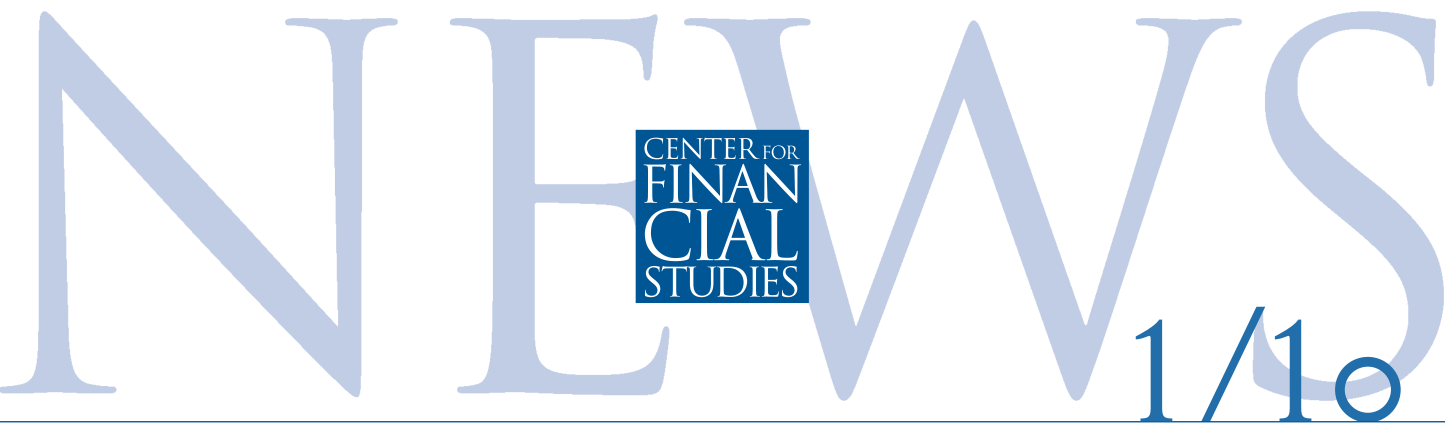

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Editorial

The Meaning of *Crisis* in Greek

Causes of the Crisis and Crisis Management

While trying to recover from a financial crisis, Europe is hit by a major sovereign debt crisis, whose main causes are to be traced to structural problems, especially in the South. While contributing to the crisis, speculation in credit swap markets and government bond spreads were not its root causes. Drastic revisions in Greek deficit forecasts following the Greek elections late last year, coupled with a tainted reputation for misreporting economic statistics, served to focus attention on Greece's fiscal fundamentals, including the country's ability to collect tax revenues – the very aspect that guarantees sovereign debt. This ability was doubted, because of massive tax evasion and considerable corruption in the tax collection mechanism; and because of low productivity and heavy reliance of the private sector on public sector projects and funds.

Ironically, both the German and the Greek governments were blamed for delayed ⇛

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reaction to the crisis, that significantly aggravated the crisis. Politically, this criticism does not seem justified: German taxpayers were particularly averse to dishing out funds for a country characterized by excessive spending, limited tax and pension contributions, antiquated and generous labor market and retirement rules. Greek voters, on the other hand, would not have accepted the current harsh measures immediately following Greek elections where unnecessarily huge pre-election promises were made.

Economically, perhaps the unusually high spreads in early May could have been avoided through earlier concerted European action. Yet, at the time of writing, and despite available funds and apparent ECB purchases of Greek bonds, spreads remain quite high, reflecting market uncertainty as to whether Greece will be able to repay loans even at a 5% interest rate. If the market is right, the current spreads are induced by fundamentals and not by inaction. The criticism could be valid, though, if the market's current assessment of sovereign risk is partly due to the erratic behavior of governments as they were groping for an agreement.

Timing issues aside, there is little doubt that the safety net and associated ECB purchases of sovereign bonds were unavoidable, given the risk of contagion to other European countries with similar but less pronounced structural debt problems, and the threat to stability of the currency union. Indeed, buying government debt does not mean per se that the ECB has lost its independence. Independence is questioned if the ECB is forced to accept higher inflation in violation of its stated targets – a development it currently rules out. However, much more is needed to ensure that debt gets repaid and such problems do not recur.

More is needed – Now

Emergency debt refinancing measures need to be combined with changes that ensure longer-run fiscal viability and ability to generate tax revenues, in order to meet debt obligations and achieve debt retirement. The alternative of a transfer union seems politically unworkable and economically very costly, given the transfer union's detrimental effects on fiscal discipline and reduced incentives of net payers. This is especially so if transfers are not used to smooth temporary imbalances in either direction. The other alternative, namely default on sovereign debt, carries with it a heavy stigma that could cut off European countries (not only Greece) from important sources of future financing and would most likely also lead to the break-up of the Eurozone, the scenario the current crisis management wanted to avoid. The stigma is especially pronounced when default cannot be attributed to exogenous factors, such as a world financial crisis, but to bad domestic institutions and practices.

Massive reforms are needed to ensure future increases in productivity, growth, and competitiveness, so that European countries can generate the funds to meet future obligations, reduce debt levels, and offer their people hope for the future. Without such reforms, the current cuts in fiscal expenditures and nominal wages, as well as the increases in consumption taxes simply reduce disposable income, raise unemployment, and create a deep recession with massive costs that jeopardize social cohesion.

At the core is fiscal coordination that does not prevent fiscal competition. Rules for setting limits on government spending and for designing methods of tax collection should be harmonized with reference to best practices. Restraints on fiscal deficit and debt levels need to be monitored very closely and in a timely fashion. The rules of the competitive economic game should be simplified and harmonized, with emphasis on providing equal opportunities, sound incentives, and rewards for productive effort rather than political favors. Labor market rigidities should be abolished, including 'closed professions' and groups with preferential treatment based on political power, in order to allow access to outsiders and to improve flexibility and hence productivity in European economies. Clear incentives to invest financial and human capital in the private sector should be provided and bureaucratic procedures (e.g., for setting up a business) should be drastically simplified. The pension system needs to be modernized and rationalized, reducing implicit public debt (which is far larger than the official debt figures in many European countries), an urgent task in rapidly aging European societies.

A big danger is that these structural reforms are seen as needed only 'over the longer run'. Contrary to Keynes' famous dictum, Europe actually needs to make sure it survives in the long run, and this is a process that starts today. Europe needs to act not only as a tough lender but also as a coordination device that helps countries to move towards sound fiscal behavior. If all that happens today is the misery of tax collection and wage reduction, a number of countries can be drawn into a deflationary spiral; and countries such as Greece may exhibit a form of hysteresis, whereby they lose some of their most productive people and dynamic and internationally competitive firms. In a crisis, such losses occur fairly quickly as people re-optimize, but they are difficult to reverse. In sum, Europe as a whole needs to use this crisis in a way consistent with the many positive meanings of the word in the ancient Greek language where it originated: test, judgment, choice, competition, and resolution.

Michael Haliassos and Uwe Walz

CFS Strategy 2010

CFS is in the process of redefining its role within the House of Finance. More emphasis is being put on the cooperation with the different entities – institutes and departments – in the House. The aim is to eventually create synergy effects for all parties involved, thus contributing not only to research excellence, but also to research relevance.

CFS' role remains anchored in its mission statement, stressing its role as an independent research institution with a strong international orientation. CFS builds on its experience as a forum for dialogue between academia, policy-making institutions and the financial community. CFS' role is being recognized and valued in- and outside the academic community, in Germany and abroad.

Since its foundation, CFS has been active as an important bridge, not only between the finance and money group at the University, but also between the academic world and the main private and governmental institutions around us. CFS has several long-standing cooperation projects, e.g. with central banks, private and public sector banks, and key financial sector institutions. CFS will further develop its network within academia and the financial industry in Europe.

Besides running lecture series, workshops and conferences, CFS will extend its role in inducing and generating high-quality research with an eye on policy relevance in key areas of financial and monetary economics. Several initiatives will help to provide additional effective stimuli for research and dialogue.

Our research facilities will be enhanced by a **CFS Research Visitors Program** and a **CFS Data Center** (more information can be found on page 4). In addition to that, the existing research programs will get a "remake", with fewer research areas and stronger emphasis on cooperation among researchers and across disciplines. The idea is that a network (both internationally and locally) of research fellows and affiliates is built around each research area. The networks, each headed by a Research Professor, will apply for projects and funding and will set up their research program. The five **research networks** currently envisaged are:

1. *Household Finance*
2. *Financial Stability and Banking Regulation*
3. *Law & Economics of Financial Organizations*
4. *Monetary Policy*
5. *Economics of Trading in Financial Markets*

CFS will also contribute considerably to facilitating research by providing "logistic" support for the research activities in the areas and their networks. With the **Program Network Support** initiative, CFS will assist in the submission process for research grants by writing and subsequent monitoring of research proposals. This central contact point will work closely with the research networks and will look at the opportunities for network building and support.

Not to forget, CFS is a co-founder of and an active participant in the recently established **House of Finance Policy Platform**, jointly run by researchers from the House of Finance with a strong experience in policy advisory. CFS' role in fostering policy relevance is assisted by another new initiative which links its activities to the University's Ph.D. programs in Economics, Finance and Law.

This is the planned **CFS-GSEFM Policy Research Network**, which will develop a direct linkage between policy debate and academic research.

The New CFS Program of Research Visitors

by Michael Haliassos

As part of its new strategy, CFS is launching a new program of Research Visitors, at two levels: Senior and Junior. In both cases, the program is intended to provide an opportunity for useful exchanges and transfer of knowledge that promote research within CFS research networks but also among graduate students and Goethe faculty at large.

Senior Visitors

Senior visitors will be invited to spend a short period at CFS, usually two weeks. During this period, they will be asked to give a graduate minicourse, intended to communicate to graduate students and faculty the latest research tools, methods, and results in the area of the research visitor. Typically, the material will be drawn from the latest papers in the current research field of the visitor. The minicourses will be open to students and faculty of CFS, any CFS fellows in residence at the time of the visit, and possibly to individuals from selected Frankfurt institutions with which CFS has reciprocal arrangements for access to data or to researchers. In addition, senior visitors will be asked to give either one research seminar at Goethe University or a CFS public lecture to the broader Frankfurt financial community. The choice will depend on the field of the visitor and its likely appeal to the research and practitioner community. Finally, visitors agree to be available for discussions on research with CFS fellows, Senior and Junior, as well as with interested faculty at Goethe University. The visits will be typically funded through external funds, and such funding will be explicitly recognized when advertising the research visit.

Junior Visitors

Junior visitors will typically be young researchers who have finished their Ph.D. and are currently doing interesting research in one of the CFS research networks. They will be visiting typically for periods of 6 months to 2 years, and their main obligation will be to work on their research papers and to provide positive externalities (but not regular formal teaching) to students and faculty at Goethe University. The latter may include contributions to our Data Center (e.g., in the form of data or programs), a few lectures on new issues or techniques with which they are familiar, collaboration in the organization of research conferences or seminar series, and other related activities. Junior visitors will be paid at rates comparable to those of researchers at Goethe University. In addition to external funds made available to it by its sponsors, it is envisaged that CFS will apply, in due course, to funding agencies, such as the European Union Marie Curie program for postdoctoral fellows.

The New CFS Data Center

by Uwe Walz

The creation of the CFS Data Center is one of the main pillars of the new CFS strategy to foster the production of research in the area of financial and monetary economics. Access to high-quality data sets is a necessary condition for top quality research in many parts of these two fields. Thus, the CFS Data Center is likely to be a valuable resource for the entire CFS community, including not only CFS researchers, but also their visitors and fellows based outside the CFS. It is envisaged that this data center will complement other initiatives being pursued under the new strategy.

The CFS Data Center will host data from three different sources: commercial data sets; data sets that are publicly available free of charge; and proprietary data sets.

