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## Editorial

# The Issing Heritage

*Times are changing again at the world's two most important central banks. With Alan Greenspan leaving the Chairman's seat, an era of U.S. monetary policy conducted by the maestro has ended a few months ago. The handover to Ben Bernanke, a well-known professor of economics with previous experience as Fed Governor and presidential adviser, went very smoothly indeed. Now, the ECB is getting ready for a new chief economist with Otmar Issing's impending departure by the end of this month. Well, to be precise, the ECB is simply waiting for a new Member of the Executive Board since the ‚Chief Economist' is not a formal ECB position but an informal title given by the press--if anyone.*

*What then comprises the Issing heritage at the ECB?*

*In terms of territory it would include the Directorates General Research and Economics, which together employ most Ph.D. economists at the ECB. Rumor has it that this territory will be split up among different Board Members. Critics, however, have noted that such a split might favor the presentation of conflicting policy analyses just when a united perspective of Executive Board members is needed on the Governing Council.*

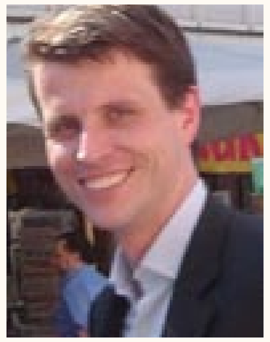
*In terms of spokesmanship on the Council, the Issing heritage would include the presentation of the economic forecast and policy alternatives. The Executive Board Member who will take on this role from June 2006 onwards will certainly have the strongest claim to Issing's informal title of Chief Economist. A possible alternative would be the Fed model where top staff economists present the staff forecast and policy alternatives to the decision-making committee. This would ensure maximum continuity in the face of changes on the Executive Board. However, staff economists may not be as successful in terms of uniting decision makers around a specific outlook and policy recommendation as a Board member of Issing's caliber.*


*The most important element of Issing's heritage is his vision of monetary policy and strategy, a vision formed and strengthened by 16 years of policymaking at the Bundesbank and the ECB. It includes the medium-term orientation of policy making and the ECB's two-pillar strategy with particular emphasis on a monetary reference value. Certainly, the ECB is keen to reaffirm its commitment to Issing's vision for achieving price stability at this time so as to maintain the immense credibility it has built up over the years. Recently, the much-criticized monetary pillar has received renewed academic support, perhaps most clearly at a conference organized by the ECB in honor of Issing and widely reported on in the press. Nevertheless, it is sure to remain an issue for further debate.*

*Finally, Issing's contribution to communication and public discussion of policy will surely be missed. His capability for open and spontaneous debate with academics, professional ECB watchers and journalists alike is not easily matched. In fact, one element of Issing's communication strategy was the CFS conference series ‚The ECB and its Watchers' which was originally initiated by Issing and former CFS director Axel Weber. Once a year, for the last eight years, Issing stood ready to discuss policy with the ECB's critics from academia, the private sector and the media in this forum, thereby making a unique contribution to central bank transparency. The „ECB watchers HOT SEAT" is now free and we at the CFS will keep it ready for future debate with ECB policymakers.*

# How Integrated are European Goods Markets? Evidence on the Integration Effects of Monetary Unions

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



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**His research focuses on:**
- **Relative prices and goods market integration**
- **Causes and characteristics of inflation dispersion in monetary unions**
- **Optimal monetary policy under uncertainty**

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In January 1999, the euro was introduced in 11 European countries. Its proponents argue that the common currency would foster trade by reducing transaction costs and by increasing price transparency and it would therefore increase integration of European markets. While it is relatively widely acknowledged that European financial markets have grown closer together, it is questionable whether we will observe a similar process for the goods markets after January 1999. Previous empirical studies show that global goods markets are still very segmented and that there doesn't seem to be a trend for a decreasing segmentation of goods market even under free trade arrangements like NAFTA. The central concept on which all these studies are based is the PPP theory (when using aggregate data) or the Law of One Price (LOOP, when using disaggregated data). Based on the methodological approach, two major groups of studies can be classified: The first category of papers looks at the time series behavior of PPP/LOOP deviations, the second category compares within-country and cross-country price dispersion.

**Table 1: German Economic and Monetary Union (GEMU),** Regression Results for Individual Border Estimates, Overall Period (1991.01 - 2002.12) and pre-EMU- and EMU Subperiods (1991.01 - 1994.12, 1995.01 - 1998.12, 1999.01 - 2002.12), Volatility Measure 1

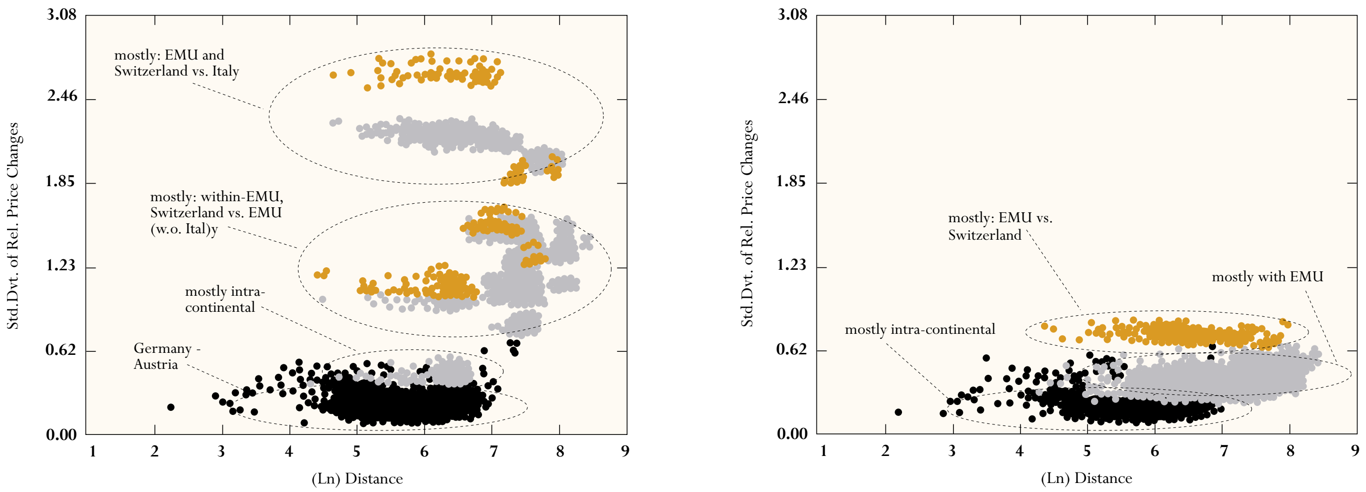
| | Overall Sample | | Subperiod 1 | | Subperiod 2 | | Subperiod 3 | |
|---|---|---|---|---|---|---|---|---|
| Var. | Coeff. | t-stat | Coeff. | t-stat | Coeff. | t-stat | Coeff. | t-stat |
| ln(dist) | 0.17 | 4.49 | 0.31 | 7.08 | 0.16 | 3.91 | 0.08 | 1.35 |
| we-ea | 14.20 | 76.88 | 25.31 | 76.04 | 0.76 | 9.07 | 0.27 | 1.52 |
| we-au | 2.64 | 60.57 | 3.60 | 49.68 | 3.06 | 60.15 | 1.30 | 12.64 |
| we-ch | 12.24 | 38.08 | 13.24 | 25.88 | 15.01 | 136.00 | 8.90 | 31.90 |
| ea-au | 14.32 | 76.21 | 26.25 | 76.86 | 2.83 | 30.02 | 0.82 | 5.89 |
| ea-ch | 19.74 | 52.52 | 29.70 | 48.05 | 14.85 | 105.95 | 8.37 | 27.66 |
| au-ch | 11.44 | 35.04 | 13.92 | 27.45 | 13.98 | 108.76 | 6.64 | 20.90 |
| $R^2$ | 0.996 | | 0.997 | | 0.992 | | 0.935 | |
| $R^2_{adj}$ | 0.995 | | 0.997 | | 0.992 | | 0.931 | |
| *s.e.r.* | 0.0005 | | 0.0007 | | 0.0005 | | 0.0008 | |

**Notes:**
1) Table 1 reports results from estimating equation (1) in section ?? of the main text. The dependent variable is volatility measure 1. There are 666 observations in each regression. 'we' is the short form for 'Western Germany', 'ea' stands for 'Eastern Germany, 'au' for Austria and 'ch' for Switzerland.
2) In brackets, t-statistics are reported. In computing these statistics, White's heteroscedastic-consistent standard errors were used.
3) $R^2$ denotes the (unadjusted) coefficient of determination, $R^2_{adj}$ denotes the adjusted co-efficient of determination and the term *s.e.r.* denotes the standard error of regression.





**Figure 1: Relative Price Volatility versus Distance, Pre-EMU- (1995.01 - 1998.12, Upper Panel) and EMU- (1999.01 - 2002.12, Lower Panel) Subperiod**




**Note:**
Figure 1 plots our measure for relative price dispersion across regions against the distance (in logs) between these regions for the pre-EMU-subperiod (upper panel) and the EMU-subperiod (lower panel). Relative price dispersion between region i and region j is computed as the standard deviation of two-month relative price changes between the two regions, i.e., $V(q_{ij})=\sqrt{var(\Delta q_{ij,t})}$ (2) where $\Delta q_{ij,t}$ denotes the two-month changes between region's *i* and region's *j* relative price and var*(.)* denotes the empirical variance of $\Delta q_{ij,t}$.

Using modern panel econometric techniques and data spanning long time periods to increase testing power, the studies of the first category arrive "at a surprising degree of consensus on a couple of facts" (Rogoff (1996)): First, they find that PPP/the LOOP holds, but only at the very long run. And second, they all point to very long half lives of PPP/LOOP deviations between 3 and 5 years. Similar results are obtained in the second category of empirical studies. Starting with the seminal paper by Engel and Rogers (1996), these papers show, that international price dispersion is significantly higher than intra-national price dispersion. Looking for the reasons of this so-called border effect, transaction costs, formal and non-formal trade barriers, the existence of nontradeable goods, pricing to market behavior and short-run price stickiness together with highly volatile nominal exchange rates are prominent candidates.

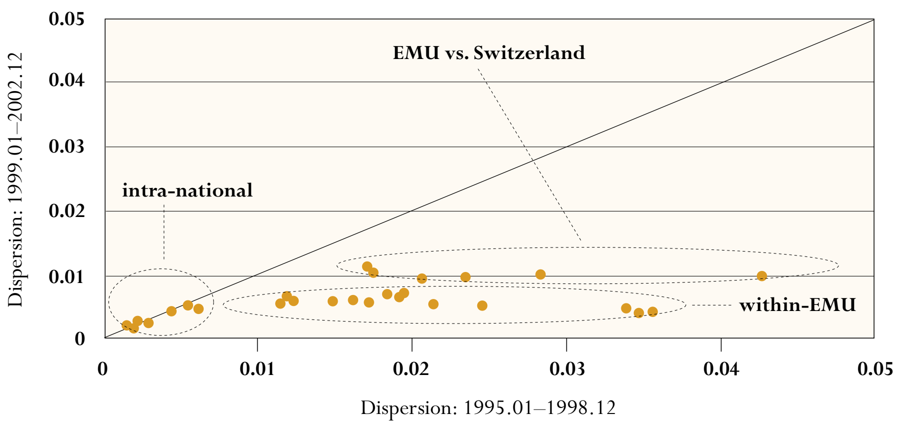
In Beck and Weber (2005), we investigate how relative price dispersion evolves under a monetary union and we try to shed some light on the relative importance of the above mentioned factors responsible for PPP/LOOP deviations. We do this by examining the development of real exchange rate volatility before and after the setup of the **European Monetary Union (EMU)** and for the case of the **German Economic and Monetary Union (GEMU)**. Following Engel and Rogers (1996) and others we examine the impact of national borders on the integration of two markets by regressing the volatility of the prices of similar goods sold in different locations on the distance between the locations and other explanatory variables, including a dummy variable for whether the cities are in different countries, i.e., we estimate regression equations of the form:

$$V(\Delta q_{ij}) = \Sigma\, \alpha(c)D(c) + \beta ln\,(d_{ij}) + \delta B_{ij} + \gamma\, V(\Delta s_{ij}) + u_{ij} \quad (1)$$

where $D(c)$ is a dummy variable for each city in our sample, $d_{ij}$ is the distance between cities $i$ and $j$, $B_{ij}$ is a dummy variable for each national border that separates cities $i$ and $j$, and $V(\Delta s_{ij})$ is a measure of nominal exchange rate volatility between cities $i$ and $j$ located in different countries.

In our European sample, we use comparable price data for the aggregate CPI and for 11 dis-aggregate components from seven European countries. These countries include Germany (12 regions), Austria (20 cities), Finland (5 regions), Italy (20 cities), Spain (18 provinces), Portugal (7 regions), and Switzerland (4 regions). We find that both transactions costs (distance) and nominal price rigidities (exchange rate volatility) play an important role for real exchange rate dispersion across European regions. However, these factors cannot explain all of the existing dispersion: In all cases, the border variable is significantly positive showing that inter-country goods market integration is less developed than within-country dispersion.

**Figure 2: Border Estimates in the pre-EMU- (1995.01-1998.12) and EMU- (1999.01-2002.12) Subperiod**




**Note:**
Figure 2 plots estimates of border dummies for the EMU-subperiod (1999.01-2002.12) on the vertical axis, and the pre-EMU-subperiod (1995.01-1998.12) on the horizontal axis. The solid line is the 45° line.

