reliably analyse these risks and that the banks selling them will still carefully monitor the obligors and collect interest and principal claims. The idea behind CDO-transactions is to pool many different credit risks so as to obtain a well diversified portfolio which is easier to evaluate. Then this portfolio is sliced into various tranches so as to attract different types of investors. Investors with little skills in risk management may simply want to invest cash earning them some basis points above LIBOR, while skilful investors may prefer securites with more credit risk which they carefully evaluate and manage to earn them attractive risk premia.

The CFS*seminar* „Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement“ together with Dirk Jens F. Nonnenmacher (DZ BANK AG) schedulded for June 17-19 as well as for November 25-27, 2004, teaches the necessary know-how for understanding and using instruments for trading credit risks and addresses related institute specific challenges.

More information on all CFSseminars can be found under www.ifk-cfs.de or contact Christiane Bauder, Tel: +49(0)69-242941-30, Email: bauder@ifk-cfs.de.

CFS*research activities*

ECB-CFS Research Network

Since April 2002, the ECB-CFS Research Network aims at coordinating and stimulating top-level and policy-relevant research that significantly contributes to our understanding of the current and future structure and integration of the financial system in Europe and its linkages to the financial systems of the United States and Japan.

Third Workshop of the ECB-CFS Research Network

The Third Workshop of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe" took place on November 20-21, 2003 in Athens, hosted by the Bank of Greece. The workshop concentrated on three different topics of the network's research agenda: European Securities Settlement Systems; Start-up Financing and "New Markets"; and European Bond Markets.

In his opening remarks, Nikolaos Tsaveas (Bank of Greece) described a central bank's role as fostering the chances and mitigating potential risks arising from further integration of capital markets in Europe. Given the generally conservative focus of central banking, he emphasized the attention that the workshop devoted to rather new financial concepts such as venture capital and initial public offerings. His opening speech was followed by a tour of the exhibition celebrating the 75th anniversary of the Bank of Greece.

In the morning of the workshop's first day, two different topics were discussed in parallel sessions. In the first session, Avanidhar Subramahnyam (UCLA), Yui Chung Cheung (University of Amsterdam) and Michael Fleming (Federal Reserve Bank of New York) presented various aspects of "Government Bond Market Microstructures, Liquidity and Spillovers". The session was chaired by Eli Remolona (Bank for International Settlements), with a discussion of the papers given by Albert Menkveld (Vrije Universiteit Amsterdam). The second, parallel session, saw Charles Kahn (University of Illinois) as chair. Under the heading "Topics in the Governance and Integration of European Financial Markets", Mariassunta Giannetti (Stockholm School of Economics) discussed investor protection and equity holdings. Leo Kaas (University of Vienna) in his talk concentrated on financial market integration and loan competition and asked whether entry deregulation might by socially beneficial. Finally, Cyril Monnet (European Central Bank) analysed aspects of settlement systems. A discussion of the three papers was given by Hans Degryse. The two sessions in the morning were followed by a lunch speech by P. Thomopoulos (Deputy Governor of the Bank of Greece) on the Greek experience of financial liberalisation.

In the afternoon, the workshop started with a key lecture by Marco Da Rin (University of Turin, ECGI and IGIER) on European Venture Capital. He outlined the possible future development of venture capital under further financial integration in Europe. In particular, he emphasized the role and geography of exit channels such as IPOs, that might vary with the demand for investments following changes in the European economic structure. His speech was followed by two parallel sessions on "Corporate Bond Financing and the Cost of Capital" and "IPOs in New Markets". The first of these sessions, chaired by Joseph Bisignano (Bank for International Settlements) saw Yigal Newman (Stanford University) present theoretical analyses of illiquidity spillovers and empirical evidence from European Telecom bond issuance. His talk was followed by Joao Santos (Federal Reserve Bank of New York) discussing why firm access to bond markets differs over the business cycle. The papers presented were discussed by Arnaud Mares (ECB). In the parallel session, Armin Schwienbacher (University of Amsterdam), Tereza Tykvova (ZEW) and Vicente Pons (Yale University) analysed different aspects of venture capital finance and IPOs.

The discussion was given by Wolfgang Bessler (Giessen University).

The second day of the workshop started with two sessions on "Securities Settlement Systems" and "The Determinants of VC Investments". In the first of these sessions, chaired by Vitor Gaspar (European Central Bank), Jens Tapking (European Central Bank) examined the role of costs on competitive structures in the securities settlement industry. Karlo Kauko (Bank of Finland) in a theoretical approach analysed strategic commitments in interlinking securities settlement systems. Finally, Heiko Schmiedel (European Central Bank) presented work on the economies of scale and technological developments in securities depository and settlement systems. The papers were discussed by Charles Kahn. The second session, chaired by Jan P. Krahnen (Goethe-University of Frankfurt and CFS) centered on VC investments. Douglas Cumming (University of Alberta), Tuomas Takalo (Bank of Finland) and Giovanna Nicodano (University of Turin) analysed both theoretically and empirically the determinants of private equity investments, in particular of venture capital investments. The final discussion of the presented papers was given by Heather Gibson (Bank of Greece).