Commercial Data Sets

Based on the expertise and the underlying demand in the new research networks, we aim to provide commercial data sets that are in high demand in the main areas of research at CFS. These data sets are intended to complement the existing data sources already provided under the data pool sponsored by the House of Finance and the Department of Business Administration and Economics at Goethe University. CFS will thus offer a complementary source of research information that links itself with other entities at the House of Finance and beyond.

Publicly available Data Sets

In a number of fields, data sets are freely available to the public. Often, they require some polishing and/or interfaces in order to make their application much less demanding and less time-consuming. Thus, the polishing of data sets and the setting up of (web-based) interfaces will be at the core of the activities of the staff of the CFS Data Center. A future way of producing valuable data sources from publicly available data will be to merge respective data sets (e.g. across countries) in a consistent manner.

Proprietary Data Sets

In a significant number of cases, valuable proprietary data sets have been set up by members of the CFS community which, however, are clearly underused (e.g. due to fact that people move on to other research areas or focus on only certain aspects of a data set). This would include, for example, data on share prices and listed German companies for the period 1880 to 1950. The main contribution of the CFS Data Center here will be to polish these data sets and to make them more accessible by providing proper interfaces and data descriptions and other necessary documentation.

Altogether, the CFS Data Center will not just be a provider of data sets, but rather a comprehensive service center; one which ensures that data access is more user friendly and, therefore, more attractive.

The CFS-GSEFM Policy Research Network

The inaugural "Global Economic and Financial Policy Series" lecture by Citigroup Chief Executive Officer Vikram Pandit in October 2009 was the first event organized jointly by CFS and the Graduate School of Economics, Finance, and Management (GSEFM). Through his speech, Pandit triggered a lively discussion with GSEFM graduate students on issues of financial innovation, financial regulation and the future of banking. The event was highly successful (see also Newsletter 2/09) and has inspired CFS and GSEFM to widen their cooperation. As part of this widened cooperation, CFS and GSEFM have agreed to launch the new "Policy Research Network", aimed at stimulating research on key aspects of economic and financial policy. The new CFS-GSEFM Policy Research Network will link to the "Policy Platform" already established at the House of Finance (HoF), providing the doctoral students at GSEFM with various forms of structured interaction with internationally recognized senior researchers and policy makers.

The HoF Policy Platform – founded in 2009 by CFS, the Institute for Financial and Monetary Stability as well as the Institute for Law and Finance – is currently operating a website featuring policy commentaries and OpEds written by academics from within the HoF, the Faculty of Economics and Business Administration, as well as the Faculty of Law at Goethe University (see also page 7).

GSEFM – founded in 2008 – constitutes an alliance between Goethe University Frankfurt, Johannes Gutenberg University Mainz and Technical University Darmstadt. GSEFM aims to realize the three universities' joint vision to establish a premier European center for quantitative and research-oriented graduate-level education in economics, finance and management. Leveraging the achievements of Goethe University's established and highly successful Ph.D. Program in Economics, GSEFM's overarching objective is to produce outstanding economists capable of taking leading positions in academia or serving as experts in international institutions, government and the private sector (see also www.gsefm.eu).

Michael Binder

The CFS-GSEFM Policy Research Network will involve summer institutes and other forms of structured interaction between GSEFM doctoral students, GSEFM faculty members, the heads of the CFS research areas and policy makers. While the papers written within the Policy Research Network will likely have significant impact well beyond the confines of academia, in line with the focus of GSEFM, the Policy Research Network will give strong weight to placement of the papers in refereed journals. Michael Binder, who is Founding Dean of GSEFM and has had a long-standing affiliation with CFS, will head the CFS-GSEFM Policy Research Network. His close interaction with GSEFM's doctoral students and his thorough understanding of the CFS network make him an excellent choice for directing this highly promising new initiative.

Encouraging Research on Banking Regulation and Banking Supervision

Klaus Düllmann

A first event already took place this spring, when **Dr. Klaus Düllmann** from the Deutsche Bundesbank spoke to advanced Ph.D. students and faculty members about possible research initiatives in the field of banking regulation and supervision. The workshop was meant to initiate collaboration between the Research Centre at the Bundesbank and young researchers at the university. The idea is to give students the possibility to participate in research projects on topics related to banking regulation and the recommendations of the Basel Committee on Banking Supervision.

During the workshop, Düllmann and his team outlined a number of "hot" topics for policy research. He presented several ongoing regulation initiatives, and outlined for each initiative a number of related research topics. The research subjects he presented covered a range of issues, including macro-prudential regulation, liquidity regulation, securitization and the originate-to-distribute (OTD) model, crisis solution and intervention, as well as improvements to stress tests.

Having outlined the various research topics, students were invited to speak with Bundesbank staff members present at the workshop about the possibility of collaborating on specific research projects.

CFS-LEMF Summer School

Our yearly summer school will also be adjusted to reflect the new strategy. Cooperation with other departments or university entities has now been brought to the forefront and the overall emphasis has shifted towards course offerings for Ph.D. students and PostDocs. This year's Summer School will be held from 16 till 20 August 2010, and is a joint project with the Doctorate/Ph.D. Program on Law and Economics of Money and Finance.

A brochure can be downloaded from the internet:
http://www.hof.uni-frankfurt.de/lemf/images/brochure_summer school 2010.pdf

The 2010 Summer School will focus on the legal and economic aspects of contracts. The guest speakers will be Scott Baker (Professor of Law at Washington University, St. Louis) and Douglas Cumming (Associate Professor in Finance and Entrepreneurship at the Schulich School of Business, York University, Canada).

A broad range of subjects will be covered. The program has been divided into three main areas: 1) Legal Topics; 2) Economic Theory; and 3) Financial Contracting. Students will consider, for example, how to analyze and interpret contracts, as well as the economics behind contracts and contract analysis.

House of Finance Policy Platform

▶ Website: www.hof.uni-frankfurt.de/policy_platform

The Policy Platform website gives access to a pool of OpEds and working papers written by researchers from the House of Finance, or members of Goethe University's Faculty of Economics and Business Administration, and Faculty of Law. The contributions are published either as Policy Letter or as White Paper. White Papers comprise more comprehensive research-based contributions to current policy debates. Policy Letters are short essays or commentaries on current policy topics, usually written for publication in the press.

The objective is threefold, to make in-house generated policy-relevant research accessible to the general public, to support policy makers through ad-hoc advisory teams and policy briefs, and to write policy-oriented White Papers on strategic aspects of finance and lawmaking.

In the first half of 2010 the following articles were made available online:

Policy Letters 2010

Mit Sparen stützt der Staat die Wirtschaft
Volker Wieland
Handelsblatt – 8 June 2010

Die Mär von der Spekulation
Otmar Issing
FAZ – 27 May 2010

Den Stabilitätspakt stärken: Staatsschulden besteuern
Stefan Gerlach
Börsen-Zeitung – 14 May 2010

Noch haben wir die Krise nicht gebannt
Stefan Gerlach
Handelsblatt – 4 May 2010

Wie arm oder reich ist Griechenland wirklich?
Michael Haliassos
Handelsblatt – 7 May 2010

Warum werden die Banken immer verschont?
Jan Pieter Krahnen
Handelsblatt – 7 May 2010

How to be a good European …
Volker Wieland
www.oekonomenstimme.org – 4 May 2010

G20 and Macro-prudential Policy
Stefan Gerlach
Bruegel | G20 Blog – 22 April 2010

Frühwarn- und Überwachungssystem zur Stabilisierung der Finanzmärkte
Stefan Gerlach
Neue Zürcher Zeitung – 16 April 2010

Germany's role in the Greek drama (letter to the editor)
Stefan Gerlach
Financial Times – 12 April 2010

Anheben des Inflationsziels wäre verheerend
Stefan Gerlach
Börsen-Zeitung – 1 April 2010

Höhere Löhne sind keine Lösung
Otmar Issing
Financial Times Deutschland – 22 March 2010

Zur Stärkung der Deutschen Bundesbank
Stefan Gerlach, Emilie Yoo
Ökonomenstimme – 22 March 2010

Die Konsolidierung im Inneren muss Vorrang haben
Helmut Siekmann
Börsen-Zeitung – 12 March 2010

Ein staatliches Hospital für kranke Banken
Jan Pieter Krahnen, Günter Franke
FAZ – 27 February 2010

White Papers 2010

Risiko und Risikosteuerung im Aktienrecht
Theodor Baums
7 June 2010

Are the Golden Years of Central Banking Over? Monetary Policy after the Crisis
Stefan Gerlach
May 2010

Systemische Risiken im Finanzsektor – Lehren aus der Finanzkrise
Roman Inderst
19 April 2010

Consumer Protection in Markets with Advice
Roman Inderst
16 April 2010

Future Development of Global Imbalances
Stefan Gerlach
8 March 2010

Rettungsstrategie ohne Moral Hazard – Versuch eines Gesamtkonzepts zur Bankkrisenvermeidung
Jan Pieter Krahnen, Helmut Siekmann
12 February 2010

Die Unabhängigkeit des Vergütungsberaters
Theodor Baums
January 2010

Rescue Strategy without Moral Hazard

This article summarizes the concept for crisis prevention and intervention, outlined in the White Paper by J. P. Krahnen and H. Siekmann "Rettungsstrategie ohne Moral Hazard – Versuch eines Gesamtkonzepts zur Bankkrisenvermeidung". The paper was a draft for talks at the Federal Chancellery (Bundeskanzleramt) that took place in Berlin in February 2010. The complete German version can be downloaded from the Policy Platform website. A revised English version of the paper is scheduled to appear soon.

The financial crisis caught many unaware. Although a major collapse of the banking system could be prevented, the measures taken at the time are now generally considered to be unsuitable for the future. The main objection is the enormous incentive for moral hazard, associated with state-financed rescue measures.

One of the most common insights gained in this crisis has been that systemic risks in the highly interlinked financial system represent a real threat. The danger of systemic risk and worldwide contagion must be faced, without at the same time creating negative incentives "ex ante". This suggests that a balanced set of instruments must be at hand with which banks may be rescued or wound down in an orderly fashion.

Making a distinction between acute and preventive rescue measures (crisis intervention and crisis prevention) is crucial. Furthermore, a distinction must be made between the problems of an individual bank and those of the financial system as a whole. Four cases or fields for regulation arise from making this distinction:

CRISIS TYPE/ STRATEGY	CRISIS PREVENTION	CRISIS INTERVENTION
SINGLE BANK (IDIOSYNCRATIC)	EQUITY/BASEL II (+ESF)	BANK HOSPITAL (+CREDITOR LIABILITY)
SEVERAL BANKS (SYSTEMIC)	RISK MAP, SYSTEMIC RISK CHARGE (+ESRB)	BANK HOSPITAL (+COCO)

Key: ESF = deposit guarantee funds · CoCo = contingent convertible bonds · ESRB = European Systemic Risk Board

Single Banks and Crisis Prevention

It can undoubtedly be said that the system of banking supervision aimed at preventing a crisis within the financial system has not fulfilled its intended purpose. This is true with respect to both the supervisory institutions as well as the recommendations of the Basel Committee.

The implications of systemic risk and the eventuality of contagion between banks have hitherto received little or no attention. An important issue is the protection of individual institutions against a bank run, since it reduces the risk of contagion for other financial institutions and contributes to the stability of the system as a whole.
In Germany there exists in this context a considerable need for reform. The guarantee scheme for claims against banks is divided according to the pillar structure of the German banking system. These claims are thus walled off from one another, which reduces the efficiency of the system. Furthermore, the voluntary guarantee schemes that exceed the legally prescribed minimum insurance do not constitute a legal obligation and are not sufficiently covered by capital. The funding obligations are at least in the case of the deposit guarantee funds of the Association of German Banks (Bundesverband deutscher Banken) too low. Furthermore, reciprocal insurance can only work in the case of isolated banking problems. In any event an additional state deposit guarantee fund will be required and it might be advisable to emulate the American Federal Deposit Insurance Corporation that acts as regulator and in the U.S. is perceived to be the most efficient supervisory institution.