When splitting our sample period to consider the effects of the EMU on cross-country price dispersion, we find that roughly 80% of the pre-EMU cross-country relative price dispersion has vanished after January 1999. This is illustrated in Figure 1 which plots our measures for the relative dispersion of prices between two regions (y-axis) against the (log) distance between the corresponding two regions for the period before (upper panel) and after (lower panel) the introduction of the euro. The scale of both graphs is chosen to be the same, so that the reduction of relative price volatility for all cross-border city pairs is more directly visible. In panel (b) of Figure 1 it is impossible to discriminate visually between within-country and within-EMU relative price volatility, whereas the EMU-Swiss city pairs are still clearly identifiable as having higher volatility. As a first approximation one may therefore be tempted to conclude that the EMU has eliminated international differences in relative price volatility between EU cities. Our formal analysis indicates, however, that this conclusion is not valid and that national borders continue to matter for relative price volatility even in the EMU. This is shown in Figure 2 where plot our estimates for the border variable for the pre-EMU period (y-axis) and the EMU period (x-axis). The estimation results show that all border dummies remain highly significant even after 1999, drop considerably in size, however. These results indicate that staggered price setting plays an important role but cannot explain all of the existing real exchange rate dispersion. The remaining border effects are likely due to the existence of nontradeables and also due to pricing-to-market behavior. Formal and non-formal trade barriers are probably of less importance. To our knowledge, this is the first study that examines border effects in an international context "without trade barriers or currency fluctuations" (Parsley and Wei (1996)). We suggest that cross-country dispersion will continue to decrease in the next years when European goods market segmentation and therefore pricing-to-market behavior will decline further.

Looking at the case of the GEMU, we explore the cross-sectional and the time-series dimension of our price data sample that is based on CPI observations from seven West and six East German regions. Proceeding analogously to the European case, we find that a shadow border dummy variable between West and East German locations is highly significant for the period immediately following the establishment of the GEMU at the beginning of the 1990s.
However, the importance of this variable declines rapidly and it becomes insignificant at the end of the decade (see Table 1). Thus, from an economic point of view, German integration has made tremendous progress within the short period of only ten years. These results are confirmed by the time series behavior of real exchange rates. Using panel techniques, we find that implied half-lives of PPP deviations between West and East German regions are in the range of one year and thus significantly below the well documented three to five years pointed out by Rogoff (1996).

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# Interview on Gold and Central Banking

**Do central banks need to hold stocks of gold as reserve assets? What could be considered an appropriate level? In an interview with the Frankfurter Allgemeine Zeitung (FAZ), held on 17 February 2006, Volker Wieland answers questions on gold and central banking. The interview by Benedikt Fehr "Kein Gold für das Defizit" has been translated for the CFSnewsletter.**

Volker Wieland, Professor for Monetary Theory, University of Frankfurt

## "No gold for the budget deficit"

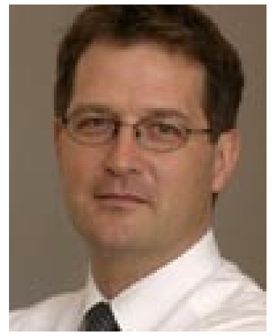
*Do central banks nowadays still need currency reserves?*
Yes, for example, to be able to support the domestic currency in the event of undesirable exchange rate fluctuations by intervening on the currency markets. Also, confidence in a currency on the part of its users may also depend on the reserves held by the central bank.

*Is the volume of reserves held by the Bundesbank appropriate?*
The question regarding the optimal level of central bank reserves is not easily answered. In a fixed exchange rate system, the level must undoubtedly be greater than under a regime of flexible exchange rates. With respect to the Euro, the total reserves of the euro system matter. I see a need for more research on the question of the optimal level of central bank reserves.

*To ask the question more precisely – is the volume of reserves held specifically in gold appropriate?*
Most of the Bundesbank's reserves are held in gold and interest earning dollar deposits. In absolute terms, the Bundesbank has the second highest volume of gold reserves after the United States. Relatively speaking, however, the Bundesbank reserves measured, for example, in terms of gold reserves per capita or the ratio of gold reserves to annual expenditure on imports are not conspicuously greater than those of other leading industrial countries.

*What are the arguments in favor of and what are those against holding reserves in gold?*
The main argument against gold reserves is the fact that they yield no interest unlike deposits in foreign currencies. Furthermore, the price of gold fluctuates due to changes in the supply and demand for gold on the market. However, one drawback of holding reserves in the currency of other countries is that their value directly depends on the monetary policy of these countries.

*Does it make sense to sell gold in favor of investing in interest earning reserves?*



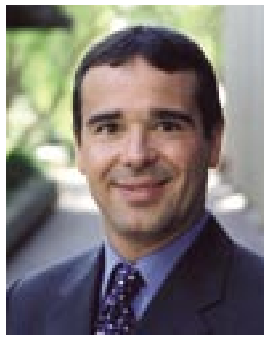
The primary objective of the Bundesbank is to ensure monetary stability rather than to make a profit. Thus, the Bundesbank should first of all decide what volume of reserves is required in order to fulfill the objective. The Swiss National Bank, which in 1988 held a per capita volume of reserves eight times greater than that of the Bundesbank, decided in 1999 that half of these reserves were no longer needed for monetary policy purposes. The resulting sale of gold reserves has since been completed.

*Would it not make sense to use profits from gold sales to service the national debt?*
According to Philipp Hildebrand from the Swiss National Bank Board of Directors, the most important lesson to be learnt from the sale of Swiss gold was that a decision to sell should be made independently of any considerations regarding the use of returns. In my opinion, profits from the sale of gold reserves by the Bundesbank should definitely not be used in the coming years to finance budget deficits.

# Trends in Income and Consumption Inequality in the United States: What Happened, and Why?*

*by CFS Research Fellow Dirk Krüger (University of Frankfurt, CEPR, CFS, MEA and NBER), 6 February, 2006*

## 1 Introduction



Labor earnings and income inequality in the United States have increased substantially in the last 25 years. This trend is attributable both to increases in the dispersion in earnings between groups as well as rising dispersion of earnings within groups[1].1 A group is defined by a common, observable characteristic, most notably education.

However, if one is interested in the welfare impact of these changes in the income distribution, simply looking at the distribution of current income might not be sufficient. Current income of a household may be temporarily high (say, because of temporary overtime work or a lottery win) and thus may not be an appropriate measure of lifetime resources available to agents. Thus its distribution might not be a good measure of how economic welfare is allocated among households. In addition, the same change in income inequality might have a very different impact on the welfare distribution, depending on the structure of financial markets available to agents for smoothing income fluctuations. This is why in recent work Fabrizio Perri and I have studied changes the distribution of household consumption in the United States in the last 25 years.

In this essay I will first describe the main findings from our investigation of a large household level data set for the US that contains both information on income and consumption. I will then set forth a theoretical hypothesis for jointly explaining the recent trends in US income and consumption inequality. I will conclude with some empirical support for our hypothesis and some cautioning remarks about the welfare implications of our findings.

## 2 The Facts: Trends in income and Consumption Inequality

For the purpose of documenting how income and consumption inequality have evolved in the United States during the last 25 years the Consumer Expenditure (CE) Interview Survey is used. This data set, which is continuously available from 1980, contains detailed quarterly information on income and consumption expenditures for about 5000 representative individual households.

We measure labor income as (inflated-deflated) after-tax labor earnings plus government transfers (henceforth LEA+ income). This income measure is meant to capture all sources of household revenues that are exogenous to the consumption and saving decisions of households. We measure consumption as (inflation-deflated) expenditures on nondurable goods and services, plus imputed service flows from consumer durable goods, such as cars and houses. Our measure of consumption (henceforth ND+) is meant to capture the flow of consumption services that accrue to a household. Finally we correct our household income and consumption measures by household family size[2].

Figure 1 displays the trend for four common measures of cross-sectional inequality of LEA+ income and ND+ consumption. First, we observe that labor income inequality in the United States has increased significantly in the last quarter century: the Gini index has risen from 0.3 to around 0.37, and the variance of the logs displays an increase of more than 20%. The 90/10 ratio for income surges from 4.2 to over 6, suggesting a large divergence between the two tails of the income distribution over time. Finally the 50/10 ratio displays an increase from 2.2 to 2.7, revealing that households in the bottom tail of the income distribution have lost ground relative to the median. The figure also presents our main empirical finding, namely that the increase in consumption inequality has been much less marked; the increase has been from 0.23 to 0.26 for the Gini and about 5%in the variance of logs. The 90/10 ratio has increased from 2.9 to around 3.4, suggesting a much more moderate fanning-out of the consumption distribution. Finally, the 50/10 ratio increases only from about 1.7 to 1.9, implying that in terms of consumption (compared to income), households in the bottom part of the distribution have lost less ground relative to the median[3]. Note that since our income definition includes government taxes and transfers, changes in government income redistribution policies cannot be responsible for the divergence between the two series.

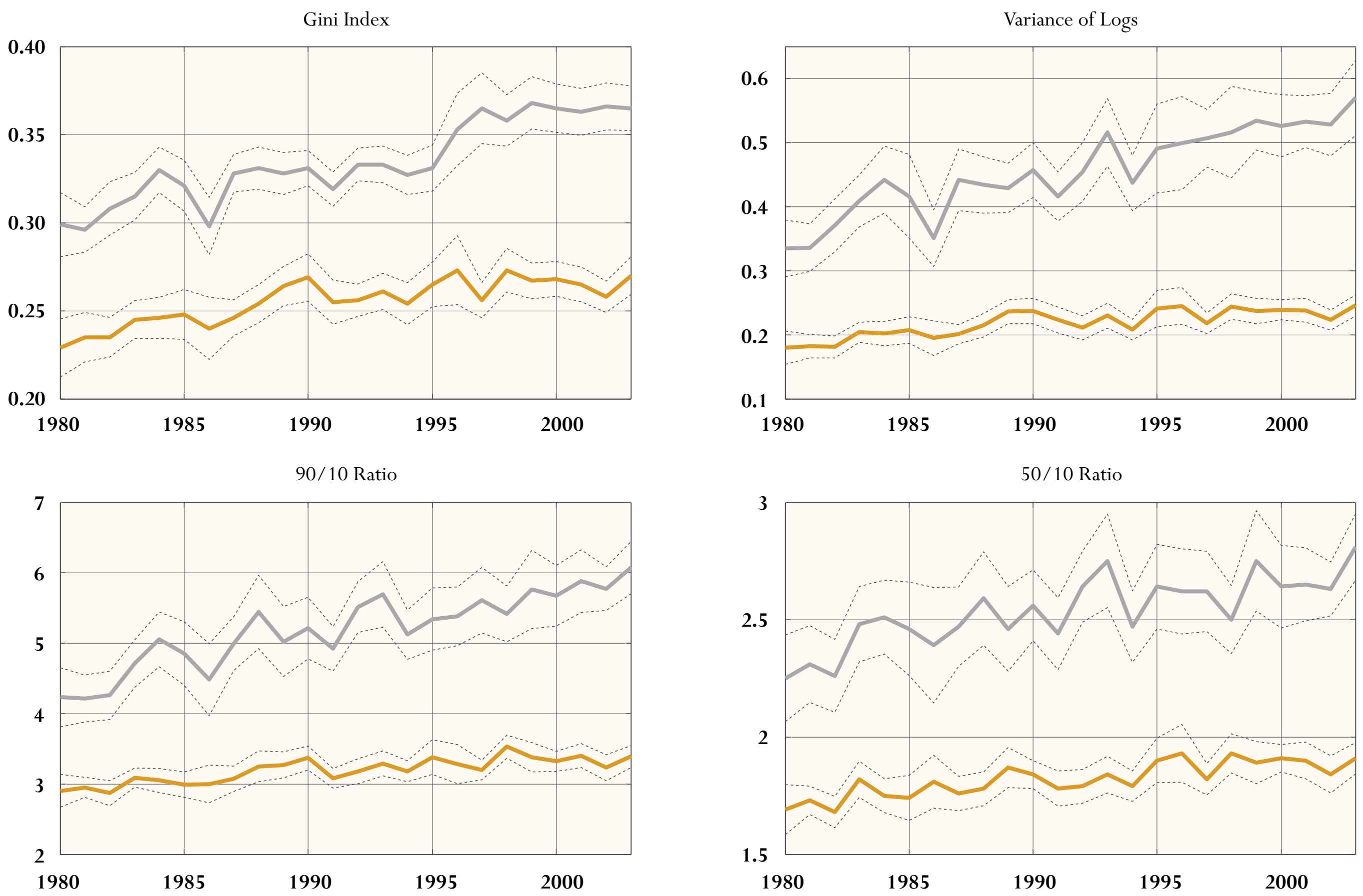
What lies underneath these diverging trends in income and consumption inequality? We decompose these changes into changes in between- and within-group inequality. Between-group inequality is attributable to fixed and observable characteristics of the household (e.g., education, experience, and sex). Within-group income inequality is a residual measure that includes inequality caused by idiosyncratic income shocks (such as becoming unemployed even if the job market for households with similar characteristics is doing fine).

Figure 2 shows the evolution of between-group (panel a) and within-group (panel b) income and consumption inequality. For income both the between- and within-group components display an increase. Panel (a) shows that for consumption, the between-group component displays an increase similar in magnitude to that of income. Panel (b) reveals a very different picture for the within-group component: the increase in consumption inequality is an order of magnitude smaller than the increase in income inequality. Consequently, understanding the trends in panel (b) is crucial for understanding the patterns of income and consumption inequality in the US.

