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Jan Pieter Krahnen
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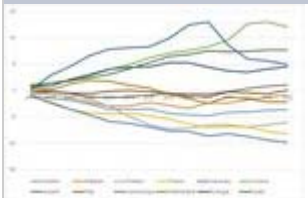

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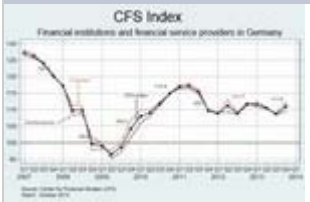

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House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
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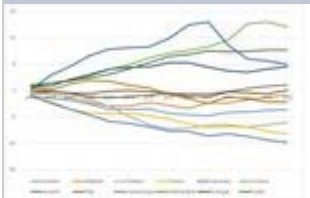

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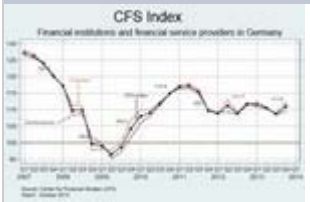

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Editorial

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The ECB move: The upcoming comprehensive risk assessment, a euro area-wide evaluation of bank balance sheets and business models, is unprecedented. Its implementation and its progress will be watched by financial markets worldwide with bated breath. This fact makes it hard to imagine that the outcome, which will not be seen until the end of 2014, will simply be a muddling-through. More likely, it will cause a significant shake-up of national banking systems across the euro area, possibly with side-effects on other EU economies.

Strengths: With the comprehensive assessment, the ECB aspires to define a set of valuation principles and models, together with a reliable data basis, that can be applied uniformly across euro area countries. For this reason, the exercise is bottom up, starting from the underlying data all the way up to finding common models for the assessment of hard-to-value products (“level-3 assets”) – ranging from complex derivatives to private equity and illiquid foreign investments.

Opportunities: If carried out properly, the 2014 comprehensive assessment will lead

the euro area into a new era of banking supervision. The exercise will confront the industry, or large segments of it, with the new rules and the new governance of the supervisory process. As a very desirable side effect, it is likely that the assessment process will severely trim the colorful bouquet of national exceptions and particularities in the supervision of financial institutions that has survived the European integration process over the past 20 years and that clouds the vision of a single market for financial services in Europe.

Weaknesses: However, there are considerable risks, too. Most importantly, the comprehensive assessment is meant to put away with the so-called legacy assets that have accumulated over the crisis years. Should the exercise reveal insufficient capital at some institutions, recapitalizations will be necessary and expected. If private capital is not readily available, other measures may be required. For example, profits may be retained, assets may be sold, business lines may be separated and consolidated in the process. While simple on paper, these responses to capital shortfalls are hard to predict unless clear procedural rules are drawn up at the national level including a definition of ultimate backstops in case the private measures do not meet the minimum threshold.

Threats: The greatest threat lies in the reaction of financial markets which provide an important part of banks' funding. In order to retain access to market funding, the backstop for banks needs to be put in place rather soon. Short term bank funding is as shy as a deer, the slightest doubt in the availability of backstop capital of any sort will cause bank creditors to run and to transfer their funds elsewhere causing systemic vibrations which will be felt throughout the whole system.

Check to National Authorities! As a result, policy makers in euro area countries are now under severe pressure to define a credible backstop framework. It is inconceivable and insufficient that such a framework will be simply a set of national backstops. Instead, a broader, quasi-European system of mutually reinforcing backstops is needed. Thanks to the ECB's bold move in ordering the comprehensive assessment, national authorities are now forced to give up their resistance, not only against more unified supervisory power at the euro area level, but also against a common reinsurance system for failing financial institutions.

So: Check to national authorities! Let us watch the next move closely.

Yours sincerly,
Jan Pieter Krahnen

Please click here for more information about a special survey carried out by the CFS Index in October 2013 on the comprehensive assessment.

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Bank Restructuring and Bail-In

Germany and France no Role Model in Bank Restructuring

by Hans-Joachim Dübel

Germany and France cannot serve as a role model in bank restructuring when comparing the most striking examples of Hypo Real Estate and Dexia to similar cases in other European countries. This is the key message of a study about "The Capital Structure of Banks and Practice of Bank Restructuring", written by Hans-Joachim Dübel of Finpolconsult and commissioned by the Center for Financial Studies, which was published in October.

For fear of negative systemic consequences and the loss of initial public investments, Germany and France focused on repeated recapitalizations with public money while leaving private creditors largely spared. Against the background of the wasted creditor participation potential, the classic European approach to the banking crisis, mainly driven by these two countries, – targeting a soft landing through forbearance combined with a prevalence of public bailouts – must be seen as discredited. Taxpayers elsewhere, e.g. in Ireland and most recently in Greece, were held hostages to this approach. It is the smaller European countries Denmark and the Netherlands that have developed best practice in bank restructuring. Spain, under tremendous political pressure through the mis-selling scandal of junior bank bonds to households, has reached a reasonable

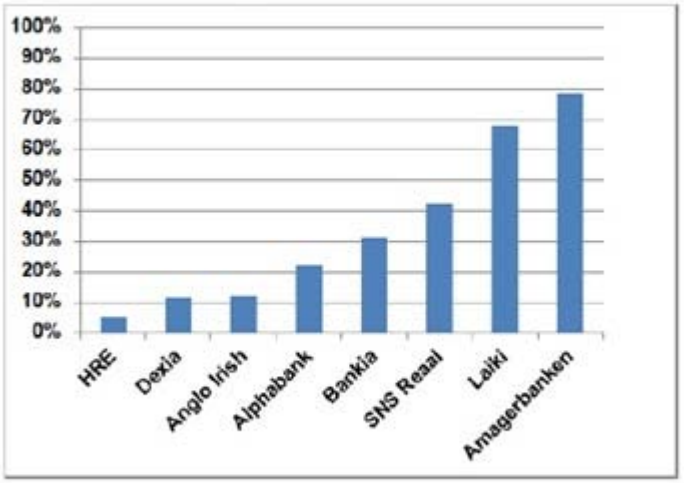
compromise.

The study provides an empirical analysis of the capital and liability management in eight cases of bank restructurings and resolutions: Alpha Bank (Greece), Amagerbanken (Denmark), Anglo Irish Bank (Ireland), Bankia (Spain), Cyprus Popular Bank/Laiki (Cyprus), Dexia (Belgium/France), Hypo Real Estate (Germany) and SNS Reaal Group (Netherlands). Four of the eight cases are resolutions, i.e. the original bank was unwound (Anglo Irish Bank, Amagerbanken, Dexia, Laiki), while the four other banks have de-facto or de-jure become nationalized and are awaiting re-privatization after the restructuring (Hypo Real Estate, Bankia, SNS Reaal, Alpha Bank). The case selection follows considerations of their model character for the European bank restructuring and resolution policy discussion.

For each case, the study draws a timeline between the initial credit event and the (most recent) restructuring. It assesses the respective extent of creditor participation as well as the expected losses by governments. Also, a discussion is provided of what could have been a least cost restructuring approach.

For essentially all cases (in particular for Hypo Real Estate, Dexia, Anglo Irish and Alpha Bank) the study shows that significant potential for creditor participation has been wasted due to too early public investment before at least junior creditors were bailed in. However, differences are striking: whereas the creditor participation rate in the cases of Laiki or Amagerbanken exceeds 65% and 75% respectively, this rate is only at about 5% in the case of Hypo Real Estate (see Figure 1). Frequently, governments must be expected to lose almost all of their investment (Hypo Real Estate, Anglo Irish Bank) with the median expected loss being at about 75%. An exception is the Dutch case of SNS Reaal where the government may expect to break even.

Figure 1 Estimated Participation of Bank Creditors in Financing the Capital Gaps of the Case Banks



Source: Bank reporting, Finpolconsult assumptions and computations.

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A striking example for wasted creditor participation in Germany is the case of Hypo Real Estate where there is still around EUR 4 billion of outstanding debt, de facto still owed by junior debt investors, despite the fact that the fiscal restructuring costs paid by German taxpayers are close to EUR 19 billion. Similarly, Irish taxpayers may wonder why Denmark was permitted by the European Union to let government guarantees for historic senior bond holders expire by late 2010 and bail these in, while Ireland had to shoulder at least another EUR 7 billion in fiscal losses as a result from being kept from using this option.

However, a trend for higher creditor participation can be observed over time. The study shows, with only a few exceptions, that in line with the general policy turnaround the early restructuring cases (Anglo Irish Bank, Hypo Real Estate) feature the lowest creditor participation levels and the latest restructuring cases the highest (Bankia, SNS Reaal, Laiki).

The study suggests a number of policy lessons. The most important are minimizing restructuring delay (which usually causes evasion and thus reduces the bail-inable capital substantially) and increasing the depth of participation through suitable legislation. The relevant legislation has still not been adopted in many countries as the relevant European directive was postponed to 2018.

For the future European bank resolution rulebook, a number of rules follow: avoid paying cash to shareholders and junior debt investors, stop guaranteeing historic senior bond cohorts to keep future options for bail-in open, invest government funds, if anything, into senior hybrid capital instead of shares, and only after junior bond investors have been bailed in, and generally use restructuring and resolution concepts that tie the fate of historic assets to the fate of historic liabilities. This means preferring the “good bank” approach (horizontal balance sheet split with dubious asset pricing to be determined in the future) over the fiscally highly risky “bad bank” approach (asset swaps at arbitrary current valuations of dubious assets) and use other direct linkage options such as debt to equity or credit default swaps.

*The full version of the Working Paper can be downloaded **here**.*

Why Bail-In is not a Fata Morgana

by Jan Pieter Krahnen

Hard times for bail-in. There is a widely shared view these days that bail-in is a futile exercise. A study by Hans-Joachim Dübel recently published as CFS Working Paper (see above) shows that for the most important bank failures during the financial crisis bailout, not bail-in, was the name of the game. Even earmarked hybrid capital was rarely ever touched in the restructuring process. Rather, subordinated debt was redeemed at full or near-full nominal value almost universally and governments preferred to inject taxpayers’ money right away. This is true not only for Greece, Italy or Spain, but also for Ireland and particularly France and Germany. No wonder many observers have concluded that bail-in must be a fata morgana: evoked when far away and dissolving

when need arises.

Fortunately, this conclusion is false. It confounds the "is" with the "ought". Bail-in can be a fundamental game-changer – when done right. Existing bail-in proposals miss out on one simple but decisive point.

Why is bail-in a game changer? The role of bail-in in the European Recovery and Resolution Directive, and in many other concurrent legislative projects, is to allow for banks to become failable. Banks shall become like any other industrial corporation: an entity investing freely and taking risks at the owners' discretion, making profits in good times, and absorbing losses in bad times – no intervention of the taxpayer needed. In order to make such a market economy in banking possible, a congruence of decision making and private responsibilities is required.