Single Institutions and Crisis Intervention

Crisis prevention can only be successful when it is not counteracted by the expectations of market participants about the behavior of regulators and central banks in the event of a crisis (crisis intervention). The expectation has now arisen that, in an emergency, banks will be unconditionally supported using taxpayers' money and that creditors will be safeguarded from any financial losses. These expectations must now be credibly countermanded. A legally binding mechanism must be introduced by which shareholders and creditors participate in the burden of a bank collapse.

The existing insolvency proceedings have proved to be unsuitable. This deficiency should be remedied by creating an institutionalized restructuring process for failing banks. A so-called "bank hospital"

will be required, a state-run institution endowed with the power to enforce the necessary procedures, even in the face of opposition from creditors and bank owners. In the event of a sudden crisis, the failing financial institution could be safeguarded from insolvency and then be restructured without haste. Parts of the business could be sold off or liquidated. Finally, the accounts could be settled and the remaining losses charged to the shareholders and creditors. In this way the principle of privatizing profits and losses could be enforced and the incentives for excessive risk-taking could be effectively curtailed.

It would be appropriate not to focus on the institution in its entirety but rather on the individual contracts that the bank has entered. A financial institution's commitments could then be classified as being either systemically relevant or systemically non-relevant. This evaluation of debt would be the task of the state that underwrites the guarantees. In this way the systemically relevant parts of the company can be safeguarded without eliminating the insolvency risk for the remainder. The risk of default on non-systemic debt must remain solely with the creditors. Through the appropriate regulations it must be ensured that all institutions at all times have sufficient non-systemic outstanding liabilities at their disposal. In this way an institution should be prevented from evading its immediate responsibilities by claiming that all its debt is "systemic".

The Banking System and Crisis Prevention

It is not always easy to differentiate between the crisis of a single institution and that of several institutions, or indeed of the system as a whole. The Lehman bankruptcy showed that the linkage between financial institutions and their common dependency on the market evaluation of individual assets can have fatal results for other institutions. If a systemic crisis threatens to become a simultaneous collapse of several important institutions, then there is no alternative to coordinated state intervention. In this case it makes no difference whether the cause is a run on the banks by depositors or the mutual loss of confidence between the banks themselves.

In fact the accumulation of systemic risk is generally not directly perceived by the individual financial institution, nor is it apparent in its balance sheet. The incurrence of systemic risk is in economic terms an externality and it needs to be internalized in order for it to appear in the operational costs and in the calculation of return. In the first place a compulsory duty may be envisaged, which could be in the form of a compensation charge. This type of charge is quite common in environmental policy aimed at minimizing negative (polluting) behavior or at offsetting specific advantages or disadvantages. The level of the charge should be set according to the degree by which the asset in question contributes to the overall systemic risk. This type of charge would ensure that systemic risks are made sufficiently "expensive" for individual institutions.

Nevertheless, determining the systemic risks of individual banks or debts can give rise to considerable practical problems. Almost no one saw in the top rated securities held by some banks the trigger for a global crisis. In this context, we should remember the notion already proposed by the German government at the G20 meetings of a risk map, capturing the bilateral financial relationships between big, internationally active financial institutions. It is a prerequisite for even being able to calculate the charges outlined above.

Assuming that it is indeed possible to levy such a charge, the question still remains what should then happen to the money. There are several arguments in support of a reinvestment of the proceeds in the encumbered institutions in the form of contingent convertible bonds (CoCo), namely bonds that upon demand may be converted into equity. The conversion takes place when the financial institution is deemed to be solvent but illiquid. Via the conversion the institution gains direct access to fresh capital and is able to reduce its interest payments, thus increasing its operating income and improving its liquidity situation. When there is no crisis, such bond holdings are risk adequate and bear interest at the going market rate. The decision for conversion should lie with the supervisory authorities.

The Banking System and Crisis Intervention: the Role of the Regulator

Combating a crisis of the entire banking system will again be a case for the bank hospital. The measures adopted will differ, since the so called CoCo accumulated in times of no crisis can be completely or partially converted into equity. Following the conversion the obligation to pay interest is immediately dropped (liquidity effect) and equity capital is increased without having to resort to the capital market (solvency effect).

For appropriate crisis prevention and intervention, it is imperative to have a well functioning supervisory authority. There are clear indications that the trend towards „self regulation“ in the financial sector in lieu of a strong supervision contributed significantly to the crisis. Measures and institutions aimed at securing financial market stability serve society as a whole and should therefore be largely financed by federal budget. The regulatory laws set out in the Banking Act and its implementing regulations require a thorough revision.

Too Much Money is Dangerous

"Inflation is always and everywhere a monetary phenomenon" is a well-known statement by Milton Friedman. Since the crisis, billions of cheap money are available in the market. Many articles recently titled "Keynes is back". Indeed, a Keynesian spirit reigns around the globe. The Keynesian policy however implies huge public deficits and new financial bubbles. Does a renaissance of monetarism seem set?

The recent Keynesian renaissance is not surprising. The crisis that started in 2007 can only be compared in history with the Great Depression after 1929. Keynes' *General Theory of Employment, Interest, and Money* written in 1936 meant at that time a turning point towards an economic policy that tried to steer employment from the demand side. This perception was long present in Anglo-Saxon policy but also in academic discussions.

The dominance of Keynesianism began to dwindle following two developments. The first was the theoretical and empirical work mostly connected to Milton Friedman. The so-called monetarists challenged fundamental elements of the Keynesian theory and its application in economic policy. The second development was a failure of the Keynesian policy when government spending led to high inflation without in the end reducing unemployment. Monetarism offered an explanation for the failure of the Keynesian policy and central banks started to integrate the new ideas in their policies. The Bundesbank, for example, was the first central bank to introduce a money supply target in 1975.

Long before the outbreak of the current financial crisis, monetarism was already on the retreat. Numerous financial innovations, for example, were more or less affecting the significance of monetary aggregates and the control of the money supply was neglected or even ignored by most central banks. Since the mid 90s, direct inflation targeting became the dominant strategy and academic discussions reflected these findings.

Is monetarism dead? Although many recent developments might point in that direction, one should not ignore some of the key points of criticism that monetarism has brought forward.

If central banks ignore the time lag in the effect of monetary policy measures, which could be one to two years, there is a danger that the inflationary dynamics are being underestimated. This in return could lead to a delayed exit from the expansionary policy. Is it possible that the high days of Keynesianism are already over again? There is more and more evidence that the government spending multiplier effect is over-rated and that there is a changing attitude towards the huge government deficits.

The widespread Keynesian belief that *money doesn't matter* has proven to be wrong. The inflation of asset prices worldwide would not have been possible without the immense expansion of the money supply and the credit volume.

Monetarism will not return to its old recipes. The models to explain monetary development will not rely on simple money supply concepts. Credit volume in all its facets will play a more central role. The European Central Bank with its two pillar strategy and its refined monetary analysis will be well-armed to face future challenges. Let's only hope that the world doesn't have to endure a new phase of inflation in order to value Milton Friedman's words.

This article summarizes a contribution by Otmar Issing that was published in Die Zeit on 5 March 2010 under the title "Zu viel Geld ist gefährlich". The online version can be found on: www.zeit.de/2010/10/F-Monetarismus. An article on this topic is also forthcoming in „The International Economy" (Spring 2010 Edition).

Die Mär von der Spekulation

Otmar Issing, F.A.Z. – 27 May 2010

In this article, Otmar Issing argues that the "Greek debacle" is a striking example of bending the truth, in that financial speculation is blamed for the recent developments in Europe. Speculation supposedly brought Greece to the brink of national bankruptcy, and then drove the euro down. According to Issing, this is a myth which tries to conceal the root causes of the crisis by shifting the focus of attention to speculation – one that could cause some serious damage by opening the doors for the wrong policy responses.

Is "speculation" really at play when pension funds and investors turn their backs on Greek government bonds in the face of Greece's clearly failing national economic policy? Having said this, the reasons for the current difficulties in Europe are not just to be found in the budgetary problems of Greece. All eurozone governments bear part of the responsibility, given the previous tolerance of irresponsible fiscal behavior.

Proposals for reforming the Stability and Growth Pact, for improving the system of supervision and for sanctions are now on the table. Every effort should be made to find credible solutions, so that the mistakes of the past are not repeated.

CFS Publications

Beiträge zum CFS Colloquium – Volume 47

Finanzinstitutionen: Neue Produkte – Neue Strategien?

Financial Services Providers: New Products – New Strategies?

Peer Steinbrück	*Finanzplatz Deutschland: Wachstum oder Krise?*
Dr. Josef Ackermann	*Strategieentwicklung im Spannungsfeld globaler und nationaler Orientierung*
Dr. Siegfried Jaschinski	*Zwischen privatem Wettbewerb und öffentlicher Trägerschaft: Strategie der Landesbanken heute*
Johannes P. Huth	*Entwicklungsperspektiven für das Private-Equity-Geschäft in Europa*

Centre for Financial Studies

Beiträge zum CFS Colloquium

Finanzinstitutionen: Neue Produkte – Neue Strategien? Financial Services Providers: New Products – New Strategies?

47

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The volume is available in bookstores.
ISBN 978-3-8314-2618-8
Price: € 17,80

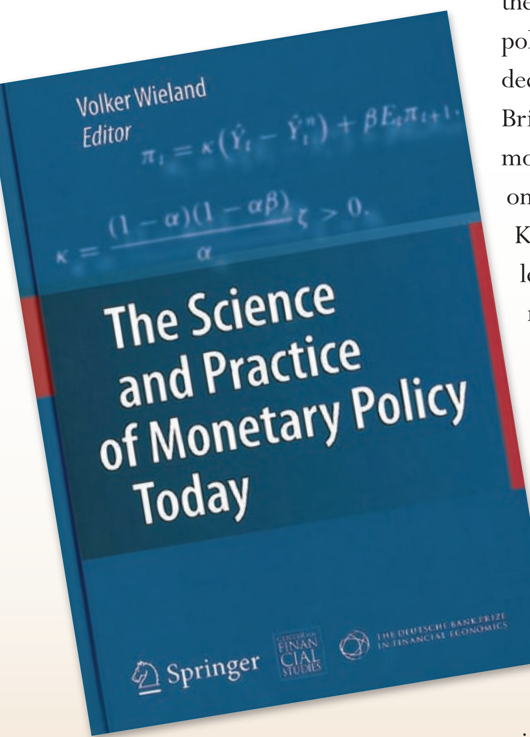
The 47th edition of our publication series "Beiträge zum CFS Colloquium" is devoted to the colloquium lectures that took place between February 2008 and April 2009. This period of time, directly after the outbreak of the financial crisis, was marked by a number of foreboding events. Months of financial trouble and the collapse of several institutions, such as Bear Stearns, Northern Rock and IKB, climaxed with the bankruptcy of Lehman Brothers. It was a period of great distress and far-reaching distrust within financial markets. The lectures that took place during this turbulent period reflect the insights of leading personalities in the German financial industry. Peer Steinbrück (German Federal Minister of Finance from 2005 to 2009), Josef Ackermann (Chairman of Deutsche Bank), Siegfried Jaschinski (then head of Landesbank Baden-Württemberg) and Johannes Huth (Kohlberg Kravis Roberts & Co.) all gave their views on our financial system against the backdrop of the crisis.

Steinbrück laid out the fundamental principles behind German state intervention at the beginning of 2008. At that time, the focus was on keeping financial markets operational, providing liquidity and ensuring the solvency of certain banks. Looking back, it becomes clear that, at that stage, macro-prudential supervision and international coordination were not yet issues of concern. Ackermann spoke about the underlying business strategy of Deutsche Bank, which is one of complementing a global orientation with a strong domestic base. This strategy proved to be successful, particularly in the time of crisis, when many institutions were in need of support. Johannes Huth highlighted the role of private equity firms during the financial turmoil. They were able to demonstrate their crisis management capabilities and were forced to take a long-term perspective on corporate development. Siegfried Jaschinski shared his views on the future role of the German *Landesbanken*.