The workshop ended with a policy panel on "European Securities Settlement Systems". Under the chairmanship of Alberto Giovannini (Unifortune), the speakers Kenneth Garbade (Federal Reserve Bank of New York), Randy Kroszner (University of Chicago), Joel Mérère (CEO, Euroclear France) and Gertrude Tumpel-Gugerell (Member of the Executive Board of the European Central Bank) presented and discussed their views on the settlement systems in Europe. In this respect Gertrude Tumpel-Gugerell argued in the ECB's view that obstacles to further consolidation have to be removed, using the work of the Giovannini Group that has identified a number of barriers to efficient cross-border clearing and settlement in the EU. Randy Kroszner, in contrast, rediscussed the decision between fragmentation and consolidation and argued that, eventually, a fully integrated settlement system has to include also the U.S. and Asia. With Kenneth Garbade and Joel Mérère as speakers, the panel also included one further regulatory, an industry view respectively on the pros and cons of optimal securities settlement systems. The workshop ended with the concluding remarks of Vitor Gaspar. He thanked the hosting Bank of Greece and the workshop participants, and invited them to the network symposium on 10-11 May 2004 in Frankfurt. In bringing together the main topics of the network's "roadmap", it will conclude the first two years' research results of the network. In particular, the symposium will concentrate on European Financial Integration and Its Implications, Financial System Structures in Europe, and Financial Linkages Between Europe, the U.S. and Japan. The European Central Bank and the Center for Financial Studies encourage submission of papers until March 15, 2004.

Christina E. Bannier (Goethe-University Frankfurt and CFS)

For further information, see http://www.eu-financial-system.org/CallPapersFrankfurt.pdf.

Workshop on Venture Capital and New Markets

The CFS program area "Venture Capital and the New Markets" under its program directors Mark Wahrenburg and Uwe Walz (both Goethe-University, Frankfurt and CFS) hosted this workshop in October 2003 at the Collegium Glashuetten in Glashuetten. The aim was to give young researchers the opportunity to present and discuss their current research in this area…

The complete report is available at http://www.ifk-cfs.de/content/veranstaltungen/data/20031017Worksh.htm.

The First RICAFE Conference

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

The RICAFE held its first conference on October 24-25, 2003 at the Financial Markets Group (FMG) of the London School of Economics and Political Science (LSE). Given the focus of the research network, the contributions to the conference covered a multitude of aspects relevant for the financing of innovative companies through risk capital.

After an introduction from David Webb (FMG/LSE and RICAFE project leader), David Thesmar (ENSAE/CREST, Paris) presented joint work with Augustin Landier (GSB, Chicago) titled "Financial Contracting with Optimistic Entrepreneurs: Theory and Evidence". They consider a setting in which entrepreneurs are more optimistic about their project's prospects than investors and look at the implications on incentives or contracts. One of the results is that for optimistic entrepreneurs the optimal contract uses short-term debt as the probability of not meeting repayment terms is underestimated. By contrast, realistic entrepreneurs would prefer long-term debt. Empirically tests of their theoretical model confirm that optimists indeed do use short-term debt more often.

Alexander Ljungqvist from NYU presented "The Investment Behaviour of Private Equity Fund Managers", joint work with his colleague Matthew Richardson. The authors examine how changes in the degree of competition affect a fund manager's investment behavior. In particular, they investigate the speed with which private equity funds invest their capital over time, when the capital is returned to investors, when exit occurs and what returns are realized. Their empirical analysis shows that the competitive environment is important in shaping investment decisions. When investment opportunities are good (when competition is low) funds are invested more quickly, exit takes place more rapidly and returns are higher.

Marco Da Rin (Turin University and RICAFE member) posed the question "Are financial intermediaries defined by their organizational structure or their people? Evidence from venture capital", jointly with Laura Bottazzi (Bocconi University, Milano) and Thomas Hellmann (Stanford University). They empirically examine aspects of organization, human capital and investment decisions in venture capital. Their survey-based database allows the measurement of the human capital of the partner(s) involved in venture capital deals. Funds investing in venture capital turn out to invest more in early stage and high tech (relative to firms that also do some buyout) and show a higher involvement in the recruitment of directors and management. Overall, the authors argue that both human capital and organizational structure are important.

Michel Habib (Swiss Banking Institute) continued with "An Analysis of Shareholder Agreements", joint work with Gilles Chemla (University of British Columbia) and Alexander Ljungqvist. Shareholder agreements frequently feature clauses such as put and call options, pre-emption rights, catch-up clauses, drag-along rights, demand rights and tag-along rights. The authors develop a model in which options can be seen as a solution to problems arising from a two-sided non-verifiable actions problem. Furthermore, when the jointly owned project can be sold to outsiders, various conflicts of interest may arise which could be solved with appropriate clauses in shareholder agreements.

Charles Cuny from Texas A&M University presented a joint paper with Eli Talmor from the London Business School on "The Staging of Venture Capital Financing: Milestones vs. Rounds". Their model provides an analysis of whether venture capital funds are committed round by round or when such a commitment stretches over several rounds, conditional on certain milestones being achieved. Round financing implies that future investment will be committed at the market price, while the commitment to a higher level of investment implicit in milestone financing implies that the investor must be allocated more cash flow rights.