This is the underlying philosophy of the European banking union project and its attempt to overcome too-big-to-fail. And this philosophical tenet has been hard-earned. The financial crisis has demonstrated very clearly that any bank rescue relying on taxpayers' money results in a Pyrrhic victory. Once markets understand that taxpayers' money is available always and everywhere, it becomes priced-in by bank debt markets. As a result, banks can fund themselves even cheaper than before the rescue, and the price of debt is no longer related to the risk taken by the bank. If this happens – and this is what has been happening every day since 2007 – the banking system is out of market control.

Can we change this? Yes, we can. The trick is: we need to make a portion of a bank's overall debt credibly "bail-in-able". Credibility is given if there is no fear of contagion, no fear of systemic risk, when a bank gets in trouble. As we learn from the aforementioned study, governments have routinely bailed-out bank creditors because they feared – rightly or wrongly – a contagious wave of losses flushing across the banking system, should they ever dare to bail-in creditors. The government is caught in a bailout trap.

But now we can see the way out of the bailout trap: define a layer of bank debt which is subordinate and – this is the key – held by non-bank investors. This dual characteristic is decisive to making bail-in credible: subordinate and held by investors outside the banking system – more precisely: held by long-term investors such as pension funds, life insurance companies, and sovereign wealth funds. Such a credible bail-in layer of subordinate debt, applied uniformly across the banking system, transforms the bail-in tenet from a fata morgana into reality, an oasis in the middle of a desert.

Credible bail-in, as a prerequisite for the banking union, was advocated by the Liikanen Commission a year ago. It resonates in the current policy of the ECB and its strong stance on bail-in. And it may explain the persevering no of the German government to further bailouts, as evidenced by the Cyprus case and possibly other cases to come.

To put it in a nutshell: bail-in needs credibility to be effective. It can be done.

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Challenges for Monetary Policy

by Otmar Issing, CFS President

Challenges in Times of Crisis

The financial crisis has caused a tremendous challenge for monetary policy. The simple concept of inflation targeting has lost its position as state of the art. Central banks are called upon to focus monetary policy on fighting unemployment and tolerating temporarily somewhat higher inflation. This has triggered the question whether the mandate of a central bank should not be widened, especially in case employment and/or economic growth are not (yet) included in the present institutional arrangement. At the same time, a comparable discussion has started on the responsibility of central banks to ensure financial stability. To counter the economic inertia, central banks have also modified their communication strategies by introducing forward guidance as a new policy tool. This has triggered a general debate regarding the adequate level of transparency in monetary policy. International cooperation, or rather coordination, in the sphere of monetary policy has also become an issue. In this context, the status of independence of the central bank has been challenged.

The Zero Bound and Forward Guidance

Central banks have reacted to the crisis manifold with ad hoc measures. The risk of time inconsistency gives a strong warning that pure discretion will lead to uncertainty and volatility. One attempt to overcome this situation and to anchor expectations is by the use of forward guidance as a policy tool. Ben Bernanke has explained in Jackson Hole 2012 that this "is not an unconditional promise", but rather, "a statement about the FOMC's [the Federal Open Market Committee's] collective judgment regarding the path of policy that is likely to prove appropriate, given the Committee's objectives and its outlook for the economy". As such it is a self-evident statement and therefore meaningless.

Forward guidance suffers from the same sort of time inconsistency it intends to remedy. Saying that the policy rate is likely to remain low well into the future does not imply that the central bank, from the perspective of a future date and in the face of rising inflation, will have the incentive to follow through on its commitment. The reason being that at this moment in the future it will be confronted with all the costs associated with keeping the promise while the benefits will have been reaped in the past.

Over an extended period of time it is extremely difficult to forecast the impact of the announced monetary policy on the economy. New shocks might hit the economy. The time dimension of those developments varies with the type and magnitude of shocks, the prevailing financial sentiment, the international environment and many other variables. Is it therefore not impossible to set the horizon for monetary policy in advance? Credible forward guidance, and thereby the anchoring of public expectations, cannot come from announcing a fixed number for a policy rate but from providing a strategy which allows the public a kind of ex-ante understanding of policy decisions under varying conditions by the central bank.

Announcing a specific number for the policy instrument, the main interest rate, for an extended period of time, might be seen as an unconditional commitment, which carries the risk that any change will be interpreted as a surprise, with the potential to cause turbulence in markets and hurt the credibility of the central bank. On the other hand, "conditionality" of such an announcement might, in the end, give no forward guidance at all. There is even the risk that a kind of implicit pessimism about future growth might have an adverse effect.

An Adequate Level of Transparency

The adoption of forward guidance as part of central banks' communication strategies has triggered a renewed discussion on the level of transparency in monetary policy. The more convincing central banks can explain the reasons for their monetary policy decisions to the public, the more effective their monetary policy will be.

Experience has shown, however, how difficult it is to communicate to the public all the information relevant to the decision-making process in a way that is not only exhaustive, but also clear and comprehensible. As monetary policy takes effect via financial markets,

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whose agents are directly affected by monetary policy decisions, misperceptions of monetary policy activity can cost them dearly. Consequently, praise and complaints from the markets have understandably become permanent companions of monetary policy. Central banks are therefore exposed to the temptation of ascribing an importance to market reactions that goes beyond their "transmission" interest.

There is a high risk that forward guidance will maximize this problem. The more detailed the central bank distributes information, the higher the risk that "markets" interpret the information in a way that is different from the view of the central bank.

There is, however, another dimension of the predictability of decisions. In the medium to longer term, it becomes a question of consistency between the sum of individual decisions and the longer term objectives of monetary policy. If such consistency is achieved, monetary policy is predictable and credible in the long term. Reconciling the two different dimensions of predictability is, and will remain, one of the main requirements of communication and monetary policy per se. It is hard to see how forward guidance can meet this challenge.

The Status of Independence of the Central Bank

The discussions of expanding the mandate of the central bank – a request which has strong political support in some European countries – and of the heavy purchases of government bonds have triggered a debate on the independence of central banks.

In the longer run there is no trade-off between price stability and goals like employment or growth, and considering that the effects of monetary policy decisions have a rather long time-lag, a single mandate – price stability – is the logical consequence. A dual – or even triple etc. – mandate blurs the final possibilities and therefore responsibility of the central bank. The government will always give priority to fighting unemployment and will implicitly have a bias for short-termism. Under such an arrangement, a central bank voluntarily or under political pressure is always tempted to embark on a more expansionary monetary policy.

If the central bank's independence status is exposed to strong political opposition, giving up independence *de facto* might be seen as an option to preserve *de jure* independence. However, this would come at the expense of undermining the fundament of independence for the central bank.

In any case, a central bank must abstain from measures which are directed to having distributionary effects, like giving cheap credit to special groups and not to others. Redistributive monetary policy is a complex concept. A central bank which is embarking on such a course will have to explain, or rather justify, its decisions in political fora and cannot refer to "immunity" based on its independence status. This is probably even more relevant if a central bank, in its function as bank supervisory authority, has the task and the power to save or close a bank. This implies that the supervisor, i.e. the central bank, will be heavily involved in the actions of fiscal authorities as providers of taxpayer's money, which could result in political pressure jeopardizing the central bank's independence.

It does not come as a surprise that preferences in government, parliament, and the wider public for independence might change over time. A central bank can defend its

independence status only to the extent that it delivers on its mandate, communicates its policy to the public in a transparent and coherent way – but at the same time abstains from all measures which imply "de facto" dependence. Otherwise, the status of independence, – de jure and de facto – is exposed to changes in preferences of politics and society.

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Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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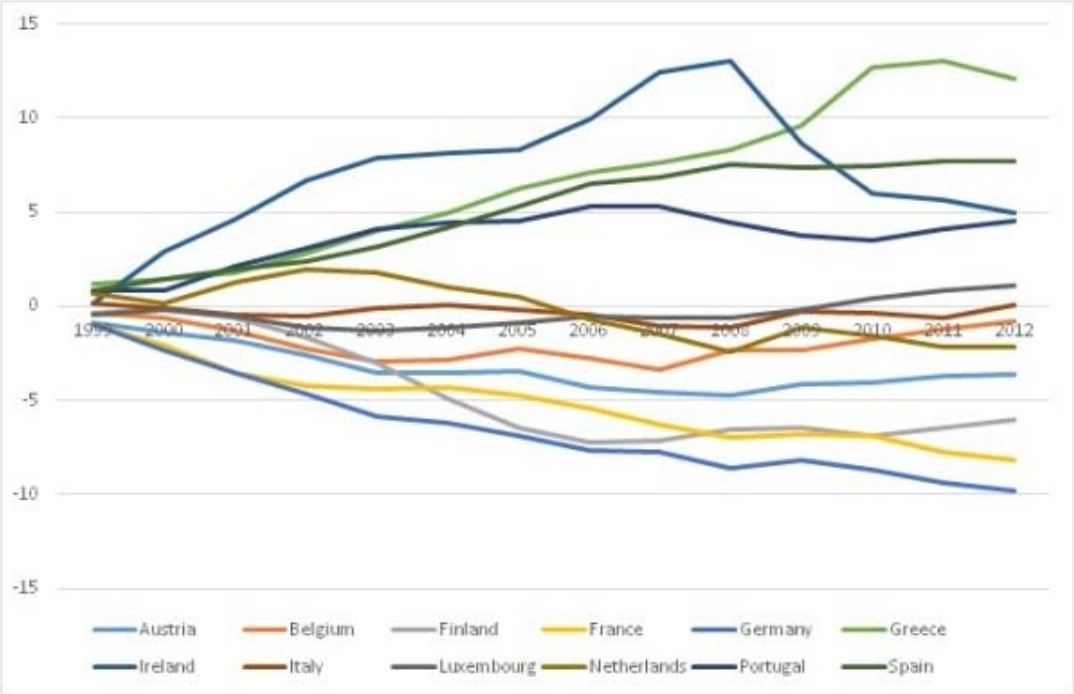
Current Research by CFS Scholars

The Determinants of Inflation Differentials in the Euro Area

by Laura Moretti

After the adoption of the single currency, inflation differentials in the euro zone countries have remained persistent. This phenomenon has increasingly become a cause of concern and it has contributed, partly, to the building up of the imbalances within the monetary union. In fact, common policy rates are set based on aggregate inflation and output gap, and countries with inflation persistently higher than average have experienced lower real interest rates for a protracted period of time. This led to divergent developments in competitiveness and to a stronger credit growth and housing booms in some countries. Moreover, lower real interest rates allowed governments to borrow easily, slowing-down fiscal consolidation.