We are convinced that this volume will be a valuable source of information and point of discussion for analysts as well as commentators with a keen interest in the German financial system. It contributes to a better understanding of how the positions of varying agents evolved during the crisis.

The Science and Practice of Monetary Policy Today

Editor: Volker Wieland



This book presents important aspects of the New-Keynesian theory of monetary policy and its implications for the practical decision-making of central bankers today. Bridging the theory and practice of monetary policy, it provides an exposition on the key elements of the New-Keynesian approach, outlines important lessons for policymakers, and points to new directions for further research. Important policy implications of the New-Keynesian approach such as the case for forecast targeting as a strategy for monetary policy, the combination of model-based forecasts with cyclical analysis, and strategies for cross-checking model-based policy recommendations are presented in detail. The book brings together new contributions from leading scientists and experienced policymakers presented at an academic symposium on the occasion of the awarding of the Deutsche Bank Prize in Financial Economics 2007 to Professor Michael Woodford.

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Springer Verlag Berlin
Heidelberg 2010
ISBN: 978-3-642-02952-3
Price: € 96,25

http://www.springer.com/economics/financial+economics/book/978-3-642-02952

CFS Working Papers

The following CFS Working Papers appeared in the first half of 2010 and can be downloaded from our website: www.ifk-cfs.de

2010/01 **The Impact of Macroeconomic News on Quote Adjustments, Noise, and Informational Volatility**
Nikolaus Hautsch, Dieter Hess David Veredas

2010/02 **Are particular industries more likely to succeed? A comparative analysis of VC investment in the U.S. and Europe**
Roman Kräussl, Stefan Krause

2010/03 **A Call on Art Investments**
Roman Kräussl, Christian Wiehenkamp

2010/04 **Risk and Expected Returns of Private Equity Investments: Evidence Based on Market Prices**
Narasimhan Jegadeesh, Roman Kräussl, Joshua Pollet

2010/05 **Blockholder Dispersion and Firm Value**
Sander J.J. Konijn, Roman Kräussl, Andre Lucas

2010/06 **Washington Meets Wall Street: A Closer Examination of the Presidential Cycle Puzzle**
Roman Kräussl, Andre Lucas, David R. Rijsbergen, Pieter Jelle van der Sluis, Evert B. Vrugt

2010/07 **Hold-Up in Multiple Banking: Evidence from SME Banking**
Antje Brunner, Jan Pieter Krahnen

The Macroeconomic Model Data Base
A New Comparative Approach to Macroeconomic Modeling and Policy Analysis

Modern macroeconomics has come under severe public criticism for failing to deliver a warning ahead of the global financial crisis and offering sufficient policy prescriptions for fighting the crisis. In particular, critics have pointed to an excessive reliance in macroeconomic modeling on the dominating paradigm of rational decision-making by representative households and firms. Research on revising popular models is now well under way. To analyze and compare the usefulness of state-of-art tools, traditional modeling approaches and forthcoming innovations a new approach is necessary. The Macroeconomic Model Data Base project provides such a new comparative approach to model-based research and policy analysis, that enables individual researchers to conduct model comparisons easily, frequently, at low cost and on a large scale.

Volker Wieland

Sebastian Schmidt

This project is part of the EU-sponsored joint initiative on "Modelling and Implementation of Optimal Fiscal and Monetary Policy Algorithms in Multi-Country Econometric Models" (MONFISPOL), on which we have reported in CFS Newsletter 1/09.

The project is headed by Volker Wieland (Goethe University and CFS). Sebastian Schmidt is working as CFS Researcher on the project.

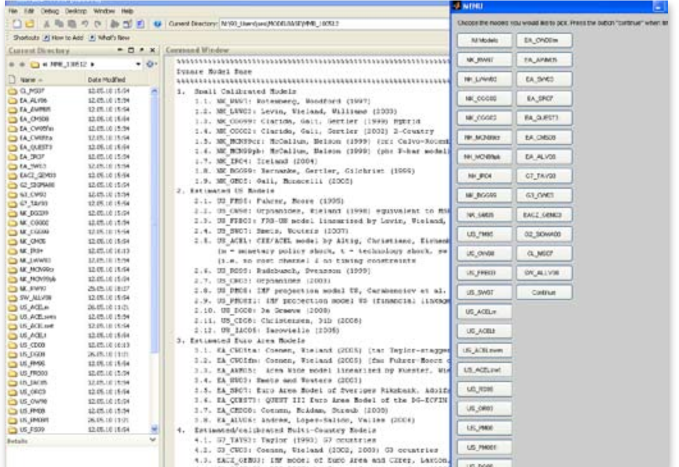
In order to make this approach operational a model archive is built that includes many well-known empirically estimated macroeconomic models which may be used for quantitative analysis of monetary and fiscal stabilization policies.

Today, academics and researchers at central banks, treasuries and international organizations are confronted with a wide range of macroeconomic models that aim to explain the behavior of the main aggregates of the world's economies. Not surprisingly, those models differ in terms of economic structure, estimation methodology and parameter estimates.

Hence, the effects of a policy measure may vary depending on which particular model is used for its evaluation. In fact, the results of policy evaluations sometimes differ tremendously for alternative models, a particular policy measure can appear highly desirable in one model but lead to poor results in a competing model. This makes the systematic comparison of the empirical implications of the set of available models as well as the evaluation of the performance of different policies across many models highly relevant. Yet, in the past such projects have been infrequent and costly. Earlier comparison projects involved multiple teams of researchers, each team working only with one or a small subset of available models, thereby complicating the consistent comparison of alternative models' characteristics and policy implications.

The Macroeconomic Model Data Base project develops a new approach that involves several documented steps in order to make models consisting of different variables, distinct structural assumptions and alternative notation comparable to each other and useful for policy analysis. In particular, these steps involve the augmentation of the models with a set of common variables, parameters, shocks and equations. A formal exposition is given in Wieland et al. (2009).

The approach has been used to create a computational platform written in MATLAB and employing the DYNARE software package that includes by now about 30 augmented models, representing a wide range of alternative modeling assumptions and paradigms. A user interface allows one to engage in straightforward comparison of models' characteristics and implications of alternative policies such as different monetary policy rules. New models can easily be included and evaluated against the existing benchmarks.



Some illustrative examples of the Modelbase software together with the detailed documentation of the comparative approach can be found in Wieland et al. (2009) and a first version of the software is available for testing at:
www.macromodelbase.com.

We expect that the combination of a comparative approach and the provision of an accessible model archive should improve the replicability of quantitative macroeconomic analysis and should strengthen the robustness of policy recommendations.

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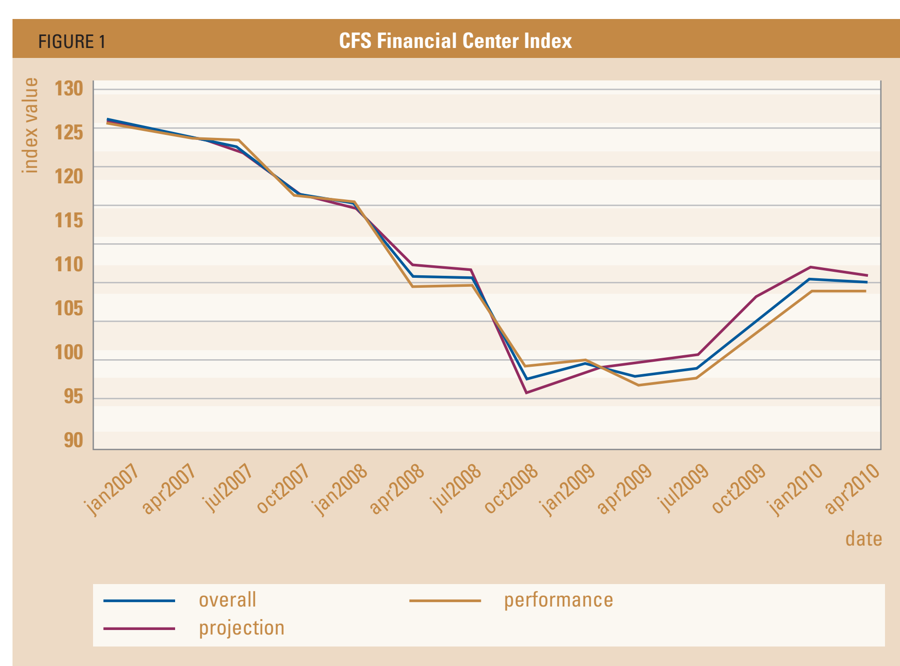
CFS Financial Center Index Remains Unchanged Special Survey on a Bank Levy

With a value of 108.0 points, the overall CFS Financial Center Index has effectively remained unchanged from its January level (108.6). Looking at the different business parameters of the index (transaction volume, profits, employment, and investments), it becomes clear that the current business climate is not all that consistent. On the one hand, participants expressed a positive view on return and investments but, on the other, showed more restraint concerning revenues and employment.

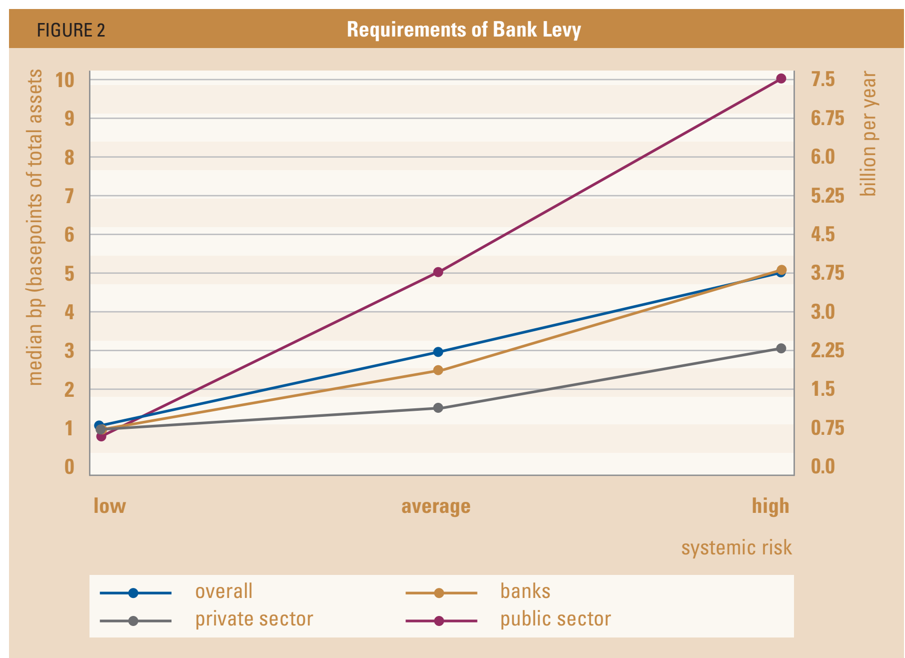
There are also significant disparities between the four branch-specific groups that are being surveyed (financial institutions and brokerage firms, financial sector service providers, supervisory and academic institutions, and connected enterprises). Financial institutions and brokerage firms, for example, reported a considerable rise in profits (+11.1 points), thus surpassing the expectations recorded in the last survey. However, their employment forecasts for the upcoming quarter show a decrease of 9.0 points. “This modest view with respect to employment figures shows that last quarter’s job market expectations have not been fulfilled. It proves that the financial sector is continuing to employ cost discipline, as the sustainability of economic growth is still being questioned,” says CFS Director, Jan Pieter Krahnen.

For the first time, the overall index is presented together with two sub-indices, namely those for “performance” (evaluating the past quarter) and for “projection” (forecasting the upcoming quarter) in a line-shaped diagram (see Figure 1). The diagram also shows that, in the past year, the projection sub-index was consistently higher than the performance sub-index, while both sub-indices are now converging around the overall index. It appears, however, that in the fall of 2008, following the Lehman disaster, performance exceeded projections.



