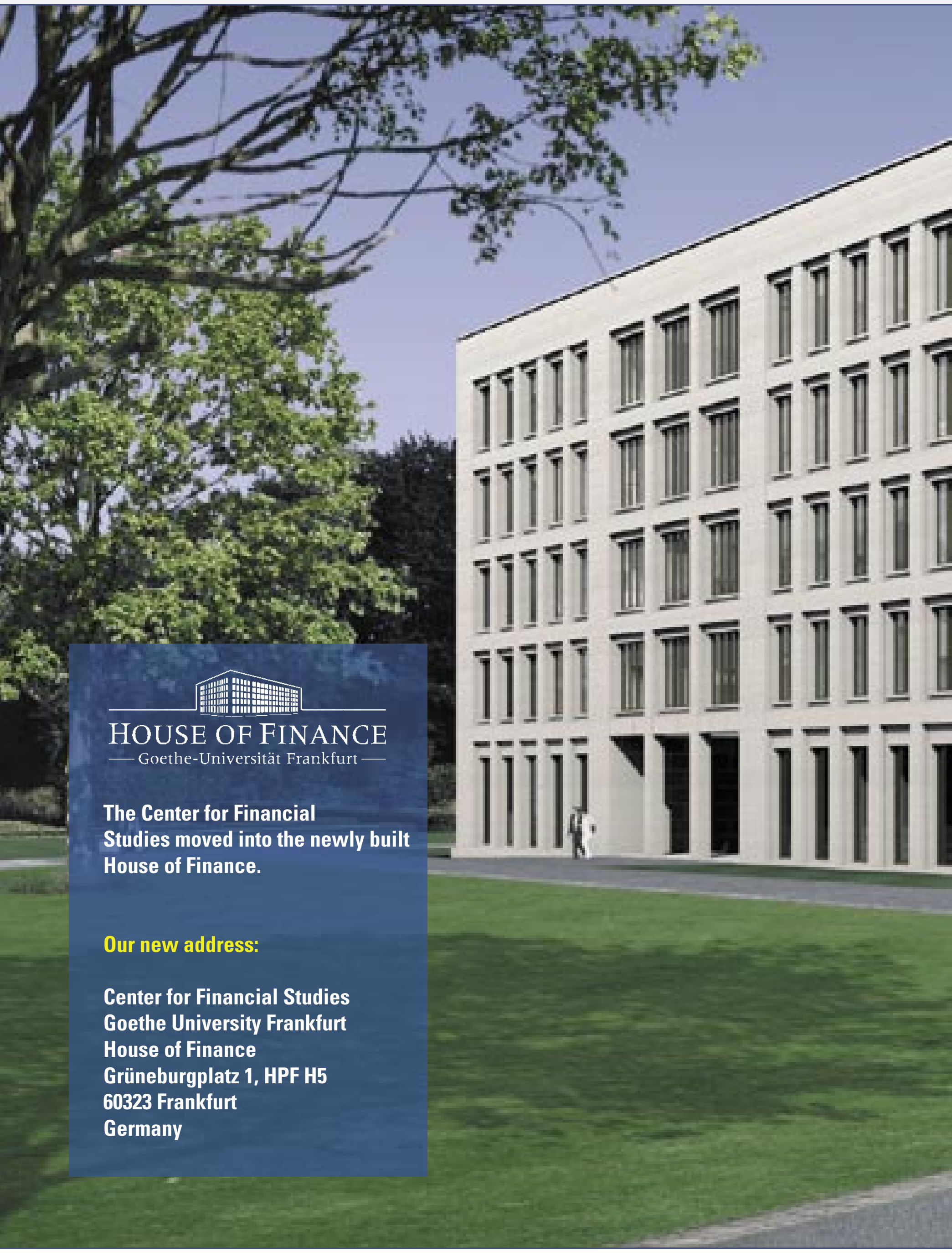
NEWS

CENTER FOR FINANCIAL STUDIES

2/08

10 YRS

THE ECB AND ITS WATCHERS



HOUSE OF FINANCE
Goethe-Universität Frankfurt

The Center for Financial Studies moved into the newly built House of Finance.

Our new address:

Center for Financial Studies
Goethe University Frankfurt
House of Finance
Grüneburgplatz 1, HPF H5
60323 Frankfurt
Germany

Editorial

Crisis Prevention: Two conundrums and one step forward

by Jan Pieter Krahnen

There is a pile on my desk that gets taller by the day. It contains proposals and communiqués issued by national and international institutions, and by individuals as well as policy advisors – all on the same topic, namely what should be done to put an end to the credit crisis, and how can it be prevented from ever happening again. The Institute for International Finance, the International Monetary Fund (IMF), the Bank for International Settlement (BIS), the Financial Stability Forum (FSF), just to name a few of the most prominent contributors to the debate, all have issued a report containing an interpretation of the crisis as well as a list of proposals for reforming the regulatory system.

Rather than comparing or even discussing these proposals, I want to ⇛

point at three features of the debate that are unique to the current economic situation: the micro-macro conundrum, the short term-long term conflict, and the paucity of factual knowledge.

First, when the crisis started in mid 2007, the discussion was all about poor lending decisions taken in the U.S. mortgage market, allowing people to invest in real estate that had no income or other wealth, and borrowing way too much given the value of the collateral. The crisis then unfolded, affecting mortgage banks (like Northern Rock) and highly leveraged investors (like Sächsische Landesbank), then interbank markets. This is the microeconomic story. Increasingly, a second story was putting its stamp on the debate. Too low interest rates for too long a period had contributed to asset bubbles, e.g. in the housing market. It was accompanied by an excessive supply of central bank liquidity, and extreme leverage among financial and non-financial institutions. When the bubble burst, shock waves were running through the financial system, causing collateral damage all along the value chain, from debt origination to long term investors. The interplay of micro- and macroeconomic clout is a constellation we have not seen in a lifetime – how can it be incorporated into a systematic diagnosis of the crisis?

A second unique challenge relates to the inherent conflict between short-term crisis management and long-term crisis prevention. While all proposals for a new regulatory framework that I have seen so far are focused on the long term, basically assuming that an improved regulatory framework can be built in a benign economic environment, there may be an additional defiance for any new framework, largely overlooked to date. The forgotten factor is the crisis management currently under way. While the concerted interventions by central banks and governments to stabilize banks and interbank markets we have seen in the past months have been admirably successful, at least seen from today, the same interventions are likely to be part of market participants' expectations next time around. Put differently, it will be hard, and probably also costly, to take financial institutions through a withdrawal treatment, now that they have had a taste of benign state aid. Once this crisis is over, will default risk still be the same bogey man it used to be?

Both conundrums, threatening as they are for the economy out there, are also eminent opportunities for us economists. Clearly, academic research on the interrelationship of micro and macro drivers in crisis dynamics, and on the interdependency of short- and long-term crisis management is in high demand now, and at CFS we try to contribute to the debate as well (see our website for details). In a recent talk at the House of Finance, the Nobel laureate Robert Merton suggested to appoint an international high-level panel, representing regulators, central bankers and academics that regularly report on the safety of the financial system. Apart from the question whether or not this task isn't already performed by the BIS in Basle, the innovative idea of Merton relates to a special data collection authorization granted to the panel. This has always been the dream project of us academics, being allowed to tailor the data set to the questions we have, rather than the other way around. While I do not think that Merton's proposal will eventually be realised one hundred percent, it would be a big step forward if timely data access for researchers would be considered an adequate new instrument in crisis prevention.

CFS Working Paper

The Future of Securitization

2008/31

Günter Franke (University of Konstanz and CFS), Jan Pieter Krahnen (Goethe University, CFS, and CEPR)

→ The full report can be obtained from the CFS website

The paper presents a causal analysis of the credit crisis which started 18 months ago. On the basis of our findings, a list of policy recommendations is derived. These proposals for regulatory action differ significantly from what we have seen in the debate to date.

Currently, two camps dominate the debate. According to the first, macroeconomic view, the financial crisis has been caused by the bursting of a house price bubble in the US. As a result, a sudden shift of expectations led to liquidity constraints at financial institutions, and strong investor sentiments. This is seen as one part of a well-known cycle, going from euphoria to fear, as Alan Greenspan put it.

THE CFS STUDY ON THE FUTURE OF SECURITIZATION, BY GÜNTER FRANKE AND JAN KRAHNEN, GIVES AN INTERPRETATION OF THE REASONS LEADING TO THE CURRENT FINANCIAL MARKET CRISIS, AND DERIVES A SET OF CONCRETE REGULATORY MEASURES NEEDED TO REVITALIZE FINANCIAL MARKETS, AND SECURITIZATION MARKETS IN PARTICULAR. THE POLICY CONCLUSIONS WERE PRESENTED ON OCTOBER 16 IN WASHINGTON, AT THE BROOKINGS-TOKYO CLUB-WHARTON CONFERENCE "PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE 2007 MORTGAGE SECURITIES MELTDOWN"

The second view, in contrast, focuses on incentives and risk management. Irresponsible lending, overly complex financial instruments and conflicts of interest impaired market transparency, and translated into market illiquidity.

In the present study, we add to the second view, finding incentive misalignment to be the root of the crisis. However, these incentive misalignments were not transparent to investors and presumably were not correctly reflected in ratings.

More concretely, one important misalignment relates to the first loss piece in securitizations. Information asymmetries enable the originator of a securitization transaction to benefit from adverse selection and moral hazard at the expense of investors. The standard cure for these problems is that the originator retains a substantial fraction of the first loss piece. Over the years it appears that originators sold more and more of this piece, invalidating their incentives to safeguard the quality of the securitized assets. Since originators refuse to tell investors about the retained first loss piece, investors were not aware of this problem for a long time.

Another important incentive misalignment relates to bank manager compensation. A substantial part of the compensation is an annual bonus which can never be negative. By setting up SIVs, and similar structures, and by strongly leveraging their activities, managers can raise their bonus income. Therefore we observe leverage ratios which endanger financial stability. One way to discourage managers from taking excessive risk is to supplement the bonuses system by appropriate malus components.

Given these incentive misalignments, and their impact on the quality of the underlying asset portfolio, once they are recognized they will render the valuation of financial assets opaque. Opacity, in turn, will contribute towards a breakdown of asset markets. In addition, opacity of financial asset valuation translates into opacity of institutions trading or holding those assets. Therefore, the risks of these institutions cannot be evaluated by peer institutions, and interbank markets will collapse, too.

The paper develops a structural explanation of the crisis. In it, the bursting of the house price bubble may have triggered the crisis, but it is not its primal cause.

The paper also proposes several measures to improve transparency in a specific way, and it gives regulation the role to enforce this transparency.

1. Markets need to know at all times the size and the fraction of first loss position retained by the originator. However, there should not be a mandatory retention because a rule can always be gamed.

2. Compensation schemes of managers need to balance bonus and malus components. Again, no regulation is required, only transparency on remuneration policy, including an independent assessment of incentive properties of the scheme, e.g. by rating agencies.

3. An extra capital charge should be imposed on banks whose risks are opaque, reflecting the externality imposed on the market as a whole.

4. Rating processes should not be regulated, while rating performance measurement (i.e. the validation of ratings) should be made public. Also, ratings should provide information on incentive alignment in complex transactions.

5. Comprehensive data on risk exposure of financial intermediaries (a risk map) should be collected and published quarterly, signalling early warnings.

After its release, the study led to an immediate response in the press. Finanz &Wirtschaft, for example, published the following article on October 22, 2008


Finanzkrise legt diverse Mängel offen

Studie kritisiert mangelhafte Anreizsysteme und Intransparenz – Pauschale Regulierung ist kein guter Ansatz

Von Dietegen Müller

Interventionen im Blindflug

Rationales Marktverhalten

Leverage-Aufbau wurde belohnt

Eckpunkte für Transparenz und Stabilität

→ All working papers can be found on the CFS website.

CFS Financial Center Index

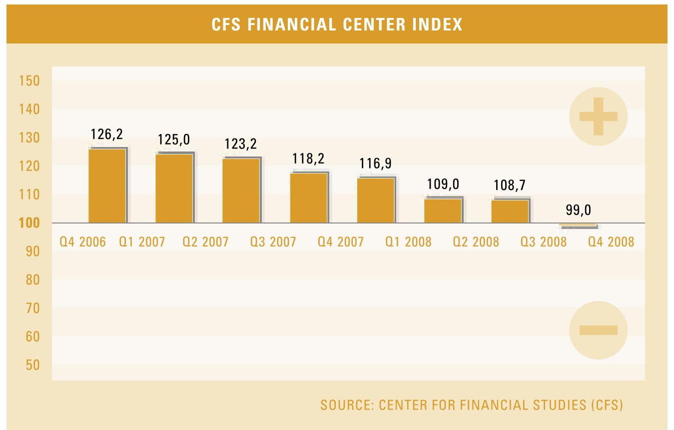
Project Team: Christian Knoll & Corinna Wolf (CFS)

Index Dips Below 100 for the First Time

The latest CFS Financial Center Index survey, which took place in October/November 2008, produced a negative (below 100) index value for the first time ever. At 99, the index is 9.7 points lower than the previous index value of 108.7. This strong decline clearly reflects the negative business sentiment prevailing in German financial markets, and markedly deviates from the more optimistic expectations noted in previous quarters.

There are significant differences between the results of branch-specific groups. The biggest decrease in business sentiment is registered for the core group of banks. Financial sector service providers, however, are cautiously more positive. In an international comparison, a majority believes that the financial crisis may have a positive effect on the importance of Germany as a financial center.

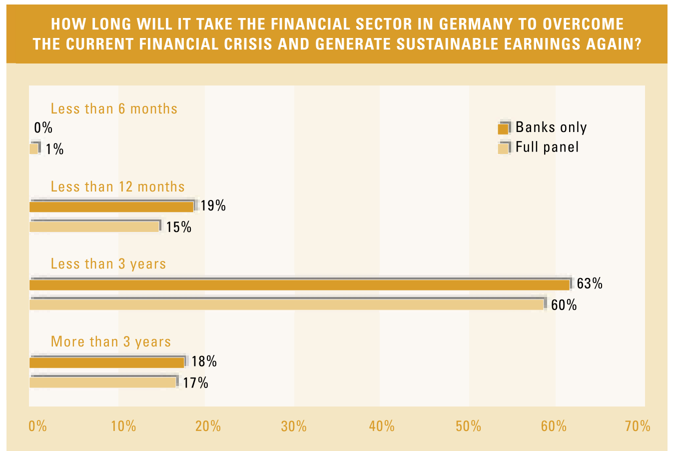
CFS director Professor Jan Pieter Krahnen expects a continuing negative trend in financial business for the next quarter.



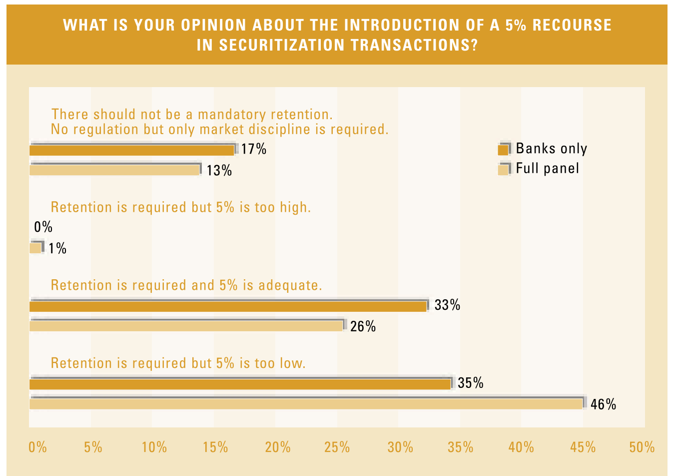
Special Survey

The special survey conducted this time dealt with the financial crisis and its consequences. 496 leading executives were asked a.o. about their expectations regarding the duration of the crisis, as well as their views on the regulation of securitizations, the marking-to-market of assets, and remuneration of managers.