Figure 1 presents the cumulative inflation differentials since the adoption of the euro and shows the considerable divergence between Ireland and Greece, the countries with the highest cumulated inflation, and Germany, the one with the lowest.



It is not uncommon for inflation to temporarily diverge in a monetary union, due to differences in business cycles or a process of real convergence. However, if inflation differences are persistent, they might signal different institutions and asymmetries in the implementation of structural reforms.

The literature presents contrasting results on the role of product versus labor market regulation on inflation. In this work, I take a further look at the effect of those institutions after the adoption of the single currency. I show that a higher level of labor market regulation moderately increases the persistence of inflation while it significantly dampens the responsiveness of inflation to shocks to the output gap. Product market regulation has no significant effects on these variables. However, a reduction in product market regulation significantly reduces the inflation rate.

Country specific institutions are particularly important for the reduction and absorption of asymmetric shocks, because a common currency precludes the use of monetary policy to offset asymmetric shocks, and the use of competitive devaluation to regain competitiveness. For this reason, countries have been requested to continue their efforts in implementing structural reforms in both product and labor markets. In fact, it has been shown that a reduction in regulation increases productivity and growth. However, the results of this work suggest that structural reforms in the product market have a negative impact on inflation and this might have adverse effects in a recession.

News

Competition and Fragmentation in Equities Markets

Financial markets in the US and Europe have evolved from a largely consolidated structure comprising the primary listing venues, regional exchanges and the OTC markets, to a highly competitive but fragmented structure comprising several exchanges and alternative trading systems like crossing networks, electronic communications networks, dark pools, and multiple broker-dealers offering internalization services. These changes have been fueled by an increase in computational capabilities, improvements in networking technologies and several regulatory initiatives like the Regulation-National Market System (Reg-NMS) in the US and the Markets in Financial Instruments Directive (MiFID) in the EU. While these changes have brought about several benefits like reduced transaction costs, regulators and market participants have raised concerns about the potential adverse effects associated with an increase in execution complexity as well as the impact on market quality of new types of venues like dark pools. **Peter Gomber, Satchit Sagade, Erik Theissen, Moritz Christian Weber and Christian Westheide** have reviewed the theoretical and empirical literature, which examines the reasons why markets fragment as well as the resulting impact on different aspects of market quality.

The literature surveyed provides several important lessons: First and foremost, the reasons underlying market fragmentation need to be examined keeping in mind two opposing economic forces acting simultaneously in securities markets. On the one hand, due to the presence of strong network externalities, financial markets have a tendency to consolidate in space and time. Additionally, there are also economies of scale in concentrating order flow, as it allows exchanges to amortize fixed costs over more trades. On the other hand, given the heterogeneity of traders' preferences it is difficult to envisage a single market that can cater to the needs of all market participants – traders differ with respect to their motives, required levels of transparency or opacity, order sizes, and levels of patience.

Second, while examining the larger welfare implications of market fragmentation, it is important to recognize that embedded in securities markets is the market for trading services as well as the market for the traded securities. While the reduced explicit transaction costs resulting from competition in the market for trading services can be beneficial to market participants, competition in the market for the traded securities can be harmful as the quality of prices may be adversely affected potentially increasing implicit transaction costs. The theoretical and empirical literature examining the impact of dark, non-transparent venues seems to be a case in point.

Recent developments in the market structure of equities and other asset classes have raised several questions which remain unanswered. The reasons as to why different stocks fragment differently are still unclear. For example, according to LiquidMetrix, in 2010 London Stock Exchange's (LSE) market share in FTSE 100 stocks ranged from 50% to 80% whereas the market share of the BATS Exchange ranged from 2% to 15%. Similar patterns can also be observed in continental European equities and stocks traded across the Atlantic. Empirical studies have also shown that the market share of the OTC market is significant – in Europe it is around 40% for equities. The reasons for these patterns in fragmentation also remain unclear. Last, but not the least, as compared to equities, research examining the impact of fragmentation/competition in other asset classes is scant, and in some cases non-existent. This question is especially important in light of the MiFID II proposals currently being debated in Europe, under which a significant portion of OTC trading in all asset classes will be subjected to increased transparency requirements and regulatory oversight.

The complex, subtle and simultaneous interactions of the forces discussed in this paper make the task of designing optimal policy responses and regulatory interventions extremely difficult. Policy-makers, regulators and exchanges should carefully evaluate the impact of their decisions keeping in mind these issues.

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Index: Business Sentiment Continues to be Positive in 2013

CFS Index

The CFS Index remained on a solid level throughout the last twelve months indicating a

positive business climate in the German financial industry. During the first three quarters of the year the index declined marginally, which can mainly be attributed to reductions in both business volume (revenues) and employment level of financial institutions. At the same time, service providers remained steadily positive in all index components (business volume (revenues), earnings, investments and employment).

As Jan Pieter Krahnen, academic head of the index, explained, "the slight downward movement of the index reflects different trends on the labor market of the financial industry: declining numbers of employees amongst financial institutions are in contrast to increasing numbers of employees of service providers. This may be due to the growing importance of regulatory requirements in the financial industry." Finally, the October survey showed that the index increased in the third quarter reaching the level from the beginning of the year and indicating an improvement of the business conditions, in particular the employment level of financial institutions.

Looking more deeply into the four index components, we see that the growth in business volume (revenues) among financial institutions declined slightly throughout 2013, while financial service providers' revenue growth rates remained stable and were expected to increase towards the end of year. Financial institutions experienced a slowdown of earnings in the first three quarters, although the negative tendency has been overcome in the fourth quarter. Despite falling short in earnings in the second quarter, service providers demonstrated positive dynamics in the subsequent half of the year and also expect their earnings to rise in the future.

Investments among financial institutions exhibited a moderate increase during the year with expectations continuing to be good. Service providers' investments stayed on a constant level except for a slight decline in the third quarter. The employment development of financial institutions has shown a strong negative movement throughout 2013. Only the October survey resulted in a reversal of the negative development and provided positive expectations towards the end of the year. Among financial service providers the employment level has continued to rise constantly over the year – a trend that is also anticipated to continue.

Special Surveys

The CFS Index not only measures the business climate of the German financial industry but also, via special surveys, provides important insight into the professionals' opinion about current developments in German and European economic policy.

In January, the survey on the development of the European sovereign debt crisis showed that 85% of respondents did not think that the crisis had been overcome. Half of this group said that, in order to fully solve the crisis, further structural reforms in the crisis countries were needed, a quarter demanded a unified European banking supervision. Only 10% expressed the opinion that the crisis had been overcome and based this confidence on the ECB's bond-buying program (70%), reforms in the crisis countries (70%) and the unlimited supply of liquidity offered by the ECB (67%).

The second quarter survey on the European banking union indicated that about 80% of participants objected to the idea of connecting national deposit insurances with a

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European-wide system. In contrast, more than three quarters classified the establishment of a single supervisory and a single resolution mechanism in response to the Cyprus crisis as urgent or very urgent.

In a special survey on the low interest rate environment, carried out at the beginning of the third quarter, 53% of participants answered that they expected the low interest rate policy to end within the following two years. A majority of respondents (63%) also considered the political approach wrong to let savers contribute to solving the government debt crisis by suffering from the real depreciation of assets. Three quarters assumed that private investors would redistribute their assets into stocks if the low interest rate phase continued.

In the October survey, almost half of the respondents (43%) expressed their trust especially in the ECB (in contrast to national governments or EU Commission) to substantially contribute to finding a solution to the financial and banking crisis in the coming 12 to 24 months. Jan Pieter Krahnen then commented: "The great confidence in the ECB's role expresses a realistic view on the power relations based on the experience of the last years." Survey participants were also asked whether the European balance sheet and stress tests ("Asset Quality Review") – that are planned by the European Central Bank (ECB) in the context of the establishment of the single supervisory authority – were necessary. A significant majority (70%) classified the tests as required or strongly required for the sustainable development of a banking union and the resolution of the crisis; 45% expected a banking consolidation as a consequence of the tests, while 20% expected a banking resolution.

Ina Christ & Ilya Dergunov

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Colloquium: Jean-Claude Trichet

Is the Euro at Risk?

On 4 December 2013, Jean-Claude Trichet, Honorary Governor of the Banque de France, gave a lecture at the CFS Colloquium series addressing the question whether the euro is at risk. The former President of the European Central Bank (ECB) expressed the opinion that the euro as a currency is not at risk. On the contrary, the euro remained surprisingly stable during the financial crisis, he said, and, in his view, it will continue to exist in even more member countries over the coming decades. The lecture, which was chaired by Otmar Issing, President of the CFS, was part of the CFS Colloquium series "Political and Financial Impulses between Austerity and Growth: A Silver Bullet for Europe?".

Trichet stressed that the euro as a currency had proved to be resilient even during the worst financial crisis

since World War II. Since its implementation in 1999, the value of the euro vis-à-vis the US dollar has remained at a stable level. Furthermore, when the epicenter of the crisis moved across the Atlantic to the euro area, the euro has remained credible in the eyes of investors all over the world. Trichet highlighted that the ECB had managed remarkably well to keep the inflation rate close to the ECB's inflation rate definition of below two percent but close to two percent and, thus, to preserve price stability. In addition, the volatility of inflation expectation was lower in the euro area than in other major currency areas, Trichet said.

So, it is not the currency which is at stake, but the economic and fiscal governance of the euro area which did not function correctly. Euro area economies have been faced with very acute challenges since the epicenter of the global crisis has moved from the United States to the euro zone when it turned from a private into a public debt crisis. During this time the weaknesses of the single currency area have been revealed. Trichet stressed that the Stability and Growth Pact had not been correctly implemented by the will of the governments. It was a major weakness since the fiscal framework was necessary in a currency union where there was no full fledge political union and therefore no federal budget. Furthermore, a divergence of the competitiveness of the economies in the currency area had already been observed and stressed by the ECB systematically since 2005, long before the crisis.

Trichet also warned that there was a high correlation between the creditworthiness of states and that of banks for many reasons, in particular because the backstop for banks was usually the state. This would lead to a virtuous circle in countries with a good creditworthiness but at the same time to a vicious circle in countries with a bad one. This problem, which was observed in all advanced economies, was particularly hard to

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manage in a single currency area and had revealed an additional weakness of the euro zone. Also to be mentioned was the fact that no crisis management tool had been created at the beginning of the euro area and therefore had to be invented on the spot. On top of the previous weaknesses which were specific to the euro area member countries, Trichet stressed two additional weaknesses that were shared by all 28 member countries of the European Union (EU): the fact that the single market had not been achieved and the absence of active implementation of the structural reforms that are overdue in the EU. These weaknesses of the 28 member countries were particularly grave for the 17 euro area countries which needed a full fledge highly flexible single market for facilitating the necessary competitiveness adjustment within the area.