Special Survey: Private and Public Sector at Odds over a Bank Levy

The special survey that was held this spring focused on what participants think about a possible levy on the financial sector. Respondents were equally divided as to whether they are in favor of a bank levy or against it, albeit with there being



CFS project team: Florian Hense and Christian Knoll

a clear discrepancy between the opinion of respondents from private banks and those from their public and cooperative sector counterparts. While a relatively high percentage of respondents from private banks (40%) are in favor of a bank tax, 50% of those from public banks oppose this idea.

All respondents, however, largely agreed that any levy should flow into an external fund that is clearly separate from the state budget. 27% of respondents consider the Deutsche Bundesbank as the most appropriate institution for setting the annual amount of this tax, while 21% would prefer the European Systemic Risk Board to be in charge once measures are introduced across Europe. The majority of banks (52%) support a levy for all financial institutions, including insurance companies and other financial institutions, such as hedge funds, private equity firms, etc. Insurance companies, for their part, favor a solution that involves only banks.

With respect to an actual figure for the size of the tax, the survey reveals that 1 basis point or 0.01% of the balance sheet is considered an appropriate level when systemic risk is low. For an average to high systemic risk, the survey finds that this level should be increased threefold and fivefold respectively. For comparison, the German government proposed introducing an annual tax on banks worth a total € 1.18 billion. Given that the German banking system has an aggregate balance sheet of € 7,500 billion (Deutsche Bundesbank, February 2010), this would imply a rate of 1.6 basis points or 0.016 % of the balance sheet.

Having said this, there is a clear difference of opinion between groups of respondents regarding the progressiveness of such a levy (see Figure 2). Those from public and cooperative banks, in particular, are in favor of high levies in the case of high systemic risk.

Tobin Tax

The survey also shows that there is considerable opposition to another regulatory measure now being considered, namely the so-called “Tobin tax”. A clear majority of all respondents (65%) are against a tax on financial transactions. “Despite a great deal of skepticism among private banks about a bank levy, it is still regarded as a more appropriate regulatory instrument than a tax on financial transactions,” explains Krahnen.

The CFS Financial Center Index is part of the “Financial Center Monitoring” project, which aims to measure the competitiveness of Germany as a financial center in the European context. The index is presently based on a quarterly survey of management at 400 enterprises in Germany. The survey panel consists of financial industry enterprises and institutions, as well as selected companies that profit from the financial sector. The survey contains four questions related to participants’ views on different business parameters (i.e. transaction volume, profits, employment, and investment in product and process innovations). Participants are asked to reply whether they are “positive”, “neutral” or “negative” for both the previous and current quarter. The index is compiled from different sub-indices, as all participants are allocated to branch-specific groups. Within each group, a balance of the share of positive and negative responses is evaluated and transformed into performance data. These performance data are then aggregated in order to construct the final index. Under this process the maximum index value is 150; the minimum index value is 50; and a value of 100 signals that business sentiment is neutral.

CFS Colloquium

Mehr Stabilität für die globalen Finanzmärkte – die Sicht der Banken

Towards a More Robust Global Financial System – the Perspective of Banks

17 March 2010

Josef Ackermann

On March 17, CFS welcomed Josef Ackermann, Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG, as a guest speaker at the CFS Colloquium. In his speech, Ackermann discussed the role of financial markets and outlined six key measures for a new regulatory framework for the global financial system.

Josef Ackermann

A Clear Focus Required

Ackermann observed that the current debate on the reorganization of the financial system following the crisis is marked by a dichotomy. On the one hand, financial experts are involved in a complex technical debate on the measures required for financial market reform. On the other hand, a broader public debate on the future role of financial institutions and markets is taking place. Between both sides there is a large gap: Ackermann said that the technical debate is lacking a general orientation, while the public debate is missing a technical fundament about the importance of financial markets and the effects of market regulation. Both debates should be reconciled in order to find a clear orientation and focus. Ackermann proposed that the following three questions be considered: 1) what role do financial markets play in a modern economy; 2) what type of financial markets and financial products do we want to have; and 3) how can we find the appropriate regulatory framework for this without creating unwanted financial instability?

The Role of the Financial System

As regards the role of the financial industry, Ackermann pointed out that its first duty is to provide financial services for the real economy. But in addition, financial markets have an autonomous role in adding economic value by providing liquidity and increasing the information content of prices. According to Ackermann, high quality pricing signals represent the most important contribution of modern financial systems, as these provide the basis for investment decisions for individuals, institutions and political decision makers. However, Ackermann

also noted that the results of market processes are not always without failings and therefore have to be assessed carefully. He emphasized that the dynamic character of financial markets is the outcome of a liberal economic order, which values the importance of market prices, thereby valuing the decisions and preferences of a large number of autonomous agents.

What Type of Financial Markets?

It is not sufficient just to agree on the role that the financial system should play. It also needs to be clarified what kind of financial markets we want to have in order to ensure that the system can play its role. Ackermann sees two problematic schools of thought that have recently emerged. The first involves a drive to return to supposedly safe local financial markets with far-reaching powers (de jure and de facto) of intervention for national regulators. The second, as proposed i.a. by Paul Volcker, calls for a simpler and more transparent banking system; one that concentrates on traditional banking activities (that would be eligible for state help in case of emergency) and which does not engage in riskier activities, such as derivatives or private equity and hedge fund investments. According to Ackermann, both are problematic, as the abandonment of integrated international financial markets would imply a breach with the traditional, internationally-minded orientations of economic policy in the West and would result in a major welfare loss. No modern economy could afford to restrict the broad range of financial instruments presently available without facing negative welfare effects. He gave several examples, including the importance of currency and commodity derivatives for industry, and the role of emission certificates and weather derivatives in managing the costs of climate change. Derivatives and hedging instruments are an essential component of our economy. Using credit default swaps as an example, he said that these instruments provide important price signals to the market and allow for an allocation of credit risks that would otherwise be difficult to achieve.

However, there is no doubt that the regulatory framework needs to be reworked, taking the causes and consequences of this financial crisis into careful consideration.

Ackermann emphasized that risk management, which proved to be widely inadequate before and during the crisis, falls primarily within the area of responsibility of banks. Some banks as well as other financial institutions bore risks that strongly exceeded their risk bearing capacity. Ackermann acknowledged that the incentives for certain financial products, as well as for the internal allocation of capital, had in many cases been inadequate. However, banks alone were not the only source of the problem. On the macro side, loose monetary policy and the toleration of global imbalances also helped to precipitate the financial crisis. Ackermann identified regulatory weakness and inappropriate accounting standards as further causes of the crisis. Given that a large number of factors have contributed to the emergence and intensity of the financial crisis, Ackermann concluded, it was necessary to employ a multi-pronged approach in order to make the financial system more resilient.

Key Measures for a Robust Financial System

Ackermann presented six key measures that could provide the basis for a more resilient financial system. First, he emphasized the importance of macro-prudential supervision as a complement to the supervision of individual financial institutions. In Europe, much progress has already been made here, as evidenced by the plans for a European Systemic Risk Board. In order to successfully implement systemic risk supervision, it was necessary to have: 1) a close collaboration between macro- and micro-prudential supervisory authorities; 2) a comprehensive and global coordination of macro-prudential activities; and 3) a broad concept of the systemic risk factors that need to be analyzed.

As a second measure, Ackermann called for a careful reform of capital adequacy requirements. The crisis has made it clear that the equity base of the financial system has been insufficient. Consequently, the Basel Committee has proposed reform measures in support of a stronger and higher quality equity base for banks. For Ackermann, however, some of these proposals, such as the Leverage Ratio, are conceptually weak. Although rules for higher equity capital are in principle correct, they need to be introduced gradually and with a reasonable

transition period, Ackermann said, as otherwise a severe deflationary effect could be exerted on the real economy.

Third, Ackermann pointed out that the liquidity management of financial institutions needs to be improved. In the past, liquidity of financial markets was basically taken for granted, leading to substantial losses during the course of the crisis. The Basel Committee recently made some new proposals in this respect as well. Ackermann emphasized the importance of an international approach to the supervision of liquidity risk, as many multinational financial institutions manage their liquidity at a group level.

Fourth, Ackermann called for a robust market infrastructure that allows for a reduction in the complexity of financial interrelations. One of the main goals here should be to prevent "sick" banks from "infecting" healthy competitors by isolating them in a way that avoids systemic failure. As an example of a well-functioning system, he mentioned the so-called "CCPs" (Central Counterparties) used for clearing derivatives. It needs to be considered, though, that such systems lead to a greater standardization of contracts, which can itself lead to less flexibility and/or smaller margins for banks.

As a fifth measure, Ackermann suggested to install an effective and well-defined crisis management system. Such a system should address many issues, including the rights and rules for (early) intervention by supervisory authorities, so-called "contingent capital arrangements" for raising capital in times of financial distress, a streamlined organizational structure for financial institutions, a stability fund for banks in distress, and a well-functioning insolvency regime for the banking sector as a whole. Ackermann pointed out that such a crisis management system would effectively decrease uncertainty in times of crisis and enhance the resilience of the financial system.

As a last measure, Ackermann called for a well-equipped supervisory system with access to adequate resources, including highly competent staff. He also underlined the need for more consolidated supranational supervision, as well as a close collaboration between national authorities.

David Nicolaus (CFS)

THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS 2011

In 2011, the Center for Financial Studies (CFS) and Goethe University Frankfurt will present the Deutsche Bank Prize in Financial Economics for the fourth time. This prestigious academic prize will be awarded to an internationally renowned researcher, in recognition of an outstanding achievement in the field of financial economic research.

Starting in October this year, 3,800 academics from over 55 countries whose research focuses on this field of expertise, will be called upon to take part in the nomination procedure until the beginning of December 2010.

A Jury of international financial experts decides on the recipient of the Deutsche Bank Prize in Financial Economics. The members of the Jury for 2011 are: Luigi Guiso (European University Institute), Michael Haliassos (Goethe University and CFS), Charles Yuji Horioka (Osaka University), Otmar Issing (CFS President), Jan Pieter Krahnen (Goethe University and CFS), Raimond Maurer (Goethe University), Thomas Mayer (Deutsche Bank Group), Carmen M. Reinhart (University of Maryland), Robert J. Shiller (DB Prize award winner 2009 and Yale University) and Uwe Walz (Goethe University and CFS).

The winner of the award, which carries an endowment of € 50,000, will be **announced in February 2011**. 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 an **award ceremony in Frankfurt on 22 September 2011**. 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.

Sabine Kimmel (CFS)
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www.db-prize-financialeconomics.org

From National to European Regulation Towards European Financial Supervisory Authorities

19 May 2010

Onno Ruding

The next speaker at this year's colloquium series on "Rebuilding Financial Markets" was Onno Ruding. He gave his views on the financial reforms that are needed in Europe. Given his long-standing international career (see box), Ruding has a broad and extensive knowledge of the workings of Europe and its financial markets. He presented a very interesting and all-encompassing picture of how regulation and supervision should evolve in the coming years.

Onno Ruding

In 2008, Onno Ruding was a member of the High Level Group on Financial Supervision in the EU (de Larosière Group). He holds a Ph.D. from Erasmus Universiteit Rotterdam. With a thesis on integrated European capital markets, he already showed a keen interest in this topic at an early stage of his career.

During the course of his career, Ruding has been: a Board Member and Chairman of AMRO; Executive Director of the International Monetary Fund (IMF); the Minister of Finance of The Netherlands; and Chairman of the Board of Governors of the Asian Development Bank and the Inter-American Development Bank.

He became a Director of Citicorp in 1990 and was appointed Vice Chairman of Citicorp/Citibank in New York in 1992 and later Vice Chairman and Director of Citicorp and Citibank N.A.

In 2002, he became Chairman of the Board of the Centre for European Policy Studies (CEPS) in Brussels, the largest independent think tank in Europe concerned with European integration.