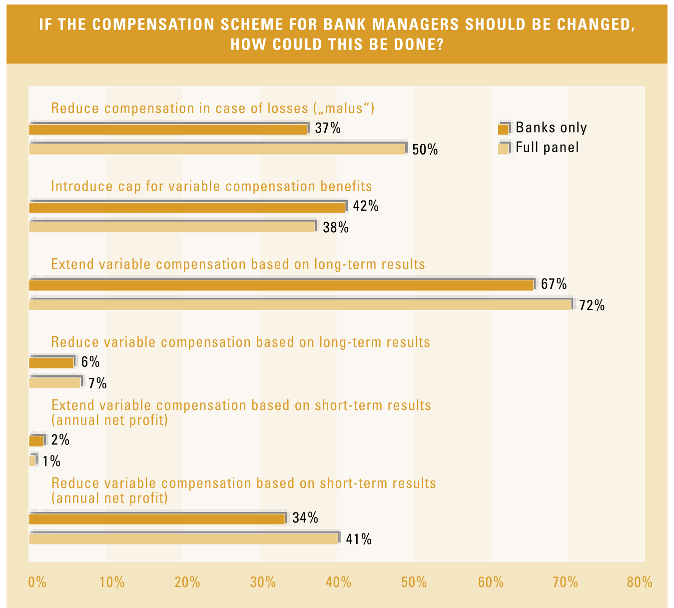
Duration of the crisis:



Securitization:



Compensation scheme for bank managers:



Difference to 100%: no statement

→ For more results / information on the survey, please visit the CFS website or contact Corinna Wolf (wolf(@)ifk-cfs.de)

→ Further details can also be found at www.financialcenterindex.com

The CFS Financial Center Index is a quarterly index that measures the evaluation and expectations of financial market agents for Germany as a financial center. The index is based on surveys of leading executives from the financial community in Frankfurt and Munich. The maximum attainable index value is 150, the minimum index value 50. An index value of 100 indicates a neutral business sentiment.

CFS Colloquium

Europa-Strategien im Immobilien Investment Banking
European Strategies in Real Estate Investment Banking

17 September 2008

A speech by Bernd Knobloch

On the 17th of September 2008 Bernd Knobloch, former chairman of the board of directors for Eurohypo AG and former member of the board of directors for Commerzbank AG, held a speech on European strategies in real estate investment banking titled "Europa-Strategien im Immobilien Investment Banking" in the CFS Colloquium series.

Bernd Knobloch

After being introduced by Professor Raimond Maurer (Center for Financial Studies and Goethe University), Knobloch started by asking whether real estate will keep its importance for investment banking in the future.

He then described the development of real estate investment banking towards an asset class of its own: the rise of cross border real estate trading; the importance of financial engineering; and now the abrupt ending after the subprime crisis. According to Knobloch, the subprime crisis was based on the assumption that real estate prices would keep growing and that interest rates would stay low. For a long time, this allowed high returns. However, when the period of low interest rates came to an end, the subprime crisis emerged and credits defaulted. Following the financial crisis, investment in real estate almost no longer exists as mistrust has become too widespread. Today, financial investments in real estate are again "on-balance sheet", which limits markets' scope.

One crucial element in fostering the rise of this crisis was the role of the U.S. Federal Reserve. Its expansionary policy over several years, said Knobloch, incited investors to increase their leverage in order to raise returns. Given good ratings from rating agencies, institutional investors invested large amounts in all asset classes which, in turn, increased asset prices. When the U.S. Fed raised its target rate, many credits in the subprime sector defaulted, triggering the financial turmoil in the United States.

With respect to the critical financing situation, Knobloch stressed the revival of traditional financial instruments such as the German Pfandbrief, which, though highly regulated, currently have strong advantages in terms of raising liquidity.

As regards an outlook for the duration of the current financial crisis, Knobloch said that the situation is not likely to improve prior to the end of 2009, and that one should now concentrate on reconditioning and recapitalizing banks. However, and with regard to his initial question about the future role of real estate investment banking, once this crisis is over, it would be regrettable if real estate investment banking was relegated to a niche existence within investment banking.

Knobloch then proceeded to highlight what the real estate branch has learned, namely: that economic development, particularly within the real estate branch, is cyclical; that one should not only rely on complicated mathematical instruments but also on common sense; that stronger regulation is not the correct answer because it only seems more secure (in reality regulators were as well surprised by unexpected developments in the markets); that the solution to the problem has to help coping with moral hazard; that rating agencies are not unimpeachable; and that more transparency is necessary.

Marcel Bluhm (CFS)

Brauchen Emittenten noch Banken?
Do issuers still need banks?

20 August 2008

A speech by Dr. Kurt Bock (CFO, BASF SE)

Kurt Bock, Chief Financial Officer of BASF SE, was a guest speaker at the CFS Colloquium on August 20, 2008. After a short introduction by Jan Pieter Krahnen (Center for Financial Studies and Goethe University), he started his talk by acknowledging that issuers do indeed still need banks, given that we live in a world with imperfect capital markets. The question to be posed is: for which businesses and to what extent should issuers rely on the services of banks?

Kurt Bock

The current financial crisis has severely affected banks and other financial intermediaries, and their credibility has been corroded. Issuers, although they still need banks, have to worry whether banks can still deliver the service they require. Bock also noted that his firm has had no funding constraints in the financial markets so far and that its relative credit strength in contrast to the financial sector had improved.

Bock continued with a theoretical consideration of the topic. Banks are important actors in the debt/equity origination process. Their role of intermediating services and information between corporates and investors is essential. In addition to the brokerage services they provide, banks play a crucial role in generating information about corporates and certifying such information for investors.

Bock explained that due to deregulation and technological progress the landscape for intermediation is currently changing, thus allowing investors and corporates to interact directly. This direct auctioning of securities has certain advantages and disadvantages for an issuer. On the one hand, fees and indirect issuing costs are lower and price setting is more transparent. On the other hand, the information generation and brokerage services traditionally offered by banks are lacking.

Market acceptance of securities that are directly auctioned through the internet depends on the type of security involved. The potential for disintermediation varies with the quality of the issuer and the degree to which the product can be standardized and made transparent. Market acceptance of direct issuance can be high for certain highly standardized products, such as commercial paper.

Bock then described the current position of the BASF Group. He gave an overview of the source and use of BASF funds during the period 2003 to 2007, showing that a large portion of funds were used for acquisitions, dividend payments and share buybacks. In his speech, Bock gave further details about BASF's strategy with regard to these topics. He also showed that company debt has increased over the last years due to acquisitions, and that a great part of this debt has been financed by issuing commercial paper, largely through direct auctioning.

Bock concluded that disintermediation can be pursued to a certain extent, but this does not make banks redundant.

Lut De Moor (CFS)

CFS Colloquium – Upcoming Event 2009:

„Entwicklungsperspektiven für das Private Equity Geschäft in Europa"

Johannes P. Huth (Head of European Operations, Kohlberg Kravis Roberts & Co. Ltd.)

Joint Lunchtime Seminar Series

Bartosz Maćkowiak, Mathias Hoffmann, Günter Beck

Since 2001 the Joint Lunchtime Series has been organized by the CFS, the Deutsche Bundesbank and the ECB. It creates a platform for economic experts, particularly in the area of monetary policy, to present their current research findings to a selected circle of central bankers and macroeconomists. This year, the three organizers, **Günter Beck** (CFS), **Mathias Hoffmann** (Deutsche Bundesbank) and **Bartosz Maćkowiak** (ECB), have again invited a number of economic professionals from academia, central banks, private institutions and consulting companies from all over the globe. Besides discussing the most recent findings of their research projects, many guest speakers have also addressed various aspects of the financial turmoil.

Stephan Sauer (ECB), for example, provided a framework for analyzing the emergency liquidity assistance provided by central banks to the financial markets in response to aggregate and idiosyncratic liquidity shocks. His model brings together the microeconomic view of liquidity as the ability to sell assets quickly and at low costs, as well as the macroeconomic view of liquidity as a medium of exchange that influences the aggregate price level of goods. The central bank is confronted with a trade-off between limiting the negative output effects of dramatic asset price declines, on the one hand, and more inflation on the other. Moreover, the anticipation of central bank intervention causes a moral hazard effect among investors. This gives rise to the possibility of an optimal monetary policy under commitment.

A presentation on liquidity and liquidity risk premia in the credit default swaps (CDS) market was held by **Frank de Jong** (Tilburg University). Specifically, he developed a framework for studying the effect of liquidity on prices of CDS. He found that the exposure to credit risk is priced and provided evidence of a liquidity premium attributable to the protection seller. This liquidity effect is mainly due to expected liquidity rather than the liquidity risk itself. His results imply that CDS spreads cannot be used as frictionless measures of default risk, as is often done in the recent literature.

Matteo Iacoviello (Boston College) focused on the housing market and investigated the consequences of an increase in individual income risk and a decrease in down-payment requirements for aggregate volatility. In analyzing this issue, he made a clear distinction between the period from the 1950s through 1970s, when individual risk was relatively small and maximum loan-to-value ratios were low, and the period from the 1980s through today, characterized by high individual risk and high loan-to-value ratios. In the earlier period, precautionary saving is small, wealth-poor people are close to the maximum borrowing limit, and housing investment, home ownership and debt closely track aggregate productivity. In the later period, precautionary saving becomes larger as a result of higher idiosyncratic risk, wealth-poor people borrow less than the maximum, and become more cautious and able to self-insure in response to aggregate shocks. Consequently, the correlation between debt and economic activity on the one hand, and the sensitivity of housing investment to aggregate shocks on the other, are lower, as in the data. Quantitatively, his model explains (i) 30% of the reduction in the volatility of household investment; (ii) the sharp decline in the correlation between household debt and economic activity; (iii) between 5 and 10% of the reduction in the volatility of GDP.

Celia Wieland (CFS)

In the second half of 2008, the CFS has welcomed the following speakers:

David Lopez-Salido (Federal Reserve Board Washington)
Harris Dellas (University of Bern)
Kai Leitemo (Norwegian School of Management)
Refet S. Gürkaynak (Bilkent University)
Silvana Tenreyro (London School of Economics)
Carlos Thomas (Banco de España)
Olivier Pierrard (Banque Centrale du Luxembourg)
Karl Schmedders (Northwestern University)
Steve Ambler (University of Quebec)
Øyvind Eitrheim (Norges Bank)
Sergey Slobodyan (CERGEI-EI)
Eric Jondeau (HEC University of Lausanne)
Ernesto Pastén (Toulouse School of Economics)
Juan Carlos Conesa (Universitat Autònoma de Barcelona)
Kevin Sheedy (London School of Economics)
Giovanni Favara (HEC University of Lausanne)
Matteo Iacoviello (Boston College)
Glenn D. Rudebusch (Federal Reserve Bank of San Francisco)
Michael Reiter (Institute for Advanced Studies)
Stephan Sauer (European Central Bank)
Gerhard Sorger (University of Vienna)
Tom Cosimano (University of Notre Dame)

→ For further information and registration please contact Celia Wieland, email: JLS@ifk-cfs.de

CFS Presidential Lectures

Über die Währungsunion zur Politischen Union in Europa? Der Euro – Währung ohne Staat

Via Monetary Union towards a Political Union in Europe? The Euro – A Currency without a State

15 October 2008

Otmar Issing

On the 15th of October 2008 CFS President Otmar Issing gave a lecture on the topic of political, economic, and monetary integration in Europe. Issing spoke about the economic and political achievements in Europe and about the challenges ahead. The following paragraphs contain a brief summary of the key issues featured in this speech.

The term "Europe"

Issing began his presentation by looking at the origins of the term "Europe" and the concept it has come to represent. Europe was initially a predominantly geographical concept whereas nowadays this is just one aspect of a many faceted entity with common cultural roots and common ideas of freedom and human rights.

Otmar Issing

After the Second World War, the western world usurped the term "Europe" and used it to denote its sphere of influence. First of all there was the European Coal and Steel Community

(ECSC) followed by the European Economic Community (EEC), the European Monetary System (EMS) and, finally, the European Monetary Union (EMU). Countries in the geographical west laid claim to the term since the first steps were taken towards integration.

Europe as political goal

In post-war Europe, the grounds for striving towards integration were in the first place political, stemming from the desire to avoid another war at any cost. However, at that time the notion of fully-fledged political integration with common statehood for a large number of countries was inconceivable. Therefore, success could only be booked through specific economic initiatives by a smaller nucleus of countries.

Justifiably, the Schuman Plan, initiated in 1950, can be seen as the starting point of the European integration process. Although the motive for founding the ECSC was political, the instrument used was that of economic cooperation. Soon it became clear that this was the only way to move forward. Any effort to make progress at the political level failed.

On 1 January 1958 the Treaty establishing the European Economic Community came into effect between the six founding countries. The first enlargement of the EEC occurred in 1973. It was clear that the integration process could not follow the path of sectoral integration – as was initially the case with the ECSC – nor could it be reached via supranational statehood. Therefore, the basic aim was to create a single European market. This market integration could only be reached when competition distortions were lifted. This was realized via four principles of economic freedom, i.e., the free movement of goods, services, capital, and people. The biggest change, however, took place in 1992 when the EEC became the European Union and the fall of the so-called Iron Curtain had allowed expansion to the East.

The role of a single currency

The start of the monetary union raised the integration process to a new level. On the one hand, the introduction of a single currency stood for the accomplishment of the single market. Considering the volume that current speculative attacks on currencies could potentially reach, it is not hard to imagine the impact the current financial crisis would have had if Europe were still to have its national currency regimes. Despite central bank interventions, a breakdown of the exchange rate system might have been unavoidable.

On the other hand, the impact of introducing a single currency, however, extended beyond effects of a solely economic nature. Indeed it also meant that participating countries were not only required to surrender part of their sovereignty to the European Central Bank but they were to some extent even compelled to relinquish part of their identity by giving up their local currency.

The single currency as catalyst for political unification?

In the 1960s and 1970s, there was much debate about which policies were most likely to be successful with a view to achieving European integration. At one end of the spectrum were those who advocated a step by step approach to dismantling intra community barriers, a process which would ultimately culminate in a single currency, and on the other hand there were those who believed that monetary integration should in fact be amongst the first steps to be taken and would automatically lead to the necessary economic adjustments. Elements of both approaches are manifested in the Maastricht Treaty: the "economistic" view is reflected in the demand for compliance with the convergence criteria and the "monetaristic" approach is reflected in the fixed starting date set for the monetary union.

Irrespective of any such economic considerations, politicians in Europe have, time and again, tried to use the monetary union as a stepping-stone towards political unification. A statement such as "L'Europe se féra par la monnaie ou ne se féra pas" (by J. Rueffs, 1950) reflects this attitude well. Many politicians – such as Richard von Weizsäcker or Jacques Chirac – saw the European single currency as a strategic instrument for foreign policy interests.

Issing warned against loading a political mission onto the single currency. The notion, indeed the hope, that a monetary union could be tied to expectations that reach beyond economic issues has at the same time been a major fear of many politicians, such as Margaret Thatcher. She was not prepared to accept the inevitable loss of sovereignty in many fields that a single currency implies.

Consequences for fiscal policy

The Stability and Growth Pact is meant to fill a "political gap" in a European Monetary Union. As sovereignty over fiscal policy in principle remains at the national level, a suitable framework was needed to keep the national budgets in line with the common monetary policy goals. By introducing fiscal rules, the EU member countries should be prevented from drifting towards imprudent fiscal policies. Issing pointed out that the pact requires member states to comply with and give priority to the European rules. This, however, can lead to a conflict with national interests of a country. According to Issing, this conflict cannot be solved by eroding national fiscal sovereignty. He sees no need for the creation of an "economic government" as proposed by President Nicolas Sarkozy. Firstly, the European Council has the necessary mandate to take necessary decisions within the scope of the Stability and Growth Pact. Secondly, this economic government could undermine the constitutionally guaranteed independence of the European Central Bank.

Europe and the financial crisis

The current financial crisis demonstrates the weaknesses of Europe's unfinished political house. Spillover effects of the crisis are evident throughout the EU, but the member states are experiencing difficulties in finding a balance between national and European interests. Unilateral measures adopted by individual member states can have a negative impact on many or all of the other states. Issing thus emphasized that the principle of a single market requires coherent rules.

With regard to the creation of a special European rescue fund, Issing stressed that this would need not only acceptance by local parliaments but also by the population as a whole.

Nonetheless, as Issing also pointed out, the financial crisis undoubtedly offers opportunities for finding new European solutions for financial market supervision.

Can the monetary union in Europe survive without a political union?

In the foreseeable future, the Euro will most probably remain a currency without a state. Helmut Kohl was convinced that "a monetary union without political union is doomed to fail". Have we created a constellation that is doomed to collapse because of the single-handed start of the currency union?

The ECB's single monetary policy has led to a situation that requires certain minimal conditions to be fulfilled in order to be successful. These comprise a fiscal policy in line with the monetary goals of the ECB as well as flexible markets, in particular flexible labor markets. Substantial progress has been made but still there is much to be done.