## 3 The Theory

From a purely statistical point of view the reason for the diverging inequality trends can be found in the fact that a lot bigger idiosyncratic income shocks have not translated into substantially larger consumption variation. We put forward the hypothesis that well-functioning financial markets have efficiently responded to the higher need of individual households to smooth larger idiosyncratic income shocks. More precisely, we suggest that households facing larger income shocks now than 25 years ago place more value on access to financial markets to insure against these shocks. Financial intermediaries (such as banks and credit card companies) rationally expand credit lines of their customers over time to accommodate their needs. Thus households facing larger income shocks have access to improved consumption smoothing mechanisms, explaining why idiosyncratic consumption

**Figure 1. The Evolution of Income and Consumption Inequality in the US, 1980-2003**




Note: The standard errors are computing using a bootstrap procedure with 100 repetitions — ND+ Consumption — LEA+ Income ······ 2SE Bands

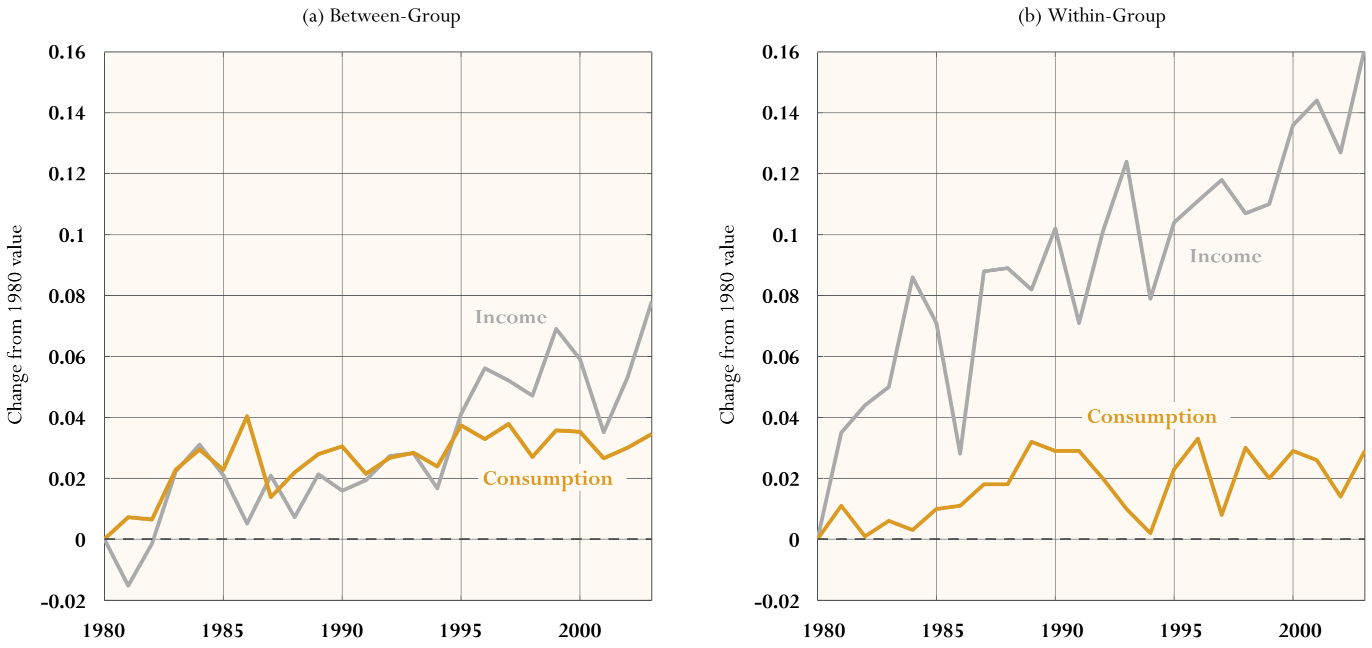
*This essay is based on joint work with Fabrizio Perri, which is forthcoming in the Review of Economic Studies and is referred to as Krueger and Perri (2006). All errors, however, are solely my responsibility

1 See, e.g., Katz and Autor (1999)

2 For details about the construction of the data, the sample selection and the adjustment for family size please consult Krueger and Perri (2006).

3 These findings are consistent with those of Slesnick (2001), who found that poverty rates for income increased from 11.1% in 1973 to 13.8% in 1995, while poverty rates for consumption declined from 9.9% to 9.5%.

**Figure 2. Changes in between and within-group Income and Consumption Inequality**




volatility has not followed the upward trend in idiosyncratic income volatility (see panel (b) of figure 2).

There are several mechanisms that may explain the improved supply of credit for consumption smoothing over time. First, recent advances in information and communication technology may have made it cheaper for financial intermediaries to screen a potential customer's credit risk. Second, a change in the law in the early 1980's effectively abolished interest rate ceilings on credit contracts that had before stifled the credit card industry. The mechanism that we prefer (and formally model in our work) derives the deepening of financial markets endogenously from the higher volatility of income shocks. Larger shocks reduce the incentives of households to default on loans if the punishment of default is (temporary) exclusion from financial markets and thus life in autarchy. Thus more loans can be extended to households in the presence of larger income shocks without increases in default rates. The consumption smoothing possibilities of households hence improve over time, as a consequence of higher income volatility.[4]

## 4 Conclusion

The mechanism through which households in our theory keep their consumption profiles stable in the light of more volatile income is an expansion in the use of credit. Did this expansion take place in the data? One simple measure of such credit which is not contaminated by recent trends in the U.S. real estate market is the ratio of aggregate unsecured (by real estate or other durables) consumer credit to disposable income. Figure 3 plots this ratio from U.S. data for the last 40 years, as well as the Gini coeffient for U.S. household income. The two series display a remarkably similar long-run trend. Combining this figure with our consumption inequality observations may suggest that consumers could and in fact did make stronger use of credit markets exactly when they needed to (starting in the mid-1970s), in order to insulate consumption from bigger income fluctuations.

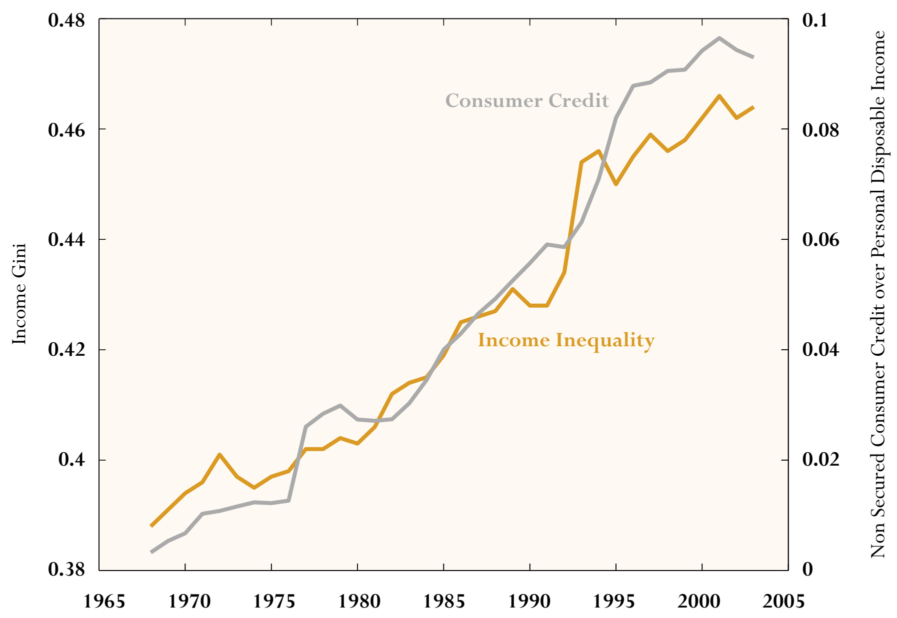
Do our findings imply that there are no welfare costs associated with the recent increase in U.S. income inequality? Absolutely not! First we saw in figure 2(a) that the increase in between-group income inequality is mirrored almost one-for-one in increased consumption inequality, with associated societal welfare losses (which we quantify in Krueger and Perri, 2004). Second, keeping consumption stable in the light of idiosyncratic income shocks comes at the cost of increased household indebtedness (both in our theory as well as in the data). This may represent an efficient response of financial markets (as our theory implies), or foreshadow a debt crisis in the U.S. household sector. Finally, a comprehensive evaluation of welfare cannot ignore the trends in labor supply inequality. It may be the case that stable consumption pro…les are partially the result of increasing labor supply of other household family members in case the primary earner of the household suffers an adverse earning shock. The results of Krueger and Perri (2004) suggest that this may indeed have happened in the data.

4 In Krueger and Perri (2006) we formally prove these conjectures in a simple model and then document that a large scale computable general equilibrium model with this mechanism can account well for the diverging trends documented above. A model with a static structure of …nancial markets, on the other hand, predicts that consumption inequality follows income inequality fairly closely.





**Figure 3. Income Inequality and Consumer Credit**

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2005/28 **Tullio Jappelli, Luigi Pistaferri**
Intertemporal Choice and Consumption Mobility

2005/27 **Luigi Guiso, Paola Sapienza, Luigi Zingales**
Trusting the Stock Market

2005/26 **Michael Haliassos, Michael Reiter**
Credit Card Debt Puzzles

## CFS*conference readers*

### „Open Forum on Germany's Banking System“

In the fall of 2003, the International Monetary Fund published the results of its latest Financial Sector Assessment Study, focusing this time on Germany. This report contained some important conclusions regarding the future of Germany's three-pillar banking system.

The ensuing public debate revealed that our knowledge of the basic performance characteristics of Germany's banking system was actually quite limited. On an international level, response to the IMF report indicated a high level of interest in the evolution of the German financial system. As a result, a conference entitled "Open Forum on Germany's Banking System" took place on 7 March, 2005. The conference brought together representatives of Germany's three banking pillars, policymakers and academics, for discussion of the following issues:

- What action can be taken in line with the conclusions and proposals in the original IMF report?
- What developments have taken place since the authors of the report collected their information in 2003?
- What comments do outside observers make on the performance and stability of this bank-based financial system?

The conference indicated that a definite assessment of the welfare implications of the three-pillar system is less evident than most observers in Germany seem to believe.

The CFS*conference reader* **"Open Forum on Germany's Banking System"** includes excerpts from all the contributions to the conference. They not only show where we stand but they also make a significant contribution to our expectations for the near future.

**We have a limited number that we can send out for free. Please mail your request to: media_contact@ifk-cfs.de**

### „Capital Markets In the Long Term: Demography, Economic Development and Funded Pension Systems“

The conference **"Capital Markets In the Long Term: Demography, Economic Development and Funded Pension Systems"**, organized by the Allianz Group and the Center for Financial Studies on 23 September, 2004, focussed on the long-term impact on capital markets and pension systems. The speakers attempted to identify the direction and magnitude of potential changes as well as the likelihood of an eventual asset meltdown.

**We still have a limited number of the CFSconference reader that we can send out for free. Please mail your request to: media_contact@ifk-cfs.de**

## CFS*colloquium series*

# Basel II und die Konsequenzen für das Risikomanagement / Basel II and its Impact on Risk Management

### What Senior Bank Management needs to understand about Risk: The Challenges of Basel II and Sarbanes-Oxley

**Are codes of practice, International Regulatory Accords and the new legislation in the US focusing on the right thing? Sir Howard Davies, Director of the London School of Economics, doubts that either the Sarbanes-Oxley Act, or the Basel II Accord, or the corporate governance codes really focus the attention on some of the big risks that have brought about failure in major financial institutions in the past. In his opinion, given the new control framework, there should be a rebalancing of effort, i.e. more time should be spent on big strategic questions and on the interpersonal dynamics of the business**

In his speech at the CFS*colloquium* on 5 October, 2005, **Sir Howard Davies**, Director of the London School of Economics, stressed that there is currently no shortage of both generic and specific advice to the boards and top management of banks. The question, however, is whether this advice can be regarded as adequate. Some have argued that in many cases the codes and accords are solutions in search of a problem. In his analysis of this statement, Sir Howard Davies referred to a number of studies and reflected on the actual problems he encountered during his many years as head of the banking supervision in the UK.

The first study considered by Davies was carried out by European banking supervisors, known as the 'Groupe de Contact', who looked at a number of banking problems across the continent between 1988 and 1998. They concluded that management and control weaknesses were underlying, fundamental, and contributory in almost all of the cases they considered. Referring to a second study, Davis mentioned that a very similar conclusion was reached by a group of European insurance supervisors who focused on 21 cases of failure, or near failure, in European insurance companies between 1996 and 2001. They discovered four forms of management malfunctioning: incompetence, with firms straying outside their field of expertise or uncritically following the herd instinct; an excessive appetite for risk; lack of integrity, and lack of autonomy and inappropriate pressure to produce short-term results. According to Davies, it is useful in this case to distinguish between management and governance problems. Moreover, he perceives governance topics to be the main issue at stake in at least three of these four cases.

The third source referred to by Davies was a special issue of the New York Fed Review published in April 2003, entitled "Corporate governance: what do we know, and what is different about banks?" One of the papers from this review volume concludes that board composition does not, on the one hand, seem to be a useful predictor of firm performance. On the other hand, the authors find that in the US, at least, board size has a negative relationship to performance. In other words, the bigger the board, the poorer the results. Furthermore, they note that there are different corporate governance structures in different industries, which have developed in response to the different needs of companies in each sector. Thus, they stated "reforms that do not take into account industry differences may not have the same intended effect across industries". Davies concluded from this review that there should be some wariness of "one size fits all" codes that propose the same rules for companies of different sizes and in different sectors.

Davies was able to draw some conclusions based on his own observations from many years as the head of banking supervision in the UK. He emphasized, first, that people are more important than processes. Many of the failed, or near failed firms, had boards with the prescribed mix of executives and non-executives, with socially acceptable levels of diversity, with directors appointed through impeccably independent processes, yet the individuals concerned were not suited, be it either on the grounds of ability or temperament, to facing the challenges that arose when the business ran into difficulty. Second, Davies pointed out that there are some good practice processes worth adopting. Properly chosen audit committees and board risk committees can play an important role, as long as they are prepared to listen carefully to sources of advice from outside the firm. Audit committees should require that the internal audit functionaries report to them, not to senior management, and should encourage both internal and external auditors to challenge management.

Davies also focused on the idea that a regulatory regime built on senior management responsibilities is absolutely crucial. Senior management must consider themselves to be responsible for the control environment. It is quite reasonable to expect the CEO to ensure that there is a risk-management structure and a control framework throughout the business capable of identifying aberrant behavior. Essentially, this is the philosophy behind Sarbanes-Oxley.

Davies called upon regulators to focus attention on the top level of management in the firm. A well-structured board and a confident management should welcome an independent view, which they may challenge and contest if they wish. In addition, non-executive directors should find it helpful to receive an informed view of the institution that does not come from, or through, its own senior management. Davies also mentioned that boards should take more interest in the nature of the incentive structure within the organization. A number of the most problematic cases in recent years have had their roots in a misalignment of incentives, he said. Finally, Davies stressed that no corporate governance system will work well unless there is some engagement on the part of shareholders. If shareholders are not prepared to vote via their shares, then their accountability becomes somewhat notional and, therefore, unlikely to be effective.

In his conclusion to the question "Are the codes of practice, the International Regulatory Accords and the new legislation in the US in particular, focusing on the right things?", Sir Davies stated that it is not clear that either Sarbanes-Oxley, or Basel II, or the corporate governance codes really focus the necessary attention on some of the big risks, that have brought about failure in major financial institutions in the past and by risks he meant the dangers created by an over dominant Chief Executive, by pursuing unachievable strategies, or by adhering to strategies which require management skills their firm does not have.