The first day of the conference ended with a presentation by Ulrich Hege (HEC, Paris, and RICAFE member) on "Determinants of Venture Capital Performance: Europe and the United States" (joint work with Frederic Palomino from Tilburg University and Armin Schwienbacher from the University of Amsterdam). They find that monitoring activities are positively related with performance: US VCs are more active monitors and perform better than European VCs. Moreover, use of contingent control rights is more widespread in the US. The authors assert that these differences in the contractual relationship drive the differences in performance at portfolio level.

Felix Münnich started the second day of the conference with a joint paper with Roman Inderst (both FMG/LSE and RICAFE members) on "The Benefits of Shallow Pockets". They investigate the role of portfolio management within private equity funds in alleviating entrepreneurial agency problems. When projects are financed in stages, the investor limits the amount of investment raised to create competition among portfolio entrepreneurs for later stage funding. As a result, the non-contractual device of limited funds may allow the venture capitalist to provide incentives and sort between entrepreneurial types.

In his paper "Public Policy and Venture Capital Backed Innovation", Christian Keuschnigg (University of St. Gallen) proposes an industry equilibrium model of the venture capital industry. Within this model, the author analyzes a range of public policy instruments that are meant to promote innovation by facilitating start-up entrepreneurship in new industries, such as public spending on basic research, entry subsidies to VCs, an investment tax credit on start-up investment spending or capital gains taxation. The author argues that government should provide capital gains tax breaks to successful firms in innovative industries, rather than give subsidies to entrepreneurs or support public research.

Josh Lerner (Harvard University) presented "Private Equity in the Developing World: The Determinants of Transaction Structures" (joint work with Antoinette Schoar from MIT). Their paper analyzes empirically details of private equity transactions from several developing countries. The main findings are that contract structures for investments differed significantly from that observed in the US: While convertibles are the dominant security used for such investments in the US, contracts in developing countries rely much more on common stock and debt-like securities. There is also much less provision for control rights and anti-dilution protection than in the US and control is normally achieved through majority ownership.

Enrico Perotti (University of Amsterdam) presented the paper "Circulation of Ideas: Firms versus Markets", joint work with Thomas Hellmann. They examine the comparative advantage of markets (with unregulated communication) versus firms (with only internal communication) for the generation and implementation of ideas. The authors consider a setting in which the development of ideas is costly and requires a second agent with the right complementary skills. Overall, the market is shown to be better at circulation and implementation, but firms turn out to be better at supporting the generation of ideas.

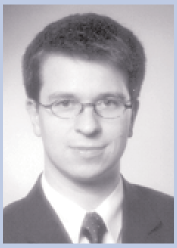
The paper "Contractual Relations Between European VC-Funds and Investors: The Impact of Reputation and Bargaining Power on Contractual Design" was presented by Daniel Schmidt and co-authored by Mark Wahrenburg (both Goethe-University, Frankfurt, and RICAFE members). They explore factors that influence the design of contracts between venture capital investors and European venture capital funds. The empirical study finds that established funds are more severely restricted by contractual covenants and that managers of these funds are more often obliged to invest their own capital alongside with investors' money. The analysis also shows that managers of venture capital funds receive higher performance related compensation when capital inflows are strong.

Ibolya Schindele (University of Amsterdam) presented the final paper of the conference, entitled "Advice and Monitoring: Venture Financing with Multiple Tasks". She offers a theory for the joint allocation of cash flow and control rights in venture capital contracts, highlighting the roles of venture financiers as both advisers and monitors to entrepreneurial projects. There is a conflict of incentives between these tasks, if monitoring has the role of limiting downside risk. It is found that entrepreneurs who are more capital constrained need to accept intensive monitoring and limited advice and offer a convertible security to the venture financier.

Patrick Herbst (CFSresearch staff)

The next RICAFE conference will take place on October 15-16, 2004.

Staff



Patrick Herbst

Patrick Herbst joined the CFS in October 2003 to work under the RICAFE ('Risk Capital and the Financing of European Innovative Firms') international research network. Patrick studied Economics at the University of Tuebingen and the London School of Economics and Political Science (LSE) where he graduated in 1998 with a Master of Science in Economics. He continued academic studies at the University of Tuebingen on economic theories of local labor markets and human capital investment, with Uwe Walz (now Goethe University, Frankfurt and CFS) as his supervisor. His research focus has lately shifted towards issues of venture capital finance and general questions on corporate control. Patrick's internships at Deutsche Bank, Frankfurt, and ING Barings, London, and particularly his two year position as an equity portfolio manager at Allianz Dresdner Asset Management, Frankfurt, provided him with hands-on financial experience.

Please note, that in future, announcements of all CFS*events* will be send to you by e-mail. Therefore we are kindly asking you to provide us with your e-mail address. Thank you for your support!