Discussions about the future of political union are mostly raised in connection with demands for a common foreign policy and defense policy. Progress in these fields depends entirely on the political willingness of member states to meet these demands, and it is only when it comes to the issue of financing them that the Euro comes into play. According to Issing, this shows, once again, that a political union cannot be reached through the backdoor of a monetary union.

The importance of a stable currency

Today's Europe is torn between its single market subscribed to by all member states, a monetary union formed by a smaller group of states, and the controversy surrounding the notion of political union. Europe's success is based on its economic achievements with the single market and the creation of a stable currency.

A stable currency can only be ensured by an independent central bank that can take decisions without being influenced by political interests. The demand for "apolitical money" was reflected in the Maastricht Treaty. This requirement should not be violated as it safeguards stable money and the economic success of Europe. Monetary stability is a condition sine qua non for a proper functioning of the markets.

Whether the Euro can contribute to a European identity and help promote political union is hard to say. However, a stable Euro and monetary stability are the basic foundations for any remodeling of Europe.

Lut De Moor (CFS)

CFS Presidential Lectures – Upcoming Event:

Lecture by **Jean-Claude Trichet,** President of the European Central Bank on **16 March 2008**

→ Further details about this event will soon be available on our website

CFS Conferences

IMF-CFS Conference

"A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrating Market"

26 September 2008

Frankfurt am Main

How should financial stability be managed in an integrated cross-border market? And what does the ongoing financial crisis imply for the European Union's financial integration project and its financial stability framework? A long-planned but unexpectedly timely conference on these topics was held in Frankfurt on September 26, in a joint organization by the IMF and the Center for Financial Studies.

The aim of the conference was to provide a forum at which policymakers, supervisors, market participants, and academics could carry forward the debate on the European Union's (EU) cross-border financial stability arrangements. In the midst of a global financial crisis—the news of the closure of Washington Mutual greeted the conference participants that morning in Frankfurt – this until-recently-obscure topic had suddenly become very tangible. Indeed, recent developments had provided a plethora of interesting material to spice up the discussions. Holding a conference on financial stability in the midst of a financial crisis also comes with a drawback, though, in the form of several high-profile last-minute cancellations. Still, the conference brought together an impressive array of experts. In various ways, the discussions foreshadowed what was about to happen in Europe's financial system.

- The ongoing crisis demonstrates that Europe must be better prepared to deal with bank failures.
- A new financial stability architecture for the EU should be based on joint responsibility and accountability.
- An inadvertedly timely IMF-CFS conference in Frankfurt discussed these issues.

In his introductory remarks, **Alessandro Leipold** (International Monetary Fund) called for a more integrated financial stability framework that delivers joint responsibility and accountability, better preparedness for cross-border bank failures, and more rapid progress toward these objectives.

Pointing out that Europe is not immune to financial stress and bank failures, as illustrated too well by the ongoing crisis, Leipold emphasized that Europe must be better prepared to deal with bank failures. He noted that the IMF staff has long taken the view that financial integration is crucial to the EU's growth prospects, and that achieving and safeguarding financial integration requires some form of integrated financial stability framework.

Charles Goodhart (London School of Economics) argued that when trying to come up with a financial stability framework, it is important to "follow the money." He emphasized that it is the ministry of finance that ultimately has to decide whether to bail out a bank. He warned quite presciently that the need for large scale solvency support created by the ongoing crisis could result in increased national control over financial systems, which would set back financial integration. Thus, the crisis risked exposing financial stability as a key faultline between the euro area's centralized

Charles Goodhart, Jan Krahnen

Johnny Åkerholm, Gerd Häusler, Sergio Lugaresi

monetary policy and decentralized fiscal policy. To counter this risk, he argued for limited fiscal federalization for the euro area, and eventually for the whole EU.

One of the conference themes was the role of regulation and supervision in achieving the integration of financial systems that are rooted in very different legal and regulatory systems. Reviewing progress in creating a regulatory level-playing field in Europe, **Johnny Åkerholm** (Nordic Investment Bank and Inter-Institutional Monitoring Group) characterized the process as "going in the right direction, but painfully slowly." He called on politicians to agree on an ambitious vision similar to the one that resulted in Monetary Union. He suggested modeling the prudential architecture on the Eurosystem's "hub-and-spokes" setup, thus retaining proximity between supervisors and financial institutions at the national level while establishing a level playing field and streamlining the oversight of cross-border groups. **Sergio Lugaresi** (Unicredit) argued for the introduction of a specific corporate statute adapted to the needs of cross-border banking groups.

Arnoud Vossen, Thomas Steffen, David Mayes

A closely related conference theme was crisis prevention, more specifically the monitoring and management of cross-border risks in the single financial market. **Thomas Steffen** (Committee of European Insurance and Occupational Pensions Supervisors and BaFin) noted that crisis prevention is an ambitious target that has received substantial political and institutional attention in recent months, including by the EU Council. **Arnoud Vossen** (Committee of European Banking Supervisors) elaborated on this theme, noting that the so-called Level 3 Committees have become more active in coordinating the work of the national supervisory agencies. **David Mayes** (Bank of Finland) pointed out that despite these efforts, there is still too much scope for national supervisory discretion. He called for a more rules-based system of prompt corrective action, which could give authorities in one country more confidence that other country authorities' would intervene into a troubled bank relatively early and take it over before its capital is depleted.

Franklin Allen

In light of the ongoing developments, there was a very lively discussion on handling failures of cross-border financial institutions in the EU. **Josef Tošovský** (Bank for International Settlements) quoted a recent survey carried out by the Financial Stability Institute, which found that the cross-border financial stability framework largely consisted of memoranda of understanding and ad-hoc meetings. **Franklin Allen** (University of Pennsylvania) presented an analysis of the recent large bank failures in the United States, noting that there are opposing explanations for what happened, leading to very different recommendations for handling the failures. **Dirk Schoenmaker** (Dutch Economics Ministry and VU University Amsterdam) pointed out that the objective of a


Dirk Schoenmaker

stable and integrated financial system in the European Union is inconsistent with national financial stability policies. He argued that the stability of the EU financial system could not be assured if a financial crisis, involving one or more of the emerging pan-European banks, were to happen.


Jaime Caruana

The concluding policy panel, chaired by **Mr. Jaime Caruana** (International Monetary Fund), focused on concrete steps to strengthen Europe's financial stability framework. The views expressed by the panelists provided a revealing illustration of the state of the debate and the remaining sensitivities. Recurring themes were calls for greater centralization of financial supervision (although opinions differed on the form this should take and on ECB involvement), better bank resolution frameworks, enhanced coordination between macro and micro prudential policies (i.e., between central banks and supervisors), a single rules book, and expeditious progress toward an improved regulatory framework that addresses the weaknesses exposed by the financial crisis.

Lorenzo Bini Smaghi (European Central Bank) and **Pervenche Berès** (European Parliament) both called for far-reaching reforms of the financial system, even though their emphasis was different: Mr. Bini Smaghi emphasized the role of conflicts of interest in the financial system; Ms. Berès stressed the need for more stringent regulation of certain financial market activities. In a reaction from the audience, **Jan Pieter Krahnen** (Goethe University and CFS) argued that the causes of the problems must be well understood before major new regulations are introduced. Views also differed on the degree of supervisory integration that Europe needs: **Jonas Niemeyer** (Sveriges Riksbank) called for much more integration, including possibly the creation of a single European supervisory agency, while **Zdeněk Tůma** (Czech National Bank) emphasized the challenges faced by host country authorities, and called for a return to greater host country control. **Danielle Nouy** (Commission Bancaire) reviewed the experience with colleges of supervisors, and suggested to build on that experience.


Danielle Nouy

Even though views differed on specifics, there was a broad consensus that the EU countries individually and Europe as a whole need to be better prepared to prevent, manage, and resolve bank failures. There was also widespread recognition of the fact that the current crisis will lead to profound debate on the foundations of modern finance. Likewise, policymakers ought to turn this crisis into an opportunity to have an open, unconstrained debate about the EU's financial stability arrangements – a debate freed from long-standing national red lines and infused with a greater sense of multilateralism and urgency, and thus leading to policy action. The largely uncoordinated response of European policymakers in the days that followed the conference underscored the importance of these conclusions.

Elena Carletti (CFS),
Martin Čihák, and Wim Fonteyne (both IMF)

→ For more details, including a list of the speakers and the relevant background materials, see:
http://www.ifk-cfs.de/index.php?id=1360.

ECB-CFS Conference
"Household Finances and Consumption"
4-5 September 2008

Frankfurt am Main

Organizers: Luigi Guiso (EUI), Michael Haliassos (Goethe University and CFS), Lucrezia Reichlin (ECB), Peter Mooslechner (Austrian National Bank)

On the 4th and 5th of September 2008, the ECB and the CFS Research Program on Household Wealth Management jointly organized a conference on household finances and consumption, which took place at Campus Westend of Goethe University. The conference's main purpose was to present recent research on household finance and to discuss prospects for creating a "Euro Zone Survey of Household Finances and Consumption". Preparatory work for the creation and launch of such a survey has lasted almost three years, with Luigi Guiso (EUI), Michael Haliassos (Goethe University and CFS) and Arthur Kennickell (Board of Governors of the Federal Reserve System) acting as academic consultants. Researchers and practitioners from the U.K., the United States and various European countries used the opportunity provided by the conference to present recent research, put this project into perspective, and to discuss the usefulness of such surveys in academic research and policy design.


Orazio Attanasio

The first day of the conference was introduced by **Orazio Attanasio's** (University College London and Institute for Fiscal Studies) plenary talk, which addressed the question whether or not house price growth drives consumption growth in the U.K. Given their strong association, is this due to wealth and collateral effects on consumption or does this arise from common factors, such as expectations, affecting both house prices and consumption growth? The speaker emphasized the need for micro level data for differentiating between these two possibilities. Wealth, house prices, and income expectations are likely to have different effects on different age groups, with older people responding more to capital gains and younger people responding more to income expectations.

The second plenary talk was held by **Deborah Lucas** (Northwestern University). She argued that the widely taught representative agent approach misses the household heterogeneity that is crucial to understanding important issues in household finance. By mentioning a number of surveys which are conducted in the U.S., including the Survey of Consumer Finances and the Panel Study of Income Dynamics, she, too, placed emphasis on having such a survey within Europe. Her talk focused on questions such as how diversified are stock holders, and how important are "mistakes", such as non-participation, limited diversification, and the like? All of these explicitly call for modeling frameworks that allow for heterogeneity across individuals.


Deborah Lucas

The two plenary talks were followed by a speech from **Vítor Constâncio,** Governor of the Banco de Portugal. He highlighted the need for micro level data from a central banking perspective. Monetary policy makers need survey data so as to be able to assess the determinants of consumption and saving, to understand wealth effects and, importantly, to assess the determinants and consequences of indebtedness. After introducing the main features and characteristics of the Portuguese survey on household wealth, Governor Constâncio pointed out the potential that a Euro Zone Survey would have – it would allow for both country specific as well as for an aggregate examination. He also said it should contain a panel structure so as to allow for the analysis of lifecycle and cohort effects.

Michael Ehrmann

The next session was directed more concretely towards the household finances and consumption project. **Caroline Willeke** and **Michael Ehrmann** (both European Central Bank staff) presented the project and were then followed by a panel discussion led by **Manuel Arellano** (Centro De Estudios Monetarios Y Financieros), **Christopher Carroll** (Johns Hopkins University), and **Tullio Jappelli** (University of Naples and Center for Studies in Economics and Finance). Manuel Arellano opened the discussion by putting the project into perspective. According to Arellano, household survey data on income, wealth, and consumption are an essential input for evidence-based policy. On top of this, information technologies and increasing computing power create new opportunities for the analysis of large micro datasets. Moreover, such datasets are not only used within academia but also within central banks. The floor was then given to Christopher Carroll, who made suggestions on how to proceed with the survey. Among other things, he suggested creating a public website where people can post programs, results, and the like, and which would serve as a forum where they can discuss all questions related to the survey and its use in empirical research. Secondly, he emphasized the need for some standardized structure of the survey for different countries so as to make results as comparable as possible. Tullio Jappelli completed the discussion and the first day of the conference by reviewing the advantages of having internationally comparable data available. Since there is a huge variety of European institutions and policies, their impact can certainly only be understood if one compares these across time and countries. As regards data collection, Jappelli highlighted both the importance of repeated cross-sections and panel data structures which would allow one to study age and cohort effects, portfolio transitions, and how people respond to shocks. Also, data on subjective probabilities have been promising with respect to explaining people's behavior, as they can help in analyzing, inter alia, social security expectations, investment expectations, and survival probabilities.

Tullio Jappelli

Sumit Agarwal

Session One on the second day of the conference, titled "Consumer Bankruptcy and Default: The Role of Individual Social Capital Formation Characteristics", was led by **Sumit Agarwal** (Federal Reserve Bank of Chicago). He presented a paper written jointly with **Souphala Chomsisengphet** (U.S. Office of the Comptroller of the Currency) and **Chunlin Liu** (University of Nevada-Reno). The purpose of their study is to assess empirically the role of individual social capital formation characteristics on personal bankruptcy and default outcomes in the consumer credit market. Among other things, they find that default risk rises and falls over the lifecycle, while borrowers who own a home and are married have a lower risk of default/bankruptcy. The discussant was **Daniel Dorn** (LeBow College of Business, Drexel University).

The second paper was titled "Household External Finance and Consumption" and is a joint work by **Paolo Surico, Neil Meads** (both Bank of England staff), and **Timothy Besley** (Bank of England and London School of Economics). This paper uses mortgage data to construct a measure of the terms on which households have access to external finance, and relates this to consumption at both the aggregate and cohort levels. They adduce evidence that the terms of access to external finance matter more for consumption by young cohorts in U.K. data. Their results are solid with respect to a wide variety of specifications.

The first paper in the following session, by **Marjorie Flavin** (UC San Diego) and **Takashi Yamashita** (Reed College), was titled "Owner-Occupied Housing: Life-cycle Implications for the Household Portfolio". The authors consider the effect of housing in a portfolio allocation problem by conditioning on the current holding of housing. In order to determine the optimal holding of financial assets they use the mean-variance framework. The authors consider the implications of the model for the composition of the portfolio over the lifecycle, the main finding being that while collateral and non-negativity constraints are present, the optimal portfolio will depend both on the degree of household risk aversion and the ratio of house value to net wealth. They conclude by examining the lifecycle patterns in portfolio data provided by the Survey of Consumer Finances.

Annamaria Lusardi

The second talk in this session was based on joint work by **Annamaria Lusardi** (Dartmouth College) and **Peter Tufano** (Harvard Business School), titled "Debt Literacy, Financial Experience and Over-Indebtedness". In their paper, a new dataset, based on a U.S. survey from November 2007, is used to analyze the financial experience of survey respondents, their debt literacy, and their own judgments about the level of their indebtedness. Overall, the authors find that debt literacy is low, especially among certain demographic groups. They also find a clear relationship between debt literacy and both debt loads and financial experience. The results suggest that individuals who are less literate report that their debt loads are excessive and that they are unable to judge their debt position.

The first study of the third session, titled "Diversification and its Discontents: Idiosyncratic and Entrepreneurial Risk in the Quest for Social Status", was presented by **Nikolai Roussanov** (University of Pennsylvania). Roussanov uses a portfolio choice model that incorporates preference for social status in order to explain a number of stylized facts about the heterogeneous nature of asset holdings among U.S. households. Concern about social status is introduced by incorporating a household's wealth relative to aggregate wealth in the economy directly into the utility function. His model has been calibrated such that it matches the empirical level of risky asset holdings.

The second paper of this session was then presented by **Oded Stark** (University of Bonn). He presented a paper written jointly with **Donald Cox** (Boston College), titled "Bequests, Inheritances, and Family Traditions". The purpose of this study is to consider whether family traditions have an impact upon bequest behavior, i.e. to question whether an individual who receives an inheritance is then more likely to give a bequest to his or her children. The authors use data from the U.S. Health and Retirement Survey, which is one of the few such surveys providing data both on bequests and inheritances. The main finding of their study is that intended bequests and inheritances are indeed positively and significantly related, importantly so after controlling for household characteristics such as household net worth.

The fourth and final session of the day started with a focus on the paper "House Prices and Consumption: A Micro Study" written by **Mette Gortz** (AKF, Danish Institute of Governmental Research), **Martin Browning** (Oxford University), and **Soren Leth-Petersen** (University of Copenhagen). The paper studies the close relationship between house prices and consumption, and stresses that no consensus has been found on the causes of an apparent link between these two factors. Despite a number of alternative explanations in the literature, these authors favor the idea that the observed correlation may be due to "common causality", in that changing house prices may be correlated with expectations of general productivity changes in the economy. In their study, they focus on a panel data set that is available for Denmark, comprising information on individual house ownership, income, and wealth for about 10 percent of the population here.