Ruding began his speech by pointing out the necessity of financial reform in Europe; not only in order to reduce the likelihood of another crisis, but also to reinforce the EU internal market. The primary goal should be to achieve a truly single European market for financial services. However, we are still far removed from this goal and financial policy is currently facing a trilemma in that it is trying to achieve concurrently three non-consistent policy goals – financial integration, financial system stability, and national regulation and supervision of financial institutions – and this imposes a great amount of tension. For this reason, Ruding finds it unavoidable that Europe will shift from national regimes for banking supervision towards a system of decision making at the EU level.

Europe is currently confronted with almost simultaneous banking and sovereign debt crises. It is incorrect to believe that the causes for both are the same. While banks can largely be blamed for the first crisis, it is governments and their macroeconomic policies that are responsible for the latter. However, both types of crisis mutually reinforce each other and historically have very often followed each other. The reverse of a banking crisis after a sovereign crisis has also proved to occur in the past (e.g. during the Latin American crisis of the 1980s).

Priorities for Banking Reform

In order to prevent a recurrence of the recent financial crisis, Ruding put forward four areas in which reform is needed and where it is indispensable.

First, the capital and liquidity base of financial institutions needs to be strengthened in order to create a stronger buffer against failure. This should be done by increasing the capital ratio, more specifically the ratio of Tier I capital. There is also

a need for higher quality equity capital, and stricter standards for what can qualify as capital. In addition, other requirements need to be considered, such as higher capital requirements for high risk transactions, a new maximum leverage ratio to reduce excessive growth, and the inclusion of off-balance sheet exposures in the calculation of capital adequacy requirements. Indeed, the Basel Committee on Banking Supervision is preparing a package of proposals to strengthen global capital and liquidity regulations, with a view towards making the banking sector more resilient at a global level.

The second point of action is an improvement in the risk management of banks. Bank supervisors need to have sufficient authority and an effective set of instruments at their disposal for realizing the stricter standards for risk management.

Onno Ruding

Thirdly, a more EU-based system for the regulation and supervision of banks needs to be implemented. The proposals of the de Larosière Group should be the basis to work from here. The final report of this committee comprises proposals for macro-prudential and micro-prudential supervision and was adopted by ECOFIN last year (albeit in substance, but with a regrettable weakening as regards certain issues). These proposals are now being reviewed by the European Parliament which, Ruding hopes, will restore the stricter, original version.

Lastly, Ruding sees the need to agree on priorities beyond the de Larosière proposals. One of the next steps would be to work out legal provisions for an orderly resolution of ailing banks. Currently, authorities have a rather limited choice of options in case of a banking crisis. Banks that are in trouble can either be bailed out, which is very costly to the taxpayer and leads to the so-called "too big to fail" dilemma. In the longer run, this can also result in the problem of "moral hazard", as banks no longer have an incentive to restrain their risk behavior. Alternatively, troubled banks can default, which would lead to chaos and large losses for their counterparties and possible domino effects on other institutions. Therefore, Ruding strongly favors setting up a resolution mechanism for banks, whereby an official resolution authority would be entrusted to step in ex ante when ailing banks are still operational and to possibly resolve them when necessary. In this case, the profitable parts of a bank could be sold to interested parties and other activities wound down in an orderly manner. Shareholders and subordinated bond holders would be held accountable for the resulting losses. This mechanism has the advantage that it would be less disruptive than a regular bankruptcy, less costly for the taxpayer, and that it solves the problem of moral hazard. It would also make the distinction between systemic and non-systemic banks superfluous. In order for it to be implemented, a change in bankruptcy rules would be required.

The Discipline of Market Forces

It is widely agreed that irresponsible risk management by banks was at the core of the financial breakdown and that financial regulators and supervisors did not react vigorously enough to contain the crisis. Added to this, an erroneous rating system misguided investors. Ruding, however, pointed out that financial market participants also contributed to the crisis with their own inadequate risk behavior. Many had been investing irresponsibly for too long and for too large an amount of money. If there had been more financial discipline among investors, big losses could have been avoided and the outbreak of the crisis would have been felt with less force.

Ruding then asked what could be done in order to increase market discipline. For a long time, the issuance of subordinated bonds was considered advantageous for several reasons (e.g. as a less expensive form of capital that investors can judge according to the risk profile of the issuer). In reality, however, such bonds did not lead to the market discipline anticipated. Therefore, the amended Basel rules will most likely sharply curtail the acceptance of subordinated bonds as Tier I capital. Having said this, new techniques for subordinated bonds have recently been tested, where a debt-equity swap is compulsory in case a bank's capital ratio falls below a certain level. This scenario would allow subordinated debt to continue being treated as Tier I hybrid capital. According to Ruding, such issuances would be advantageous, as they would lead to increased *contingent capital*, i.e. raise the capital buffer at exactly the time required. However, he doubts that the capital markets are willing to absorb substantial amounts of these.

The Volcker Rule

Ruding continued by taking a closer look at some of the proposals for banking reform. At the heart of the debate here, some advocate a fundamental regulatory change, whereby large banks are broken up and the legally permissible activities of regulated banks are strictly limited. The former Chairman of the Federal Reserve System, Paul Volcker, is an outspoken proponent of *narrow banking* as a way to solve the "too big to fail" dilemma. What he proposes does not go as far as the restrictions that were put in place under the Glass-Steagall Act.

Ruding criticized the ban on proprietary trading proposed by the Volcker Rule in order to end risky trading practices. Under this, banks would only be allowed to execute trading orders on behalf of clients, as part of the regular service they offer. All other trading, collectively considered "proprietary trading", would be legally prohibited. Ruding, however, pointed out that banks also function as market makers and, as such, play an important role in helping to keep financial markets well-functioning and liquid. To separate this vital role from pure proprietary trading is in practice very difficult. He also does not agree with the proposal to put a mandatory limit on the size (in terms of balance sheet) of banks. His argument here is that smaller banks are not inherently less risky, and that a string of small failures can aggregate to a heavy burden. Moreover, most recent small and mid-sized bank failures were caused by losses in traditional retail banking. It is an illusion to believe that the narrow banking proposed would eliminate the need for any rescue of regulated banks in the future. According to Ruding, a further argument against the narrow banking approach is that there are more effective ways to reduce the likelihood of a bank default, such as appropriate capital requirements, effective supervision, and accountability of shareholders and creditors.

Bank Taxes

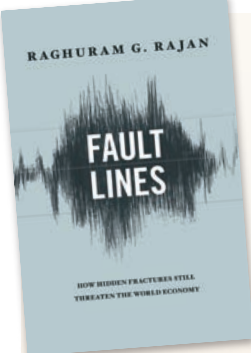
Ruding then raised the discussion around the various proposals for taxes and levies on banks. Ruding emphasized that international coordination is absolutely imperative to retaining *a level playing field*. He also warned against any permanent bank tax for which the proceeds generated have no clear purpose. Proponents of such a tax, such as the IMF, are convinced that it would discourage risk taking. Ruding, however, believes that it could in fact raise the risk profile of a bank, as this would need to generate more profits in order to compensate for the tax.

If a bank tax is imposed, Ruding is strongly in favor of transferring the proceeds into a stability fund for future emergencies. His preferred solution would be to create an emergency fund at the EU level, whereby banks contribute according to their risk profile.

He concluded his speech by outlining a number of dilemmas associated with banking reform: 1) some would prefer to focus on measures that punish the banking sector, while others would emphasize measures to reduce the probability of future financial crises; 2) a variety of official measures may lead to an accumulation of reforms that heavily increases the burden of restrictions on the financial sector, and which eventually reduces the availability of credit to the private sector; 3) introducing bank taxes might weaken support for the tough capital and liquidity rules now being considered by the Basel Committee; 4) differences in the outcome of banking reform in the U.S. and Europe may result in an uneven playing field and an absence of comparable conditions would imply a distortion of competition.

According to Ruding, two opposing developments are currently taking place – a weakening in the drive for banking reform and a push in favor of excessive regulation. Which development will ultimately prevail is unknown, but the end results will certainly be a mixture of both these forces.

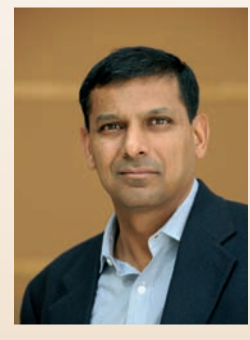
Lut De Moor (CFS)



Upcoming Event:

30 June 2010

Prof. Raghuram G. Rajan
(The University of Chicago)
will talk about his book
"Fault Lines:
How hidden fractures still threaten the world economy"



Raghuram Rajan was one of the few economists who warned of the global financial crisis before it hit. Now, as the world struggles to recover, it's tempting to blame what happened on just a few greedy bankers who took irrational risks and left the rest of us to foot the bill. In Fault Lines, Rajan argues that serious flaws in the economy are also to blame, and warns that a potentially more devastating crisis awaits us if they aren't fixed.

CALENDER FOR THE 2010 CFS COLLOQUIUM SERIES
„Wiederaufbau der Finanzmärkte / Rebuilding Financial Markets“

30 June 2010
Fault Lines: How hidden fractures still threaten the world economy
Prof. Raghuram G. Rajan
(The University of Chicago, Booth School of Business)

8 September 2010
Wertpapierhandel im Umbruch: Chancen für Börsen und Ihre Kunden
Dr. Reto Francioni
(Vorsitzender des Vorstands, Deutsche Börse AG)

22 September 2010
New Architecture for Financial Regulation (provisional title)
Prof. Charles Goodhardt
(London School of Economics and Political Science)

10 November 2010
Supervision of International Financial Markets
José Viñals
(Financial Counselor and Director, Monetary and Capital Markets Department, International Monetary Fund)

8 December 2010
Capital Requirements (provisional title)
Nout Wellink
(President, De Nederlandsche Bank)

CFS Lectures

Monetary Discipline, Global Currencies and the Crisis in Eastern Europe

27 January 2010

Adam Posen

In the wake of the financial market crisis, currency regimes have been – quite naturally – put under severe pressure. This holds true in particular – though to varying degrees – for “Emerging Eastern Europe”, as the varied region between the Czech Republic and the Baltics is sometimes called. Here, previously ample FDI inflows, which had fuelled domestic demand-led growth and significant current account deficits, suddenly reversed. With imbalances starting to unwind rapidly, and against the backdrop of an extraordinary increase in risk aversion, the pressure on interest rates and – concurrently – exchange rates became very significant.

Adam Posen

The speaker, Adam Posen, is a senior fellow at the Peterson Institute for International Economics and serves as an external member of the Bank of England’s Monetary Policy Committee. He specializes on the European (in particular German) and Japanese economies and has authored numerous stimulating and influential books and articles on, among other issues, inflation targeting, the appropriate framework for monetary policy, as well as the international monetary system. The lecture was organized by Hans-Helmut Kotz (Deutsche Bundesbank), Jan Krahnen (CFS) and Gertrude Tumpel-Gugerell (ECB) as part of a joint lecture series.

Th. Mayer (DB Research), G. Tumpel-Gugerell, A. Posen, H.-H.Kotz

Posen began his presentation by outlining three points for discussion. He first asked how much, in what way, and to what extent an economy (or a group/union of economies) with a global "anchor" currency should interact with surrounding countries. Secondly, he highlighted the tradeoff between monetary discipline and a closer integration with surrounding countries as a consequential problem. Finally, he commented on Central and East European countries and their connections with the euro zone.

Posen argued in favor of encouraging integration between an anchor currency economy and its surrounding countries. The positive effects of such a policy for the reserve currency country would be: 1) seigniorage gains; 2) the advantage of pricing imported goods in the national currency and of avoiding exchange rate fluctuations; 3) an increased inflow of foreign direct investments, information, education, etc.; and 4) the benefits arising from the so-called "exorbitant privileges" of being a global reserve currency.