Newsletter Special

The research output from CFS has been receiving increasing attention in the press.
Volker Wieland and Jan P. Krahnen (both Goethe University Frankfurt, and CFS directors) were interviewed by Andreas Scholz and Michael Wudonig from Bloomberg TV for the Bloomberg Forum. Volker Wieland spoke about "Monetary Policy" on October 1, 2003 and Jan P. Krahnen talked about "The Future of the Financial System" on January 14, 2004.
Furthermore, an article by Volker Wieland under the heading "Power and Impotence – Independent central banks hit their limits. How should they react?" appeared in DIE ZEIT on October 30, 2003 (45/2003, special issue).
We have reprinted the shortened and edited versions here:

Power and Impotence – Independent central banks hit their limits. How should they react?

The Power

by Volker Wieland

In more and more countries, a small circle of people are gaining the power to influence the prosperity of their fellow citizens and indeed at any time the economic development of the entire nation. These groups make their decisions independently of any government or parliament. Their discussions are secret. Their members can be neither elected nor dismissed. We are not talking here about some furtive secret society, but rather about the governing boards of politically independent central banks.

Since the 1930s the U.S. central bank, the Federal Reserve, has enjoyed extensive independence from both government and parliament. After the Second World War the United States pushed the creation of an independent central bank in West Germany. The German Bundesbank in turn bequeathed its high level of independence to the European Central Bank (ECB). Many other countries have only liberated their central banks from the throes of politics in recent years. The Bank of England, for example, has only been allowed to make monetary policy decisions without consulting the Chancellor of the Exchequer beforehand since 1997. The reason for this trend is the success it has enjoyed. Today most economists and economic policymakers are in agreement that an independent central bank is the best insurance against a monetary policy motivated by election tactics, uncontrolled national debt and excessive inflation.

If the central bank is independent, then the power to determine the money market interest rate lies solely in the hands of the central bank's governing board. The money market interest rate is the price at which banks in the short run can obtain money via a loan. When the central bank increases this rate to counteract the danger of future inflation, then the savings and investment interest rates for firms and household also rise. Savers are pleased. Prospective home buyers, on the other hand, see their dreams of owning their own four walls slipping further into the future because of higher interest rates on loans. Firms have to postpone investments that are no longer tenable. The end result is that the economy grows more slowly and there are less new jobs. Output growth and inflation slow down.

The Impotence...

Despite being independent in their policy decisions, central bankers are becoming increasingly aware that there are limitations to their power - not only from politics but also from market mechanisms themselves. Whilst they are confidant that they can influence the development of prices decisively in the long run, central bankers are not keen to issue concrete statements about the measurable effects of interest rate decisions.

Central bankers become even more reticent when asked about the effects of their interest rate policy on real economic growth. Whilst the central bank controls the nominal interest rate, it can only influence the real interest rate, i.e. the nominal interest rate minus the expected rate of inflation, indirectly. Firms, however, base their investment decisions on the real rate of interest. For this reason a fall in the interest rate leads to stronger economic growth only if it is not immediately compensated for by a decrease in the expectations of inflation. It is only the sluggishness of prices, i.e. the slow adjustment of inflation rate expectations, that permits monetary policy to influence real (i.e. price change-adjusted) growth and employment.

The large majority of economists is convinced that the central bank can influence the rate of inflation in the long run, but real economic production only temporarily.

During the last ten years economic research has made considerable progress in determining the relationships between monetary policy and the real economy. Researchers have developed models that enable a better understanding of sluggishness in price development and thus of the effects of monetary policy on real variables. These models emphasize the existence of price and income contracts that endure for a while and the step-wise adjustment behavior of market participants as the reasons for the real effects of monetary policy. But they also show that the formation of expectations and intelligent decision behavior on the part of firms and private agents can change the relation between monetary policy and the real economy. This danger exists particularly when the central bank's objectives are not sufficiently clearly expressed and monetary policy decisions come as a surprise.

For this reason, economists would like to pass on some rules to monetary policymakers. One example is the so-called Taylor rule, named after John B. Taylor, Professor at Stanford University and currently Deputy Secretary for International Affairs at the American Ministry of Finance. The Taylor rule recommends that the money market interest rate should be systematically linked to deviations of the inflation rate from a long-run inflation target as well as to deviations of real production from its natural level. In this way inflation should be controlled in the long run and growth should be stabilized.

Apart from the everyday problem of having to set the interest rate correctly in accordance with the economic situation, the central bank also has to be prepared for the event that its favorite monetary policy instrument might at some point become ineffective. The Bank of Japan has a tale to tell in this context. Since September 1995 the money market interest rate has been close to zero. Thus, the Bank of Japan lacks the wherewithal for stimulating economic growth via a drop in the interest rate. Even worse, the fall in the rate of inflation to below zero, i.e. deflation, has lead to an increase in the real interest rate weakening the Japanese economy even further. Economists have proposed alternative ways out of the crisis such as, for example, an aggressive increase in the money supply, a devaluation of the yen or the announcing of a higher inflation rate target. The Bank of Japan, however, has acted on these suggestions only timidly, or not at all - and is still suffering today from deflation.

...AND HOW THEY SHOULD BE HANDLED.