Trichet underlined that, in the context of the crisis, these weaknesses have actively started being corrected. For example, the new Treaty on Stability, Coordination and Governance as well as the Macroeconomic Imbalance Procedure (MIP) were established, which he considered both extremely important. Trichet highlighted the currently planned banking union as a further improvement. Especially with the Single Supervisory Mechanism, which will be installed very close to the ECB, good progress has already been made. Trichet said that savers and investors worldwide recognized the improvements in governance that are being made and had also realized the remarkable adjustments in crisis countries which are now, looking at all five countries, that had been under market stress, taken together, back to a slight surplus from a consolidated current account deficit of more than eight percent of the GDP four years ago.

Finally, Trichet argued that the euro zone has already come very far in terms of a de facto political union, for example when deciding on fiscal issues like the improvement of the Stability and Growth Pact, or monitoring macroeconomic policy through the MIP procedure. He suggested that it was now time to reinforce the democratic legitimacy of this de facto political union in the making. He suggested that the European Parliament, which is democratically elected by European citizens, should take a significantly bigger role in the democratic process in the future.

Ina Christ

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Deutsche Bank Prize 2013: CFS Symposium in Honor of Raghuram Rajan

Leading academic economists discussed Rajan's highly influential contributions in a broad range of research areas in financial economics. Policy panel members addressed topical

policy issues relating to Rajan´s work.

Plenary Lecture: “Financial Dominance”

Markus Brunnermeier, Edwards S. Sanford Professor of Economics at Princeton University, presented his views on financial dominance, which refers to the situation in which a central bank is unable to raise interest rates because it would drive the financial sector into difficulties.

An important issue in a financial crisis is who, between the government and the banking sector, is better equipped to hold liquidity risk. In fact, government shoulders liquidity risk when it borrows short-term and faces rollover risk. Instead, if it issues long-term bonds the liquidity risk is shifted onto banks. However, the banking sector provides the service of maturity transformation and liquidity insurance only if it well capitalized, otherwise the risk will fall back onto the government sector later on.

The role of monetary policy is to reduce the amplification effects of an adverse shock to the repaying capacity of borrowers. Nevertheless, there are two different views on how to achieve it: the money view and the credit view. In the money view, the deflationary pressure is contrasted by increasing money supply and debtors benefit from this policy intervention. In contrast, the credit view suggests recapitalizing healthy banks in order to restore credit.

Monetary policy could be seen as an insurance scheme that increases the value of long-term bonds in bad times, when interest rates are cut, and acts as a tax in good times by decreasing the value of long-term bonds, when interest rates are raised. Therefore, it is essential to have good bank regulation in order to limit moral hazard. In this way, it is possible to stabilize the economy and switch off all the amplification mechanisms.

However, when long-term government bonds bear also default risk, a negative credit shock reduces credit, GDP, and tax revenues and, as a consequence, the government is less balanced. There could be fiscal dominance if the government refuses to balance the budget in the long run, or monetary dominance if the central bank refuses to accommodate. If nobody blinks, the only outcome is default of the government bond, which would hurt bank sustainability. However, if the central bank accommodates, there is inflationary uncertainty as a result of the opposite forces of deflation, due to the recession, and inflation, due to the accommodative monetary policy.

He concluded by pointing out the importance of preventive monetary policy and of paying attention to early warning signals, such as credit growth, imbalances, periods of low volatility and intensive financial innovation.

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Plenary Lecture: “Dynamics of Growth, Debt and Taxation”

Viral Acharya, C.V. Starr Professor of Economics at the New York University Stern School of Business, presented his recent work with Raghuram Rajan, “Sovereign Debt, Government Myopia and the Financial Sector” (*Review of Financial Studies*, 2013), in which the authors present an alternative explanation of the still open question of why countries repay their debt. In fact, the classic explanation of fear of exclusion from the debt markets are at odds with the fact that defaulters are able to return to the international capital markets reasonably quickly.

The authors analyze a situation in which governments continue to service their debt even though a debt restructuring would be more beneficial for the long-run growth perspective of the country. Their proposed explanation stems from the assumption that governments are myopic and suffer from short-termism because they are constraint by elections. In fact, short-horizon governments do not care about the accumulation of debt that needs to be serviced because they can pass it on future governments, but they are interested in the current cash flow. As long as the new borrowing exceeds the service of the current debt, they are willing to continue servicing the debt. In fact, default, even though in some cases might be beneficial for the long run growth perspective of the country, it would only reduce the current availability of cash.

Moreover, they analyze the mechanism that leads to the entanglement of the financial sector with sovereign debt. In fact, ownership by domestic banks of government bonds raises the cost of defaulting. Anticipating this, foreign lenders will continue to service the debt. At the same time, myopic governments would not be worried about debt accumulation as long as they are able to roll over the accumulated debt plus an extra.

In the light of this model, Acharya discussed the current emerging of home bias in Europe in government bond holding. Moreover, he pointed out the need of a mechanism to break the sovereign-financial sector nexus. Bruegel think-tank proposed the creation of two kinds of bonds: “Blue” bonds, held by domestic banks and guaranteed by the euro area, and “Red” bonds, guaranteed by the issuing country and not held by domestic banks. However, there would be a lack of commitment in repaying “Red” bonds giving the absence of entanglement with the domestic financial sector.

Plenary Lecture: "Banks are Where the Liquidity is"

Luigi Zingales, Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business, discussed the features that make banks unique, an important topic in Rajan's research

and in previous Deutsche Bank prize winners, such as Eugene Fama.

Traditionally, one important role played by banks has been the transactional demand for liquidity. However, Zingales raised the provocative question of whether this role of banks is still valid in the current environment of low transaction and communication costs, or whether bank deposits could be substituted by a money market account.

He used a simple model to show that the role of banks is to meet the demand of people with liquidity needs, who prefer to hold a disproportionate part of their endowment in riskless debt. Moreover, he explained that the default of a bank has more negative consequences than the default of any other similar sized company because it has a large impact on people that have liquidity constraints.

Keynote Lecture: "The Causes and Consequences of Unconventional Monetary Policy"

Deutsche Bank Prize winner **Raghuram Rajan** presented his personal views on the developments after the crisis, the benefits of unconventional monetary policy and some possible drawbacks. In the years leading to the crisis, demand was debt-fuelled in part to boost slow growth. As argued in "Faulty Lines", in the United States there might have been also a political motivation in the expansion of housing and in the practice of borrowing against housing value. In the euro area, instead, euro integration opened up opportunities to cheap finance, which led to over borrowing in the periphery partly fueled by lending from the euro core.

The first reaction to the crisis was to fix the financial sector and markets adopting a variety of measures that worked well. Moreover, central banks aggressively cut interest rates and implemented unconventional policies when interest rates reached the zero lower bound. In fact, given fiscal constraint and the difficulty in implementing structural

reforms, the focus turned to monetary policy as a way to restore growth. Since the real interest rate of equilibrium is negative, central banks lowered interest rates in order to promote consumption and investment. However, in a post-crisis environment there might be other factors, such as policy uncertainty and lack of available credit, that constrain investment.

Moreover, demand suffers also from the fact that people with high level of consumption before the crisis are now too highly indebted to increase spending. Households who saved before the crisis might not be willing to increase their consumption either despite the low interest rates. In fact, if they saved to reach a certain target, which was reduced by the crisis, they might want to increase savings even further. Hence, lowering interest rates might not have the desired expansionary effect.

Since the debt-fueled demand was highly localized, the post crisis disruption is also local. Therefore, Rajan raised the question of whether monetary policy interventions might be too blunt and not targeted enough, while fiscal policy might be better suited for interventions in the most hit areas, even though he recognized the potential (political) difficulties in its implementation.

Assuming monetary policy was the only answer to the crisis, the Federal Reserve has implemented ultra-low interest rates without raising inflationary expectations by forward guidance, with which the Fed has signaled that it will keep interest rates low for long. However, one important issue is the degree of commitment of such policy and its credibility. The other tool used aiming to lower long-term real interest rates was large-scale asset purchases.

Then, Rajan discussed the unintended consequences of unconventional monetary policy. In particular, the increase in risk taking in an environment of low interest rates and the spillover effects with capital flow and asset price booms particularly in emerging markets. Moreover, central banks by stepping in and offering a viable solution to the crisis, have taken the pressure away from politicians to implement the needed reforms. An important issue is the exit from unconventional monetary policy and the repercussion that this might have especially on emerging markets, which were the recipients of large capital

flows.

He concluded by praising central banks for avoiding a new great depression and for saving the financial system. However, he warned that keeping low interest rates for a long period could fuel the next crisis and he suggested taking into account the spillover effects of monetary policy in order to break the cycle of crises.

Policy Panel "Liquidity and Monetary Policy"

The symposium ended with a panel discussion, chaired by **Michael Haliassos** (Chairman of the Jury and Symposium Organizer 2013, CFS Director and Goethe University Frankfurt) on "Liquidity and Monetary Policy". Participants included **Vítor Constâncio**, Vice-President of the European Central Bank, **Otmar Issing**, CFS President and Jury member of the DB Prize, and **Jeremy Stein**, Governor, Board of Governors of the Federal Reserve System.

J. Stein, V. Constâncio, M. Haliassos, O. Issing (l. to r.)

Vítor Constâncio introduced the elusive concept of liquidity and explained how the European Central Bank (ECB) evolved its monetary policy and its liquidity provision during the crisis. In fact, the ECB since 2008 has abandoned the system of auction with variable rates and entered a mode of fixed rate, full allotment supplying as much liquidity as banks demanded, provided they have eligible collateral. Moreover, in December 2011 and February 2012 the ECB launched the long-term refinancing operations (LTROs), extraordinary liquidity provision with 3-year maturities.

One of the benefits of LTROs is that the future absorption of liquidity in excess would be easier, because banks have to repay their borrowings at maturity. He also added that, given the improved situation, European banks have already repaid 362 billion euro, or 64% of the net increase of 500 billion euro, and excess liquidity, which reached a peak of 813 billion euro in March 2012, has now fallen to 218 billion euro. The ECB is therefore exiting quietly and smoothly from an extraordinary phase of high central bank liquidity provision.

Finally, Constâncio mentioned the recent change in the ECB monetary policy and the introduction of a form of "forward guidance". In fact, the ECB stated that it will keep the key interest rates at present or lower levels for an extended period of time, depending on the assessment of medium-term prospects for inflation. The new policy has already bore positive results by lowering the forward curve of euro rates up to two years.

Otmar Issing discussed how liquidity, despite being such an elusive concept, has become the focus of monetary policy. In fact, after the recent crisis, central banks have increased the available liquidity not only by lowering policy rates, but also by expanding their balance sheets. Unfortunately, the increased liquidity has not yet translated in a stronger demand.