*Felizitas Thom, Lut De Moor (CFS staff)*

## Basel II and the future development of the internal market in financial services

**With Basel II the European Parliament has provided its Member States with new chances . Alexander Radwan, Member of the European Parliament, has called upon the national legislators to make use of these opportunities.**

**Alexander Radwan**, Member of the European Parliament, Economics spokesman of the EPP-ED Group and coordinator in the Committee on Economic and Monetary Affairs, focused on three topics in his presentation at the CFS*colloquium* on 12 January, 2006. The first topic was Basel II from the legislation point of view. He then turned to the Lamfalussy process. His third topic focused on a survey of financial markets regulation that is in store at the European level.

Radwan emphasized that with Basel II an EU Directive has been enacted, which must now be implemented in national law by the national legislators, "It is now up to the national legislators, and correspondingly the respective financial supervisory authorities to make use, on behalf of the banks, of the opportunities we have created ". The European Parliament's aim has been to create a uniform framework for internationally active European bank groups and at the same time to take into account the special features of regional banks in national markets. It has been particularly important, according to Radwan, to provide small and medium-sized businesses with greater room to manoeuvre. Basel II deals with the credit ratings of borrowers with respect to the capital requirement. Whereas in the first draft only an external rating was to be regarded as acceptable, implying that every small and medium-sized business would be forced to seek out an accredited rating agency in order to obtain an external rating, Radwan sees it as a sign of success that now an internal rating is to be considered equal to an external rating.

In Radwan's opinion, several changes from Basel II will promote further developments in the European financial markets. For example, with respect to Pillar I, which regulates the minimum capital requirements, there will now be a Lead Supervisor. Radwan said that large institutions with cross-border operations had expressed the wish that they should have to comply with only one regulation in regard to Pillar I. It is also new that the supervisory authorities in the EU state where a bank carries out its activities, must collaborate and come to an agreement with the supervisory authority of the country in which the financial institution in question has its headquarters. If no agreement has been reached within six months, then the home Member State authorities can deal with the matter and this will be legally binding. The prerequisites for extending this concept to Pillar II, which is concerned with the regulatory decrees of the supervision process, and Pillar III, which deals with market discipline, according to Radwan, are not yet given. After four years, however, the Commission is to examine to what extent the process has been successful and will analyze in a report whether an extension would be advisable.

A further concern of Radwan is the extent to which parliamentary control may be exercised on committees working within the framework of the "comitology" system. As is the case with respect to other financial services legislation, in order to change the Basel II Directives, the Lamfalussy process is used. On the second level the technical implementation regulations will therefore be absolved by committees within the comitology system. In order to strengthen the democratic rights for the European Parliament it is essential with respect to this system that there be a "call back" mechanism for the Parliament. In general this involves a parliamentary means of control for committees working within the framework of the comitology system. With respect to the Basel II Directives as well as other legislation, a sunset clause was inserted to the effect that the delegated powers to the committee can be used until a certain date. The sunset clause is valid till 1 April, 2008. Within this timeframe, the European Parliament calls upon the Council and the Commission to reach an inter-institutional agreement, which would grant to the European Parliament on both the European and the international level the rights demanded. Should this not be the case then the European Parliament will allow the Lamfalussy process for the financial services legislation to expire.

The European internal market will become one of the central themes of financial market legislation in the near future, according to Radwan. On paper the single European internal market has existed for over ten years, but says Radwan, " In the meanwhile we have had to acknowledge the fact that the single European internal market is not present in many areas ". He emphasized that in the service sector, particularly that of financial services, markets that are strongly fragmented on a national basis with national legislation and supervision still continue to exist. The Commission has introduced the Financial Service Action Plan which seeks to create a single market for financial services in Europe. The main corner stones are the Market Abuse Directive, the Prospectus Directive and the Investment Services Directive. The Prospectus Directive is a legal framework that creates an effective „single passport" for issuers. In other words it means that once a prospectus of a firm is authorized in one Member State, it can be used in all the others. The firm may go, for example, from Frankfurt to England or Austria without having to file an additional prospectus that complies with national legislation. The main objective of the Markets in Financial Instruments Directive (MiFID) and investment services Directive is to boost competition between the stock exchanges and large investment institutions with respect to trading in Europe, said Radwan.

A primary subject of focus in the future, according to Radwan, will be the financial supervision in Europe. Basel II has provided first steps in this direction. Large financial institutions that operate across national boundaries would prefer an EU framework with a single European supervisory authority. The regional institutions, on the other hand, would prefer a supervision authority that is specific to the domestic market only. These two concepts must be harmonized by the European Parliament.

Initiatives by the Commission currently take the form of Green Papers on mortgage credit in the EU and on investment funds. According to the Commission, there is as yet no integrated market for mortgages. „In the field of investment funds, we are concerned with the question of how we should proceed with respect to the UCITS Directives, the European passport and the cross border acceptance of such funds", said Radwan. A further big issue is the proposal for a Directive for a common payment area. The aim of the Single European Payment Area would be to implement a common system for non-cash payments. Finally Radwan mentioned a few further points concerning the legal framework that are currently being debated.

In conclusion, Alexander Radwan called for the interests of Germany's financial community to be included in European legislation within good time.

*Felizitas Thom, Lut De Moor (CFS staff)*

# Joint Lunchtime Seminars

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

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

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

30 May 2006 — DSGE Models in a Data-Rich Environment
**Marc Giannoni** (Columbia University)

23 May 2006 — Optimal Taxation of Entrepreneurial Capital with Private Information
**Stefania Albanesi** (Columbia University)

16 May 2006 — Understanding Real Exchange Rate Movements When Trade is in Middle Products
**David Parsley** (Vanderbilt University)

2 May, 2006 — Banking and Regulation in Emerging Markets: The Role of External Discipline
**Xavier Vives** (IESE Business School, Barcelona)

25 April, 2006 — Heterogeneous Believes and Inflation Dynamics: A General Equilibrium Approach
**Fabiá Gumbau-Brisa** (Federal Reserve Bank of Boston)

18 April, 2006 — Financial Stability in European Banking: the Role of Common Factors
**Clemens Kool** (University of Utrecht)

11 April, 2006 — Product Market Reforms, Labour Market Institutions and Employment
**Rupert Harrison** (University College London & Institute for Fiscal Studies)

4 April 2006 — Social Networks in the Boardroom
**Francis Kramarz** (University College London & Institute for Fiscal Studies)

21 March 2006 — Optimal Inflation Stabilization in a Medium-Scale Macroeconomic Model
**Stephanie Schmitt-Grohé** (Duke University)

14 March 2006 — Sharing Underwriters with Rivals: Implications for Competition in Investment Banking
**Alexander Ljungqvist** (New York University)

7 March 2006 — A Dynamic Factor Model with Time-Varying Parameters
**Christopher Otrok** (University of Virginia)

28 Feb. 2006 — Plant-Level Nonconvexities and the Transmission of Monetary Policy
**Roman Sustek** (Bank of England & Carnegie Mellon University)

21 Feb. 2006 — C-CAPM without Ex Post Data
**Paul Söderlind** (University of St. Gallen)

14 Feb. 2006 — The Impact of Organizational Structure and Lending Technology on Banking Competition
**Hans Degryse** (University of Leuven & Tilburg University)

7 Feb. 2006 — Financial Development, Growth, and Volatility
**Leo Kaas** (University of Konstanz)

17 Jan. 2006 — Regulating Financial Conglomerates
**Alan Morrison** (Said Business School)

4 Jan. 2006 — Career Progression and Formal versus on the Job Training
**Costas Meghir** (University College London)

21 Dec. 2005 — Putting the New Keynesian Model to a Test: An SVAR Analysis with DSGE Priors (Preliminary)
**Gert Peersman** (University of Ghent)

14 Dec. 2005 — Endogenous Labor Market Participation and the Business Cycle
**Christian Haefke** (Universitat Pompeu Fabra)

7 Dec. 2005 — Forecasting Using Information Theoretic Model Averaging
**George Kapetanios** (University of London)

30 Nov. 2005 — Downward Nominal Wage Rigidity in the OECD
**Steinar Holden** (University of Oslo)

23 Nov. 2005 — On the Hump-Shaped Output Effect of Monetary Policy in an Open Economy
**Christian Pierdzioch** (Universität des Saarlandes)

16 Nov. 2005 — International Price Dispersion and the Direction of Trade
**Marios Zachariadis** (University of Cyprus)

9 Nov. 2005 — The Effect of Unemployment Compensation on Unemployment Duration
**Bernd Fitzenberger** (University of Frankfurt)

2 Nov. 2005 — Evaluating the New Keynesian Phillips Curve: Evidence for Canada
**Stephen Murchison** (Bank of Canada)

**26 Oct. 2005 — Cultural Biases in Economic Exchange**
**Luigi Guiso** (University of Chicago)

19 Oct. 2005 — Bank Competition and Fragility Revisited: New Theory and New Empirics
**John Boyd** (University of Minnesota)





# CFS*research conferences*

## International Conference on
## Public Versus Private Ownership of Financial Institutions

Call for papers

**Venue and Date:** **Frankfurt, 17 and 18 November, 2006**
**Deadline:** **15 June, 2006**

The Center for Financial Studies (CFS) together with the Deutsche Bundesbank and the Wharton Financial Institution Center (WFIC) invites the submission of theoretical, empirical and policy-oriented papers on the implications of the ownership structure of banks, insurance companies and other financial institutions.

The submission of research and policy papers on the following topics is particularly encouraged:

- Effects of government and cooperative ownership on performance, competition, credit availability, stability of the financial sector, and the ability to adapt to technological change (risk sharing, crisis resolution, and specific regulatory measures).
- Relationship between corporate governance and ownership of financial institutions (cooperative, public sector, and central banks).
- Other forms of state involvement in the financial sector (role of national champions, postal banks, mortgage-back securities, investment programs, private-public hybrid institutions).
- The process of consolidation within and across different ownership structures, regions and countries.
- Experiences with privatization and financial sector reforms around the world.

Interested authors should submit their draft papers electronically (in pdf format) together with full contact information to Isabelle Panther at ownership@ifk-cfs.de by 15 June, 2006. Contributors will be notified at the beginning of September 2006.

**Further information can be found at: http://www.ifk-cfs.de/English/content/veranstaltungen/data/20061117Public.htm**

## CFS Summer School 2006
## 13 – 20 August, 2006

*Training Center of the Deutsche Bundesbank Eltville (near Frankfurt am Main), Germany*

### "Empirical Asset Pricing"

**Organized with the support of the Deutsche Bank Prize in Financial Economics 2005 under the auspices of the winner Eugene Fama**

The Finance Summer School on "Empirical Asset Pricing" is organized by Erik Theissen (University of Bonn) and Jan Pieter Krahnen (University of Frankfurt and CFS).

**Faculty:** Erik Theissen (University of Bonn): Classical Tests of Asset Pricing Models
Joachim Grammig (University of Tübingen): Stochastic Discount Factor models
Lubos Pastor (University of Chicago): Bayesian Asset Pricing.

### "Empirical Macroeconomic Modeling"

The Macro Summer School on "Empirical Macroeconomic Modeling" is organized by Michael Binder (University of Frankfurt and CFS)

**Faculty:** Charles M. Engel (University of Wisconsin, USA): Empirical Models of Exchange Rates
Philip E Lane (Trinity College Dublin, Ireland): Modeling External Balances
Kenneth D. West (University of Wisconsin, USA)
Michael Binder (University of Frankfurt): Dynamic Panel Modeling in Macroeconomics

As in previous years, participants will also have the opportunity to present their own work.

**Further information can be found at: www.ifk-cfs.de**

# The BSI Gamma Foundation-CFS Conference on "Behavioral Finance 15 March 2005

**The conference organized by the BSI Gamma Foundation and the Center for Financial Studies brought together many people from the academic world and the private sector. New studies on behavioral finance were presented, followed by fruitful discussions. The event shed light on the debate about the rationality of financial markets and on how researchers and practitioners evaluate the issue.**

The opening speech was held by **René Stulz** (Ohio State University and BSI Gamma Foundation) and **Jan Pieter Krahnen** (University of Frankfurt and CFS). René Stulz introduced BSI Gamma Foundation's range of activities. BSI Gamma Foundation, which is a private Swiss foundation established by BSI Lugano, was also involved in the organization of the first conference on behavioral finance held in Zurich in December 2005 in collaboration with the University of Zurich and NCCR FINRISK.

The first paper, presented by **Alok Kumar** (University of Notre Dame; co-authored by Warren Bailey and David Ng, both Cornell University), examines the determinants of the choice of individual stocks versus stock mutual funds. Their study provides evidence of sophisticated and unsophisticated mutual fund clienteles whose portfolio decisions are influenced by the characteristics of the peer group they belong to. The authors also find that mutual fund investments are lower in states with favorable lottery environments.

**Izhak Ben-David** (University of Chicago) gave a talk on his work with John A. Doukas (Old Dominion University), in which they test whether the quality and availability of information affect trading behavior of institutional investors. They find that institutional investors exhibit 'cut losses/ride gains' behavior with respect to purchase price and they are reluctant to realize losses with respect to 'ever-high' price.

The third paper, presented by **Enrico De Giorgi** (University of Lugano; co-authored by Thorsten Hens and Janos Mayer, both University of Zurich), incorporates prospect theory into classical portfolio theory. De Giorgi et al. discuss the two-funds separation and the asset allocation puzzle, and they suggest a risk-reward representation of Prospect Theory that uses mean-variance analysis without running into asset allocation puzzle.

The afternoon session was started by **Gurdip Bakshi** (University of Maryland), presenting joint work with Liuren Wu (Baruch College) on investor irrationality in relation to the Nasdaq bubble. The aim of the paper is to empirically investigate competing explanations of the bubble. Their finding is in line with the hypothesis that "investors are driven by irrational euphoria with systematic shifts in the market prices of risks", as studied by Greenspan, Shiller (2000) and Shleifer (2000). In addition, Bakshi and Wu assume more rationality for the option market compared to the stock market by linking the logic behind hedging to the rational behavior of investors.