The second paper within the fourth session, titled "The Response of Household's Consumption and Balance Sheets to the Risk of Losing the Job: Evidence from Firing Costs", is a joint work by **Ernesto Villanueva** and **Christina Barcelò** (both Banco de España staff). Their study focuses on the question whether and, if so, to what extent, individuals exposed to the risk of losing their job postpone consumption plans and thereby increase their savings. Firing costs are taken as a potential predictor of transition into unemployment and are found to serve this purpose very well. The link between the probability of household members losing their job and the wealth and consumption of their households is examined using a survey of wealth and consumption.

The second to last presentation was devoted to "Financial Literacy, Retirement Planning and Household Wealth" by **Maarten van Rooij** (De Nederlandsche Bank), **Rob Alessie** (Utrecht School of Economics), and **Annamaria Lusardi** (Dartmouth College). Their purpose is to investigate the relationship between financial sophistication and household net worth using survey data from the Dutch DNB household survey. According to their findings, this relationship is both statistically and economically significant. In addition, they indicate two channels through which a correlation emerges. Firstly, individuals and households may be more likely to invest in the stock market if they have some knowledge about financial instruments. Secondly, financial sophistication may increase households' awareness of the importance of retirement planning and may, in this regard, have an impact on their behavior.

The conference was subsequently closed by the presentation of a paper by **Frederic Lambert** (Banque de France) and **Matteo Pignatti** (New York University), namely "Saving Behavior Over the Lifecycle Does Not Differ Across Countries. Portfolio Choices Do". This paper compares consumption and savings profiles in Italy and the U.S. over the lifecycle using detailed micro data for both countries. The authors highlight that savings profiles are very much alike, while differences are found when looking at wealth-age-profiles, first and foremost when considering the portfolio composition of households between housing and financial assets. Household portfolios in general appear to be more leveraged at the beginning of the lifecycle in the U.S. than in Italy.

By and large, the ECB-CFS Conference on the Household Finances and Consumption Network provided a great opportunity for researchers and practitioners in the field of household finance as well as planners of the European survey of household finances to meet and discuss recent stimulating

research. It also enabled them to consider how this survey could provide an important input into such research in the future. The crucial importance of having a panel dimension within the survey was emphasized, as this would allow changes in portfolios to be tracked over time and age and cohort, and also enable time effects to be separated. In Chris Carroll's words, such a feature would give the Euro Zone Survey of Household Finances and Consumption "a chance to beat the Americans!"

Marco Buchmann (Goethe University Frankfurt)

International Research Forum on Monetary Policy

26-27 June 2008

hosted by the European Central Bank in Frankfurt

The fifth conference of the International Research Forum on Monetary Policy took place in Frankfurt on the 26th and 27th of June 2008, and was hosted by the European Central Bank. This year's conference was organized by Matthew Canzoneri (CGES), Dale Henderson (FRB), Lucrezia Reichlin (ECB), and Volker Wieland (Goethe University Frankfurt and CFS). As in previous years, the audience consisted of researchers from leading universities, international organizations, and central banks, but also included financial market observers from private sector firms and representatives of the financial press.

After welcoming the speakers and the audience, **Lucrezia Reichlin** opened the conference with a session on "Financial Markets, Financial Crises and the Transmission of Monetary Policy". In the first research contribution, **Markus Brunnermeier** (Princeton University) analyzed the 2007-2008 liquidity and credit crunch. He identified four amplification mechanisms to explain why the mortgage crisis caused such large dislocations and turmoil in the financial markets: liquidity spirals that arise from deterioration in borrowers' balance sheets; hoarding and interest rate surges in the interbank market driven by uncertainty about future funding needs; runs on financial institutions when financiers try to preempt each other; and network and gridlock risk when financial institutions are lenders and borrowers at the same time. While the losses in subprime mortgages appeared large at first, the author emphasized that the 2007-2008 crisis was surprisingly "classical". The new element, however, was the extent

of securitization which increased the exposure to counterparty risk while also creating additional difficulties in valuing structured products. As a consequence, the author called for the regulatory framework to be rethought.

Robert King (Boston University and NBER) and **Julia Thomas** (Federal Reserve Bank of Philadelphia and NBER) presented a model economy nesting two models, a standard New Keynesian setting and a setting where small transactions costs engender an evolving distribution of money across households. In contrast to the standard New Keynesian setting, portfolio adjustment costs lead to a breakdown of the Keynesian dichotomy such that aggregate demand can no longer be determined without reference to monetary variables. In examining the nature of dynamic responses arising in their setting, the authors found that the model has also desirable empirical properties.

The importance of foreign factors for domestic inflation was the topic of the paper by **Luca Guerreri, Christopher Gust** and **David López-Salido** (all Federal Reserve Board). In the spirit of Dornbusch and Fischer (1985), the authors developed and estimated an open-economy New Keynesian Phillips curve in which variations in desired markups of domestic producers arise in response to changes in competitive pressure from abroad. Their main result was that foreign competition plays an important role in accounting for inflation dynamics: reducing the desired markups of domestic producers, foreign competition lowered domestic goods inflation in the U.S. in the 2000-2006 period by about 1 percentage point. The authors also found that movements in relative import prices associated with changes in foreign competition accounted for over one-third of the volatility of goods price inflation over the 1983-2006 sample period. Finally, the results also provided evidence in favor of demand curves which lead to endogenous variations in markups.

Markus Brunnermeier, Nuno Cassola, Franklin Allen, Lucrezia Reichlin

In his luncheon speech titled "Global Economic Integration and Decoupling", **Donald Kohn** (FRB) warned against taking the current slowdown in the U.S. as indicative of apparent divergences in economic performance between the major industrial countries. Although the latest downturn was not felt as uniformly in the global economy as previous ones, these divergences do not constitute breaks from historical benchmarks but rather represent distinct shocks hitting the global economy. As construction utilizes mainly local inputs and results in output that is not traded internationally, its spillovers on the real side of foreign economies are limited. Hence, although the financial turmoil triggered by problems in the U.S. housing sector has been more international in scope, its effects on the real side of foreign economies have been limited so far. Simultaneously, improved economic and financial policies have made emerging market economies more flexible and less subject to internal and external shocks so that assets from these financial markets were not sold off after the financial turmoil in the U.S. Thus, greater economic

Donald L. Kohn

and financial integration can indeed be reconciled with less synchronization of developments across countries.

After the lunch break, **Fabio Milani** (University of California, Irvine) presented a DSGE model in which agents' learning speed (their gain coefficient) is endogenous, responding to previous forecast errors. A changing gain coefficient would endogenously generate time-varying macroeconomic volatility. Taking the model to the data, the author's estimation results confirmed the evidence of large changes in the gain over the post-war U.S. sample. These changes could imply important changes in macroeconomic volatility roughly matching the magnitude of the Great Moderation. The author concluded that neglecting these learning dynamics would lead to an overestimation of the importance of changes in the volatility of exogenous shocks.

Next, **Gianni Amisano** and **Oreste Tristani** (both ECB) investigated empirically the interaction between shifts in trend productivity growth, policy interest rates and the natural rate in a small New Keynesian model of the euro area. The authors found that shifts in trend productivity could explain a sizable portion of observed euro-area inflation over the 1980s and 1990s. In contrast to what was usually found in DSGE models, the authors' estimates of the natural rate were much smaller, suggesting that monetary policy had mostly behaved consistently with the objective of eliminating all sources of inflationary pressure from the economy.

The last paper on the first conference day by **Carlos Thomas** (Bank of Spain) and **Francesco Zanetti** (Bank of England) dealt with the effect of labor-market reform on inflation volatility. Their analysis was based on a New Keynesian model with search and matching frictions. The model suggests that changes in unemployment benefits or firing costs affect inflation through their effect on real marginal costs. However, when taking the model to the data, the authors found that changes in unemployment benefits or firing costs had very small effects on the volatility of inflation.

In his dinner speech, **Lucas Papademos** (ECB) addressed the audience with a central banker's perspective on financial market excesses and corrections. After discussing the underlying causes of the financial turmoil, he turned to the role of central bank policies and tasks in both preventing financial market imbalances as well as mitigating the consequences of a sharp correction in the financial system. While the ECB has alleviated financial stability risks through the effective management of liquidity in interbank money markets in response to the financial market turbulence, he highlighted that there is also scope for the central bank to prevent asset price bubbles. For example, central banks can minimize the likelihood of financial turmoil by enhancing their monitoring of financial stability, by further developing the pertinent methodologies and models and by improving the availability of relevant data. In view of the policy issues arising from the latest financial market turbulence, he emphasized the importance of further research on financial market imbalances and appropriate policy responses in an environment such as "The International Research Forum on Monetary Policy".

The conference continued with **Maria Demertzis** (De Nederlandsche Bank and University of Amsterdam) and **Nicola Viegi** (University of Cape Town and ERSA) who interpreted inflation targeting as a means for communication rather than a monetary policy strategy and modeled monetary policy as an information game between the bank and private agents. The combination of communicating the target and a tolerance band around it provides a clear framework with which to evaluate monetary policy outcomes. As a result, a successful central bank builds up credibility and a credible central bank is in a better position to be successful in later periods. The authors showed how and when inflation targeting exploits this self-reinforcing loop to help the central bank to endure large and long-lasting shocks. A trade-off emerges when choosing the bandwidth around the target: too narrow bands provide a focal point but reduce the likelihood to be successful. Too wide bands more easily lead to success but fail to deliver a clear focal point.

Josephine Smith and **John Taylor** (both Stanford University) instead took a closer look at how shifts in the central bank's policy rule cause shifts in the term structure of interest rates. They derived a new representation of the term structure in which long-term interest rates are related to inflation and output, and the term structure is simply a series of implied policy rules for long-term interest rules with response coefficients measuring the size of the interest rate reaction. Using this they derived analytically an equation relating the response coefficients in the implied long-term interest rate rules to response coefficients of the short-term interest rate rule of the central bank. The main result was that a secular shift in the monetary policy rule in the mid-1980s in the U.S. explains the large shift in the term structure. The model also helps to explain the behavior of the longer-term interest rates during the period 2003-2005.

How much inflation is necessary to grease the wheels? This was the question that **Jinill Kim** (Federal Reserve Board) and **Francisco Ruge-Murcia** (University of Montréal) analyzed. Taking up the proposition by Tobin that inflation "greases the wheels" of the labor market, the authors employed a DSGE model with asymmetric wage adjustment costs. The authors' econometric results suggested that nominal wages are downwardly rigid and that the optimal level of grease inflation for the U.S. is about 1.2 percentage points per year. This optimal level of grease inflation naturally depends on the specified model.

The lunch break was followed by **David Arseneau** (Federal Reserve Board) and **Sanjay Chugh** (University of Maryland) who re-examined the conventional wisdom regarding labor tax-smoothing in the presence of frictional labor markets. In these markets, if wages are determined by ex-post Nash bargaining, tax smoothing is not optimal. If instead wages are determined before workers and firms meet and search is directed by wages while labor markets are governed by competitive search equilibrium, the optimality of tax smoothing is restored. As a consequence, whether or not tax smoothing is as important as standard theory suggests critically depends on the wage-formation process. One has to accept a Walrasian or competitive view of wage determination in order to accept the prescription of tax smoothing.

Federico Ravenna and **Carl Walsh** (both University of California, Santa Cruz) concluded the conference with their paper on the welfare consequences of monetary policy and the role of the labor market. Exploring the nature of distortions in sticky-price labor friction models, the authors found that the monetary authority faces a trade-off between stabilizing the retail price markup as a policy goal in its own right or moving the markup to mimic the cyclical tax policy that would lead to efficient vacancy posting. Deviations from price stability are optimal if wages are rigid around an inefficient level. In these cases, the welfare gains of deviating from price stability are larger in economies with more volatile labor market flows such as the U.S. Higher firing and hiring costs as in the EU make price stability a closer approximation to the optimal policy.

Julia Le Blanc (CFS)

→ The complete conference program including papers and speeches can be found at: http://www.ifk-cfs.de/?id=1398

Since its creation in 2002 by the European Central Bank (ECB), the Board of Governors of the Federal Reserve System (FRB), the BMW Center for German and European Studies at Georgetown University (CGES), and the Center for Financial Studies (CFS), the Research Forum's goal has been to encourage research on monetary policy issues that are relevant from a global perspective. To this end the Forum regularly organizes conferences held alternately in the Euro area and the United States.

The Industrial Organization of Securities Markets: Competition, Liquidity and Network Externalities

13-14 June 2008

Frankfurt am Main

The securities markets landscape has been changing quite significantly over the last years, through the increase of competition, the advancement of technology and the restructuring of the industry. This process depends heavily on the characteristics of the industry within the individual layers of the entire value chain (trading, clearing and settlement), be it e.g. liquidity effects and network externalities. The industrial organization of securities markets will keep on evolving, as the value chain will be impacted by regulatory changes. In the European Union initiatives such as the Markets in Financial Instruments Directive (MiFID) or the clearing and settlement industry's Code of Conduct, and in the U.S. the Regulation NMS are already challenging the industry of securities markets. The aim of the conference was to shed light on all aspects of the industrial organization of securities markets. The issues addressed at the conference covered the entire value chain in the exchange business, including both cash and derivatives trading, as well as the post-trade area that is essential for an effective and efficient functioning of an organized market.

Reto Francioni

The conference was co-organized by Deutsche Börse AG, the E-Finance Lab and the Center for Financial Studies and held on the premises of Deutsche Börse AG on June 13 and 14, 2008. The audience was a stimulating mix of academics and practitioners.

The welcome address was delivered by **Reto Francioni**, the CEO of Deutsche Börse AG. He stressed that the conference deals with issues that are highly pertinent to today's exchange industry and noted that a listed company like Deutsche Börse AG in today's world of globalized competition quite simply cannot afford to ignore new ideas in technology, product development and market design. Francioni then commented on the business strategy of Deutsche Börse AG. He stressed the advantages of integrating all elements of the value chain - trading, clearing and settlement. The integrated model, in his view, creates synergies, provides economies of scale and increases the operational efficiency of the market. The integrated business model of Deutsche Börse AG is the basis for growth along three dimensions: new products, an expansion of the customer base, and the penetration of markets in new regions. Francioni concluded by noting that the legitimacy of markets critically depends on their integrity, on the transparency they offer, and on their allocative efficiency – in other words: on their ability to maximize overall welfare.

The first presentation by **Michel Robe** (U.S. CFTC and American University) dealt with recent changes in the governance structure of exchanges. In the last decade many exchanges have been converted from mutual not-for-profit organizations into profit-maximizing firms. An important question in this context is whether profit-maximizing exchanges have sufficient incentives to enforce investor-protecting regulation. Based on a formal theoretical model Michel Robe concluded that – in contrast to oft-stated concerns – a shareholder-value maximizing exchange in many circumstances has stronger incentives to enforce regulation.

Albert Menkveld (VU University Amsterdam) analyzed the increasingly important phenomenon of algorithmic trading. Based on an empirical analysis of data from the New York Stock Exchange he finds that algorithmic trading causes an increase in liquidity. **Markus Gsell** (Goethe University Frankfurt) looked at algorithmic trading from a very different angle. He performed simulations in order to assess the impact of algorithmic trading. The results indicate that large volumes executed by the algorithmic trader have an increasing impact on market prices. On the other hand, lower latency (i.e., a higher speed of execution) appears to lower market volatility.

Investors may have different access to market information. For example, retail investors may observe market prices and best bid and ask quotes only with a delay. **Giovanni Cespa** (Queen Mary University of London, CSEF-Università di Salerno and CEPR) presented a rational expectations model which analyzes the consequences of these informational asymmetries. Insiders (those receiving real-time information) get higher expected utility. Average welfare, however, is maximized when only a fraction of investors have access to real-time information. A market for information can implement the optimal fraction of insiders.

Standard models of trading assume that buyers and sellers are equally patient. This does not have to be the case, however. In a panic, for example, sellers are likely to be very impatient while buyers may be patient. **Mark Van Achter** (University of Bonn) presented a theoretical model that describes the interaction between traders with differing degrees of patience. The model yields important insights on order submission strategies and the dynamics of prices and quotes.