Finally, he warned that the ultra-low interest rates could provide banks with the wrong incentives to make risky investments searching for yields and possibly feeding the next bubble. Moreover, the ample availability of liquidity could postpone the clear up of banks' balance sheets and support the survival of "zombie" banks.

Jeremy Stein discussed his recent work with Sam Hanson of Harvard Business School on the monetary transmission mechanism.[1] They document that changes in the stance of monetary policy have surprisingly strong effects on long-term forward real interest rates. These findings are at odds with standard New Keynesian macro models in which a change in monetary policy rates should have no effects on forward real rates at long horizons such as 10 years. Moreover, they suggest that monetary policy may have a stronger effect than implied by standard models because it affects long-term real interest rates (TIPS), which influence a variety of investment decisions.

Stein explained that the movements in distant forward real rates are mainly due to changes in term premiums and not to changes in expectations about short-term real rates far into the future. In fact, a decline in TIPS after a monetary policy easing is not due to the expectations of lower real short rates in 10 years, but of the fact that TIPS have become more expensive relative to the expected future path of short rates.

The theoretical explanation draws on Rajan's idea that low nominal interest rates can create incentives for certain types of investors to "reach for yield". A reduction in short-term nominal interest rates would cause yield-oriented investors to buy long-term bonds to avoid a decline in their overall yield. This causes a raise in price of long-term bonds and hence a decline in long-term yields and forward rates. They provide evidence that when the yield curve steepens, commercial banks increase the maturity of their holding.

Laura Moretti

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[1] Samuel G. Hanson and Jeremy C. Stein (2012), "Monetary Policy and Long-Term Real Rates." The reported views are only of the author and are not necessarily shared by other members of the FOMC.

For further information on the award ceremony and symposium please click on the following link: speeches as video and slides as pdf files

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Bank Restructuring and Bail-In

Germany and France no Role Model in Bank Restructuring

by Hans-Joachim Dübel

Germany and France cannot serve as a role model in bank restructuring when comparing the most striking examples of Hypo Real Estate and Dexia to similar cases in other European countries. This is the key message of a study about "The Capital Structure of Banks and Practice of Bank Restructuring", written by Hans-Joachim Dübel of Finpolconsult and commissioned by the Center for Financial Studies, which was published in October.

For fear of negative systemic consequences and the loss of initial public investments, Germany and France focused on repeated recapitalizations with public money while leaving private creditors largely spared. Against the background of the wasted creditor participation potential, the classic European approach to the banking crisis, mainly driven by these two countries, – targeting a soft landing through forbearance combined with a prevalence of public bailouts – must be seen as discredited. Taxpayers elsewhere, e.g. in Ireland and most recently in Greece, were held hostages to this approach. It is the smaller European countries Denmark and the Netherlands that have developed best practice in bank restructuring. Spain, under tremendous political pressure through the mis-selling scandal of junior bank bonds to households, has reached a reasonable

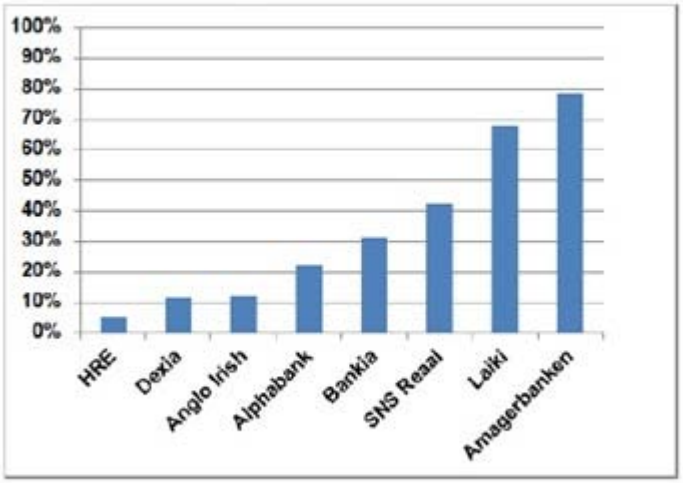
compromise.

The study provides an empirical analysis of the capital and liability management in eight cases of bank restructurings and resolutions: Alpha Bank (Greece), Amagerbanken (Denmark), Anglo Irish Bank (Ireland), Bankia (Spain), Cyprus Popular Bank/Laiki (Cyprus), Dexia (Belgium/France), Hypo Real Estate (Germany) and SNS Reaal Group (Netherlands). Four of the eight cases are resolutions, i.e. the original bank was unwound (Anglo Irish Bank, Amagerbanken, Dexia, Laiki), while the four other banks have de-facto or de-jure become nationalized and are awaiting re-privatization after the restructuring (Hypo Real Estate, Bankia, SNS Reaal, Alpha Bank). The case selection follows considerations of their model character for the European bank restructuring and resolution policy discussion.

For each case, the study draws a timeline between the initial credit event and the (most recent) restructuring. It assesses the respective extent of creditor participation as well as the expected losses by governments. Also, a discussion is provided of what could have been a least cost restructuring approach.

For essentially all cases (in particular for Hypo Real Estate, Dexia, Anglo Irish and Alpha Bank) the study shows that significant potential for creditor participation has been wasted due to too early public investment before at least junior creditors were bailed in. However, differences are striking: whereas the creditor participation rate in the cases of Laiki or Amagerbanken exceeds 65% and 75% respectively, this rate is only at about 5% in the case of Hypo Real Estate (see Figure 1). Frequently, governments must be expected to lose almost all of their investment (Hypo Real Estate, Anglo Irish Bank) with the median expected loss being at about 75%. An exception is the Dutch case of SNS Reaal where the government may expect to break even.

Figure 1 Estimated Participation of Bank Creditors in Financing the Capital Gaps of the Case Banks



Source: Bank reporting, Finpolconsult assumptions and computations.

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*The full version of the Working Paper can be downloaded **here**.*

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by Jan Pieter Krahnen

Hard times for bail-in. There is a widely shared view these days that bail-in is a futile exercise. A study by Hans-Joachim Dübel recently published as CFS Working Paper (see above) shows that for the most important bank failures during the financial crisis bailout, not bail-in, was the name of the game. Even earmarked hybrid capital was rarely ever touched in the restructuring process. Rather, subordinated debt was redeemed at full or near-full nominal value almost universally and governments preferred to inject taxpayers’ money right away. This is true not only for Greece, Italy or Spain, but also for Ireland and particularly France and Germany. No wonder many observers have concluded that bail-in must be a fata morgana: evoked when far away and dissolving

when need arises.

Fortunately, this conclusion is false. It confounds the "is" with the "ought". Bail-in can be a fundamental game-changer – when done right. Existing bail-in proposals miss out on one simple but decisive point.

Why is bail-in a game changer? The role of bail-in in the European Recovery and Resolution Directive, and in many other concurrent legislative projects, is to allow for banks to become failable. Banks shall become like any other industrial corporation: an entity investing freely and taking risks at the owners' discretion, making profits in good times, and absorbing losses in bad times – no intervention of the taxpayer needed. In order to make such a market economy in banking possible, a congruence of decision making and private responsibilities is required.

This is the underlying philosophy of the European banking union project and its attempt to overcome too-big-to-fail. And this philosophical tenet has been hard-earned. The financial crisis has demonstrated very clearly that any bank rescue relying on taxpayers' money results in a Pyrrhic victory. Once markets understand that taxpayers' money is available always and everywhere, it becomes priced-in by bank debt markets. As a result, banks can fund themselves even cheaper than before the rescue, and the price of debt is no longer related to the risk taken by the bank. If this happens – and this is what has been happening every day since 2007 – the banking system is out of market control.

Can we change this? Yes, we can. The trick is: we need to make a portion of a bank's overall debt credibly "bail-in-able". Credibility is given if there is no fear of contagion, no fear of systemic risk, when a bank gets in trouble. As we learn from the aforementioned study, governments have routinely bailed-out bank creditors because they feared – rightly or wrongly – a contagious wave of losses flushing across the banking system, should they ever dare to bail-in creditors. The government is caught in a bailout trap.

But now we can see the way out of the bailout trap: define a layer of bank debt which is subordinate and – this is the key – held by non-bank investors. This dual characteristic is decisive to making bail-in credible: subordinate and held by investors outside the banking system – more precisely: held by long-term investors such as pension funds, life insurance companies, and sovereign wealth funds. Such a credible bail-in layer of subordinate debt, applied uniformly across the banking system, transforms the bail-in tenet from a fata morgana into reality, an oasis in the middle of a desert.

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Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Bank Restructuring and Bail-In

Germany and France no Role Model in Bank Restructuring

by Hans-Joachim Dübel

Germany and France cannot serve as a role model in bank restructuring when comparing the most striking examples of Hypo Real Estate and Dexia to similar cases in other European countries. This is the key message of a study about "The Capital Structure of Banks and Practice of Bank Restructuring", written by Hans-Joachim Dübel of Finpolconsult and commissioned by the Center for Financial Studies, which was published in October.

For fear of negative systemic consequences and the loss of initial public investments, Germany and France focused on repeated recapitalizations with public money while leaving private creditors largely spared. Against the background of the wasted creditor participation potential, the classic European approach to the banking crisis, mainly driven by these two countries, – targeting a soft landing through forbearance combined with a prevalence of public bailouts – must be seen as discredited. Taxpayers elsewhere, e.g. in Ireland and most recently in Greece, were held hostages to this approach. It is the smaller European countries Denmark and the Netherlands that have developed best practice in bank restructuring. Spain, under tremendous political pressure through the mis-selling scandal of junior bank bonds to households, has reached a reasonable

compromise.

The study provides an empirical analysis of the capital and liability management in eight cases of bank restructurings and resolutions: Alpha Bank (Greece), Amagerbanken (Denmark), Anglo Irish Bank (Ireland), Bankia (Spain), Cyprus Popular Bank/Laiki (Cyprus), Dexia (Belgium/France), Hypo Real Estate (Germany) and SNS Reaal Group (Netherlands). Four of the eight cases are resolutions, i.e. the original bank was unwound (Anglo Irish Bank, Amagerbanken, Dexia, Laiki), while the four other banks have de-facto or de-jure become nationalized and are awaiting re-privatization after the restructuring (Hypo Real Estate, Bankia, SNS Reaal, Alpha Bank). The case selection follows considerations of their model character for the European bank restructuring and resolution policy discussion.

For each case, the study draws a timeline between the initial credit event and the (most recent) restructuring. It assesses the respective extent of creditor participation as well as the expected losses by governments. Also, a discussion is provided of what could have been a least cost restructuring approach.