The next presentation was held by **Andrei Simonov** from the Stockholm School of Economics. Simonov and Massimo Massa (INSEAD and CEPR) analyze the link between social interaction and portfolio choice by focusing on college-based interaction and using Swedish data. They find evidence that all different sources of social interaction affect stock-picking where college-based interaction has a greater explanatory power compared to other forms of social interaction.

The last presentation of the conference was on a paper by Daniel Dorn (Drexel University) and **Gur Huberman** (Columbia University), which uses survey responses and trading records of a German broker. The paper studies the causes for the apparent failure to buy and hold a well-diversified portfolio. It presents the investigation on the correlation between trading intensity and gender, age, wealth, education and judgment-based characteristics such as knowledge, risk aversion and over-confidence. The main findings show that men trade more, as do those with access to more information, whereas those who are risk-averse trade less.

The final session of the conference chaired by **Jan Pieter Krahnen** (University of Frankfurt and CFS) was an open discussion on the merits of behavioral finance research for fund management. The panel started with **Lukas Menkhoff** (University of Hannover) where he discussed the links between his research on momentum puzzle and the needs of fund management. **Joachim Goldberg** (Cognitrend) explained his motivation for behavioral finance by focusing on 'losers' and how to find out the reference points of losers since they are never able to exit the market. **Stefan Rehder** (Bayern LB) presented how they integrate behavioral finance in their 'value added chain'. He also stated that they make use of empirical academic research in the job. **Manfred Huebner** (Deka) also believes that behavioral finance has better explanations. For that reason fund managers try to track and analyze investor behavior in a systematic way. Finally, **James Montier** (DrKW) presented the results of a questionnaire which shows evidence of illusion of control for managers, confirmatory bias in the industry and high preference reversal. The discussions showed that the research on behavioral finance is also relevant for practitioners and that fund managers make use of models integrating behavioral aspects in their decisions. In addition, much of research in practice is geared towards the sales side. Consensus was reached on the importance of behavioral finance with the following statement: "Human beings make mistakes which should be taken into consideration."

**The complete conference program including papers and presentations can be found at: http://www.ifk-cfs.de/English/content/veranstaltungen/data/20060315Behavi.htm**

*Günseli Tümer-Alkan (CFS research staff)*

# DSGE Modeling at Policymaking Institutions

**The conference on DSGE Modeling at Policymaking Institutions was held in Washington DC on 2 and 3 December, 2005 and was sponsored by the International Monetary Fund (IMF) and the International Research Forum on Monetary Policy. The Forum comprises the European Central Bank (ECB), the Federal Reserve Board (FRB), the Center for Financial Studies (CFS) and the BMW Center for German and European Studies at Georgetown University. The sponsoring institutions were represented by Matthew Canzoneri (BMW Center for German and European Studies at Georgetown University), Dale Henderson (FRB), Gian Maria Milesi-Ferretti (IMF), Lucrezia Reichlin (European Central Bank) and Volker Wieland (University of Frankfurt and CFS), who had jointly organized the program. The papers presented at the conference will be considered for a special issue of the *Journal of Economic Dynamics and Control*.**

The conference had two main objectives: to consider applications of the dynamic stochastic general equilibrium (DSGE) models constructed at some policymaking institutions and to assess what must be done to make such models useful in practical policymaking.

Recent years have seen significant progress in explaining macroeconomic fluctuations in a dynamic stochastic general equilibrium (DSGE) setting. Macroeconomic models nowadays seek to combine sound economic foundations at the individual decision-maker level (consumers, firms and other agents in the economy) with some necessary frictions in the Keynesian tradition. A unified modeling strategy of this kind offers a coherent framework for policy analysis. Not surprisingly, policymaking institutions have welcomed the DSGE framework and have also made their significant contribution towards extending the research frontier. It was in this context that the CFS*research conference* "DSGE Modeling at Policymaking Institutions: Progress and Prospects" was held in Washington, aiming to provide both a status report and an outlook for future developments in the area.

The conference brought together participants from a wide international range of central banks (such as central banks from Europe, America, Japan, Korea and New Zealand), as well as policymaking institutions like the IMF and the U.S. Congressional Budget Office, and also leading academics, many of who are renowned for their research in this field.

The first day of the conference began with a presentation by **Guenter Coenen** (ECB) on an application of tax reform to the euro area. Guenter Coenen (ECB), Peter McAdam (ECB) and Roland Straub (IMF), using the ECB's New Area-Wide Model, concluded that lowering taxes to levels prevailing in the U.S. would result in an increase of euro land output by more than 10 percent.

The second paper by **Ippei Fujiwara** and **Yuki Teranishi** (both Bank of Japan) argued that, in an ageing economy, the channels by which monetary policy affects activity are likely to change. In a DSGE model for Japan, however, they concluded that demographics hold only minor implications for the monetary policy setup. There may, however, be non-trivial distributional and politico-economic aspects.

The third presentation focused on the estimation of a structurally rich open-economy DSGE model for Sweden. **Malin Adolfson** (Swedish Riksbank) presented work co-authored by Stefan Laseen, Jesper Lindé and Mattias Villani (all Swedish Riksbank). The paper's main analysis aimed at replicating the persistence in the real exchange rate that is currently lacking in most of the literature.

The afternoon session began with a paper by **Michel Juillard** (Université de Paris and CEPREMAP), Michael Kumhof (IMF), Douglas Laxton (IMF) and Ondra Kamenik (Czech National Bank). Michel Juillard showed that the paper allowed for a more flexible price-setting specification than most of the literature and for permanent shocks to technology. The authors estimated their model using U.S. data. Their modifications lead to a sizeable share of business cycle variation over longer horizons being explained by technological advances.

The next paper by **Stephen Murchison** and **Andrew Rennison** (both Bank of Canada) used the Bank of Canada's projection model and found that monetary policy was influential in shaping high inflation persistence and strong exchange rate pass-through in the 1970s.

A paper by **Lawrence Christiano** (Northwestern University), Massimo Rostagno (ECB) and Roberto Motto (ECB) concluded the presentations for the first day by presenting the results of an application of the DSGE paradigm to the issue of "Bubbles, Financial Shocks, and Monetary Policy".

The second day of the conference began with a presentation by **Rochelle Edge** (FRB) of work co-authored by Michael Kiley and Jean-Philippe Laforte (both FRB). This showed an estimated two-sector model of the U.S. economy. They argued that allowing for different real growth rates for different expenditure categories may be the key to generating reliable measures of importance – such as potential output.

Next, **Christopher Sims** (Princeton University) discussed his ideas on how to improve the current state-of-the-art modeling in monetary policy by addressing methodological issues. Despite all the progress made to date, in order to have real impact on policy, projections from DSGE models need to be well communicated to decision-makers.

The final paper of the morning session was presented by **Pedro Alvarez-Lois** (Bank of England; co-authored by Richard Harrison, Laura Piscitelli and Alasdair Scott, all Bank of England), who argued that the issue of communication deserves more interest from the community. A lack of clear communication might otherwise hinder more widespread (and beneficial) influence of DSGE-type inference on policymaking.

After a general discussion and lunch, research by **Hamid Faruqee** (IMF), Douglas Laxton (IMF), Dirk Muir (Bank of Canada) and Paolo Pesenti (Federal Reserve Bank of New York) was presented. They used a dynamic, multi-region model of the world economy to discuss the viability of eradicating both the world macroeconomic imbalances that have emerged since the start of the decade and possible effects on world economic activity. Their work outlines the impact on specific groups of countries under different policy scenarios.

The conference concluded with a presentation of work by **Christopher Erceg**, Christopher Gust and Luca Guerrieri (all FRB). Using the FRB's open-economy DSGE model, they illustrated that accounting properly for the composition of trade flows in DSGE models can make a vast difference when it comes to analyzing the effects of trade shocks.

A number of excellent discussions followed each of the presentations.

It is expected that the special issue of the Journal of Economic Dynamics and Control, currently under preparation, will become an important point of reference in the coming years, not only for academic researchers but also for practitioners at policymaking institutions and in the private sector.

*Keith Küster (University of Frankfurt)*





## Third RICAFE Conference „Entrepreneurship, Risk Capital and the Financing of Innovative Firms“

**The 3rd annual RICAFE Conference was held at Fondazione Collegio Carlo Alberto, Moncalieri near Turin on 18 and 19 November, 2005. The conference, which was attended by participants from both sides of the Atlantic, attracted high quality papers relating to various aspects of venture capital (VC). The conference program comprised four sessions, each with a different thematic focus, i.e. entrepreneurship, venture capital contracting, the effects of venture capital financing, and entrepreneurial firms going public.**

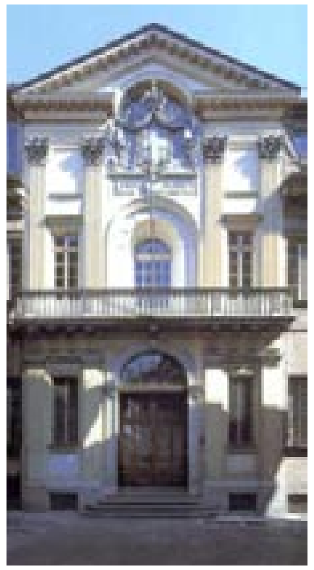

Photo has been kindly provided by the city of Moncalieri and was taken from the book "Il Reale Collegio e i barnabiti a Moncalieri - Educazione e custodia delle memorie", eds. Filippo Gallino, Celid-Torino.

The initial session, chaired by **Alessandro Sembenelli** (University of Turin), focused on entrepreneurship. **Frédéric Palomino** (HEC Paris) presented the first paper in the session, "Risk Aversion and Entrepreurship" (co-authored by Eloïc-Anil Peyrache , HEC Paris). This paper is based on the observation that most research explicitly distances itself from studying the impact of the entrepreneur's risk aversion. Risk aversion, however, has a first-order effect on the decision to become an entrepreneur. Therefore, the authors discuss by means of a base model the effect of such an assumption relative to that of risk neutrality. In a second step, the authors discuss 'job-back guarantees', a wide-spread instrument that allows entrepreneurs to return to their old job in the event that their venture turns out to be unsuccessful.

The second paper in this session, entitled "What are Firms? Evolution from Birth to Public Companies", was presented by **Per Strömberg** of the Stockholm Institute of Financial Research (co-authored by Steve Kaplan, University of Chicago, and Bengt Sersoy, University of Chicago). In this work, the authors use a proprietary data set of 49 venture capital-financed firms to analyze how young, entrepreneurial firms develop and transform into mature, listed firms.

The session's third paper, devoted to "Mixing Family with Business: A Study of Thai Business Groups and the Families Behind Them", was presented by **Antoinette Schoar** (MIT; co-authored by Marianne Bertrand, University of Chicago, Simon Johnson, MIT, and Krislert Samphantharak, University of California, San Diego). It explores how family dynamics affect the organization, governance, and performance of business groups. To perform this analysis, the authors create a unique dataset that contains the family trees of approximately 100 of the largest business groups in Thailand.

The second session of the conference dealt with venture capital contracting and was chaired by **Frédéric Palomino** (HEC Paris). **Stefan Arping** (University of Amsterdam) presented the first paper of this session entitled "The Ownership and Implementation of Ideas". The paper develops a model in which success in a project depends on entrepreneurial effort.

The second paper on "The Design of Syndicates in Venture Capital" was presented by **Lucy White** (Harvard Business School; co-authored by Giacinta Cestone, University of Salerno, and Josh Lerner, Harvard Business School). The paper seeks to provide a better understanding of the design of venture capital syndicates across two dimensions. It analyzes, first, who chooses to syndicate with whom and, second, the financial claims used in syndication to mitigate incentive and information problems.

The final paper in the second session investigating "The Dynamics of Venture Capital Contracts" was presented by **Carsten Bienz** (FMG and CFS; co-authored by Julia Hirsch, University of Frankfurt and CFS, Frankfurt). The authors analyze the degree of contract completeness with respect to the staging of venture capital investments using a hand-collected German data set of contract data.

The third session focused on the effects of venture capital financing and was chaired by Professor **Uwe Walz** (University of Frankfurt and CFS). **Merih Sevilir** (University of North Carolina) presented the first paper in this session entitled "Size and Focus of a Venture Capitalist's Portfolio" (co-autho-

red by Paolo Fulghieri, University of North Carolina). Sevilir presented a theoretical model aimed at addressing a number of questions, i.e. what determines the size and scope of a VC's portfolio, and how does size affect performance? Given the scarcity of VC human capital, is it better to concentrate all resources on a single start-up, or to spread resources over many start-ups? On the basis of the analysis, the paper is able to identify three main effects of portfolio size on entrepreneurial and VC incentives: (i) the value dilution effect, (ii) the rent extraction effect, and (iii) the resource allocation effect. The interaction between the above three effects produces several implications for the way the VCs form their portfolio.

The second paper of the session, "Whom you know matters: Venture Capital Networks and Investment Performance", was presented by **Yael Hochberg** (Northwestern University; co-authored by Alexander Ljungqvist, New York University, and Yang Lu, New York University). Networks feature prominently in the VC industry, and this paper investigates empirically the performance consequences of the organizational choice made by VCs, especially in syndication networks. The paper uses graph methodology to derive measures of networking.

**Marco Da Rin** (University of Turin) presented the last paper of the session on the "Endogenous Matching and the Performance of Venture Capital Backed Companies" (co-authored by Marina Di Giacomo and Alessandro Sembenelli, both University of Turin). This paper tries to answer empirically the question asking which venture capital firms make companies in their portfolio grow faster. They use a novel framework by accounting for the endogenous matching between a VC and the entrepreneur, and in the process, they make an important methodological contribution to the literature.

Session 4, which was chaired by **David Webb** (FMG/LSE), was concerned with IPOs and the decision to go public. **François Derrien** (University of Toronto) presented a study on "Analyst Hype and Bookbuilding" (coauthored by François Degeorge, University of Lugano, and Kent Womack, Tuck School of Business, Dartmouth College). In this study of the French stock market from 1993 to 1998, the authors compare two popular methods of determining the price of new issues, i.e. auctions and bookbuilding. Motivated by the stylized fact that bookbuilding results in higher underwriter fees than auctions, they embark on a thorough investigation of why bookbuilding has nevertheless proved to be the more popular method in recent years.