Many electronic limit order markets allow traders to submit hidden orders, also called iceberg orders. Only a fraction of the true size of a hidden order is displayed on the trading screens. **Patrik Sandas** (University of Virginia and CEPR) presented a paper which analyzes the impact of the existence of hidden orders on liquidity. Based on an analysis of Xetra data he concluded that the presence of hidden liquidity is associated with greater liquidity and higher trading volume. He also presented evidence consistent with the existence of hidden orders enhancing the welfare of all market participants.

Robert Schwartz (Baruch College) empirically analyzed the impact the 2004 introduction of Nasdaq's opening and closing call auctions has had on market quality. He reports that volatility follows a U-shaped intra-day pattern that is largely driven by just three minutes (the two that follow the open, and the one that precedes the close). Generally, both calls have reduced volatility and improved the efficiency of price discovery.

In his presentation **Craig Pirrong** (University of Houston) dealt with the issue of clearing and settlement. The execution, clearing, and settlement of transactions are all subject to economies of scale and scope, which may make them natural monopolies. He argued that the integration of these three functions improves efficiency by economizing on transaction costs. In his view, transaction cost considerations rather than market power considerations should be the primary focus of analysis.

Many regulated markets (and derivatives exchanges in particular) employ a central counterparty. **Cyril Monnet** (FRB Philadelphia and European Central Bank) presented a model which compares user-oriented and profit-maximizing central counterparties. The two types differ with respect to the amount of collateral they demand from members and with respect to the trading volume they allow. None of the types dominates from a welfare perspective.

It is a characteristic of many liquid markets that the quoted bid-ask spread is often equal to (and bounded by) the minimum tick size (e.g. one cent). The paper presented by **Jonathan Field** (Man Investments) empirically analyzes four futures markets for which this is the case. Further, in these markets limit orders with the same price limit are executed on a pro-rata allocation base (rather than by relying on time precedence). The results indicate that depth at the best quotes is extremely high and that order cancellation rates are also very high. The author than presented a theoretical model which explains these stylized facts. The main result of the model is that there exists an incentive to submit over-sized limit orders most of which are cancelled later on.

Gunther Wuyts (University of Leuven) presented a paper which analyzes the dynamics of the best bid and ask quotes in the Spanish stock market. Based on vector autoregressive models he finds that several dimensions of liquidity (e.g., spread, depth, resiliency) deteriorate after a shock to one of the dimensions. This interdependence between the dimensions of liquidity results in a somewhat less favorable picture of liquidity than often found in the extant literature.

Recent empirical research has concluded that liquidity is an important determinant of expected stock returns and that realized stock returns are systematically related to market-wide liquidity. **Azi Ben-Rephael** (Tel Aviv University) presented empirical evidence that both the sensitivity of returns to liquidity and the liquidity premium have substantially decreased over the last forty years and have now reached a level that is indistinguishable from zero. A possible explanation for this surprising finding is the gradual introduction and proliferation of index funds and exchange traded funds.

Joachim Grammig (University of Tübingen) analyzed the process of price discovery for Canadian stocks that are cross-listed in the U.S. The standard methodology (Hasbrouck's 1995 information share approach) only yields upper and lower bounds to the contributions to price discovery. Increasing the data frequency lowers the spread between the upper and lower bounds but, at the same time, may lead to distorted estimation because of microstructure noise. The paper introduces a new approach which relies on distributional assumptions. It allows a unique identification of the contributions to price discovery while controlling for microstructure noise. The results indicate that previous research has underestimated the contribution of U.S. markets for the process of price discovery of Canadian cross-listed firms.

The "riskfree rate" (typically proxied by the rate of return on short-term government issues) is one of the most important variables in finance. **Michel van der Wel** (VU University of Amsterdam) analyzed empirically how the riskfree rate is affected by macro announcements. The results indicate that some of the impact is reflected immediately after the publication of the macro announcement but that the full impact is only discovered after about 15 minutes and is only revealed by customer order flow. Additional analyses confirm the result that customer order flow is informative and that intermediaries can profitably use the information learned from their customer order flow.

The last paper of the conference, presented by **Christian Voigt** (Deutsche Börse AG) studies differences in intraday pattern of Principal- and Agent Account Trading at Xetra. The paper provides empirical evidence that Agent-Account trading dominates the beginning of the trading day, while Principal-Account trading dominates the evening. The results are consistent with the predictions of a theoretical model by Hong and Wang (2000).

Both the stimulating discussions during the conference and the positive feedback received after the conference provide reliable evidence of a successful event. The second conference on the Industrial Organization of Securities Markets is scheduled for the summer of 2010.

→ All papers presented at the conference are available online as CFS Working Papers.

Asset Management and International Capital Markets

29 – 30 May 2008

Frankfurt am Main

The objective of the conference on "Asset Management and International Financial Markets" was to bring together academics and members of the investment banking community to focus on state-of-the-art academic research on asset management and international capital markets. The conference was jointly organized by Wolfgang Bessler (Justus-Liebig-University Giessen), Wolfgang Drobetz (University of Hamburg), and Jan Pieter Krahnen (Goethe University Frankfurt and CFS).

Jan Pieter Krahnen welcomed the participants to Frankfurt. He strongly emphasized the importance of an exchange of ideas between academic researchers and practitioners as well as the implementation of research findings in asset management.

The organizers Wolfgang Drobetz (left), Wolfgang Bessler (3rd from left) and Jan Pieter Krahnen (right), together with Yakov Amihud (2nd from left) and Gordon Alexander.

Wolfgang Bessler also welcomed the participants in his opening speech. He underlined the international focus of the conference. Initially intended as a small international academic research conference it attracted tremendous interest in that more than 80 academic papers were submitted for presentation. The final conference program featured keynote speeches, four academic sessions, and a panel discussion to cover a wide range of issues on asset management in international financial markets. The program also attracted great interest from the asset management industry in that about 40 academics and 80 practitioners attended this two-day event.

In the first keynote speech **Gordon Alexander** (University of Minnesota) provided a brief review of the development from Markowitz's portfolio theory to modern risk management techniques. He then discussed more sophisticated tools for measuring and managing risk. In particular, Alexander focused on the adequacy of value-at-risk measures and on the impact on investment outcomes of a portfolio manager who is faced with investment restrictions based on conventional value-at-risk measures. For example, a wide range of efficient low-risk portfolios may become infeasible under these constraints. As a result, the portfolio manager might end up choosing a portfolio with an unnecessarily high standard deviation. He proposed using the conditional value-at-risk as an alternative, which is the expected loss given that the loss is greater than the value-at-risk. Therefore, this measure takes the shape of the return distribution below the value-at-risk into account. Gordon Alexander also presented evidence that even the combination of conventional value-at-risk measures with commonly used stress tests cannot adequately determine minimum capital requirements because bank trading books usually contain short positions. Again, the conditional value-at-risk measure could improve the currently employed methodologies.

Gordon Alexander

The first session on Investment Models and Asset Pricing was chaired by **Richard Stehle** (Humboldt University Berlin). Focusing on the impact of long-run consumption risk on equity prices, **Jesper Rangvid** (Copenhagen Business School) demonstrated that in this novel setting the magnitude of the empirically measured risk aversion of investors appears to be more realistic than in prior studies. However, a focus on long-run consumption risk cannot help to explain the cross-country dispersion in excess returns. **Andreas Schrimpf** (Centre for European Economic Research, ZEW, Mannheim) highlighted in his discussion the importance of long-run consumption growth in asset pricing models compared to contemporaneous consumption growth, but also warned that the explanatory power of the model is still limited. **Alexandros Kostakis** (University of York) argued in the next presentation that the use of conventional performance measures such as the Sharpe ratio or Jensen's alpha induce an incentive for fund managers to actively load higher moment risks. This strategy enables them to outperform conventional benchmarks that do not account for these risks. Empirically, he provided evidence that a large number of U.K. unit trusts did indeed load negative co-skewness risk, which contributes to the skewness of a fund's returns. In his discussion **Yvan Lengwiler** (University of Basel) pointed out that including higher moments into performance models might be a never ending game as fund managers then have an incentive to load the next higher moment risk. As a result, portfolio managers may always be able to game the applied performance measures.

Dr. Heinz J. Hockmann (CEO, Fortis Investments) outlined from a practitioner's perspective the future positioning of asset management firms. He encour-

Heinz J. Hockmann

aged the industry to put more effort into research and product development and strongly supported the view that a close relationship between academia and industry is especially valuable in the field of asset management. He encouraged the participants to intensify their cooperation. Furthermore, he commented on the increasing role of distributors in the asset management industry and suggested that the increase in fees over the last decade can partly be explained by the payment of higher provisions to distribution channels.

The first afternoon session on "Bond Portfolio Management" was chaired by **Yvan Lengwiler** (University of Basel). **Mats Hansson** (Swedish School of Economics, Helsinki) presented new empirical evidence on the diversification benefits of investing in international government bonds, emerging market debt as well as in corporate bonds from the perspective of bond investors domiciled in different countries. According to their empirical results, developed markets' government bonds do not improve the risk-return spectrum even if currency risk is hedged or short sales are restricted. In contrast, when short sales are allowed, currency hedged corporate bonds and emerging market bonds can offer diversification benefits. In her discussion, **Florinda Silva** (University of Minho) questioned to which extend the results might be driven by time variability in returns and risk. She suggested extending the paper by considering the effects of duration diversification. In the next presentation, **Marcel Marekwica** (University of Regensburg) explained the impact that different tax treatments of financial assets have on investment decisions and that this depends on the account in which these assets are held. He showed that the "tax gift" can be interpreted as an unobservable bond position in the optimization problem which affects the asset allocation over the life cycle. **Eva Liljeblom** (Swedish School of Economics, Helsinki) noted

in her discussion that the framework of the model could easily be extended to analyze the impact of different tax rates, changes in stock volatility or alternative dividend policies.

Martin Weber (University of Mannheim) chaired the subsequent session on "International Stock Investments". **Harald Lohre** (University of Zurich and Union Investment Institutional GmbH) presented new evidence on international price and earnings momentum. Focusing on 17 developed stock markets, his results suggest that price momentum in most cases seems to be earnings momentum in disguise. This relation is especially evident for European stock markets. Furthermore, the momentum effect seems to be stronger among stocks with high information uncertainty and arbitrage costs. **Dieter Hess** (University of Cologne) suggested in his discussion to incorporate analysts' forecast revisions as an additional source of new information into the analysis. **R. David McLean** (University of Alberta) demonstrated how aggregate share issuance can be used to predict the cross-section of international stock market returns. Based on an empirical study of 41 countries, he concluded that low returns follow share issuances and positive returns follow share repurchases. The importance of this effect is comparable to the book-to-market effect and is higher than both the size and momentum effects. Countries in which it is easier to issue or repurchase shares exhibit a stronger issuance effect. The discussant, **Axel Kind** (University of Basel), suggested linking the issuance effect to other return effects by introducing further control variables such as liquidity or idiosyncratic volatility.

In a provoking speech entitled "The Speculative Dynamics of World Equity

Werner DeBondt

Markets" **Werner DeBondt** (DePaul University, Chicago) presented empirical evidence that the anomalous behavior of short-run momentum and long-run reversal of individual stocks also appear in country indices in a sample of the G7 countries and 12 small countries. The winners of the previous three months tend to continue to outperform loser markets. For three year periods this effect reverses. Over longer time horizons, previously underperforming countries outperform past winners. The highest returns can be earned on those country indices that performed poorly over the past three years, but belong to the winners of the previous six months. DeBondt calls these "cheap" winners. In contrast, expensive losers subsequently experience the strongest underperformance. It is surprising that this anomalous return behavior persists over several years, as cheap investment tools such as country exchange traded funds can easily be used to exploit these effects. In his conclusions Werner DeBondt stressed to incorporate behavioral factors into the decision process.

Wolfgang Drobetz (University of Hamburg) welcomed the participants and introduced **Yakov Amihud** (New York University), the keynote speaker of the second day. Amihud addressed a broad spectrum of issues related to asset pricing and liquidity. Starting from an asset pricing perspective, he explained the results of several empirical studies which document the relevance of a liquidity-risk factor in asset pricing models. Investors request a higher return from illiquid securities as they are concerned with after-cost returns and take the compounded transaction costs over the whole lifetime of a security into account. Additionally, the liquidity of individual securities is correlated with the overall liquidity level of the market. Consequently, this systematic liquidity component is a priced risk factor. Liquidity is not only a relevant factor for pricing equities, but it is also a priced risk factor for otherwise identically fixed income securities. Furthermore, Yakov Amihud pointed out that an understanding of liquidity is of importance for explaining the current housing disaster in the United States. He concluded by advising long-horizon investors to invest more heavily in illiquid securities if they are able to hold on to these securities for an extended period of time in order to earn the illiquidity premium.

Yakov Amihud

The forth academic session on "Performance Measurement" was chaired by **Hartmut Schmidt** (University of

Rolf W. Banz

Panel discussion with Rolf W. Banz, Werner DeBondt, Gordon Alexander and Heinz Zimmermann

Hamburg). In the first presentation, **Niall O'Sullivan** (University College Cork) investigated whether U.K. mutual fund performance is due to investment skill or luck. He presented evidence from a sample of 1,620 funds, for which several different performance tests were run. The major contribution of his paper was to apply a bootstrapping technique to improve the statistical inferences especially for the tails of the cross-sectional performance distribution. The results suggest that most of the loser funds are indeed unskilled. Moreover, only 7 of the top 20 ranked funds exhibited any real skill. In his discussion, **Peter Lückoff** (Justus-Liebig-University Giessen) underlined the innovativeness in the statistical approach employed but also cautioned about the sensitivity of the methodology with respect to the actual distributional characteristics of fund performance. **Rajesh K. Aggarwal** (University of Minnesota) analyzed the performance of emerging hedge fund managers and introduced a new event time approach to compare the performance of emerging and established hedge funds. The results suggest that newly started hedge funds offer an attractive opportunity, as they provide a superior performance which persists for up to five years. Additionally, these funds are still investable and not yet (soft-) closed as a result of heavy past inflows. **Iwan Meier** (HEC Montreal) highlighted in his discussion the similarity between the observations on emerging hedge fund managers with tournament behavior and the corresponding risk taking similar to that of mutual funds. In the final presentation, **Maria Céu Cortez** (University of Minho) examined the performance of European socially responsible funds. She presented evidence for neutral performance and showed that these funds are more correlated with overall market indices than with social responsibility indices. This suggests that either the holdings of socially responsible funds do not deviate much from those of traditional funds or that the risk characteristics of socially responsible companies are not inherently different from those of traditional companies. **Thomas Burkhardt** (University of Koblenz) offered in his discussion several possible extensions. For example, fund flows into socially responsible funds could also be analyzed. Furthermore, a more detailed discussion of investment restrictions might be appropriate.

Dr. Rolf W. Banz, (Chief Investment Architect at Pictet Asset Management, who is well known for his seminal research of the size-effect) recapitulated in his speech entitled: "How Relevant is Financial Economics for Investors?" the last twenty years of findings in the field of finance. While noting that financial economics is highly important for practical asset management, he emphasized that communication between researchers and practitioners must be enhanced and that both must learn to talk in the same language.

The conference ended with a panel discussion on the future of international asset management. Participants were Rolf Banz, Werner DeBondt, Gordon Alexander and Heinz Zimmermann (University of Basel). The participants delivered some insightful statements on a variety of issues. Heinz Zimmermann argued that structured finance products today are too complex to understand for most investors and even for some of the people selling them. He called for simpler structures in the future. The investor was also at the center of the statement by Gordon Alexander. He suggested using a more structured investment process. Instead of the common heuristics, investors and banks should first determine risk attitude and investment horizon, then fix the asset universe, and finally pick stocks and funds. Werner DeBondt emphasized that investors need more help with their investments. In his opinion, empirical evidence shows that they are biased in a systematic way and need to be protected from their own mistakes. Rolf W. Banz gave some insights from the industry, noting that some investment firms are on their way towards creating simpler structured products and taking into account the need for a structured investment process. All panel participants agreed that there is much to do, both for academics and for practitioners.

After the discussion, Wolfgang Drobetz closed the conference by giving his sincere thanks to all participants.

Peter Lückoff (Justus-Liebig-University Giessen)
Dirk Schilling (University of Hamburg)

Keynote speeches and selected papers from the conference will be published in a special issue of the European Journal of Finance edited by Wolfgang Bessler and Wolfgang Drobetz.