For essentially all cases (in particular for Hypo Real Estate, Dexia, Anglo Irish and Alpha Bank) the study shows that significant potential for creditor participation has been wasted due to too early public investment before at least junior creditors were bailed in. However, differences are striking: whereas the creditor participation rate in the cases of Laiki or Amagerbanken exceeds 65% and 75% respectively, this rate is only at about 5% in the case of Hypo Real Estate (see Figure 1). Frequently, governments must be expected to lose almost all of their investment (Hypo Real Estate, Anglo Irish Bank) with the median expected loss being at about 75%. An exception is the Dutch case of SNS Reaal where the government may expect to break even.

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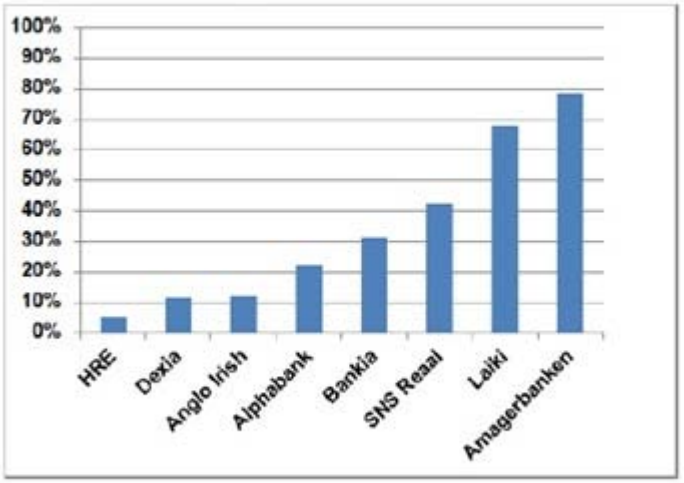

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Challenges for Monetary Policy

by Otmar Issing, CFS President

Challenges in Times of Crisis

The financial crisis has caused a tremendous challenge for monetary policy. The simple concept of inflation targeting has lost its position as state of the art. Central banks are called upon to focus monetary policy on fighting unemployment and tolerating temporarily somewhat higher inflation. This has triggered the question whether the mandate of a central bank should not be widened, especially in case employment and/or economic growth are not (yet) included in the present institutional arrangement. At the same time, a comparable discussion has started on the responsibility of central banks to ensure financial stability. To counter the economic inertia, central banks have also modified their communication strategies by introducing forward guidance as a new policy tool. This has triggered a general debate regarding the adequate level of transparency in monetary policy. International cooperation, or rather coordination, in the sphere of monetary policy has also become an issue. In this context, the status of independence of the central bank has been challenged.

The Zero Bound and Forward Guidance

Central banks have reacted to the crisis manifold with ad hoc measures. The risk of time inconsistency gives a strong warning that pure discretion will lead to uncertainty and volatility. One attempt to overcome this situation and to anchor expectations is by the use of forward guidance as a policy tool. Ben Bernanke has explained in Jackson Hole 2012 that this "is not an unconditional promise", but rather, "a statement about the FOMC's [the Federal Open Market Committee's] collective judgment regarding the path of policy that is likely to prove appropriate, given the Committee's objectives and its outlook for the economy". As such it is a self-evident statement and therefore meaningless.

Forward guidance suffers from the same sort of time inconsistency it intends to remedy. Saying that the policy rate is likely to remain low well into the future does not imply that the central bank, from the perspective of a future date and in the face of rising inflation, will have the incentive to follow through on its commitment. The reason being that at this moment in the future it will be confronted with all the costs associated with keeping the promise while the benefits will have been reaped in the past.

Over an extended period of time it is extremely difficult to forecast the impact of the announced monetary policy on the economy. New shocks might hit the economy. The time dimension of those developments varies with the type and magnitude of shocks, the prevailing financial sentiment, the international environment and many other variables. Is it therefore not impossible to set the horizon for monetary policy in advance? Credible forward guidance, and thereby the anchoring of public expectations, cannot come from announcing a fixed number for a policy rate but from providing a strategy which allows the public a kind of ex-ante understanding of policy decisions under varying conditions by the central bank.

Announcing a specific number for the policy instrument, the main interest rate, for an extended period of time, might be seen as an unconditional commitment, which carries the risk that any change will be interpreted as a surprise, with the potential to cause turbulence in markets and hurt the credibility of the central bank. On the other hand, "conditionality" of such an announcement might, in the end, give no forward guidance at all. There is even the risk that a kind of implicit pessimism about future growth might have an adverse effect.

An Adequate Level of Transparency

The adoption of forward guidance as part of central banks' communication strategies has triggered a renewed discussion on the level of transparency in monetary policy. The more convincing central banks can explain the reasons for their monetary policy decisions to the public, the more effective their monetary policy will be.

Experience has shown, however, how difficult it is to communicate to the public all the information relevant to the decision-making process in a way that is not only exhaustive, but also clear and comprehensible. As monetary policy takes effect via financial markets,

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whose agents are directly affected by monetary policy decisions, misperceptions of monetary policy activity can cost them dearly. Consequently, praise and complaints from the markets have understandably become permanent companions of monetary policy. Central banks are therefore exposed to the temptation of ascribing an importance to market reactions that goes beyond their "transmission" interest.

There is a high risk that forward guidance will maximize this problem. The more detailed the central bank distributes information, the higher the risk that "markets" interpret the information in a way that is different from the view of the central bank.

There is, however, another dimension of the predictability of decisions. In the medium to longer term, it becomes a question of consistency between the sum of individual decisions and the longer term objectives of monetary policy. If such consistency is achieved, monetary policy is predictable and credible in the long term. Reconciling the two different dimensions of predictability is, and will remain, one of the main requirements of communication and monetary policy per se. It is hard to see how forward guidance can meet this challenge.

The Status of Independence of the Central Bank

The discussions of expanding the mandate of the central bank – a request which has strong political support in some European countries – and of the heavy purchases of government bonds have triggered a debate on the independence of central banks.

In the longer run there is no trade-off between price stability and goals like employment or growth, and considering that the effects of monetary policy decisions have a rather long time-lag, a single mandate – price stability – is the logical consequence. A dual – or even triple etc. – mandate blurs the final possibilities and therefore responsibility of the central bank. The government will always give priority to fighting unemployment and will implicitly have a bias for short-termism. Under such an arrangement, a central bank voluntarily or under political pressure is always tempted to embark on a more expansionary monetary policy.

If the central bank's independence status is exposed to strong political opposition, giving up independence *de facto* might be seen as an option to preserve *de jure* independence. However, this would come at the expense of undermining the fundament of independence for the central bank.

In any case, a central bank must abstain from measures which are directed to having distributionary effects, like giving cheap credit to special groups and not to others. Redistributive monetary policy is a complex concept. A central bank which is embarking on such a course will have to explain, or rather justify, its decisions in political fora and cannot refer to "immunity" based on its independence status. This is probably even more relevant if a central bank, in its function as bank supervisory authority, has the task and the power to save or close a bank. This implies that the supervisor, i.e. the central bank, will be heavily involved in the actions of fiscal authorities as providers of taxpayer's money, which could result in political pressure jeopardizing the central bank's independence.

It does not come as a surprise that preferences in government, parliament, and the wider public for independence might change over time. A central bank can defend its

independence status only to the extent that it delivers on its mandate, communicates its policy to the public in a transparent and coherent way – but at the same time abstains from all measures which imply "de facto" dependence. Otherwise, the status of independence, – de jure and de facto – is exposed to changes in preferences of politics and society.

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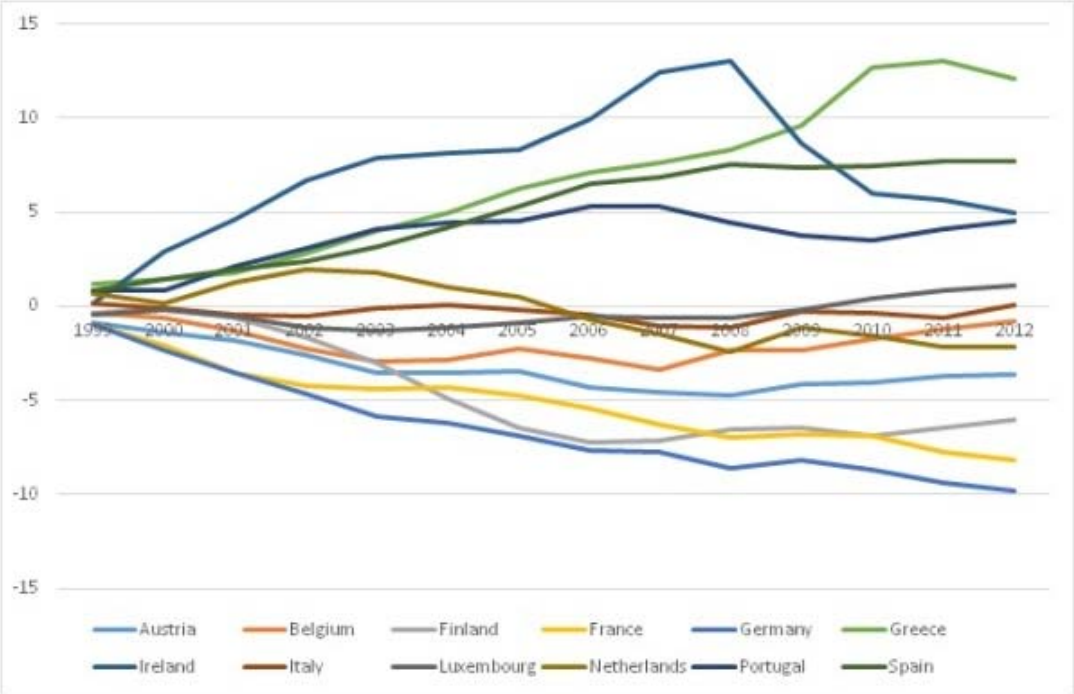
Current Research by CFS Scholars

The Determinants of Inflation Differentials in the Euro Area

by Laura Moretti

After the adoption of the single currency, inflation differentials in the euro zone countries have remained persistent. This phenomenon has increasingly become a cause of concern and it has contributed, partly, to the building up of the imbalances within the monetary union. In fact, common policy rates are set based on aggregate inflation and output gap, and countries with inflation persistently higher than average have experienced lower real interest rates for a protracted period of time. This led to divergent developments in competitiveness and to a stronger credit growth and housing booms in some countries. Moreover, lower real interest rates allowed governments to borrow easily, slowing-down fiscal consolidation.

Figure 1 presents the cumulative inflation differentials since the adoption of the euro and shows the considerable divergence between Ireland and Greece, the countries with the highest cumulated inflation, and Germany, the one with the lowest.