In the second talk of the session, **Andrew Ellul** (Indiana University) presented a paper on "External Governance and Debt Agency Costs of Family Firms" (co-authored by Levent Guntay, Indiana University, and Ugur Lel, Board of Governors, Federal Reserve System). The presentation began with the observation that while the presence of large blockholders in firms may solve conflicts of interests between shareholders and managers, it also creates problems of its own. However, as the authors point out, outstanding bonds may have disciplining effects on blockholders. This effect may be less pronounced for firms operating in weaker legal environments.

In the final presentation of the conference, **Thomas Chemmanur** (Boston College) spoke about "The Going Public Decision and the Product Market" (co-authored by Shan He, Boston College, and Debarshi Nandy, York University). Exploiting an unprecedented data-set made available by the US Bureau of Census, the authors study firms that go public before and after their entry to the stock market. The authors are especially interested in studying the effects that the decision to go public has on the firm's product market behavior. Relying on their data set, the authors are able to show that a firm's productivity peaks within a year of them going public.

*Synopsis of the Conference Summary by Sridhar Arcot (FMG/LSE) and Carsten Bienz (CFS and FMG/LSE)*





**The research network focusing on Risk Capital and the Financing of European Innovative Firms (RICAFE) includes researchers from the London School of Economics and Political Science (Financial Markets Group), the Center for Financial Studies, the HEC School of Management, Paris, and the University of Turin.**
**RICAFE is sponsored by the European Commission, DG-Research. It aims to provide research breakthroughs in the economics of risk capital financing of innovative companies, and to offer informed, insightful research advice to the Commission.**

**Further details about the network together with the full Conference Summary can be found at: http://www.lse.ac.uk/collections/RICAFE**




## Second Conference of the Second Phase of the ECB-CFS Research Network on „Capital Markets and Financial Integration in Europe“

*hosted by the Oesterreichische Nationalbank in Vienna*

**On 14 and 15 November, 2005, the Second Conference of the Second Phase of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe" was hosted by the Oesterreichische Nationalbank in Vienna. The topic of the conference was "European Economic Integration: Financial Development, Integration and Stability in Central, Eastern and Southeastern Europe", addressing, in particular, the network priorities of EU accession, financial development and financial integration.**

**The Network was launched by the European Central Bank (ECB) and the Center for Financial Studies (CFS) in 2002 as a Research Network to promote research on "Capital Markets and Financial Integration in Europe". In its second phase, the scope of the network was also extended to include the new EU Member States.**

The conference combined key lectures, research paper presentations, and two plenary panel discussions. The following summary describes the key lectures and panel discussions that were held.

The first keynote lecture was given by **Cesare Calari** on "Benefits and risks of financial integration". In this lecture, Calari stressed that financial integration between regions typically precedes trade relations and not the other way around. He referred, in this context, to recent research at the World Bank supporting the view that financial development promotes real economic growth. Financial deepening and financial integration are strongly interrelated and can mutually reinforce each other. In addition to a monetary union that certainly improves financial integration, Calari mentioned other important elements

**Cesare Calari,** Copyright by OeNB

that would increase efficiency in capital allocation and improve overall stability. He warned, however, that some of these elements could also be sources of instability. For instance, increased competition through foreign banks could, in his view, increase the incentives to take excessive risks. According to Calari, a way to rule out such perverse effects and ensure that integration indeed improves financial stability is to foster the quality of foreign bank entry. Calari welcomed the regulatory convergence owing to the Basel II Accord as representing a big step towards fewer risks from financial integration and foreign bank entry. He also pointed out that some countries may not yet be sufficiently prepared for the introduction of such complex regulations. In the subsequent discussion of his lecture, Calari elaborated on the consequences of the introduction of Basel II.

**Klaus Liebscher ,** Copyright by OeNB

The first panel discussion on the current state and future prospects for the financial sector in central and eastern European countries (CEECs) was chaired by Governor **Klaus Liebscher** (Österreichische Nationalbank). **Alexandre Lamfalussy** (former President of the European Monetary Institute) recalled the Financial Services Action Plan's (FSAP) aim to establish the regulatory framework that is essential for an integrated EU financial market. In her presentation, **Irmfried Schwimann** (Head of Unit, DG Internal Market, European Commission) argued that financial sectors in CEE are small and largely bank-based. She argued that financial sectors could be expected to deepen. **Stefan Zapotocky** (CEO, Wiener Börse AG) presented the ongoing project on the "Central European Exchange Alliance", a project initiated by the Wiener Börse, that aims at improving cooperation between stock exchanges located in CEECs. **Cristian Popa** (Deputy Governor, Banca Natională a Românei) emphasized the rapid credit growth observed in many countries in the region. He pointed to the limits of the traditional monetary and exchange rate policy instruments in this context.

**Alexandre Lamfalussy ,** Copyright by OeNB

**Erik Berglof** (Stockholm School of Economics) delivered the second keynote lecture, "Catching up: financially integrating Europe". Berglof gave a survey of the key issues and challenges to financial integration in western, central, and eastern European countries. First, he noted that western European countries had undertaken many reforms to promote financial integration. Moving on to Central and Eastern Europe, he talked of the outstanding economic growth that these countries have achieved over the last 15 years. These countries began their transition from different starting points but today there is evidence of systematic convergence. He argued that further financial

**Erik Berglof,** Copyright by OeNB




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development and integration in the EU-25 will depend on continued improvements in the institutional environment, in particular, improved enforcement of existing laws and regulations, and stronger corporate governance.

On the second day, **René Stulz** (Ohio State University) gave the third keynote lecture on "Financial globalization, corporate governance, and eastern Europe". Stulz observed that the most significant barriers to trade in financial assets have been removed. As a consequence, the neo-classical model predicts the financial world to be "flat", meaning that investors worldwide should allocate capital more efficiently. Nevertheless, poor corporate governance and high political risk (the "twin agency problems") prevent the providers of capital from fully reaping their investment returns.

**René Stulz,** Copyright by OeNB

The second panel discussion on "Financial integration and commercial bank strategies in the central and eastern European countries (CEECs)" was chaired by **Josef Christl** (Oesterreichische Nationalbank). In his introductory statement, Josef Christl explained how commercial banks could expect to benefit from financial integration. Banks can, for example, realize economies of scale and scope by conducting business in a single and integrated financial market. Credit institutions benefit from a harmonized legal framework, since this significantly reduces the costs of compliance with regulatory and supervisory rules. The removal of cross-country differences in national interest income taxation should benefit European banking. **Alessandro Profumo** (UniCredito Group) stressed the size of the CEEC markets and the strong economic growth already achieved as well as future growth potential. The high degree of complexity of the region makes it necessary to integrate

**Josef Christl,** Copyright by OeNB

different banking models and strategic approaches for different countries in order to allow people with different languages and cultural backgrounds to work fruitfully together. In just six years, UniCredito has made a number of

**Alessandro Profumo,** Copyright by OeNB

large acquisitions. **Laszlo Wolf** (OTP Bank) focused on how shareholders' value can be raised, i.e. either through operational improvements or through acquisitions. **Reinhard Ortner** (Erste Bank) spoke about the banking sector consolidation in the US. Since they are well capitalized and have large amounts of cash at their disposal, US banks, he argues, may leapfrog into Europe in the future. In order to consolidate further, however, the European banking sector will need to promote and develop cross-border transactions. **Frederik von Dewall's** (ING Bank) contribution was devoted to "Financial integration and commercial bank strategies". In his view, central, eastern and south-eastern Europe are promising regions for banks, but they have to compete with other areas, such as China and India. Still the shares of CEE in world GDP are likely to considerably increase over the next two decades. Given the weak demographics in CEE, this implies that particularly strong per capita GDP expansion will be required in this region.

*Synopsis of Conference summary*

**The complete Conference summary, written by ECB and Oesterreichische Nationalbank staff, can be found at: http://www.eu-financial-system.org/past.html**

## Upcoming Conferences of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe"

Call for papers

**The 3rd Conference of the ECB-CFS Research Network on "Financial System Modernization and Economic Growth in Europe" will be hosted by the Deutsche Bundesbank in Berlin on 28-29 September, 2006. The European Central Bank (ECB), the Center for Financial Studies (CFS), and the Deutsche Bundesbank are inviting the submission of papers to this conference.**

The objectives of the conference are to present state-of-the-art international research on how improvements in the functioning of financial systems and related policies influence behavior and enhance economic performance as well as long-run growth prospects, especially in Europe, and to provide a forum for debate among market participants, policy makers and researchers. Relevant empirical, policy-oriented, and theoretical research will be considered.

Keynote speakers will be: **Philippe Aghion** (Waggoner Professor of Economics, Harvard University), **Thomas Mayer** (Chief European Economist, Deutsche Bank London), **Axel Weber** (President, Deutsche Bundesbank).

**More information can be found at www.eu-financial-system.org**

The 4th conference of the network will be hosted by the Bank of Spain on 30 November and 1 December 2006. The main focus here will be on the network priority with respect to the relationship between financial integration and financial stability.





## New Perspectives on Fiscal Sustainability CFS-ZEI Research Conference held on 13-14 October, 2005

**The fiscal performance of a number of industrial and emerging-market countries has given cause for concern over recent years, during which even major EMU members have repeatedly failed to meet the requirements of the Stability and Growth Pact (SGP). Increasing debt burdens are in many instances further aggravated by unfavorable demographic dynamics. When does a fiscal policy become unsustainable, and what rules and incentives are most suited to prevent such development? These and related questions were addressed at a conference on "New Perspectives on Fiscal Sustainability", organized jointly by Jürgen von Hagen (Center for European Integration Studies (ZEI)), Ludger Schuknecht (European Central Bank) and Volker Wieland (CFS), and held on 13 – 14 October, 2005, at University of Frankfurt's Campus Westend.**

**Volker Wieland**

After welcoming remarks by **Volker Wieland, José Manuel González-Páramo** of the ECB's Executive Board opened the conference with a keynote speech on the fiscal consolidation required by the Stability and Growth Pact (SGP) and called the effort to date a 'mixed success'. In particular, he highlighted the considerable challenges posed by the SGP, whose rules were met by only three out of the twelve member countries.

The first session looked at "Sustainability and Stabilization" and started with an analysis of optimal fiscal policy in a monetary union by **Luisa Lambertini** (Boston College). In a two-country model with sticky prices and a common independent central bank, increases in government spending will be optimally financed through a combination of budget deficits and higher income taxes. Optimal fiscal policy is country-specific and tightens as the Debt/GDP ratio grows, while optimal monetary policy is more aggressive on impact than is prescribed by an interest-rate rule. The optimal fiscal policy results in a more stable income-tax rate than with a deficit limit as is the case under the SGP, the welfare cost of which amounts to 0.7 per cent of steady-state consumption.

The frictions resulting from combining a single monetary policy with decentralized fiscal policies were the focus of **Leopold von Thadden** and **Jean-Pierre Vidal** (both ECB), in their joint work with the late **Philippe Michel** on debt-stabilizing fiscal rules. In their OLG model, the authors found that due to the resulting distortions, the parameters of an optimal debt-targeting rule using all available fiscal instruments will be contingent on the exact target level of debt.

**Ludger Schuhknecht**

Since the instrument-specific adjustment paths for a particular targeting rule become increasingly diverse as the debt level rises, in the extreme beyond a certain

**José Manuel González-Páramo**

debt level, there may not exist a debt-targeting rule that can be implemented under all instruments. Hence, to preserve an unrestricted choice of fiscal-policy instruments at the national level within a monetary union, that union's common fiscal framework should aim for a sufficiently low target level of debt.

In the next session, **Ester Faia** (Universitat Pompeu Fabra) discussed sustainable price stability policies under a monetary union and in the face of free-riding fiscal policies. In her two-country DGE model, there is a game of strategic interaction between the independent national fiscal authorities within a monetary union and the common central bank. By

Ester Faia

comparison to the Ramsey outcome, in this non-cooperative dynamic game the sequential policy choices result in excessive nominal debt and an inflation bias when there are nominal government bonds. The sub-optimality of the Markov-perfect equilibrium is due to a co-ordination failure as the welfare costs of inflation – caused by a cash-in-advance constraint – are shared by all union members, leading to a free-rider problem. The Ramsey outcome could nonetheless be achieved by the use of trigger strategies.

In the last presentation of the first conference day, **Per Eckefeldt**, **Elena Flores**, and **Ingvild Strømsheim Wold** (all European Commission) gave an overview of the EU's approach to assessing the sustainability of public finances in its member states. As the demographic trends in Europe differ significantly from those in the rest of the world, and also from those in the U.S., long-term projections of budgetary developments in EU member states that allow for a meaningful comparison are crucial. It turns out that the majority of EU member states face significant risks to the sustainability of their public finances. To achieve long-term sustainability, the EU would need to improve permanently its national budget positions by about 3% of GDP on average. However, further refinements of the available assessment tools could make the analysis more robust via, for example, the use of comparable, common budgetary projections and enhanced sensitivity tests. Another important improvement would be an assessment of the impact of structural reforms, which could be achieved by introducing a balance-sheet approach that would provide an estimate of a government's net worth and any projected changes therein resulting from such reforms.

The first conference day ended with a keynote speech by **Otmar Issing**, Member of the Executive Board and Chief Economist of the ECB. Mr. Issing focused on the scope and limitations of fiscal policy and briefly addressed the question to which degree it should interact with monetary policy. Ever since the historic discourse between Keynesians and monetarists and Friedman's argument for a k-percent rule for money growth, have the benefits of active stabilization policies been subject to debate. In the euro area, the central bank is guaranteed institutional independence and has the clear mandate to maintain price stability. Due to its high degree of credibility, it is able to anchor inflation expectations and thereby contributes to a stable macroeconomic environment. Fiscal policy, on the other hand, can act counter-cyclically through a deliberate attempt to offset short-run swings in economic activity. While so-called automatic stabilisers – such as taxes and transfers – work in a timely and symmetric manner, active discretionary fiscal policy has shown a less successful track record in stabilizing the economy, as documented by experience and the deficit bias in many of the prospective member states prior to the start of EMU. In Mr. Issing's view, discretionary fiscal policy is more suitable






for reacting to long-term developments or exceptional circumstances, and hence plays a crucial role in the effort to preserve fiscal sustainability. While an explicit co-ordination of fiscal and monetary policies would suffer not least from a lack of enforceability, the predictability of monetary policy enables the fiscal authorities to achieve outcomes that could ex post be seen as an implicit co-ordination of policies. Similar to monetary policy, fiscal policy should be guided by a longer-term perspective, leaving the correction of temporary swings to automatic stabilization instruments.