For the sake of completeness, Posen also spoke about the arguments raised against encouragement of integration and in support of the narrow monetary discipline view. According to him, some fear that a major issue for a reserve currency economy might be the risk of rising borrowing costs. Furthermore, he mentioned the potential risk of a currency overvaluation that could undermine export competitiveness, as well as the theoretical danger of a loosening of monetary control arising from an increase in the number of countries using the currency.

Given that no firm evidence is presently available in support of these theories, he dismissed the contention that more resources flowing into a country (as a result of a deeper integration) are bad for its economy. For Posen, the only case in which this could apply is one of a huge institutional breakdown. Thus, he concluded that it is a better policy to encourage countries to be part of a currency zone.

Finally, Posen re-iterated the importance of a well-established and stable relationship between the reserve currency country and surrounding economies. In addition to that, attracting more countries to join the currency zone should be a major goal. He also said that a deeper integration of the "center" with the "periphery" should be encouraged, as this would help increase the long-term benefits (both marginal and direct) of using a single currency for all participants.

The discussion that followed was moderated by Gertrude Tumpel-Gugerell. Posen answered questions from the audience concerning capital dislocation and currency crises, as well as the role and importance of institutionalizing the use of a single currency.

Daniela Dimitrova (CFS)

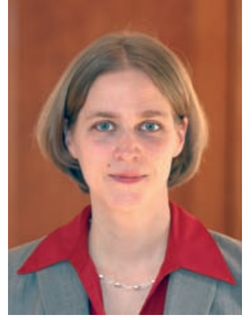
Joint Lunchtime Seminars

Bundesbank-CFS-ECB Workshop on Macro and Finance

9 October 2009

House of Finance

In October 2009, a first "Bundesbank-CFS-ECB Workshop on Macro and Finance" was organized. The workshop brought together researchers from the Bundesbank, the European Central Bank, and Goethe University to present their research in the field of macroeconomics and finance.



Nicola Fuchs-Schündeln

The first presentation was held by **Nicola Fuchs-Schündeln** (Goethe University). She presented a working paper entitled "Explaining the Low Labor Productivity in East Germany – A Spatial Analysis" (co-authored by R. Izem). The paper explores the comparatively low labor productivity in East Germany after the German reunification. In order to asses the relative importance of two factors that influence labor productivity – job characteristics (such as network effects and firm size) and worker characteristics (i.e. human capital) – the authors develop a spatial structural model that predicts commuting behavior across the former East-West border and the resulting regional unemployment rates. The results indicate that a significant part of the human capital accumulated in the East before 1990 was transferable. Hence, differences in human capital were not the reason for differences in labor productivity. On the other hand, the authors find that job characteristics differed significantly between East and West. The paper was discussed by Stephan Fahr (European Central Bank) and Ulf von Kalkreuth (Deutsche Bundesbank).

Luca Dedola (European Central Bank) presented the second paper entitled "Financial Frictions, Financial Integration and the International Propagation of Shocks" (co-authored by G. Lombardo). During the recent financial crisis we could observe that shocks (like the subprime problem in the U.S.) in one country were transmitted to other countries. In this paper the authors develop a (quantitative) two-country model that helps to understand how the international transmission of asymmetric shocks is affected in the presence of levered cross-border investors. They find that foreign exposure in interconnected balance sheets of leveraged investors can indeed act as a powerful propagation mechanism of asymmetric shocks across countries. However, in their setting, financial and real interdependence can be very strong even with minimal balance sheet exposure to foreign illiquid assets, if financial markets are integrated. In her discussion, Ester Faia (Goethe University) commented on the use of a particular debt contract in the model and questioned the portfolio choice in the model.

Martin Kliem

The third session was a presentation by **Martin Kliem** (Deutsche Bundesbank) of a working paper entitled "Bayesian Estimation of a DSGE Model with Asset Prices" (co-authored by H. Uhlig). The paper combines two strands of literature and presents an estimation of a dynamic stochastic general equilibrium (DSGE) model that explains both business cycle and asset pricing implications. Until recently the asset pricing implications of business cycle models have not been explored in much detail and this paper is one of the first to introduce asset pricing in standard models. The authors use Bayesian techniques to estimate the DSGE with macroeconomic and financial time series and are able to explain simultaneously several macroeconomic and financial market facts. One of the main innovations of the paper is the introduction of second moments of asset returns into the estimation procedure, which goes beyond the usual first order approximations used in business cycle studies. The paper was discussed by Ivan Jaccard (European Central Bank), who compared some of the models results to available data, and Mu-Chun Wang (Goethe University), who commented on technical details of the model and the strategy for solving it numerically.

Thomas Laubach

Thomas Laubach (Goethe University Frankfurt and CFS) presented a term structure model to explain movements in longer term interest rates. Instead of assuming that agents know all the parameters describing the model of the economy and that these parameters are fixed for all time, Laubach and his co-authors Robert J. Tetlow (Federal Reserve System) and John C. Williams (Federal Reserve Bank of San Francisco) introduce learning type agents into the model. In their paper "Learning and the Role of Macroeconomic Factors in the Term Structure of Interest Rates", agents re-estimate model parameters using a VAR framework. The purpose is to improve the performance of standard macroeconomic models with respect to longer term yields while at the same time keeping the model and expectation formation as simple as possible. The main finding of their analysis is that incorporating real-time learning in a macro finance model has important implications for the path of risk-neutral yields and the price of risk compared to a standard model with fixed coefficients. On purely theoretical grounds, the authors view the learning model as providing a more realistic description of the real-time problem of pricing assets in an environment of structural change and imperfect knowledge. The analysis also indicates that the learning model provides a better fit to the data than that from the standard approach of assuming constant coefficients estimated over the full sample. The discussants of the paper were Michael Krause (Deutsche Bundesbank) and Oreste Tristani (European Central Bank).

Gianni Amisono

The next paper presentation by **Gianni Amisono** (European Central Bank) also dealt with the term structure issue. The paper "A DSGE model of the term structure with regime shifts" (co-authored by O. Tristani) attempts to explain time variation in term-premia and implements two features into a simple DSGE model. The authors explore the ability of a small microfounded model with nominal rigidities to match both macroeconomic and term structure data using a full-information estimation approach. They deviate from the DSGE literature in two respects. First, they rely on perturbation methods to solve the model up to a second-order approximation and then estimate the nonlinear reduced form. The second deviation is to allow for heteroskedasticity of macroeconomic shocks, due to the fact that selected parameters are assumed to be subject to regime switches. Estimating the model on quarterly U.S. data supports the idea of generating heteroskedastic shocks subject to regime shifts. The paper was discussed by Malte Knüppel (Deutsche Bundesbank) and Josef Holtmayr (Goethe University).

Alexander Schulz

The final session of the workshop was a presentation by **Alexander Schulz** (Deutsche Bundesbank) of his paper entitled "Banking and Sovereign Risk in the Euro Area" (co-authored by S. Gerlach and G. Wolff). The authors explore the main drivers of sovereign bond spreads in the euro area since the introduction of the common currency ten years ago (defining yield spreads as the difference between sovereign bonds between euro area countries and the German sovereign bond yield). In their panel analysis they show that sovereign risk is affected by the banking sector. They find that a high risk factor leads to a pronounced widening of sovereign spreads in countries with large banking sectors and high leverage in the banking sector. The authors also show that government debt levels as well as forecasts of future fiscal deficits are other determinants of spread widening. Finally, in light of the financial crisis, the paper addresses certain policy issues, by looking at the impact of equity ratios of the banking sector on sovereign spreads. The authors find that countries, where bank equity buffers are relatively small have to pay a larger sovereign risk premium with increasing aggregate risk. Banks should thus be required to exhibit a higher equity ratio in order to decrease unfavorable effects to sovereign risk. This requirement becomes even more important in countries with a large banking sector.

8 October 2010
2nd Bundesbank-CFS-ECB Workshop
on Macro and Finance
Please contact Celia Wieland for further information
cwieland@ifk-cfs.de

Joint Lunchtime Seminars

The Joint Lunchtime Seminars are weekly research lectures jointly organized by the CFS, the Deutsche Bundesbank and the ECB. The speakers present their current research findings to a selected circle of central bankers and macroeconomists. In the first half year of 2010, the organizing institutions have hosted the following speakers:

13 Jan 2010 **Forecasting Inflation Using Dynamic Model Averaging**
Gary Koop (University of Strathclyde)

20 Jan 2010 **Debt Portfolios**
Thomas Hintermaier (University of Mannheim)

27 Jan 2010 **Risk Heterogeneity and Credit Supply: Evidence from the Mortgage Market**
Paolo Surico (London Business School)

10 Feb 2010 **Hyper-Spherical and Elliptical Stochastic Cycles**
Tommaso Proietti (Universitá di Roma)

17 Feb 2010 **Dynamic Specification Tests for Static Factor Models**
Gabriele Fiorentini (University of Florence)

24 Feb 2010 **Robustness, Information-Processing Constraints, and the Current Account in Small Open Economies**
Eric Young (University of Virginia)

03 Mar 2010 **Would Some Model Please Give Me Some Hints? An Empirical Investigation on Monetary Policy and Asset Return Dynamics**
Charles Leung (City University of Hong Kong)

17 Mar 2010 **Explaining Macroeconomic and Term Structure Dynamics Jointly in a Non-linear DSGE Model**
Martin Andreasen (Bank of England)

24 Mar 2010 **Financial Intermediation, Asset Prices, and Macroeconomic Dynamics**
Emanuel Mönch (Federal Reserve Bank of New York)

31 Mar 2010 **The Monetary Transmission Mechanism in the Euro Area: Has It Changed and Why?**
Stefano Neri (Bank of Italy)

14 Apr 2010 **Rational Price-Contingent Trading and Asset Price Dynamics**
Katrin Tinn (University of Essex)

05 May 2010 **Cyclical Risk Aversion, Precautionary Saving and Monetary Policy**
Bianca De Paoli (Bank of England)

12 May 2010 **Optimal Inattention to the Stock Market with Information Costs and Transaction Costs**
Janice Eberly (Northwestern University)

19 May 2010 **Lessons from the History of Bank Examination and Supervision in the U.S. 1863-2008**
Eugene White (University of Rutgers)

26 May 2010 **Risk Appetite and Exchange Rates**
Tobias Adrian (Federal Reserve Bank of New York)

2 June 2010 **Social Value of Information in a Levered Economy**
Paolo Volpin (London Business School)

9 June 2010 **Firms´ Cash Holdings and the Cross-Section of Equity Returns**
Berardino Palazzo (Boston University)

23 June 2010 **Credit Supply and the Price of Housing**
Jean Imbs (HEC Lausanne)

30 June 2010 **A Comparison of Seven Crises: Coskewness Contagion Testing**
Renee Fry (The Australian National University)

For further information please contact Celia Wieland cwieland@ifk-cfs.de or jls@ifk-cfs.de

CFS Conferences

Workshop
Interconnectedness of Financial Institutions: Microeconomic Evidence, Aggregated Outcomes and Consequences for Economic Policy

26 May 2010

House of Finance

The current crisis has intensified the discussion about the consequences of changes in the financial system, and in particular of a greater degree of interconnectedness of financial institutions. These changes have implications for bank behavior, financial stability, financial regulation, economic welfare, and the monetary transmission process. Empirical work has increasingly been dedicated to this debate. The Bundesbank and the Center for Financial Studies, together with Claudia Buch from the University of Tübingen and Mathias Hoffmann from the University of Zurich, organized a workshop to discuss related issues.

Claudia Buch

In her opening remarks, **Claudia Buch** emphasized the importance of new research methodologies and empirical work using micro-data that aim at bridging the gap between microeconomic evidence and aggregate outcomes.