It is not uncommon for inflation to temporarily diverge in a monetary union, due to differences in business cycles or a process of real convergence. However, if inflation differences are persistent, they might signal different institutions and asymmetries in the implementation of structural reforms.

The literature presents contrasting results on the role of product versus labor market regulation on inflation. In this work, I take a further look at the effect of those institutions after the adoption of the single currency. I show that a higher level of labor market regulation moderately increases the persistence of inflation while it significantly dampens the responsiveness of inflation to shocks to the output gap. Product market regulation has no significant effects on these variables. However, a reduction in product market regulation significantly reduces the inflation rate.

Country specific institutions are particularly important for the reduction and absorption of asymmetric shocks, because a common currency precludes the use of monetary policy to offset asymmetric shocks, and the use of competitive devaluation to regain competitiveness. For this reason, countries have been requested to continue their efforts in implementing structural reforms in both product and labor markets. In fact, it has been shown that a reduction in regulation increases productivity and growth. However, the results of this work suggest that structural reforms in the product market have a negative impact on inflation and this might have adverse effects in a recession.

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Competition and Fragmentation in Equities Markets

Financial markets in the US and Europe have evolved from a largely consolidated structure comprising the primary listing venues, regional exchanges and the OTC markets, to a highly competitive but fragmented structure comprising several exchanges and alternative trading systems like crossing networks, electronic communications networks, dark pools, and multiple broker-dealers offering internalization services. These changes have been fueled by an increase in computational capabilities, improvements in networking technologies and several regulatory initiatives like the Regulation-National Market System (Reg-NMS) in the US and the Markets in Financial Instruments Directive (MiFID) in the EU. While these changes have brought about several benefits like reduced transaction costs, regulators and market participants have raised concerns about the potential adverse effects associated with an increase in execution complexity as well as the impact on market quality of new types of venues like dark pools. **Peter Gomber, Satchit Sagade, Erik Theissen, Moritz Christian Weber and Christian Westheide** have reviewed the theoretical and empirical literature, which examines the reasons why markets fragment as well as the resulting impact on different aspects of market quality.

The literature surveyed provides several important lessons: First and foremost, the reasons underlying market fragmentation need to be examined keeping in mind two opposing economic forces acting simultaneously in securities markets. On the one hand, due to the presence of strong network externalities, financial markets have a tendency to consolidate in space and time. Additionally, there are also economies of scale in concentrating order flow, as it allows exchanges to amortize fixed costs over more trades. On the other hand, given the heterogeneity of traders' preferences it is difficult to envisage a single market that can cater to the needs of all market participants – traders differ with respect to their motives, required levels of transparency or opacity, order sizes, and levels of patience.

Second, while examining the larger welfare implications of market fragmentation, it is important to recognize that embedded in securities markets is the market for trading services as well as the market for the traded securities. While the reduced explicit transaction costs resulting from competition in the market for trading services can be beneficial to market participants, competition in the market for the traded securities can be harmful as the quality of prices may be adversely affected potentially increasing implicit transaction costs. The theoretical and empirical literature examining the impact of dark, non-transparent venues seems to be a case in point.

Recent developments in the market structure of equities and other asset classes have raised several questions which remain unanswered. The reasons as to why different stocks fragment differently are still unclear. For example, according to LiquidMetrix, in 2010 London Stock Exchange's (LSE) market share in FTSE 100 stocks ranged from 50% to 80% whereas the market share of the BATS Exchange ranged from 2% to 15%. Similar patterns can also be observed in continental European equities and stocks traded across the Atlantic. Empirical studies have also shown that the market share of the OTC market is significant – in Europe it is around 40% for equities. The reasons for these patterns in fragmentation also remain unclear. Last, but not the least, as compared to equities, research examining the impact of fragmentation/competition in other asset classes is scant, and in some cases non-existent. This question is especially important in light of the MiFID II proposals currently being debated in Europe, under which a significant portion of OTC trading in all asset classes will be subjected to increased transparency requirements and regulatory oversight.

The complex, subtle and simultaneous interactions of the forces discussed in this paper make the task of designing optimal policy responses and regulatory interventions extremely difficult. Policy-makers, regulators and exchanges should carefully evaluate the impact of their decisions keeping in mind these issues.

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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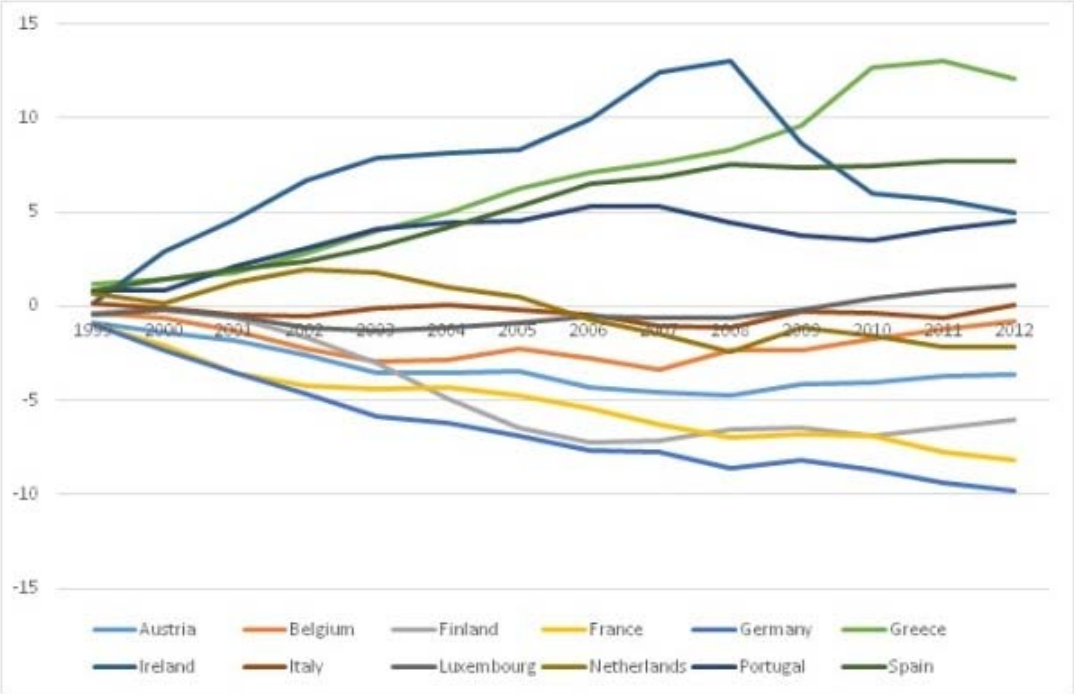
Current Research by CFS Scholars

The Determinants of Inflation Differentials in the Euro Area

by Laura Moretti

After the adoption of the single currency, inflation differentials in the euro zone countries have remained persistent. This phenomenon has increasingly become a cause of concern and it has contributed, partly, to the building up of the imbalances within the monetary union. In fact, common policy rates are set based on aggregate inflation and output gap, and countries with inflation persistently higher than average have experienced lower real interest rates for a protracted period of time. This led to divergent developments in competitiveness and to a stronger credit growth and housing booms in some countries. Moreover, lower real interest rates allowed governments to borrow easily, slowing-down fiscal consolidation.

Figure 1 presents the cumulative inflation differentials since the adoption of the euro and shows the considerable divergence between Ireland and Greece, the countries with the highest cumulated inflation, and Germany, the one with the lowest.



It is not uncommon for inflation to temporarily diverge in a monetary union, due to differences in business cycles or a process of real convergence. However, if inflation differences are persistent, they might signal different institutions and asymmetries in the implementation of structural reforms.

The literature presents contrasting results on the role of product versus labor market regulation on inflation. In this work, I take a further look at the effect of those institutions after the adoption of the single currency. I show that a higher level of labor market regulation moderately increases the persistence of inflation while it significantly dampens the responsiveness of inflation to shocks to the output gap. Product market regulation has no significant effects on these variables. However, a reduction in product market regulation significantly reduces the inflation rate.

Country specific institutions are particularly important for the reduction and absorption of asymmetric shocks, because a common currency precludes the use of monetary policy to offset asymmetric shocks, and the use of competitive devaluation to regain competitiveness. For this reason, countries have been requested to continue their efforts in implementing structural reforms in both product and labor markets. In fact, it has been shown that a reduction in regulation increases productivity and growth. However, the results of this work suggest that structural reforms in the product market have a negative impact on inflation and this might have adverse effects in a recession.

News

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Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Index: Business Sentiment Continues to be Positive in 2013

CFS Index

The CFS Index remained on a solid level throughout the last twelve months indicating a

positive business climate in the German financial industry. During the first three quarters of the year the index declined marginally, which can mainly be attributed to reductions in both business volume (revenues) and employment level of financial institutions. At the same time, service providers remained steadily positive in all index components (business volume (revenues), earnings, investments and employment).

As Jan Pieter Krahnen, academic head of the index, explained, "the slight downward movement of the index reflects different trends on the labor market of the financial industry: declining numbers of employees amongst financial institutions are in contrast to increasing numbers of employees of service providers. This may be due to the growing importance of regulatory requirements in the financial industry." Finally, the October survey showed that the index increased in the third quarter reaching the level from the beginning of the year and indicating an improvement of the business conditions, in particular the employment level of financial institutions.

Looking more deeply into the four index components, we see that the growth in business volume (revenues) among financial institutions declined slightly throughout 2013, while financial service providers' revenue growth rates remained stable and were expected to increase towards the end of year. Financial institutions experienced a slowdown of earnings in the first three quarters, although the negative tendency has been overcome in the fourth quarter. Despite falling short in earnings in the second quarter, service providers demonstrated positive dynamics in the subsequent half of the year and also expect their earnings to rise in the future.

Investments among financial institutions exhibited a moderate increase during the year with expectations continuing to be good. Service providers' investments stayed on a constant level except for a slight decline in the third quarter. The employment development of financial institutions has shown a strong negative movement throughout 2013. Only the October survey resulted in a reversal of the negative development and provided positive expectations towards the end of the year. Among financial service providers the employment level has continued to rise constantly over the year – a trend that is also anticipated to continue.

Special Surveys

The CFS Index not only measures the business climate of the German financial industry but also, via special surveys, provides important insight into the professionals' opinion about current developments in German and European economic policy.

In January, the survey on the development of the European sovereign debt crisis showed that 85% of respondents did not think that the crisis had been overcome. Half of this group said that, in order to fully solve the crisis, further structural reforms in the crisis countries were needed, a quarter demanded a unified European banking supervision. Only 10% expressed the opinion that the crisis had been overcome and based this confidence on the ECB's bond-buying program (70%), reforms in the crisis countries (70%) and the unlimited supply of liquidity offered by the ECB (67%).