The second conference day started with a session on "Financial Markets", beginning with a study by **Kirsten Heppke-Falk** (Bundesbank) and **Felix Hüfner** (OECD) of the impact of projected budget deficits on the interest-rate swap spreads of France, Germany, and Italy during 1994-2004. While there was no significant impact over the period as a whole, the spreads of France and, in particular, Germany seem to have become more sensitive to the projected deficit ratio over time, both with the signing of the SGP and after the start of EMU. An increase in the projected deficit/GDP ratio by one percentage point was found to lead to a tightening of the (negative) swap spread by 2-7 basis points. This finding was interpreted as an indication of an increase in market discipline because of higher perceived default risk resulting from the introduction of a single monetary policy.

**Thomas Stratmann** and **Bernhard Akitoby** (both IMF) went one step further and analyzed how the composition rather than just the size of fiscal adjustments affects sovereign risk spreads. Based on a panel of emerging-market countries, their analysis showed that expenditure reductions have larger and more significant effects on spreads than increases in tax revenue. Specifically, cuts in current spending have a stronger effect on spreads than reductions in public investment, and international investors are shown to have a slight preference for spending increases financed by taxes rather than by debt. Furthermore, sovereign spreads are also affected by macroeconomic fundamentals as well as by a country's liquidity position and solvency, all of which should therefore be taken into account when setting economic policies.

Long-term interest rates and their reaction to an accumulation of government debt were the focus of **Manfred Kremer** (ECB), **Paolo Paesani** (University of Rome "Tor Vergata"), and **Rolf Strauch** (ECB). Looking at the U.S., Germany, and Italy for the period 1983-2003 and decomposing the respective long-term interest rates into a permanent and a transitory component, the paper finds that a deteriorating fiscal position significantly raises the transitory component of the long-term rate in all three cases, but has an ambiguous impact on the permanent component. Adverse fiscal shocks are shown to have a negative long-term impact on the three economies by driving up real long-term interest rates (except for the U.S.) and by causing the yield curve to become steeper. Moreover, there are strong linkages between the three transitory components making these long-term interest rates susceptible to international spill-

Volker Wieland, Ludger Schuhknecht

over effects, in which the impact of the U.S. interest rate on that of Germany and Italy is particularly strong and significant.

The third and final session of the conference, under the heading "Political Economy" started with **Anthony Annett** (IMF) and his evaluation of the changes in European fiscal policies in response to the SGP. While fiscal policy has generally seen an improvement under the Maastricht and SGP frameworks, countries that rely on fiscal rules and contracts with strict budget targets ('commitment') have fared relatively better under the SGP than those countries that delegate the budget process to a body or, more typically, to a single person ('delegation'). Given that all new EU member states, except Hungary and Slovenia, fall under the commitment category, it is vital that the SGP continues to provide an external anchor for fiscal policy. For countries of the delegation type, and particularly for those that have been facing problems enforcing the SGP, a mechanism that raises the reputational costs of non-compliance, e.g. the establishment of an independent fiscal council, should – in combination with the reforms to the SGP – help to overcome some of the problems in maintaining budget discipline.

Japan's fiscal situation and the sustainability of its fiscal policy were discussed by **Takero Doi** (Keio University), **Toshihiro Ihori** (University of Tokyo), and **Kiyoshi Mitsui** (Gakushuin University). Their study compares the actual indebtedness of Japan against established sustainability tests in the literature, and leads to mixed conclusions. Based on the maturity structure of outstanding debt, a further reliance on government bonds – rather than changes in the budget – is found to be optimal for the next ten years, when the vast majority of outstanding bonds mature, after which a gradual reduction in the reliance on government bonds will be necessary. Moreover, the interaction of the fiscal and monetary authorities in light of a possible bond default is examined, and specific debt management recommendations based on theoretical models and numerical simulations are derived. Specifically, the existence of a default trigger level of public debt as well as an incentive to issue debt strategically are shown. The strategic behavior of the fiscal authorities in turn induces an inflation bias in monetary policy in an attempt to increase seigniorage. To eliminate the distortions, an institutional ceiling on debt issuance is suggested.

The session and the conference concluded with **Martín Gonzalez-Eiras** (Universidad de San Andrés) and **Dirk Niepelt** (Stockholm University), who looked at the sustainability of intergenerational transfers by embedding in an OLG model the electoral competition for the choice of social-security transfers, based on probabilistic voting. The transfers arising in politico-economic equilibrium tend to be higher than those at the social optimum, since in the process of resolving the distributive conflict between young and old, part of the transfer costs are shifted to future generations. In addition, population ageing is found to give rise to larger social security systems with social-security tax rates close to the actual rate observed in the U.S., which is higher than the Ramsey tax rate. Despite the higher tax rate, however, benefits per retiree will eventually fall. Due to its closed-form solutions, the model lends itself to various extensions, all of which show the results to be robust.

*Marcus Pramor (CFS Staff)*

**The complete conference program including papers and presentations can be found at: http://www.ifk-cfs.de/English/content/veranstaltungen/data/20051013NewPer.htm**





# Otmar Issing
# The First Chief Economist of the ECB

**Otmar Issing has been a member of the Executive Board of the European Central Bank since June 1998. For the last 8 years he was responsible for the economics and research departments of the ECB, for the preparation of the ECB's forecast and the ECB's Monthly Bulletin, and for presenting the forecast and policy alternatives to the decision-making council. Thus, he has rightly been called the ECB's 'Chief Economist'. He was uniquely qualified for this role having already held this position successfully at the Deutsche Bundesbank for 8 years prior to his appointment to the ECB. The very high degree of respect he has earned in this position is evident in the comments we have received from policymakers, academics, bankers and professional ECB watchers.**

Otmar Issing

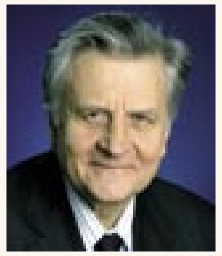
## Otmar Issing and the "ECB and Its Watchers" Conferences

Together with former CFS Director Axel Weber, Otmar Issing started a unique forum for open debate between the ECB, professional ECB watchers, academics and media representatives – the CFS conference series 'The ECB and Its Watchers'. The first conference in the series took place in 1999 and since then Otmar Issing has stood ready to debate ECB policies in this forum every year. This year's conference on 5 May, 2006 in Frankfurt, organized by Volker Wieland, will be the last one with Otmar Issing as ECB chief economist. At this occasion he will respond to ECB watchers on issues of current policy performance as well as new policy challenges and will debate best practice in terms of monetary policy strategy.

From the start, CFS aimed at establishing a platform for a mutually beneficial dialogue between the ECB, various ECB monitoring groups, academic experts on monetary policy and market participants. Such a forum was needed not only for the ECB, determined to improve its record with respect to transparency and to establish long-term credibility, but also for market participants and media trying to understand the longer-term objectives and strategy of this new central bank. Over the years the ECB has been subjected to criticism from academics and professional ECB watchers recommending alternative strategies for policy, demanding greater policy transparency and questioning specific policy moves.

Volker Wieland

Otmar Issing has addressed these criticisms head on in his exchanges at the conference series. Speaking on transparency and central bank communication, for example, he admitted in his speech on 26 June, 2000 at the second conference: "There is



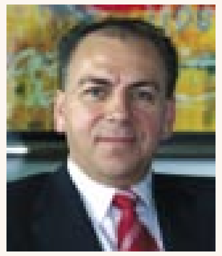
**Jean-Claude Trichet (President of the European Central Bank):**
*"Otmar Issing has been an outstanding member of the Executive Board of the ECB after having been a remarkable member of the Executive Board of the Bundesbank and an exceptional professor of economics. It has been for me an immense privilege to be the friend and companion of Otmar for many years before and after the setting up of the Euro. He has played a crucial role in the success of the transition to the Euro and in the credibility of the monetary policy of the ECB. The fact is that the new currency has benefited, from day one of the Euro, from the same very high level of credibility and confidence as the level characterizing the best national currencies, in particular the Deutsche Mark. This is due for a decisive part to the professionalism, dedication and personal commitment of Otmar Issing. The ECB and the Eurosystem owe him an immense debt of gratitude."*

clearly a communication problem between the ECB and the general public". In his opening speech at the third conference in 2001, Issing emphasized the predictability and credibility of the ECB policy, stressing that the ECB had not only been credible but for most part predictable as well.
In the subsequent conferences, Issing also used this forum as an opportunity to explain the many challenges facing the ECB. concerned. However, at this stage wanting to try to prevent deflation in the euro zone would be like wanting to commit suicide today for fear of dying tomorrow".
On several occasions, Otmar Issing has encouraged further exchange between the ECB and its critics, suggesting that this will yield important synergies and help improve monetary policy. At the CFS, we are convinced that the opportunity for dialogue and

**Rolf-E. Breuer (former Chairman of the Supervisory Board, Deutsche Bank AG):**
*"Professor Issing's role in developing and communicating the ECB's monetary policy strategy cannot be overestimated. Often, he was the one to pick up the gauntlet thrown down by Anglo-Saxon critics of the ECB. He made his points with academic rigor and always backed them with theoretical and empirical research. Still, given his academic background he was always prepared to scrutinize his own position in a self-critical manner. This trait of character might also be behind Mr. Issing's self-irony and great sense of humor, which was visible especially in his legendary disputes with academics and market practitioners at the "ECB and Its Watchers" conferences."*

In 2002, when the conference was held in Milan, he discussed challenges, such as Y2K, the cash change-over to the euro in 2002 and the aftermath of 11 September, 2001, emphasizing their successful handling by the ECB. In his opening remarks in 2003, he tackled the fear of deflation and presented the ECB's review of the two-pillar strategy. Subsequently, he was quoted in the Börsenzeitung under the heading "imaginary fears" as saying:"We are not complacent as far as the risk of deflation is debate offered by the "ECB and Its Watchers" conference series will prove even more important in coming years when the ECB will have to manage without Otmar Issing's experience with German and European monetary policy.

The 8th ECB and Its Watchers Conference on 5 May 2006 at the Commerzbank Auditorium in Frankfurt will bring together many distinguished speakers, participants and media representatives.



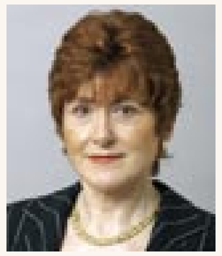
**Axel A. Weber (President of the Deutsche Bundesbank):**
*Otmar Issing was the mind behind the ECB's Monetary Policy in the first years of EMU, and he was also the steady hand on the ECB's ruder in initially unchartered waters. His pragmatic approach to monetary policy was based on a number of strong convictions, such as the desirability of stable money, the need to take a medium-term policy perspective, and the usefulness of exposing theories to the rigors of real world data in order to draw inferences about their reliability for policy decisions. These convictions formed the basis underlying the prominent role of money in the ECB's strategy, for which Otmar was initially confronted with criticism. His reaction was to initiate an ambitious and intensive research program on this topic and to enter into a debate with the critics with a view to convincing them. By the way, this is also the reason why the CFS series of ECB Watchers Conferences, which I organized in close collaboration with Otmar, initially came into being. At each of these annual events, I was impressed by Otmar's mild manner and calm style as well as his strong determination. Otmar made it a habit to deal personally with each challenge. This approach probably goes a long way to explaining why he has enjoyed such an outstanding career as one of the few German economists who has been exceptionally successful not only as an academic but also as a policy advisor and policymaker.*





**Donald L. Kohn (Governor, Board of Governors of the Federal Reserve System):**
*"Otmar has been an outstanding central banker, colleague, and friend. He has combined a clear vision of the role and objectives for central banks with broad knowledge of economics, a sharp intelligence, and a willingness to engage in principled and respectful debate. He has set an example that the rest of us can only hope to emulate."*

**Manfred J.M. Neumann (University of Bonn):**
*"Otmar Issing, an eminent scholar and central banker, has been an invaluable asset to the enterprise of European monetary unification. He created the new policy concept and has put his stamp on the first eight years of policy making. He has earned the euro trust among the population by insisting on the prerogative of price stability and by living up to the promise. Apart from this, Otmar is a man whose intellectual curiosity goes beyond economics. He has his convictions but he listens.*



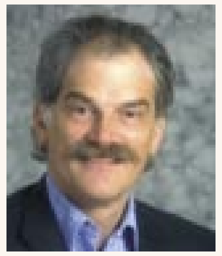
**Marietta Kurm-Engels (Handelsblatt GmbH, Redaktion Frankfurt):**
*"For Otmar Issing the ECB's communication with the markets, the media and the wider public was a matter close to his heart. This did not only become obvious in some of his contributions by which he decisively shaped the communication policy of the ECB. Issing lived up to his convictions. For him his repeated statement that the ECB needs the media at least as much as the media need the ECB was not just empty words. Journalists who worked with him on a continual basis profited from his agreeable, patient and always respectful behavior, even if the topics they raised may not have pleased him at times. In all his years at the ECB Issing never tried to cover up anything, even if clarification demanded a personal effort from him. The ECB does not only lose a highly competent board member, the ECB loses a courageous man."*