There are three conclusions to be drawn from the power and impotence of the central banks as described above. First, in a democratic society there should be clearly defined goals and objectives for the independent central bank. Europe is more progressive than the United States with regard to combating inflation. The Treaty of Maastricht explicitly stipulates price stability as an objective and the ECB has defined this goal precisely as a rate of inflation just below 2%. The role of the ECB with respect to the real economy, on the other hand, is less clearly depicted. In this case the US Federal Reserve Act makes a clearer commitment to real economic growth as a further goal of monetary policy. This goal is also taken seriously by the Fed.

Second, in an economy that is characterized by uncertainty and shocks quick and effective decision-taking on the part of the central bankers must be possible. In the United States the number of members entitled to vote on the most important decision-taking board has been restricted to twelve. The headquarters in Washington holds the majority of votes. As far as the Euro is concerned, however, it is the national central banks that hold the majority of votes and the headquarters in Frankfurt is in the minority. Already to date there are 18 members on the ECB council. And soon the central bank presidents of the ten countries due to join the European Union next year could be knocking on the door. Limiting the total number of council members will therefore become imperative.

Third, in an economy where the mechanisms involved are only incompletely understood by economic researchers, a central bank must be able to absorb and act upon new insights and indeed be able to actively promote the level of scientific knowledge. In this context European central banks could also take heed of America. Research constitutes a large proportion of the work carried out by the large body of Federal Reserve staff, and there is lively competition between Washington and the regional central banks. Fortunately, the ECB has during the few years of its existence built up an excellent staff, whose priorities include research. The big national central banks of the Euro zone could, however, enter into competition with the ECB to a much greater degree.

Special

Interview at Bloomberg TV about:

Central Banking: A Current Perspective on Fed, ECB and Bank of Japan

Volker Wieland (CFS) and Michael Wudonig (Bloomberg)

We are going to talk about monetary policy and want to cast more light, in particular, on the big central banks of this world, namely the U.S. Fed, the ECB and the Bank of Japan. Joining us in this task is Volker Wieland. Let us start with the ECB. How do you judge the actions of our currency custodians here in the Euro zone?

I think that, given the difficult task facing the ECB of drawing up and implementing monetary policy in the presence of uncertainty and in a new economic area, they have done a good job. It is particularly helpful with respect to the ECB that the inflation objective is explicitly laid down, i.e. price stability. The ECB itself had to decide what is meant by this in concrete terms. At the beginning an inflation target was talked about of under 2%, somewhere therefore between zero and two. In May 2003, Mr. Issing clarified that the inflation target is almost 2% for the rate of increase for the harmonized consumer price index. I believe setting the inflation target clearly above zero percent was a step in the right direction.

It wasn't that long ago that the risks of deflation were being discussed. This isn't mentioned anymore. Is inflation once more waiting in the wings so to speak, is this a topic for discussion again, or is it not more the case that we are currently in a phase of extremely low price rate changes?

You are quite right, we are indeed experiencing very low price rate changes. In Germany we will be considerably under the 2% rate. There is, of course, a certain amount of inflation dispersion, meaning varying rates of inflation among the European countries. However, we must make a clear distinction between the expectation of a negative rate of inflation, i.e. when deflation actually occurs, and potential deflation risks, meaning a certain probability that it might at some point occur. It is true we've had certain risks, but the expectation of deflation would not be justified.

So the whole discussion was somewhat exaggerated - maybe even by the currency custodians themselves, particularly the U.S. central bank?

I wouldn't say that the currency watchdogs were exaggerating the situation for the simple reason that the central bank at that point was under particular pressure. It was under pressure to explain what the risk of deflation would imply for monetary policy. If you have to reckon with negative inflation rates, i.e. deflation as in Japan, then nominal rates of interest are of course going to fall. In Japan we currently have a nominal interest rate of zero. To what extent monetary policy can then stimulate the economy depends on the real rate of interest. In other words, the difference between the nominal interest rate and the rate of inflation. If you have a nominal interest rate of zero but a deflation rate of 2%, then you have a real interest rate of +2%. This means that when the nominal interest rate falls to zero, monetary policy loses its most effective instrument. In the event of deflation it is then no longer able to stimulate the economy. For this reason it was very important to also communicate the nature of the problem.

Lets us look for a moment at the U.S. central bank. You have, so to speak, worked for both institutions, for the Fed and for the ECB, indeed you still act as consultant to the ECB. How, generally speaking for the viewers, do the two banks differ in their function, that is with respect to monetary policy strategy?

Well, their functions are very similar, first of all to combat inflation but also to influence positively the economy's development. However, these functions are differently specified. Policy demands on the ECB are more clearly defined. The objective is price stability, whereby the ECB has a certain degree of discretion as far as the numerical specification, the precise number is concerned. The American central bank has more room to maneuver. It should pursue the price stability objective but it also has other goals to follow, which are laid down in the so-called Federal Reserve Act. There is no explicit numerical target, thus we don't know exactly what the Fed's inflation target is. In my opinion, it would be good if the U.S. could agree to make a clear statement, too. This would be a good way of ensuring that the successes of the Greenspan era are sustained in the long run.

Greenspan has indeed been very successful in keeping inflation in the USA under control.

Let us take a look at the graph showing how the inflation rate has developed in the USA since the year 2000. We had the lowest values of just above 1% in 2002. Recently the rate has started to rise again and we currently have approximately 2.2%. In the USA there has been some talk of reinflation, saying inflation is not completely negative for the economy. What do you think about this discussion?