CFS-DAI Seminar

3rd CFS-DAI Seminar on Risk Management and Value Creation "Risk Transfer: from Corporations to Capital Markets"

11 June 2008

Frankfurt am Main

Efficient risk management has become an integral value driver for today's large corporations, and insurance remains an important means of operational risk transfer. After years of stagnant growth, the market for Insurance Linked Securities (ILS) has recently witnessed a considerable increase in issues and investor interest. As the insurance industry faces new challenges such as regulation and transparency, ILS may finally come into its own. For this reason, CFS together with the Deutsche Aktieninstitut e.V. chose to discuss the topic "Risk Transfer: from Corporations to Capital Markets" at their 3rd joint seminar, which was held in Frankfurt on June 11, 2008. The seminar is part of the CFS program "Insurance and Risk Transfer" and was organized by Walther Kiep (Managing Director of Kiep Consulting GmbH) and Christian Laux (Goethe University and Program Director at CFS).

The program topics, presented and analyzed by the distinguished speakers and approximately 40 seminar participants, provided valuable insights into numerous aspects of the insurance risk transfer value chain and potential product alternatives.

In his welcoming address, **Christian Laux** discussed challenges in risk transfer. The art involved in designing risk transfer instruments and choosing between different alternatives is to minimize the frictional cost of risk transfer. The issue is not whether risks are transferred to the market (they are), but how. Traditionally, risk is transferred to the capital market via insurers' or reinsurers' balance sheets. ILS, however, provides a means by which to transfer insurable risks directly to the capital market, using special purpose vehicles that issue claims against specific risks. An important aspect here is the choice of trigger, which may be indemnity-based or parametric. In the former case, the sponsor is compensated for the actual loss sustained, in the latter the payoff is based on an exogenous event. The optimal choice of trigger has to trade off potential incentive and information risks when using an indemnity trigger against the basis risk involved with an exogenous trigger.

Robert Herde (Executive Director, Munich Re Capital Markets GmbH) gave an overview of current market developments. Stressing the investor side, he noted that ILS products provide investors with the option to invest directly in specific insurance risks. As this is not possible when investing in insurance or reinsurance companies, ILS can be seen to complete the market. From the perspective of insurers and reinsurers, ILS have three main benefits. First, they are collateralized, reducing the counterparty risk. Second, they are long-term, ranging from 3 to 5 years, in contrast to most reinsurance contracts, which cover only one year. And third, issuing ILS helps to build a reputation in the market that is important when funds in the insurance market are scarce. However, large setup costs for both the originators and investors are still a key challenge. Although improved standardizations of ILS products were crucial for the recent growth in the ILS market, volume continues to play the major role. Thus, it is important that new products help to increase volume. Owing to potential conflicts of interest and transparency, in the long run, capital market demand will lead to parametric or index-based triggers, leaving it to insurers and reinsurers to cover the basis risk involved with these products. While CAT bonds are the most prominent example for ILS, Herde predicts that the number of ILS related to high-frequency risks – such as motor insurance – will increase. It is often argued that because of ILS products insurance and capital markets will converge. However, Herde argues that such convergence would require a higher level of arbitrage between the markets, which does not exist in the current niche situation of ILS products.

Tore Ellingsen (Managing Director, ABN AMRO Bank N.V.) discussed the role of ILS as part of insurers' and reinsurers' capital management. In the face of product market competition, financial market pressure, and regulation, efficient capital management becomes increasingly important. Several insurers react by share-buybacks, which makes it necessary to search for new sources of risk capital. Hybrid capital and securitization are important alternatives, also for small insurers who still seem to be reluctant to consider these options. One concern regarding ILS products with parametric or index triggers is that it leaves sponsors exposed to basis risk. However, as Ellingsen argued, the exclusion of certain risks in reinsurance contracts since 9/11, has also had the effect of leaving insurers with growing basis risk when using indemnity-based reinsurance. In his view, reinsurers will continue to play a significant role even if the ILS market continues to grow in the wake of Solvency II. Reinsurers will serve as a gateway to the capital market for insurable risks, acting as risk advisers and risk traders, rather than keeping the risks on their balance sheets.

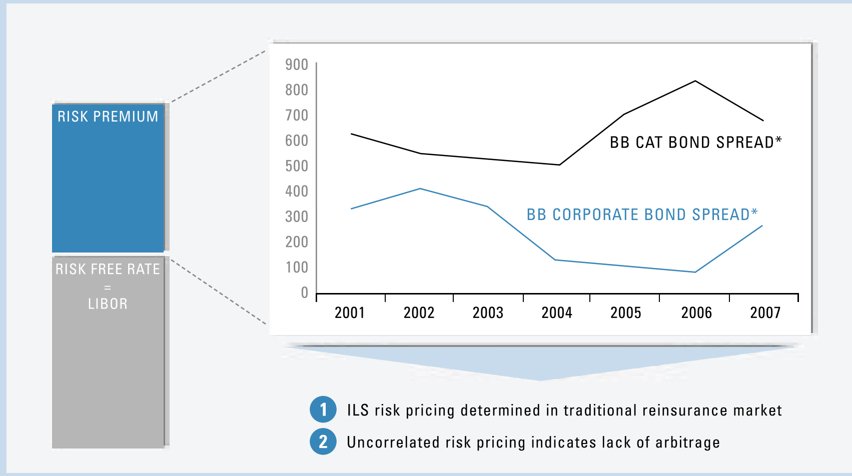
Harish Gohil (Senior Director, Fitch Rating Ltd.) outlined difficulties facing rating agencies in ILS transactions. He noted that although the ILS market has seen considerable growth, it still remains a small market. Its development has suffered from a challenging regulatory framework, difficulties in aligning interests of investors and insurance issuers, the complexity of structures, and limited investor confidence. One of the drivers of the ILS market has been rating agency involvement, in particular the issue of whether the agencies provide meaningful input to the rating analysis of the sponsoring insurance company. In its capacity as a rating agency, Fitch has been increasing not just the sophistication of its approach but also the transparency. Modeling the underlying risks is a key part of the rating process. Fitch uses its proprietary stochastic insurance capital modeling tool PRISM, wherever possible, to derive the probability of loss (PL) estimates that underlie any ILS rating decision. They are often supplemented by estimates obtained from third party modeling agencies.

Reiner Hoffmann (Head of Corporate Solutions, Allianz Global Corporate & Specialty AG) discussed ILS as a potential tool for corporations to deal directly with risks that are difficult to insure. In particular, he considered the case of product recall risk in the automobile industry. Problems in retaining this risk arise when there is amplitude of suppliers that might cause the recall, and targeted sanctions are not possible. Moreover, when there is substantial credit risk with small suppliers, the risk is ultimately borne by the original equipment manufacturer (OEM). Insuring this risk is costly and often not considered an option. Hoffmann suggests that the OEM and suppliers form a risk pool where each contributes according to its share in the value chain. In the case of a recall, the pool is then used to cover the losses without there being a need to identify the contractor responsible, which is often impossible anyway. By securitizing the claims on the risk pool, the recall risk may even be transferred to third parties. Such a product would have several benefits, including a need for the explicit consideration of recall risks and its awareness in the production process. However, several challenges remain, including how to determine the underlying risk and a fair price as well as potential information and moral hazard problems. Furthermore, securitizing the recall risk would require accurate modeling tools and information about past losses, which are currently not available. Specifically, it is the case that a new car series does not of course come with any data or prior experience of failures. Consequently, the industry is still working on a sustainable solution to address the challenges imposed by recall risk.

Insurance and financing differ with respect to accounting principles, taxes, and regulation. Whether an instrument constitutes insurance or financing is, therefore, of great importance. **Johannes Wedding** (Managing Director and Partner, Wedding & Partner) focused on the legal definition of insurance and its implications. The definition of insurance differs according to the underlying accounting principles involved, i.e. IAS / IFRS, German GAAP, US GAAP, or the International Association of Insurance Supervisors (IAIS). Important issues in the definition of insurance include the distinction between timing risk and underwriting risk as well as the significance of the involved risk transfer. Wedding discussed to what extent companies are able to set up liability reserves within their own balance sheet as a means of "risk transfer to equity claimants". This is a crucial point because it entails establishing whether tax benefits may be realized (both saving on traditional insurance tax and lowering the company's base for tax) or not. Both US-GAAP and IAS allow risk retention in the presence of significant underwriting risk, i.e. when the latter arise from previous corporate activity (such as product liability). Wedding discusses these issues in greater detail in an article that is forthcoming in "Der Betrieb".

Walther Kiep hosted a panel with leading experts to discuss the latest developments in ILS and its implications. Participants on the panel were **Frank Achtert** (Managing Director, Guy Carpenter & Company GmbH), **Werner Görg** (CEO, Gothaer Group), **Jens Lindner** (Head of Third Party Securitisation, Commerzbank AG), **Henning Ludolphs** (Director, Insurance Linked Securities, Hannover Re), and **Samuel Scherling** (Founder, ILS Value Advisors AG). The panelists agreed that the ILS market will continue to grow. Under current solvency regulation, there is no capital relief for securitized risks, in contrast to reinsured risks. Thus, Solvency II is expected to boost the importance of ILS, provided that there is no political opposition against this trend. Aligning issuers' and investors' interests remains the main challenge when structuring products. Of particular importance is the issue of transparency and the ability to model the underlying risks.

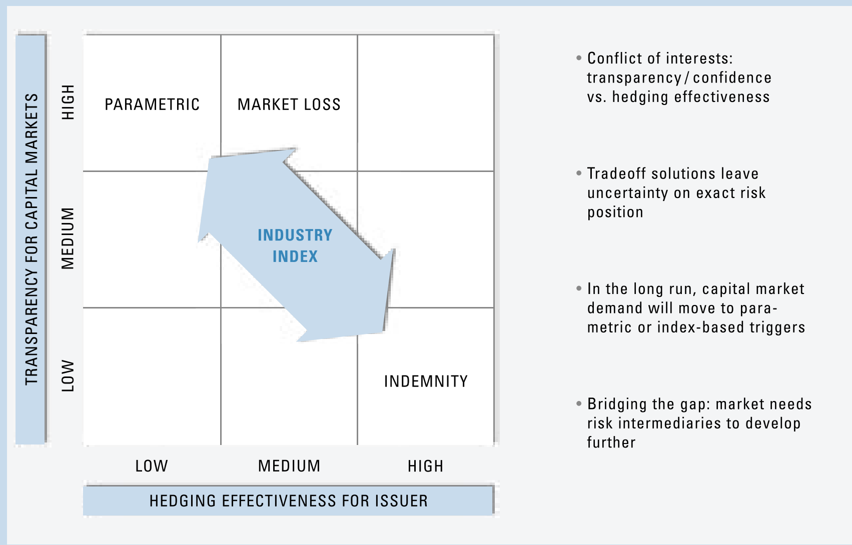
ARBITRAGE BETWEEN INSURANCE AND CAPITAL MARKETS DOES NOT EXIST IN THE CURRENT NICHE SITUATION



* CORPORATE SPREAD = BB CORPORATE SPREAD VS. SWAP, CAT BOND SPREAD BASED ON REGRESSION OF RESPECTIVE YEAR ISSUANCE AND ASSUMING BOND W/ EXPECTED LOSS OF 1%

SOURCE: MUNICH RE

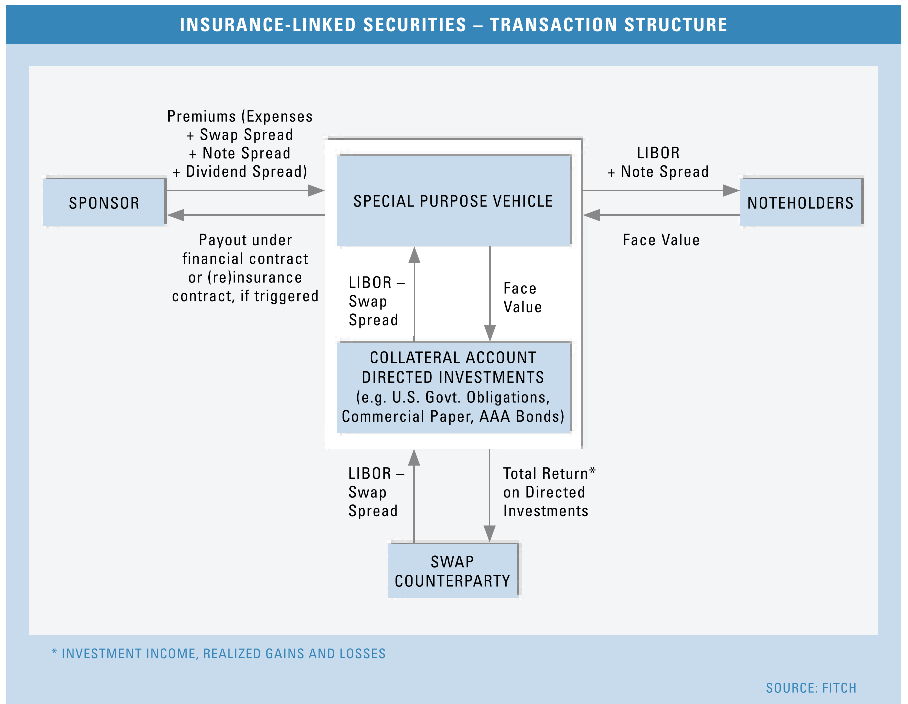
LEAVING THE NICHE WILL REQUIRE FULLY TRANSPARENT PRODUCTS W/OUT IMPLICIT INFORMATION ASYMMETRIES ...



SOURCE: MUNICH RE

Reinsurers but also reinsurance brokers will increasingly act as risk consultants in the securitization process. As the level of securitization increases, reinsurers are also likely to shift from taking and bearing risk to valuing and distributing it.

ILS products, in particular cat bonds, have lived up to the claim of being zero beta assets, as spreads have been largely unaffected by the recent capital market turmoil. However, observing prices is difficult due to the buy and hold strategy of ILS investors, which is dominated by a small group of highly specialized and sophisticated players.



As the ILS market competes with the reinsurance market, the current soft reinsurance market with low reinsurance prices is seen as one reason why the ILS market has hitherto failed to experience larger growth rates. It is predicted that the next wave of catastrophes will greatly increase ILS activities, which will also receive an additional boost from the progressive standardization of the products.

THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS

2009

Center for Financial Studies kicks off nomination process for the "Deutsche Bank Prize in Financial Economics 2009"

In 2009, the Center for Financial Studies and Goethe University will award for the third time the Deutsche Bank Prize in Financial Economics. The prize will be presented to an internationally renowned researcher, in recognition of an outstanding achievement in the field of financial economic research.

Since the beginning of October, more than 3,600 academics from over 55 countries have been given the opportunity to take part in the nomination procedure.

The winner of the award, which carries an endowment of €50,000, will be announced in February 2009.

The Jury members are widely acclaimed financial experts from different countries with academic and practice-oriented backgrounds. Representing Goethe University on the Jury this year, alongside the Jury chairman Jan Pieter Krahnen (CFS Director and Goethe University), Volker Wieland (CFS Director and Goethe University), and Otmar Issing (CFS President and Goethe University), are the well-known professors Michael Binder and Reinhard H. Schmidt. Norbert Walter, Managing Director of Deutsche Bank Research and Chief Economist of Deutsche Bank AG, is also acting as a Jury member.

- Jury comprises international financial experts from research and practice
- Some 3,600 academics from around the world can propose nominees
- Jury is looking for outstanding academic submissions with practical application

"We can observe with a certain degree of pride that the number of participating professors and academics eligible to nominate a potential prize winner has risen from roughly 1,400 in 2005 to almost 3,600 today. This bears witness to the constantly growing awareness and the increasing recognition that our academic prize for financial economics enjoys," explained Professor Jan Pieter Krahnen, Jury Chairman and Director of the Center for Financial Studies.

The Organisation for Economic Co-operation and Development (OECD) is represented by its Chief Economist, Klaus Schmidt-Hebbel. With the appointment of Takatoshi Ito (University of Tokyo), the Jury includes for the first time an academic from Asia. Furthermore, Maria Vassalou (SAC Capital Advisors LLC) and Marti Subrahmanyam (University of New York) are also serving as international Jury members.

The award itself will be presented by Josef Ackermann, the Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG at a ceremony in Frankfurt on September 30, 2009. During the course of the award ceremony, a scientific CFS Symposium will be held at Campus Westend that will focus on the research subject of the prize winner.

The Center for Financial Studies, in cooperation with Goethe University, first established an academic prize in 2004. Since then, this prize, which is sponsored by the Deutsche Bank Donation Fund, has been presented as the Deutsche Bank Prize in Financial Economics. It was awarded for the first time in 2005 to Eugene F. Fama, Professor of Finance at the University of Chicago, for developing and researching the concept of market efficiency. In 2007, Michael Woodford, Professor of Political Economy at Columbia University in New York, received the prize for his research on the theory of monetary macroeconomics.