## Program 2006

**Conference**

**"The ECB and Its Watchers VIII"**

| | |
|---|---|
| to be held at: | **Auditorium of Commerzbank AG<br>Frankfurt am Main,<br>Friday, May 5, 2006** |
| | *Organization:*<br>Volker Wieland (University of Frankfurt and CFS) |
| 8:15 -8:45 | Registration and Coffee |
| 8:45 | Welcome<br>Volker Wieland |
| 8:45 -10:15 | **Panel I (Part 1): ECB Watch - Current Policy Performance and New Challenges**<br>*Chair:* Volker Wieland<br>• Elga Bartsch (Executive Director, Morgan Stanley)<br>• Giancarlo Corsetti (European University Institute and CEPR)<br>• Peter Hooper (Chief US Economist, Deutsche Bank)<br>• Angel Ubide (Director of Global Economics, Tudor Investment)<br>• Manfred Neumann (University of Bonn) |
| 10:15-10:45 | Coffee Break |
| 10:45-11:45 | **Panel I (Part 2): ECB Watch - Review of the ECB's Strategy and Alternative Approaches**<br>*Chair:* Volker Wieland<br>• Huw Pill (Head of Monetary Policy Stance Division, European Central Bank)<br>• Jan Qvigstad (Executive Director and Chief Economist, Bank of Norway)<br>• Richard Clarida (Global Strategy Adviser Pimco and Columbia University)<br>• Athanasios Orphanides (Adviser Division of Monetary Affairs, Federal Reserve Board) |
| 11:45 | Reply to Panel I and Discussion<br>Otmar Issing (Member of the Executive Board, European Central Bank) |
| 12:30-13:30 | Lunch Break |
| 13:30 | **The ECB and Its Watchers: 1999-2006**<br>Axel A. Weber (President, Deutsche Bundesbank) |
| 13:45-15:30 | **Panel II: The Revised Stability and Growth Pact - Is it working?**<br>*Chair:* Wolfgang Schill (Director General DG Economics, European Central Bank)<br>• José Manuel González Páramo (Member of the Executive Board, European Central Bank)<br>• Michael Hüther (Director, Institut der Deutschen Wirtschaft)<br>• Lars Calmfors (Stockholm University)<br>• Servaas Deroose (Director Economy of the euro area and the Union, European Commission) |
| 15:30-16:00 | Coffee Break |
| 16:00-17:45 | **Panel III: On the Road to the Euro? Progress and Prospects of New EU Members**<br>*Chair:* Lucrezia Reichlin (Director General Research, European Central Bank)<br>• Lucas Papademos (Vice-President, European Central Bank)<br>• György Szapáry (Deputy Governor, Magyar Nemzeti Bank/The Central Bank of Hungary)<br>• Willem Buiter (London School of Economics)<br>• Daniel Gros (Director, CEPS) |
| 17:45 | Concluding Remarks<br>Otmar Issing |



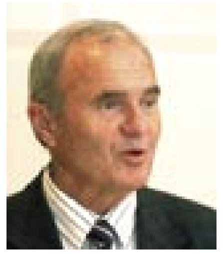
**John Lipsky (Vice Chairman, JPMorgan Investment Bank, New York)**

*"Since the object of this exercise is to enumerate – or better put, to praise -- the contributions of Otmar Issing (justifiably, of course, and not just as flattery), this piece (and the others in this volume) risk becoming impressively but impractically long. In the interest of brevity, therefore, I shall speed by his pivotal role in developing and promoting modern European monetary and financial analysis. Likewise, I will only mention his contributions as a member of Germany's Council of Economic Experts, his providing the intellectual bedrock for the Bundesbank's monetary policy and his pioneering role at the European Central Bank, where he was the key figure in establishing the ECB's monetary policy process and in forming a world-class research staff to underpin it.*

*Instead, I want to highlight an aspect of Otmar Issing's career that has not received the recognition that it deserves -- his passion for open discussion and debate. It is his genuine curiosity, his intellectual honesty, his sense of history and his natural respect for others that animated the ECB's research efforts under his guidance. Even more exceptionally, his efforts to engage both the ECB's supporters and detractors around the world helped to give the institution a stature that it would not have achieved otherwise, at least not nearly as quickly as was the case.*

*In fact, "The ECB and Its Watchers" seminar series is a direct result of Otmar Issing's suggestion and active support. So far as I know, no other central bank participates regularly in the kind of serious and substantive public scrutiny that is the hallmark of this seminar. That it is carried out in such a straightforward and unassuming fashion – despite its uniqueness and high quality -- is another testimony to Otmar Issing's special qualities. Among all the superlatives, therefore, "innovator", "inspiration" and "role model" deserve to be included prominently, without neglecting his unfailing patience, good humor and wise perspective."*

# Interview with Otmar Issing



***Question:** What has been, for you personally, the greatest challenge as Executive Board member of the European Central Bank?*

**Answer:** The greatest challenge for me personally was the same as for the ECB as an institution: how to gain, establish and maintain credibility for our monetary policy and confidence in the new currency, the euro.

***Question:** What do you consider to be your biggest achievement in your work at the ECB?*

**Answer:** We have chosen a strategy which was the optimal approach to deal with the extraordinary uncertainties at the start of EMU and which promises also to remain a framework appropriate to conduct monetary policy maintaining price stability.

***Question:** In your speech at the second ECB and Its Watchers Conference in June 2000, you stated that "There is clearly a communication problem between the ECB and the general public". How has ECB's communication improved since then? And what were the most important lessons you have drawn from the years of ECB's communication with the public?*

**Answer:** We had to understand that it takes just time until not only the general public, but also all other observers get familiar with an entirely new institution. Although we have made substantial progress in the meantime, a lot has still to be done. I trust that our new information-kit for pupils will substantially contribute to a better knowledge about the ECB and the euro.

***Question:** In 2006, CFS is organizing for the 8th time the ECB and Its Watchers Conference. What role does this conference play from your perspective?*

**Answer:** It will be the last ECB Watchers Conference in which I participate. I might use the occasion for some fundamental considerations in my concluding remarks.

***Question:** If you were asked to prepare a "to-do-list" for the Executive Board of the ECB. What would be on the top of your list?*

**Answer:** The ECB's monetary policy is on the right track. My colleagues know themselves what remains to be done.

**Joachim Fels (Chief Global Fixed Income Economist, Morgan Stanley, London)**

*"The Third Pillar"*

*"I first met Otmar Issing at the German Economics Associations' historic annual meeting, which started on 3 October 1990 – the very day of German unification – in his home town Wuerzburg. I was a young economist arguing somewhat naively what I then thought to be a brilliant case for Hayekian free currency competition as the best means to achieve first German and then European monetary union. But the experienced professor and economic policy advisor, who had just joined the board of the Deutsche Bundesbank a few days earlier, elegantly refuted my argument in his characteristically polite and persuasive manner and instead argued the case for a monopoly supplier of money, constrained by the sole objective of price stability. Ever since, Otmar Issing has been a key contributor to the success of, first, the Bundesbank and then the European Central Bank as monopolists of sound money. As a financial market economist and central bank watcher, I particularly value his intellectual integrity and the clarity of his communication over all these years. In my view, Otmar Issing has been the third and perhaps most important pillar of what is largely his brainchild – the ECB's unique and successful monetary policy strategy."*





## Our New Address

**The Center for Financial Studies left its offices at the Landeszentralbank in Hessen, Taunusanlage 6, Frankfurt and moved to University of Frankfurt buildings. Our offices are now located in Block A (3rd Floor) of the main building (Jügelhaus) of the Johann Wolfgang Goethe University. You can reach Block A through the main entrance of Mertonstraße 17 or via the entrance Senckenberganlage 27, next to the Senckenberg Museum**

**Our new mailing address and telephone are as follows:**

**Center for Financial Studies**
**Mertonstrasse 17-21, HPF 73 Tel.: + 49 (0) 69 798 30050**
**D-60325 Frankfurt am Main Fax: + 49 (0) 69 798 30077**

## New Staff Portraits

**Christian Weistroffer joined the Center for Financial Studies (CFS) in September 2005 as Visiting Young Researcher and doctoral student, under the supervision of Professor Jan Pieter Krahnen. Christian is a graduate of Darmstadt University of Technology. He also pursued graduate studies in international economics and finance at the University of New South Wales. While pursuing his academic goals at CFS, Christian continues to work at DB Research, Deutsche Bank AG's economic research department. His research focuses on financial stability analysis, with special emphasis on bank systemic risk.**

## Visiting Student

**During the winter semester of 2005, František Brázdik visited CFS and the University of Frankfurt, as a doctoral student specializing in "Macroeconomic Policy and Theory." He is currently a PhD student at the Center for Economic Research and Graduate Education (CERGE). CERGE-EI is a joint workplace, associated with Charles University, Prague and the Academy of Sciences of the Czech Republic.**

**He wrote: "In the early stages, my research focused on operational research, Data Envelopment Analysis and numerical mathematics. Recently, I shifted my research focus to monetary economics, and more specifically to questions concerning monetary unions. The final part of my dissertation dealt with small open economies, indicating my future research path.**

**The purpose of my visit, under the supervision of Professor Volker Wieland, was to meet professors who are renowned in the field of macroeconomic research, to develop ideas for research on the accession process of small open economies to the euro zone and to narrow my research focus through discussions. I attended lectures during the winter semester 2005 and the colloquium series chaired by Professor Krüger. I also had the opportunity of participating in the Joint Lunch Time seminars organized by CFS (see also page...). I also benefited from discussions with other doctoral students. Various opinions on politics, society and our own research ideas were exchanged.**

**I would like to thank the staff of the Money and Macroeconomics Department for their hospitality and their support in my study and research. I hope that the contacts I made in Frankfurt will be useful for my future career and that this link will foster closer cooperation between CERGE and CFS."**

## CFS*research conferences*

14 – 15 July 2006
*2nd German Workshop in Macroeconomics*
**Organization:** Dirk Krüger (University of Frankfurt and CFS), Salvador Ortigueira (European University Institute Florence), Klaus Wälde (University of Würzburg)

13 – 20 Aug. 2006
*Empirical Asset Pricing - CFS Summer School 2006*
**Faculty:** Joachim Grammig (University of Tübingen), Lubos Pastor (University of Chicago, USA), Erik Theissen (University of Bonn)
**Organization:** Erik Theissen (University of Bonn), Jan Pieter Krahnen (University of Frankfurt and CFS)

13 – 20 Aug. 2006
*Empirical Macroeconomic Modelling - CFS Summer School 2006*
**Faculty:** Charles M. Engel (University of Wisconsin, Madison, USA), Philip R. Lane (Trinity College Dublin, Ireland), Kenneth D. West (University of Wisconsin, Madison, USA), Michael Binder (University of Frankfurt)
**Organization:** Michael Binder (University of Frankfurt and CFS)

28 – 29 Sep. 2006
*ECB-CFS Research Network*
*The 3rd conference of the second phase of the ECB-CFS network on „Capital Markets and Financial Integration in Europe" in Berlin, hosted by the Deutsche Bundesbank*
**Organization:** Michael Haliassos (University of Frankfurt and CFS), Philipp Hartmann (European Central Bank), Heinz Herrmann (Deutsche Bundesbank)

17 – 18 Nov. 2006
*Public versus Private Ownership of Financial Institutions*
**Organization:** Franklin Allen (University of Pensylvania and WFIC), Elena Carletti (Center for Financial Studies), Jan Pieter Krahnen (University of Frankfurt and CFS), Thilo Liebig (Deutsche Bundesbank), Beatrice Weder (Mainz University and CFS)

30 Nov. – 1 Dec. 2006
*ECB-CFS Research Network*
*The 4th conference of the second phase of the ECB-CFS network on „Capital Markets and Financial Integration in Europe" in Madrid, hosted by the Bank of Spain*

1 – 2 Dec. 2006
*International Research Forum on Monetary Policy*
**Organization:** Matthew Canzoneri (BMW Center for German and European Studies at Georgetown University), Dale Henderson (Federal Reserve Board), Lucrezia Reichlin (European Central Bank), Volker Wieland (Goethe University Frankfurt and CFS)

*For further information and registration please consult www.ifk-cfs.de.*

## CFS*colloquium series 2006*

### Unternehmensverfassung im Wandel/ Corporate Governance in Transition

5 April 2006
**Max Dietrich Kley** (Mitglied des Aufsichtsrates, BASF AG)
*Was leistet Corporate Governance für die Unternehmensführung – Ein Erfahrungsbericht (Arbeitstitel)*

28 June 2006
**Klaus-Peter Müller** (Sprecher des Vorstands, Commerzbank AG)
*Corporate Governance und Banken – nationale und internationale Entwicklungen*

5 July 2006
**Dr. Thomas R. Fischer** (Vorsitzender des Vorstands, WestLB AG)
*Corporate Governance im Spannungsfeld zwischen Markt und Gesetz*

11 Oct. 2006
**Dr. Wolfgang Mansfeld** (Mitglied des Vorstands, Union Asset Management Holding AG)
*Corporate Governance in Unternehmen – Die wachsende Rolle institutioneller Anleger*

15 Nov. 2006
**Dr. Jürgen Heraeus** (Vorsitzender des Aufsichtsrates, Heraeus Holding GmbH)
*Unternehmensverfassung im Wandel aus der Sicht eines Familienkonzerns (Arbeitstitel)*

23 Nov. 2006
**Dr. Gerhard Cromme** (Vorsitzender des Aufsichtsrates, ThyssenKrupp AG)
*Corporate Governance – ein europäischer Blick*

24 Jan. 2007
**Dr. Thomas R. Fischer** (Vorsitzender des Vorstandes, WestLB AG)
*Corporate Governance im Spannungsfeld zwischen Markt und Gesetz*

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

## CFS*executive conference*

16 May 2006
*Wertschöpfung durch Risikomanagement? Risikofinanzierung versus Risikotransfer.*
**Organization:** Christian Laux (University of Frankfurt and CFS), Center for Financial Studies, University of Frankfurt, Chair for Corporate Finance and Risk Management Deutsches Aktieninstitut e.V., Frankfurt

*For further information and registration please consult www.ifk-cfs.de*

## CFS*seminars*

1 – 2 June 2006
*Zinsprodukte: Analyse und Bewertung: Teil 1*
**Prof. Dr. Wolfgang Bühler** (Universität Mannheim)

29 – 30 June 2006
*Zinsprodukte: Analyse und Bewertung: Teil 2*
**Prof. Dr. Wolfgang M. Schmidt** (Hochschule für Bankwirtschaft)

6 – 8 July 2006
*Modernes Risikomanagement mit Kreditderivaten und Forderungsverbriefung*
**Prof. Dr. Günter Franke** (Universität Konstanz), **Prof. Dr. Dirk Jens F. Nonnenmacher** (DZ BANK AG)

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

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**Furthermore, we are also pleased to announce that Merrill Lynch Capital Markets Bank Ltd, Frankfurt and Rothschild GmbH, Frankfurt have decided to upgrade their membership to become Sponsoring Members.**

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