The first presentation by **Alexander Popov** (ECB) looked at how financial distress of banks in central and eastern European countries affected the financing of local small and medium-sized enterprises (SMEs). In his paper entitled "Cross-Border Banking and the International Transmission of Financial Distress during the Crisis of 2007-2008" (co-authored by G. Udell), survey data from the period 2005 and 2008 are used. The authors separate the effects coming from bank loan supply shifts from the effects due to recession-driven demand shifts. They find strong evidence that a low equity ratio, a low Tier I capital ratio, and losses on financial assets lead to credit tightening. They also find that foreign banks transmit a larger share of the same financial shock than domestic banks, and that the decline in credit is greater among high risk firms. The discussant of the paper was Steven Ongena (CentER, Tilburg University)

The next session started with a presentation by **Alfred Lehar** (University of Calgary) of his paper "Macro-prudential Capital Requirements and Systemic Risk" (Co-authors: C. Gauthier, M. Souissi). After comparing alternative mechanisms for allocating the overall risk of a banking system to its member banks, the authors use a unique data set of the Canadian banking system to analyze how banks' individual capital requirements would change, when they are a function of a bank's contribution to systemic risk. The authors find that macro-prudential capital allocations can differ by up to 50% from observed capital levels and that this re-allocation would reduce default probabilities of individual banks as well as the probability of a systemic event by about 25%. The discussant of the paper was **Peter Raupach** (Deutsche Bundesbank).

Alexander Popov

The following paper, about "Allocating Systemic Risk to Individual Institutions", was presented by **Nikola Tarashev** (Bank for International Settlements, Co-authors: C. Borio, K. Tsatsaronis). The authors propose the Shapley value to measure institutions' systemic relevance and demonstrate the interactions between several drivers of systemic risk such as size, an institution's risk profile and strength of exposure to common risk factors. Applying their approach to various examples they demonstrate how the methodology can be used to calibrate macro-prudential capital rules. The discussant of the paper was **Christian Ewerhart** (University of Zurich).

During the lunch break, three poster sessions were organized: "Asset Pricing in the Presence of Social Interaction" by Frederik König (University of Frankfurt); "Macroeconomic Factors and Systemic Risk in Banking. A FAVAR Approach" by Esteban Prieto (University of Tübingen); and "Rethinking the Risk-Competition Nexus for Banks: The Role of Internationalisation" by Cathérine Tahmee Koch (University of Zurich).

Götz von Peter

The afternoon program started with a presentation by **Götz von Peter** (Bank for International Settlements) on Interbank Tiering and Money Center Banks. In his paper (jointly with B. Craig), he supplies strong evidence of interbank tiering – when money center banks intermediate between other banks that do not transact directly – in the German banking system. Moreover, they find that bank specific features, such as balance sheet size, help explain how banks position themselves in the interbank market.

Lydian Medema (University of Groningen) presented the next paper "Peer Monitoring or Contagion? Interbank Market Exposure and Bank Risk" (co-authors: M. Koetter, R. Koning, I. van Lelyveld, F. Liedorp). The authors use a spatial lag model to test whether interbank connectivity acts as a contagion channel and affects individual bank risk. Using quarterly data from the Dutch interbank market between 1998 and 2008, their results support the "contagion hypothesis".

Ester Faia (Goethe University) presented the final paper of the day, "A Tale of Two Policies: Prudential Regulation and Monetary Policy with Fragile Banks" (co-authored by I. Angeloni). They analyze the role of banks in the transmission of shocks, the effects of monetary policy when banks are exposed to runs, and the interplay between monetary policy and Basel-like capital ratios. The authors find that the best policy combination includes mildly anticyclical capital ratios and a response of monetary policy to asset prices or leverage.

The workshop was followed by a 2-day conference at the Training Center of the Bundesbank in Eltville.

International Research Forum on Monetary Policy Sixth Conference

26–27 March 2010

Washington D.C.

The sixth conference organized by the International Research Forum on Monetary Policy (IRFMP) was held at the Federal Reserve Board in Washington D.C. The purpose of the IRFMP is to promote the discussion of innovative research on theoretical and empirical macroeconomic issues relevant for monetary policy. The Forum is sponsored by the European Central Bank (ECB), the Federal Reserve Board (FRB), the Center for Financial Studies (CFS), and the BMW Center for German and European Studies (CGES) at Georgetown University. The organizers of this year's conference were: Matthew Canzoneri (Georgetown University), Günter Coenen (ECB), Christopher Erceg (FRB), and Volker Wieland (CFS).

A panel discussion was held on "Structural Economic Modeling: Is it Useful in the Policy Process?" The panelists were Olivier Blanchard (Chief Economist, IMF), James Bullard (President, FRB St. Louis), and Lucas Papademos (Vice President, ECB). It was moderated by Steven Kamin (FRB). Keynote Speeches were held by Daniel Tarullo (Governor, FRB) and Athanasios Orphanides (Governor, Central Bank of Cyprus)

CFS Conference Announcements

2nd International Conference: The Industrial Organization of Securities Markets: Competition, Liquidity and Network Externalities

28–29 June 2010

Frankfurt

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). 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 USA the Regulation NMS are already challenging the industry of securities markets.

The aim of the conference is to shed light on all aspects of the industrial organization of securities markets. This not only includes trading but also clearing and settlement services, and both cash and derivative markets.

The organizers are:
Peter Gomber, Goethe University Frankfurt and E-Finance Lab
Martin Reck, Deutsche Börse AG
Erik Theissen, University of Mannheim and Center for Financial Studies

The ECB and Its Watchers XII

9 July 2010

Frankfurt

This year, "The ECB and Its Watchers" Conference will take place in Frankfurt on 9 July 2010. The list of conference speakers will include, from the ECB side, President Jean-Claude Trichet, Vice President Vítor Manuel Constâncio, and the Board Members Jürgen Stark and Lorenzo Bini-Smaghi. They will be joined by John Lipsky (First Deputy Managing Director of the IMF), Charles Goodhart (London School of Economics), Anil Kashyap (University of Chicago), Rakesh Mohan (former Deputy Governor of the Reserve Bank of India and Yale University), Eduardo Loyo (former Deputy Governor of the Central Bank of Brazil and BTG Pactual), and Charles Wyplosz (Graduate Institute Geneva).

Topics to be discussed include macroeconomic imbalances and fiscal adjustment in the euro area, the case for strengthening the role of money and credit aggregates in central bank strategy, needed reforms in financial regulation and supervisory practices, as well as new perspectives on central banking from emerging markets.

As usual, attendance to the conference is by invitation only. The complete conference program can be found on our website. The next CFS Newsletter will have more on this event!

DEGIT XV
Dynamics, Economic Growth, and International Trade

3–4 September 2010

Frankfurt

DEGIT 2010 is the fifteenth event in a sequel of conferences on the same topic. Previous conferences were held in Denmark (1996), Hong Kong (1997), Taiwan (1998), Tilburg (1999), Rome (2000), Vienna (2001), Cologne (2002), Helsinki (2003), Reykjavik (2004), Mexico City (2005), Jerusalem (2006), Melbourne (2007), Manila (2008), and Los Angeles (2009).

The organizing institutions of this year's event are: the Faculty of Economics and Business Administration of Goethe University Frankfurt, the Center for Financial Studies, the Department of Environmental Business Economics at the University of Southern Denmark, and the Kiel Institute for the World Economy.

The organizers are:
Erich Gundlach, Kiel Institute for the World Economy
Rainer Klump, Goethe University Frankfurt
Bjarne S. Jensen, University of Southern Denmark

Special emphasis was put on papers focusing on general equilibrium, growth and models of large trading economies, and also on research about the roles of financial stability, global and regional trade patterns, foreign direct investment, and international governance. A subset of the papers that will be presented at the conference will also be considered for publication in an international journal, subject to the usual review process and approval by the Editorial Board.

Keynote speakers at the conference will be:
Samuel S. Kortum, University of Chicago
Olivier de La Grandville, University of Geneva

Further details about the conference program will soon be posted on the CFS website. For registration and accommodation, please contact Anne Jurkat Email: jurkat@wiwi.uni-frankfurt.de

For further information about the DEGIT conferences and related publications, please visit the DEGIT homepage: www.degit.ifw-kiel.de

CFS Conference on Household Finance

23–24 September 2010

Athens, Greece

CFS is organizing a conference on Household Finance this fall. The objective of the conference is to present state-of-the-art empirical research and empirically motivated theoretical research on household financial behavior over the life cycle, and on how this is influenced by other choices, government policies, and the overall economic environment. The main research areas of the conference are:

- Patterns of asset and debt behavior over the life cycle
- Financing retirement and the demographic transition
- Consumer indebtedness, including mortgages, and financial distress
- Behavioral approaches to household finances
- Financial literacy and the role of professional advice
- Trust, subjective expectations, pessimism, and portfolio choice
- International comparisons of household finances using micro-data

The conference will include a panel session on the Greek financial crisis and its implications for financial behavior and financial markets. We are pleased to announce that Lucas Papademos (former Vice President of the ECB) has confirmed his participation in the panel.

Further details about the conference program will soon be posted on the CFS website. For registration and accommodation, please consult our website or contact Francesca Gradi, Email: gradi@ifk-cfs.de

New staff members

Florian Hense

Florian Hense is research assistant at the Center for Financial Studies since April 2010. After graduating in Economics at the LMU Munich, he became a doctoral student within the Graduate Program "Finance and Monetary Economics" at Goethe University in October 2008. Florian Hense is working for the CFS Financial Center Index. He is responsible for public relations and the development of the panel.

Oana Maria Georgescu

Oana Maria Georgescu joined the Center for Financial Studies in June 2010 as a researcher for a new project under the supervision of Prof. Laux. The project „Rechnungslegung und Prozykliziät – Implikationen für Finanzstabilität und Regulierung" deals with the link between fair value accounting practices and procyclicality. Prior to this, Oana graduated with a Master of Science in Quantitative Economics from Goethe University. After her studies, she worked in Risk Management for KfW Bank in Frankfurt.

Senior Fellow

Hans-Helmut Kotz

Hans-Helmut Kotz is since May 2010 a Senior Fellow at CFS – with which he has been affiliated since the mid 1990s. Over the last years (since 2003) he has organized, jointly with Prof. Jan Krahnen and Dr. Tumpel-Gugerell (Member of the ECB Board) a CFS Luncheon Seminar series. He also is the designated Chairman of the CFS Research Advisory Council. As a Senior Fellow he will work, together with colleagues, on a number of policy-oriented issues, mainly touching upon financial market regulation. He also teaches at Freiburg University and, since this term, Université Paris-Sorbonne-Cité (Paris 13).

Before joining CFS, Prof. Kotz was a Board Member of Deutsche Bundesbank (2002-2010), in charge of Financial Stability, Markets and Statistics and as such a member of a number of committees and working groups of the Bank for International Settlements, the Financial Stability Board as well as the OECD, where he is acting chair of the Financial Markets Committee. He was also the Central Bank Deputy for the G7 and the G20 process. Before that, he was President of the Landeszentralbank in Bremen, Niedersachsen and Sachsen-Anhalt (1999-2002) and Chief Economist at Deutsche Girozentrale. Between 2002 and 2005 he served in a personal capacity as a member of the European Parliament's Expert Group on Financial Markets. He has published widely (Zeitschrift für Betriebswirtschaft, Revue d'Economie Financière, Intereconomics etc. as well as in numerous edited books). Prof. Kotz is moreover involved in a number of academic institutions, e.g., member of the Board of the Konstanz Seminar on Monetary Theory, the scientific councils of the Centre Cournot, Paris, as well as the Hamburger Weltwirtschaftliches Institut (HWWI), Hamburg.

We are pleased to welcome you to the EFA 2010 Annual Meeting in Frankfurt, the financial centre of Europe's largest economy and home to most of the players in its financial sector. Frankfurt is the most internationally-minded city in the country, and the only European city hosting two Central Banks (ECB and Bundesbank) and two Supervisory Authorities (Ceiops and BaFin). But it also is full of museums and universities. Goethe University's House of Finance on its newly built Westend Campus hosts many researchers in finance, money and financial law.

The EFA 2010 Annual Meeting will provide new options for academic networking and collaboration on an international scale, as well as deepening the dialogue with practitioners in finance and policy makers.

Keynote Speaker
Douglas W. Diamond
(University of Chicago
Booth School of Business)

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