Volker Wieland

It is an important discussion. Also in connection with the example you mentioned before, with respect to the effectiveness of monetary policy when the nominal interest rate is close to zero. With an inflation rate in the region of 2%, in the face of fluctuations around this average value, there is a certain safety net above the zero mark. The discussion you refer to here is concerned a bit with the question of how big this safety net for monetary policy should be? I believe an average rate between 2 and 2.5% would be a good enough target for maintaining this safety net.

Let's look now at the development of the key interest rates in the USA. We are currently seeing a historically low value, the base rate is now only 1%. A lot of people are saying that the US central bank, Alan Greenspan, has in fact already more or less completely run out of room to maneuver. What can then be done if, for example, the economic up-turn starts to falter - as is indeed currently happening on the markets - are our hands tied as far as monetary policy is concerned, or are there other alternative instruments available?

First of all, I don't think we've come to the end of the line yet. We've got after all another percentage point before we hit zero. It is quite conceivable that a further reduction in the interest rate in the region of zero would have a strong effect. On the other hand, we must of course think about the possibilities which would still be open to us should the nominal interest rate at some point fall to zero. This is difficult to explain because it is a subject that has not received much attention in the past few years. Various economists on the Federal Reserve Board have tried to communicate this; Ben Bernanke for one has spoken on the subject. The Japanese talk a lot about what instruments would still be viable. One such instrument is the exchange rate; you could try to depreciate the exchange rate.

Actually, that is being attempted at the moment by the American side. At least indirectly.

Yes, the dollar is falling. For Japan, which is already in the zero situation, this is, of course, not quite such an advantage. And that the yen is rising also worries me somewhat. Whilst we do indeed now have positive growth in Japan, the danger exists that when the yen appreciates growth will collapse again.

...which brings us back to our subject again. Let's talk more about Japan and Japanese monetary policy. Loosely speaking, do we have to concede that monetary policy has failed there? Price stability had been more or less achieved, but for many years, almost a decade in fact, the economy was down on its knees and monetary policy was unable to help revive it. Do we have to conclude that this was a case of monetary policy failure, or was the strategy involve the wrong one?

Yes, I would say the strategy was not right. If we look at the situation in Japan, then we see that the nominal interest rate has been near zero for a long time now. The inflation rate was slightly negative and growth was not particularly strong. The question you are asking is whether this situation should not have been confronted a long time ago. What else can be done to stimulate the economy? One could have done more in this case. But we must distinguish between asking the question what can be achieved with monetary policy and the question what were the reasons for Japan's downfall. I don't think monetary policy was the cause. The reasons lie much deeper in the real sector of the economy: bad credit, the wrong distribution of capital etc....However, monetary policy could have done more to help break out of this situation. For example, we could have aimed much earlier at a depreciation of the yen. Japan didn't do this. Furthermore, the attempt could have been made earlier to strongly expand the money supply. This was only done in moderation. The money supply in Japan in relation to GNP has grown annually but not by very much.

Thank you very much for the conversation.

Interview at Bloomberg TV about:

The Future of the Financial System

Our topic today is "The Future of the Financial System". Jan Krahnen, you have written a book together with some colleagues on this subject. First of all, how can a Financial System be defined?

The German Financial System is perceived in a particular way by the rest of the world, this has always been the case. It is considered to be the prototype of a relationship-oriented system and thus is the antithesis of a market-oriented system, which we observe in particular in the United States and the U.K. We set ourselves the task of looking at those developments in the last ten years which in Germany have lead to considerable changes. Is the perception of Germany still in fact true? Do we still have a relationship-oriented system with all its many facets?

In other words, these are the two extremes. Do they complement or compete with one another?

At first glance they compete. The market system exists in Anglo-American countries, where everything is geared towards openness, information, the rapid processing of information and the corresponding market appraisal. And where firms are steered by the markets, by stockholders for example. In a relationship-oriented system this is different. Here there are internal controls. There are, let's say, power structures which are not expressed via markets but rather by becoming part of the firm, supervisory board etc.

Jan Pieter Krahnen (CFS) and Andreas Scholz (Bloomberg)

The so-called Deutschland AG is part of this scenario. And in this scenario banks have a special role to play that, if you will, nurtures the contact between all elements of the Financial System. At the end of the day, the aim of our study is to provide an outlook. In what direction are we heading? Are we dealing with a permanently fixed structure, or are there signs of convergence between the two systems? And it can thereby be seen that a Financial System – in reference to your first question about what a Financial System is – is not something like a Lego set, where different bricks can be built together, taken down again and built anew. In point of fact, the system's elements are interwoven, so to speak, on the basis of a common legal foundation and on the basis of many other regulations that together produce a configuration that cannot simply be altered.

How typically German are we then? We have this 3 pillar banking system in Germany with a very specific legal framework. That's typically German, isn't it?

It is typically German. And it's also where you notice that a change towards more openness on the markets, the allowance of more competition meets with strong resistance. This is, by the way, also the case in general. In all areas where we try to instigate an opening up of markets we meet with this resistance.