Sabine Neumann (CFS)

CONFERENCE

THE ECB AND ITS WATCHERS X

5 September 2008
Frankfurt am Main

This year, the CFS celebrated the ten-year anniversary of "The ECB and Its Watchers" conference. This series, which was initiated in 1999 by Otmar Issing in his role as Chief Economist of the ECB and Axel Weber as CFS Director, has evolved into a well-established forum for the public exchange of views between ECB decision makers and leading ECB observers and critics. Many ECB watchers have commented on the usefulness of this platform for a two-way dialogue with policymakers. Perhaps, the greatest compliment to the ECB and the conference organizers has been the start of similar conference series in the United States in 2007 and in the United Kingdom in 2008.

A range of prominent speakers from the ECB, other central banks, academia and the private sector debated the role of the central bank in dealing with liquidity and solvency problems in the financial system and the proper policy responses to asset prices, inflation and economic growth or weakness.

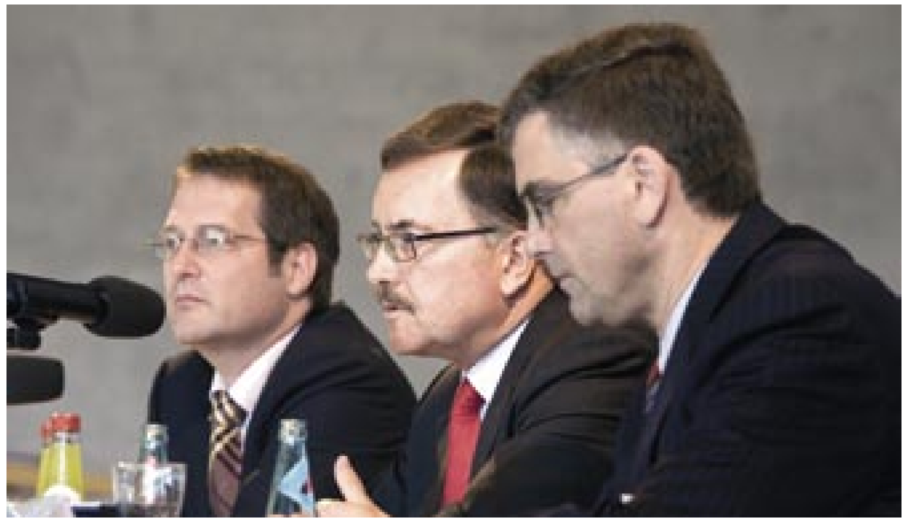
More than 250 participants actively took part in the discussions along with more than 60 media and press representatives who reported widely on the event. Part of the conference and selected interviews were again broadcasted live on business TV channels.

JEAN-CLAUDE TRICHET

It has now become a tradition that the ECB President JEAN-CLAUDE TRICHET opens the conference with a key note address. This year, Trichet spoke on the topic "Risk and the Macro-economy" and investigated the fundamental connection between financial risk and macroeconomic performance. He began by explaining that after a time of ample financial liquidity and exceptionally low rewards to risk, the loss of value of whole classes of real assets has led to a sharp reduction in investor appetite. In addition, rising commodity prices have reduced households' income prospects and raised their aversion to risk. "To the extent that the more recent turn in the markets correct past excesses, this is a welcome – if painful – process that we had anticipated and asked market participants to prepare for in past interventions," noted Trichet.

The decline in risk valuation, which has been partly reversed in the recent financial turmoil, started 25 years ago along with a similar decline in macroeconomic uncertainty. Trichet suggested that "to the extent that this moderation in macroeconomic fluctuations – in aggregate risk – would be confirmed as a permanent acquisition of modern economies, there is some reason to believe that the trend to lower risk valuations – beyond the needed corrections of the more recent excesses – could in the end reassert itself." Consequently, it is important to analyze what determined this compression of risk in effectively all markets and, whether the compression of risk reflected permanent shifts or transient ones.

Turning to the recent financial crisis Trichet noted that "spreads on financial institution debt, in particular, have widened in the Euro area and in the U.S. reflecting uncertainty over the extent of future credit write-offs, the full recognition of off-balance-sheet commitments, and future earnings capacity." The results are that intermediaries save on capital, assets are sold and lending conditions get squeezed. According to Trichet, the recent corrections and expenditure reductions of the financial markets convey two lessons: (i) non-fundamental market dynamics have grown out of fundamentals and the feed-back loops that these have created, and (ii) excessive leverage was the mechanism which turned an efficient process of risk diffusion into a dangerous spiral of risk amplifications and concentration. Finally, Trichet



VOLKER WIELAND, JÜRGEN STARK, MARVIN GOODFRIEND

JÜRGEN STARK

clarified the difficulties in dealing with a sequence of supply shocks that may become engrained in inflation expectations and turn into a sustained demand disturbance. The financial turbulences, which began last summer, as well as the increases in commodity prices, have challenged central banks to simultaneously deal with the fragilities of the financial fabric and fight inflationary pressures and economic weakness. In such "testing times", the advantages of a monetary system, which is anchored in price stability, have become very visible.

The remainder of the conference program was organized in form of four debates between ECB policy makers and observers.

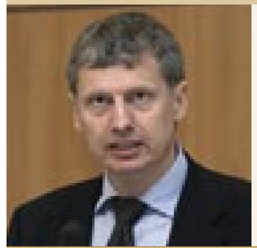
MONETARY POLICY DURING THE FINANCIAL TURMOIL: WHAT HAVE WE LEARNED?

JÜRGEN STARK (ECB) admitted that the past months had been the most challenging in the ten-year history of the ECB. The ECB was confronted with a "trilemma", consisting of rising inflation rates, a slow-down of economic activity and threat to financial stability. In his presentation, Stark discussed not only how the principles incorporated in the ECB's monetary policy framework have guided the ECB's decision making through these times but also how to face the challenges still lying ahead.

Stark emphasized that sound monetary policy making is anchored in a set of principles. Next to having a clear and unambiguous mandate to maintain price stability, a central bank must also be credible in its commitment to deliver this objective. The central bank must be a politically-independent institution and transparent in pursuing its objective. Furthermore, monetary policy should keep a medium-term orientation and should be strengthened by a comprehensive analytical framework. Finally, there must be a clear separation between the determination of the monetary policy stance required to maintain price stability and the provision of liquidity to the money market, such that market participants do not interpret liquidity operations as signals of future changes in the policy stance.

Reviewing decision making during one year financial turmoil Jürgen Stark noted the following: With

JULIAN CALLOW (BARCLAYS CAPITAL):



This annual conference is a truly unique occasion which offers the entire community of "ECB Watchers" – academics, financial market participants, and the media – a special opportunity to congregate together with central bank officials from the Eurosystem and beyond, and so foster greater mutual understanding of contemporary issues in European monetary policy.

ELGA BARTSCH (MORGAN STANLEY):

The combination of academic researchers, market practitioners, financial journalists and central bank representatives makes the ECB Watchers conferences a unique event. The two-way dialogue between the ECB and those who observe, analyze and comment its actions from their different vantage points the Watchers conferences helped to create are very stimulating.

the beginning of the financial pressures the ECB's outlook for inflation and economic growth became increasingly uncertain. In this situation, it was not clear what consequences high market interest rates would have for spending and pricing decision, as well as the availability of credit. Thus, having a single, clear and unambiguous objective supported the ECB's credibility and ensured that a policy stance appropriate for containing inflation expectations could be maintained.

Simultaneously, the ECB acted to sustain the functioning of the money market by making a clear distinction between the determination of the monetary policy stance and its implementation through liquidity operations. The turmoil also encouraged and strengthened central banks cooperation through improved information exchange, as well as joint supervision of market developments.

Stark's debating partner, MARVIN GOODFRIEND (Carnegie Mellon University), then presented his view more from a U.S. perspective. Goodfriend first gave the audience some important background information about the U.S. mortgage market before the onset of the turmoil. In this market 50% of home mortgages are securitized. Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac held or guaranteed 50% of all mortgages. The near-bank capital markets financed long-term mortgage-backed securities with short-term commercial paper. At the beginning of 2004, asset-backed commercial paper had amounted to US$ 600 billion but rose to US$ 1200 billion by August 2007. The asset-backed commercial paper market collapsed in August 2007 and contracted by about US$ 400 billion by November. At that point, the intransparent, tailored and tranched mortgage-backed securities traded at deep discounts, commercial and investment banks faced increasing capital shortages, widening interest rate spreads and elevated interbank interest rates.

Goodfriend then turned to the challenges for U.S. monetary policy.

MARVIN GOODFRIEND

The U.S. economy is affected by two opposing forces: aggregate demand is hurt by the deflation in house prices and the elevated external finance premium, while large, sustained increases in fuel and food prices have driven inflation to 5%. According to Goodfriend the capital shortage in the banking system that is at the core of the credit turmoil is more

protracted and more serious than might have been expected and may still last for a while.

Goodfriend noted that central banks should be viewed as executing two independent policies: monetary and credit policy. Monetary policy (i.e. the size of the central bank's balance sheet) should be used to set interest rates in order to stabilize aggregate employment and inflation. Credit policy (i.e. when central banks make loans to individual banks to stabilize financial markets) should be executed to stabilize financial markets. If the Fed keeps the two policies separate, credit policy changes the composition of the securities in its portfolio, but not the size of its portfolio.

He concluded that the Fed needs an "Accord" for credit policy with the following principles: (i) the Fed undertakes credit policy actions only as lender of last resort, (ii) the fiscal authorities cover the Fed against balance sheets losses incurred, (iii) Fed credit policy should not fund loans or expenditures that ought to get explicit authorization from the fiscal authorities, and (iv) the Fed should otherwise stick to the Treasuries-only policy.

ULRICH KATER (DEKABANK):

Nowhere else can you discuss with so many ECB-experts from outside and within more effectively.

SOLVENCY, SYSTEMIC RISK AND MORAL HAZARD: WHERE DOES THE CENTRAL BANK'S ROLE BEGIN AND WHERE DOES IT END?

LORENZO BINI SMAGHI (ECB) started the debate by re-iterating the ECB's "separation principle" namely to pursue the separate objectives of price stability and the smooth functioning of the money market with separate instruments that are the interest rate and market operations. In other words, the interest rate is not considered an appropriate tool to deal with liquidity or solvency problems, because it is too "blunt" as an instrument for financial stability targeting. It might generate conflict with the primary objective of price stability and un-anchor inflation expectations.

LORENZO BINI SMAGHI

Next, Bini Smaghi, reviewed the Bagehot Principle that states that central banks are to lend freely at a high rate against good collateral in order to support illiquid but solvent institutions. Thus, the central bank should avoid dealing with solvency problems that would threaten its financial independence and increase moral hazard in the financial system. However, they should lend to illiquid institutions. Illiquidity problems can lead to insolvency even when intermediaries are fundamentally sound. The central bank should act to preserve social welfare, because it is the only economic agent who is not subject to liquidity risk.

With regard to liquidity provision central banks must avoid actions that would put at risk its own balance sheet and set up adequate risk control measures. A risk control measure in the Euro area is that it accepts as collateral only assets that fulfill high credit standards. The broad range of collateral accepted by the Euro system includes non-marketable assets (i.e. credit claims), as well as marketable but less liquid assets (i.e. ABS) making it necessary to develop theoretical pricing capabilities For credit claims, NCBs can either compute a theoretical price or use the outstanding amount (in which higher haircuts apply). In order to revise the risk control measures, the ECB will introduce a number of new procedures to be implemented February 1, 2009.

WILLEM H. BUITER (LSE) began by remarking that the role of the central bank in the maintenance of financial stability is liquidity management. The reason is that the central bank is not subject to domestic liquidity risk. Any country whose banking system is large und who has a large foreign currency exposure may face liquidity problems. Buiter mentioned in particular the recent experience of Iceland but also included the U.K. in this group of countries since the British Pound is not any more a major reserve currency. There are only two such currencies left the US Dollar and the Euro.

WILLEM H. BUITER

In general, financial stability may be threatened by three types of disfunctions: bubbles, illiquidity and insolvency. With respect to bubbles Buiter recommended against using the official policy rate for targeting asset prices or any form of leaning against the wind, but proposed regulatory tools instead. With regard to liquidity he differentiated funding liquidity and market liquidity. As to funding liquidity the central bank ought to provide liquidity to systematically important institutions. However, the provision of capital to insolvent institutions, Buiter noted, is a fiscal task and should not be taken on by the central bank.

Financial stability also has an important temporal dimension. There is the need to minimize the implications of the current crisis that is the "putting out of fires". Buiter reiterated that the central bank should put its expertise, its resources and reputation on the line with regard to the provision of liquidity, i.e. its lender or market maker of last resort function. The central bank should at most use its expertise as an agent of the government in dealing with solvency problems. It should not risk its own resources or reputation to save insolvent institutions.

Buiter then acknowledged that the central bank may find it hard to keep separate the provision of liquidity to illiquid but solvent and to insolvent institutions. Thus, there always exists the risk of a capital loss to the central bank if the borrower and the issuer of the collateral put up by the borrower default simultaneously. Buiter recommended as a partial solution that the central bank should eliminate ex-ante quasi fiscal actions, that is, when it lends it should take sufficient collateral and price it punitively such that the central bank does not provide a subsidy to the borrower. There may still occur ex-post capital losses to the central bank but these should be fiscalized immediately and automatically.

HARALD UHLIG (University of Chicago), the third speaker in this debate, set out to characterize the links between what he called the subprime innovation and the moral hazard crisis. The subprime innovation allowed young home owners to borrow on future incomes, a good thing. The securitization of mortgages by standard Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac proved risky. Associated derivatives, MBS, CDO were particularly risky with some parts well characterized as "toxic waste". With the houses still there, Uhlig said, it is a crisis of the financial markets about involuntary redistribution and bailouts. In this context, he brought up two

MACCARIO AURELIO (HYPOVEREINSBANK - UNICREDIT GROUP):

I have to say that proximity to ECB policymakers clearly enhanced my understanding of the bank's decision-making process as well as the theoretical and operational framework in which the ECB is actually operating. Moreover, I liked very much the heterogeneous background of the conference participants: exchanging ideas and opinions not only with other market practitioners but also with policymakers and with academics greatly stimulated my research toward non-conventional and new directions. The CFS' and ECB's effort to establish a fruitful relationship with different type of observers can only be praised.

HARALD UHLIG

LORENZO BINI SMAGHI, VOLKER WIELAND, WILLEM BUITER, HARALD UHLIG

old principles with new additions. First, if something is too good to be true, it probably is. Second, as Bagehot suggested in 1873, in a crisis a lender of last resort should lend at a penalty rate to solvent but illiquid banks that have adequate collateral. New additions seem to be the "too big to fail doctrine" and "there is systemic risk which requires action".

For the remainder of his presentation Uhlig discussed several aspects of the recent crisis and the associated moral hazard in more detail and promised to deliver three new principles. His review led Uhlig to a number of insights. First, the risks in the real estate market are smaller than in the stock market, and smaller than exchange rate risks, but those risks were not allocated properly. Second, implicit government guarantees create moral hazard and in turn, lack of regulatory information creates fear at central banks. Third, it is a fact that there are macroeconomic risks as it is a fact that banks can go bankrupt. Not everything can be insured thus it is important to help the appropriate allocation and pricing of macroeconomic risks. Uhlig emphasized that in an emergency, central banks need to understand the consequences before acting.

Uhlig concluded with three new principles for central banks. Principal 1: Do not provide insurance for free. Principal 2: Practice gentle prodding through information advantage. Principal 3: Aid the appropriate allocation and pricing of macroeconomic risks.

ASSET PRICE BUBBLES AND MONETARY POLICY: WHAT CAN OR SHOULD THE CENTRAL BANK DO ABOUT THEM?

HANS GENBERG (Hong Kong Monetary Authority) began by stating the claim that "a central bank concerned with stabilizing inflation about a specific target level is likely to achieve superior performance by adjusting its policy instruments not only in response to its forecasts of future inflation and the output gap, but also to asset prices." Or in other words, the question is whether a central bank should take into account movements in asset prices "over and above" their influence on the inflation gap and the output gap? This, in turn, depends very much on what is meant by "over and above". If the objective of the central bank is defined as minimizing the discounted sum of expected fluctuations of inflation and output around their respective target levels, we cannot debate "over and above", because all applicable information, including that embedded in asset prices, is implicitly considered.

The question makes sense when a policy reaction function defines the policy rate with respect to inflation and output gap forecasts at a specific horizon (generally two years). The proposal is not to stabilize asset prices directly, i.e. making it an additional target in the objective function. This would necessitate very large adjustments in the policy interest rates and destabilize inflation, output and employment. Yet the debate is more about a "muted" leaning against the wind. Directly targeting an asset price would be risky, if not dangerous, because we do not know for certain what its equilibrium is. With the uncertainty about the equilibrium value, we must allow for mistakes.

MARKUS KRYGIER (CREDIT AGRICOLE ASSET MANAGEMENT):

Year after year the conference has provided a unique forum to gather and exchange intelligence on the ECB. The ECB's active participation has opened a valuable window to better understand the bank's policies and its communication. The conference has also provided a great opportunity to establish a network of like-minded ECB watchers.

MICHAEL BINDER, HANS GENBERG, THOMAS MAYER

ATHANASIOS ORPHANIDES

THOMAS MAYER (Deutsche Bank) elaborated further on the pros and cons of taking asset prices into consideration when making monetary policy decisions. One reason why not is that the central bank's mandate for price stability refers to CPI inflation. In following this mandate, the central bank already considers asset prices to the extent that they affect CPI inflation. A reason for considering asset prices arises from the fact that asset prices reflect the price of income streams in order to finance future consumption. This price should not be separated from the definition of price stability. Moreover, asset price cycles can threaten the economy without first affecting CPI inflation.

Mayer gave a number of suggestions how central banks can respond. They should form an opinion on how bubbles develop. Positive as well as negative bubbles are triggered by large cyclical swings in the willingness to tolerate risk. Mayer also proposed to "tilt the risk free central bank rate against large swings in risk appetite." By doing so, central banks will hopefully recognize developing bubbles. The ECB's two pillars strategy is "tilting in practice" but seems too narrow in that it "consists of a detailed analysis of monetary and credit developments with a view to assessing their implications for future inflation and economic growth." Besides the monetary analysis, a comprehensive analysis of the different risk attitudes among professionals and private investors must include an evaluation of changes in applied credit standards and credit quality; bond, credit and equity risk premia; various asset valuation indicators in equity and real estate markets, as well as various measures of "risk appetite".

LOOKING AHEAD: HOW TO REIGN IN INFLATION AND MAINTAIN STABLE GROWTH?

ATHANASIOS ORPHANIDES (Central Bank of Cyprus) started by pointing out that inflation in the Euro area has remained considerably above the level consistent with price stability since the fall 2007 which poses a critical challenge for the ECB. The peak of 4 % observed in June and July has been unprecedented in the history of the Euro system. The increase in inflation reflects more the global

ANGEL UBIDE (TUDOR INVESTMENT CORP):

"The ECB and its Watchers" has played a critical role in allowing a brainstorming of the relevant issues pertaining to the ECB with the participation of the key actors, policy makers, market participants and academics. One day at the conference is much more effective than weeks of individual research. It has also created a very extensive and useful network of people interested in ECB matters.

increase of the prices of food, energy and other commodities than an underlying trend. Looking at the measure of core inflation that excludes energy and unprocessed food for example, the recent pick-up in inflation is less dramatic, though still worrisome. This difference between total and core measures of inflation is a manifestation of an adverse supply shock not dissimilar to earlier experiences of such shocks. High and volatile stagflation, coupled with rising unemployment and anemic growth, are not items on any policymaker's wish list. Adverse supply shocks all have a similar initial impact but the damage caused beyond that in the economy depends on various factors. Importantly, it depends on the responses of monetary and fiscal policy and the underlying policy strategy.

What should be expected beyond the first round? According to Orphanides an important lesson of the experiences of the 1970s is that the eventual economic consequences of an adverse supply shock depend crucially on whether monetary policy allows the first round of inflation effects to propagate further into a wage price spiral. Tolerating second round effects on inflation can be devastating to the economy and can result in both lower growth and higher inflation over time. It is all too easy to fall into the trap of pursuing over expansionary policy. Slower growth for some time may be a discomfort that should be tolerated rather than resisted to avoid accumulating imbalances that may be costlier to address later. To avoid the materialization of second round effects it is imperative for policymakers to do what it takes to keep inflation expectations well anchored. This can be achieved at a lower cost, if structural elements are in place that prevent the propagation to further wage and price increases.

The ECB's strategy must exactly be seen in this context. This is why the Governing Council has taken a resolute stance against the materialization of broad based second round effects in the Euro area. Orphanides concluded that allowing expectations to become unmoved from the price stability objective will be detrimental not only to price developments, but also to employment and growth down the road. Thus, the ECB's aim must be to avoid this trap.

LAURENCE MEYER (Macroeconomic Advisers) provided a U.S. perspective on the question of reigning in inflation and maintaining sustainable growth. In terms of principles, Meyer firmly supported an explicit (qualitative) dual mandate for the central bank that covers inflation and growth. The inflation objective should be for the medium-term and although the target should be set for headline inflation, the central bank should monitor the success by focusing on core inflation. Meyer recommended a forward looking Taylor rule as strategy. In this context, it is important to anchor the long-term inflation expectations and communicate consistently.

JÖRG KRÄMER (COMMERZBANK AG):

The ECB Watchers conference brings together central bankers, academics and bank economists. This mixture delivers a very good understanding of the ECB's monetary policy.

PETER HOOPER (DEUTSCHE BANK):

Especially for any observer from across the Atlantic, this series has been an excellent source of information about how policy-oriented thinking and research on critical issues at the euro area's central bank have progressed over its first ten years.

Meyer then turned to the current situation of the U.S. economy. It has slowed down significantly due to three shocks: a housing correction, a credit shock and a long rise in energy prices. While GDP shortly expanded in the second quarter by 3.3% compared to a long-run trend of 2.5%, Meyer sees it slowing to zero in the second half into "a danger zone for monetary policy." Although optimistic that the economy will return back to trend next year he noted enormous uncertainty and emphasized that unemployment is clearly on an upward path. In August, the unemployment rate rose from 5.7% to 6.1% and FOMC projections indicated a rise in the unemployment rate that lingers considerably and suggest very limited progress in 2009 and the year after given appropriate policy. Thus, in order to deal with the consequences of core inflation being elevated the FOMC is willing to tolerate a period of below trend growth and a high and lingering unemployment rate. Meyer argued that the FOMC may be more transparent than the ECB by publishing three-year-ahead projections of inflation, unemployment and growth.

In thinking about how the Fed should be responding to the current situation Meyer presented detailed information on recession probability models and own forecasts pointing to a significant risk of slipping into a recession in the near term while inflation is high. Although core inflation is expected to rise beyond 2.5% in the second half of the year Meyer expects a moderation of inflation in the future. Energy prices are declining and prospects have improved that they will remain stable in the next two years. The dollar has stabilized and will perhaps slightly appreciate, and slack in the economy will reduce inflation.

Meyer concluded by discussing the policy implications of the credit crisis, inflation and unemployment outlooks through the lens of a forward-looking Taylor rule. Credit spreads and risk premia are factors that should lower the real neutral funds rate. He believes the Fed has therefore little insurance built into the funds rate setting. The response of the funds rate to the adverse supply shock then depends very much on how well-anchored inflation expectations are. With well-anchored inflation expectations the funds rate does not need to be raised in response to an adverse supply shock but could even ease in order to offset some of the growth impact of this shock.

Celia Wieland (CFS)

HARALD UHLIG (UNIVERSITY OF CHICAGO):

The forum has been the central open venue for communicating and discussing the results of leading ECB watchers. For example, I have had the opportunity to co-author several "Monitoring the European Central Bank" (MECB) reports for the CEPR in London. While these reports were presented elsewhere too, and while we were also particularly grateful to then ECB council member and director of economics and research, Prof. Dr. Otmar Issing, to always grant us an open-minded discussion about our findings with him and the ECB staff, the forum was the final, critical venue for discussion. The forum therefore played a crucial role for the debate on monetary policy in Europe.

INTERVIEW WITH PERVENCHE BERÈS (DEPUTY OF THE EUROPEAN PARLIAMENT) AND AXEL WEBER (PRESIDENT OF THE DEUTSCHE BUNDESBANK) ON THE FINANCIAL TURMOIL

Interviews

taken on August 18 & 20, 2008

Ms. Berès and President Weber, what are the most important lessons that we should draw from the recent experience regarding monetary policy during financial turmoil?

Berès: The ECB's strategy to inject right in the beginning of the crisis liquidity and to maintain interest rates, contrasting with the Fed's important rate cuts was welcomed as a level-headed response. This might very well be true in the short term, but on the long run, with the crisis hitting the real economy and with the additional rise of commodity prices, that I characterize as the emergence of a second age of globalization, this strategy is put into question if it is acting alone and harshly reminds us of the Eurozone's Achilles' heel: it's lack of economic coordination and of intervention tools when it comes to mastering a crisis.

Weber: It has become clear over the past year that there is more to central banking than just taking interest rate decisions. Liquidity operations, financial stability concerns, and banking supervision issues have kept us busy. Not mixing-up these distinct issues was key. Our clear separation of monetary policy and liquidity provision has helped us to ease strains in the money markets whilst at the same time remaining alert to/on guard against the substantial inflation risks.

How should monetary policy respond when the next housing or asset price bubble comes?

Berès: The tackling of the next bubble (actually commodities have already become the new bubble) shouldn't be an issue that falls into the only realm of monetary policy. As legislators and political actors, we should make sure well in advance that the next bubble is used to allocate investment properly, answering the needs of the real economy for sustainable financing.

Weber: We should reduce the likelihood of re-occurances. We are using our regulatory powers to adjust the capital adequacy and liquidity management framework for banking in the light of recent events. Aligning incentive structures and reducing the pro-cyclicality of the banking and credit business is key to avoiding a new round of problems.

Is the Euro area regulatory framework ready to deal with the collapse of a major European bank?

Berès: It is obvious that we are not only witnessing a massive market failure, but also a severe regulatory and supervisory failure. Both call for strong responses from policy makers and regulators. I believe that long ago the Commission should have delivered a comprehensive analysis of the existing EU regulatory and supervisory framework in the light of the pre-existing deficiencies that have been highlighted by the crisis. After the creation of the Euro and the ECB, the strategy for financial market's integration lacks a supervisory structure where the responsibility of the ECB is crucial.

The link between macro prudential oversight (macro-economic stability analysis) and micro prudential oversight (the actual supervision of financial institutions) has been neglected in both national and European supervisory architecture. I therefore advocate for the creation of a pan-European structure for prudential super-vision of the major cross-border financial groups, on top of but closely linked to the existing system of cooperating national supervisors. The main argument for the transfer of the prudential supervision of these groups to the European level is the systemic risk that such financial groups pose to the entire EU financial system. This proposal would also offer a response to regulatory competition, where Member States trying to attract the head quarters of financial institutions not only with fiscal incentives but also with light regulatory regimes.

Weber: The Eurosystem's swift and continued intervention in money markets has substantially reduced the likelihood of such an event materializing: As for the future, I am convinced that the high degree of connectivity and established joint decision-making processes make the Eurosystem the natural nucleus for any timely and coordinated response to potential banking problems in Europe.

CFS Researcher Receives Ladislao Mittner Prize

Elena Carletti has received this year's Ladislao Mittner prize, which is given annually under the aegis of the German Academic Exchange Service (DAAD) and the German Rectors' Conference (HRK). This award aims to promote and strengthen scientific contacts between Germany and Italy, and carries a cash amount of € 5,000 as well as funding for a four-week fellowship in Germany.

The award ceremony took place on the 11th of July 2008 in „Villa Vigoni" at Lake Como in Italy, during the German-Italian Journalists' symposium. A panel discussion with Elena Carletti on the role of Germany and Italy as partners in the common European market for financial services was held prior to the ceremony.

In his speech, Christian Bode (Secretary General of DAAD) noted that Carletti, who is also the first woman economist to have received this award, was chosen by the jury for her outstanding research in the field of banking and finance, and its special emphasis on the German financial system.

Since October 2008, Carletti has been a Professor of Finance at the European University Institute (EUI) in Florence, where she holds a joint chair Robert Schumann Centre and Economics Department. Her research interests are in the areas of bank competition and regulation, financial stability and corporate governance.

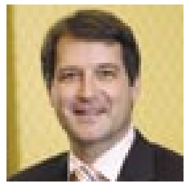
New Researchers at CFS

Marcus Fleig joined the Center for Financial Studies in June 2008 as Young Researcher under the supervision of Professor Jan Pieter Krahnen. Prior to joining the CFS, he graduated from Goethe University where he majored in Finance, Management and applied Microeconomics. Beside his studies at Frankfurt University and the University of Passau, he completed several internships in the banking and consulting sector, among others at Deutsche Bank and PwC Deutsche Revision. Marcus research focuses on Deutsche Bank and its transformation into a global investment bank. His research interest is in the field of corporate finance.

Sebastian Schmidt joined the research team of the Center for Financial Studies in October 2008. Since September 2007 he is enrolled in the Ph.D. Program in Economics at Goethe University, where he also completed a Diploma in Economics supported by the German National Academic Foundation in 2008. At the CFS, Sebastian will be working on the "MacroModelBase" project headed by Professor Volker Wieland. This initiative aims to build a public archive of macroeconomic models that are used by academics, central banks and finance minstries to quantify macroeconomic risks and evaluate stabilization policies. It is financially supported by the EU Commission as part of a new research network on monetary and fiscal policies in multi-country models (MONFISPOL).

Corinna Wolf joined the CFS research team in November 2008. Corinna holds a degree in business administration and also studied journalism at Mainz University. While working for the "CFS Financial Center Index" project headed by Professor Jan Krahnen, Corinna continues to work in the collateral management section of Deutsche Bundesbank. Her research interests focus on the impact of ratings and rating agencies.

Volker Wieland appointed as Wim Duisenberg Research Fellow by ECB



Volker Wieland, who is Director of the Center for Financial Studies and Professor of Monetary Theory and Policy at Goethe University, has been appointed as Wim Duisenberg Research Fellow by the European Central Bank. The Wim Duisenberg Fellowship is awarded annually since 2006 to internationally recognized experts in their field of research. In previous years, the Fellowship has been awarded to leading scholars such as Albert Marcet (Universitat Pompeu Fabra), Philippe Weil (Université Libre de Bruxelles) and Alex Cukiermann (Tel Aviv University). During his eleven month stay at the ECB, Wieland's focus of research is on the role of money supply in the design of monetary policy and on comparative analysis of macroeconomic models. He will also take advantage of the opportunity to have a closer look at the practical side of monetary policy.

Congratulations to Stephan Späthe

In November 2008, the House of Finance has extended its Executive Administration, with the intention to have a central point of contact for all operational and strategic issues related to the House of Finance. Stephan H. Späthe, who is a former staff member of CFS, and Bettina Stark-Watzinger will be working alongside the Executive Director, Prof. Wolfgang König, to help fulfill this objective. Before taking this position, Stephan Späthe acted as coordinator of the CFS Financial Center Index project headed by Jan Krahnen. We wish him and his colleague a successful start!

Karl Häuser, 21 October 1920 - 7 September 2008

The Center for Financial Studies lost its founding father and honorary member Prof. Karl H. Häuser. Professor Häuser made a significant contribution to the establishment of our research institute in 1967. At that time, he was Professor for Public Finance at the Goethe University in Frankfurt and he became the first director of the Institut für Kapitalmarktforschung (IfK), which later became the Center for Financial Studies. He strongly believed that research needed to focus more on capital markets, which was at that time a rather neglected discipline at academic institutions in Germany and elsewhere. His vision was to stimulate research in this area by bringing together practitioners and academics. He paved the way for a discussion platform that still exists today. The CFS Colloquium series still continues to be a well-frequented and lively forum for discussion and exchange. After Professor Häuser retired, he continued to show a keen interest in the activities of the Center and he regularly attended our events and meetings. With him, the Center lost a strong supporter and a charming person who has left his footprint on the financial community in Frankfurt. We wish his family much strength in overcoming the loss.

New Ph.D. Program

In fall 2009, the new Law and Economics of Money and Finance Ph.D. Program will start at the Goethe University in Frankfurt. This two-year program will be offered to postgraduates from law and business schools. The faculty will be comprised of highly qualified lecturers. In addition to faculty members from Goethe University and the Institute for Law and Finance (ILF), professors and researchers from top-ranked European and North American Universities will visit the program. For more information, please consult www.jura.uni-frankfurt.de/doctoral.

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