There is a fear that redistribution will be incurred that can't be controlled. Germany is almost certainly a country - to come back to your question at the beginning about the mentality aspect - that is characterized by the perception that everything has to be evened out. Risks are not allowed to be borne out by the individual, they have to be redistributed via some type of cushioning mechanism. A market system functions only when risks are indeed borne personally, and for this reason individuals adjust their actions, decisions and plans according to the potential risk involved.

Will the market prevail? In the medium or long term? Who is now going to have to provide the impetus? Who is going to have to tear down these old, completely encrusted structures?

Well. I'm convinced that the market will prevail. There are two things at the end of the day which will see to this. One of them is, to an increasing degree, international competition. We are exposed to this competition and will have to prove ourselves. However, the second more important issue, in my opinion, is to secure our old age pensions. The financing of pensions can, in the long term, function only via markets, and only to the extent that everybody assumes some responsibility.

We've now been talking about crisis in 2002 and 2003. Crisis in the banking system. Is it also a reason for this typical structure in Germany that we've done our homework too late,

started to liberate ourselves too late? Started too late with what the banks are now doing, i.e. concentrating on the essential business of banking, focussing on the core areas?

I believe that is the right direction and that it follows on the same track as what I was saying before. We will experience an opening up of the markets in the financial system and there is a lot of talk about the notion that it may amount to a consolidation within a European framework. That is possibly the second step. The first step is that we want to see more openness with regard to competition here in Germany.

the division of labor between the market and intermediaries which, in my opinion, points the way to the future for the German financial system. It is precisely this type of relationship network that can be maintained.

Therefore, we would have both - we would have the relationships and the market that makes the decisions?

That's right. But with a clear division of labor. Liquidity, i.e. funding, should essentially take place through the markets and the banks will continue to be involved in financing via their own equity capital only to the extent required for preserving lender incentives.

Jan Pieter Krahnen

Where are we going from here? Can we offer an outlook with respect to the lending business, to M&A and investment banking? Which areas are likely to be affected and in what way? Where do you expect to see the first breakthrough, the first opening up of the market?

Well, one interesting field where we are already seeing such a breakthrough is the lending business. The traditional lending business, based on a refinancing of savings deposits is increasingly being replaced by a lending business that is still carried out by the banks on the basis of customer relationships established over the course of many years, but where the refinancing of loans is increasingly conducted through the markets. And this is an example of

With respect to private customer business, retail banking – how do you view the perspectives for the big German players now that foreign interests are coming into Germany?

There is the hope that a much greater degree of cooperation will transpire among the existing players within Germany. That's one hope. A further hope is that there will indeed be a significant level of foreign investment in Germany, which will stir up the current structures here.

And the third hope is that the time has now come to think about the regional principle in the public sector, and to ask to what extent the regional principle must be combined with an orientation towards competition.

Talking of Landesbanks, i.e. the public banking sector and their ratings. This is a sensitive issue. And it shows how difficult it is to break into this area. Is this also an area where you would say it will take much longer than we perhaps imagined?

The debate about the ratings of the Landesbanks started here in Germany in November when one rating agency struck out and said it was going to publish their rating for one of the Landesbanks, once the liabilty guarantee was dropped. This rating was stopped by intervention at the highest level, from the government. I think that the way in which the attempt by a rating agency to create an information basis was treated is a sign of the fear that is still associated with market orientation. However, I also think we would be ill-advised to prevent these attempts at an early rating because we will only achieve the opposite of what is intended. On the one hand, it will damage those to whom the rating relates because the market, uninformed as it is, must fear that the situation is much worse than the rating agency wants to suggest. And on the other hand, capital markets only function properly when we have free, and more freely functioning, and thus more credible rating agencies. If we show that they can be repressed by state intimidation then we damage the market as a whole. This seems somewhat questionable for a country that is just embarking on market integration....

We will be talking about the book with you and your colleagues again when it is published in March.

source: Bloomberg TV

— New articles on Credit Ratings, Financial Hedging and Venture Capital can be found at www.ifk-cfs.de/homepages/h-infomappe.htm.

Publications

CFS*working paper series*

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2003/27	**Andreas Hackethal:** German banks – a declining industry?
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2003/29	**Christina E. Bannier:** Privacy or Publicity – Who Drives the Wheel?
2003/30	**Markus Mentz, Steffen P. Sebastian:** Inflation convergence after the introduction of the Euro
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2003/33	**Issam Hallak:** Bank Loans Non-Linear Structure of Pricing: Empirical Evidence from Sovereign Debts
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2003/35	**Torben G. Andersen, Tim Bollerslev, Francis X. Diebold:** Some Like it Smooth, and Some Like it Rough: Untangling Continuous and Jump Components in Measuring, Modeling, and Forecasting Asset Return Volatility
2003/36	**Reinhard Schmidt:** Corporate Governance in Germany: An Economic Perspective
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2003/38	**James Bullard, In-Koo Cho:** Escapist Policy Rules
2003/39	**Seppo Honkapohja, Kaushik Mitra:** Performance of Inflation Targeting Based On Constant Interest Rate Projections
2003/40	**Athanasios Orphanides, John C. Williams:** Imperfect Knowledge, Inflation Expectations, and Monetary Policy
2003/41	**Sharon Kozicki, P.A. Tinsley:** Permanent and Transitory Policy Shocks in an Empirical Macro Model with Asymmetric Information
2003/42	**Mordecai Kurz, Hehui Jin, Maurizio Motolese:** The Role of Expectations in Economic Fluctuations and the Efficacy of Monetary Policy
2003/43	**William A. Brock, Steven N. Durlauf, Kenneth D. West:** Policy Evaluation in Uncertain Economic Environments
2003/44	**Timothy Cogley, Sergei Morozov, Thomas J. Sargent:** Bayesian Fan Charts for U.K. Inflation: Forecasting and Sources of Uncertainty in an Evolving Monetary System
2003/45	**Guenter W. Beck:** Nominal Exchange Rate Regimes and Relative Price Dispersion: On the Importance of Nominal Exchange Rate Volatility for the Width of the Border
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2004/02	**Ivica Dus, Raimond Maurer, Olivia S. Mitchell:** Betting on Death and Capital Markets in Retirement: A Shortfall Risk Analysis of Life Annuities versus Phased Withdrawal Plans
2004/02	**Tereza Tykvová, Uwe Walz:** Are IPOs of Different VCs Different?
2004/03	**Marc Escrihuela-Villar:** Innovation and Market Concentration with Asymmetric Firms
2004/05	**Ester Faia, Tommaso Monacelli:** Ramsey Monetary Policy and International Relative Prices

Timetable for forthcoming events 2004

Executive Development

Apr 22-23, 04 & Sept 30-Oct 1, 04	**Bilanzierung von Finanzinstrumenten nach HGB, IAS und US-GAAP** Martin Glaum, University of Gießen/Volker Thier, KPMG
May 6-7, 04	**Euroland- und US-Wirtschaftsindikatoren als Market Movers** Conrad Mattern, Activest Investmentgesellschaft mbH
June 17-19, 04 & Nov 25-27, 04	**Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement (3 days)** Günter Franke, University of Konstanz/ Dirk J. F. Nonnenmacher, DZ BANK AG
June 24-25 & July 8-9, 04 Nov 11-12 & Nov 25-26, 04	**Zinsprodukte: Analyse und Bewertung (4 days)** Wolfgang Bühler, University of Mannheim/Wolfgang Schmidt, Hochschule für Bankwirtschaft
Sept 9-10, 04	**Finanzökonometrie und Prognosemodelle I: Statistische Grundlagen** Walter Krämer, University of Dortmund
Sept 23-24, 04	**Finanzökonometrie und Prognosemodelle II: Moderne Zeitreihenverfahren** Walter Krämer, University of Dortmund
Nov 11-12, 04	**Behavioral Finance** Martin Weber, University of Mannheim/ Joachim Goldberg, cognitrend GmbH

Unless otherwise stated, the course language will be German.

For further information and registration on all CFSseminars and CFSexecutive conferences please contact Christiane Bauder, Tel.: +49-(0)69-242941-30, Fax: +49-(0)69-24941-33, Email bauder@ifk-cfs.de

CFS*research conferences*

March 19-20, 04	**Latest Developments in Managing Operational Risk** at the Training Centre of Deutsche Bundesbank in Eltville Organization: Thomas Kaiser (KPMG and Goethe University Frankfurt), Stefan Mittnik (University of Munich, ifo Institut and CFS)
May 10-11, 04	**Symposium of the ECB/CFS Research Network on "Capital Markets and Financial Integration in Europe"** in Frankfurt. Organization: ECB and CFS
June 3-5, 04	**Market Design** Organization: Erik Theissen (University of Bonn), Prof. Dr. Ekkehart Böhmer (Texas A&M University – Mays Business School), Prof. Dr. Hans Stoll (Vanderbilt University). Attendance is by invitation only
July 2, 04	**The ECB and Its Watchers VI**, in Frankfurt. Organization: Volker Wieland (Goethe University Frankfurt and CFS). Attendance is by invitation only
Aug 25-30, 04	**CFS Summer School on Corporate Finance, Corporate Governance, and Political Economy**, at the Training Centre of Deutsche Bundesbank in Eltville. Organization: Jan P. Krahnen (Goethe University Frankfurt and CFS), Christian Laux (Goethe University Frankfurt)
Aug 25-30,04	**CFS Summer School on International Economics**, at the Training Centre of Deutsche Bundesbank in Eltville. Organization: Michael Binder (Goethe University Frankfurt and CFS).
Sep 16, 04	**Long-Term Capital Market Perspectives** Organization: Michael Heise (Allianz Group), Volker Wieland (Goethe University Frankfurt and CFS). Attendance is by invitation only

For further information and registration please consult www.ifk-cfs.de or call either Jutta Heeg, Tel. +49(0)69-242941-20, Email: heeg@ifk-cfs.de or Christine Ruhland, Tel. +49 (0)69-242941-80, Email: ruhland@ifk-cfs.de

The new CFS*colloquium series* ***"Competition between and within Financial Centers"*** will start in April 2004. We will keep you informed via our website (www.ifk-cfs.de) or by Email as soon as our lecture program has been established.

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