The second quarter survey on the European banking union indicated that about 80% of participants objected to the idea of connecting national deposit insurances with a

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European-wide system. In contrast, more than three quarters classified the establishment of a single supervisory and a single resolution mechanism in response to the Cyprus crisis as urgent or very urgent.

In a special survey on the low interest rate environment, carried out at the beginning of the third quarter, 53% of participants answered that they expected the low interest rate policy to end within the following two years. A majority of respondents (63%) also considered the political approach wrong to let savers contribute to solving the government debt crisis by suffering from the real depreciation of assets. Three quarters assumed that private investors would redistribute their assets into stocks if the low interest rate phase continued.

In the October survey, almost half of the respondents (43%) expressed their trust especially in the ECB (in contrast to national governments or EU Commission) to substantially contribute to finding a solution to the financial and banking crisis in the coming 12 to 24 months. Jan Pieter Krahnen then commented: "The great confidence in the ECB's role expresses a realistic view on the power relations based on the experience of the last years." Survey participants were also asked whether the European balance sheet and stress tests ("Asset Quality Review") – that are planned by the European Central Bank (ECB) in the context of the establishment of the single supervisory authority – were necessary. A significant majority (70%) classified the tests as required or strongly required for the sustainable development of a banking union and the resolution of the crisis; 45% expected a banking consolidation as a consequence of the tests, while 20% expected a banking resolution.

Ina Christ & Ilya Dergunov

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
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CFS Presidential Lecture: Rolf E. Breuer

"On the Development of Financial Markets – Observations of a Contemporary Witness"

"Crises do not automatically produce the right remedies for themselves."
(Daniel Cohn-Bendit)

Five years after the collapse of the US investment bank Lehman Brothers, the peak of the financial crisis, it is time to reconsider if progress has been made in overcoming the crisis. On the one hand, the reforms of the European financial sector that have been introduced so far should be seen in a positive light. They are steps in the right direction. However, the addressed topics are only the "low-hanging fruit". Moreover, the reform approaches have been mechanistic. They aim at reforming the structure of financial markets, whereas the fundamental questions have been left out so far. The central problem is the loss of confidence of citizens, taxpayers and customers, not in a single person or institution, but in the whole financial system.

In retrospect, the "Big Bang" on 27 October 1986 in Great Britain, as well as the orientation towards investment banking along with the dissolution of the Deutschland AG appear to be the milestones for the change, both positive and negative.

Looking ahead, there are two crucial reforms that have to restore confidence: a European deposit guarantee and supervision of the sustainability of business models.

But first, let us go back to the 80s of the previous century. It was the time of Ronald Reagan and Margaret Thatcher and the time of the political shift towards neo-liberalism. Major trends were the deregulation of financial markets, liberalization and globalization. The strengthening of capital markets, the rise of London to a global financial center as well as product innovations, such as derivatives, also caused a reorientation in corporate finance. In the Federal Republic of Germany, this development had various consequences. "Rhine capitalism", a variation that combines a capitalistic system with

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social partnership and state coordination, seemed outdated. Regarded equally old-fashioned was a financial system that was based on universal banks and that only hesitantly used the capital markets. The so-called “Deutschland AG”, characterized by an intermeshing of capital and people between large companies, was dissolved. Banks turned towards investment banking to counteract the competitive pressure from foreign institutes for top mandates. A shortcoming was the lack of manpower. Up until then, universities had not educated investment bankers. Therefore, the creation of investment banking was carried out by acquisitions.

In this way, different core values were introduced: those of Anglo-American financial capitalism. The result was convincing: a tremendous economic upswing, technological progress, increased growth, more competitiveness, more jobs, and more prosperity. In these successful years, the United States as well as Great Britain began to claim the absoluteness of their approach. They no longer regarded their system as one option among others but, very plainly, as the only truth. Liberalism and deregulation became a philosophy of life, and the successful Anglo-Saxon model became “law”. Helmut Schmidt called this “predatory capitalism”. On the European continent itself, this type of politics was taken up and the initial model of a “social market economy”, of a balance between competition and order, was eroded. Whenever the state claimed a regulatory role, it was considered more an impediment than an agent of support.

Looking at the financial markets in particular, financial investors were to determine the direction of events. The most recent result of this trend being a shareholder activism focused on pure returns only. Indeed, a shareholder value philosophy arose that misunderstood this concept as it was developed by Alfred Rappaport. It should not go unrecognized that this development also had some very positive effects. The pressure on the rate of return induced companies to examine their processes, structures and strategies. In general, this was extremely beneficial – especially for German industry, whose brilliant comeback to the world markets in the middle of the decade would hardly have been possible without this vigorous restructuring. On the other hand, a constant eye on quarterly reports, the anticipation of reactions by analysts, investors or the interested public, as well as the influence of institutional investors on corporate policy introduced a certain short-term orientation within the overall strategy.

The crisis of confidence has its roots in exaggerations: excesses, disproportionate payments, dubious advice as well as “toxic” and complex products.

In order to solve the crisis, different measures were taken with regard to capitalization, liquidity, the leverage ratio, isolation of risky business and the shadow banking sector. This was right and necessary, but not enough. Furthermore, the general public does not understand many of the reform proposals and topics. People are not interested in technical terms like “leverage ratio” or “shadow banking”.

People, however, are interested in the prospective European deposit guarantee, which is the third pillar of the European banking union where little progress has been made so far. Here, it must be said that political communication during the Cyprus crisis was strikingly mismanaged. It was a serious mistake to put the security of savings of less than EUR 100,000 into question. This only confirmed public distrust in the financial system. Therefore, a European deposit guarantee would be an important signal to savers that the system will protect them in a crisis situation. A European deposit guarantee would help solve cross-border problems, decrease costs and increase the viability of the system for each country. An argument raised against a European deposit guarantee is that differently structured deposit guarantee schemes are already in operation all over

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Europe. Also, practical difficulties in managing a common fund structure are mentioned. Weaker arguments include possible reservations about credibility due to a lack of local representation and an increased administrative burden. In my opinion, a European deposit guarantee has to be part of the effort to consolidate the banking union and to establish the single European banking supervision entity.

The sustainability of business models should also be reviewed. Even before the financial crisis there were doubts about this. Sachsen LB and IKB offer examples of the extensive use of the substitution of debtors with all of the well-known consequences. Therefore, the conclusion that has to be drawn is: the supervisory authority has to assess the sustainability of business models and to regularly ask which assumptions are crucial for the model's success and which adjustments have been made. This examination is a demanding task for the banking supervision authority because it includes legal and economic aspects, and the supervisor has to be at least as good as its counterpart.

Five years ago, the collapse of Lehman Brothers was a shock to the world's financial markets. Today, many of the people involved have forgotten how deeply this event and its consequences have undermined confidence in the financial system. We have to talk about a profound structural change that will not come free of charge. The "golden age" of the financial markets is over and some of today's actors will not survive in their current shape.

Rolf-E. Breuer

The author is former Speaker and Chairman of the Management Board and former Chairman of the Supervisory Board of Deutsche Bank AG as well as Chairman of the Managing Board and the Steering Committee of the Gesellschaft für Kapitalmarktforschung e.V.

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House of Finance | Goethe University Frankfurt
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CFS Conferences

European Conference on Household Finance

19-21 September 2013
Rome, Italy

The European Conference on Household Finance took place for the fourth time in September 2013. It was organized by the Center for Financial Studies/Center of Excellence SAFE, the Einaudi Institute for Economics and Finance (EIEF) and the Swedish House of Finance (SHoF), with additional support from the Sloan Foundation. It was hosted by EIEF in Rome. The objective of the conference was to present empirical research on household behavior and its responses to governmental policies and changes in

economic environment using the variety of new micro data on household finance.

The conference program was opened by **Daniele Terlizzese** (EIEF, Banca d'Italia) and started with the session "Preferences, Experience and Financial Decisions". The first talk was by **Kim Peijnenburg** (Bocconi University) who presented empirical evidence for the effects of ambiguity aversion on household portfolio choice. **Elias Henrikki Rantapuska** (Aalto University) showed that a negative shock to employment has a long-run effect on households' portfolio choice. In particular, it decreases investment in risky assets. **Fei Wu** (Shanghai Advanced Institute of Finance, Shanghai Jiao Tong University) presented an empirical work showing that people are very likely to change their investment strategy after experiencing regret over their most recently executed action. **Marieke Bos** (SIFR, Stockholm University) attributed to the discussion on whether credit bureaus should restrict the length of time during that negative credit information can be retained. Her results suggest the idea that forgetting defaults tends to make credit scores more accurate and therefore might be welfare enhancing.

The second conference day was opened by **Michael Haliassos** (Goethe University Frankfurt, CFS, and CEPR) who chaired a session on "Fraud and Trading". The first presentation of **Keith Jacks Gamble** (DePaul University) focused on how cognitive changes associated with aging impact financial literacy and financial confidence. He found that a decrease in cognition also implies a decrease in financial literacy. Therefore, overconfidence about one's financial knowledge among elderly people is a significant risk factor for being victimized by financial fraud. **Yigitcan Karabulut** (Goethe University Frankfurt), using a unique dataset containing stock holdings of each German bank and of the corresponding retail clients, demonstrated that banks deliberately push stocks from their proprietary portfolios into the portfolios of their retail customers. Those stocks subsequently underperform, and retail clients of banks with proprietary trading earn lower long-term portfolio returns than do retail clients of less conflicted banks.

The next session on "Household Finance and Macroeconomics" was held by **Tullio Jappelli** (University of Naples Federico II, CSEF and CEPR). **Wenlan Qian** (National University of Singapore) studied how consumers responded to an exogenous unanticipated positive income shock. His findings suggest that consumption rose significantly while debt only decreased moderately. **Alexander Michaelides** (University of Cyprus, CEPR, CFS and Netspar) presented a life-cycle portfolio choice model with estimated structural parameters that generate limited stock market participation and plausible holdings of money, bonds and stocks. The model predicts an increase in bond holdings over the life cycle, and a declining share of money in portfolios as wealth increases.

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The afternoon session on “Complexity, Insurance and Financial Strain” was held by **Paolo Sodini** (Stockholm School of Economics and SHoF). It started with a presentation by **Boris Vallée** (HEC Paris) who documented that financial complexity has been steadily increasing, even after the recent financial crisis, and showed that financial institutions strategically use complexity to escape competition. **Silvia H. Barcellos** (RAND, USC) presented empirical evidence that suggested that the US health insurance program Medicare offers the elderly significant protection against medical expenditure risk and financial strain. **Emily Breza** (Columbia Business School) presented the results from an on-going project where she investigates how existing peer networks might help individuals to mitigate psychological barriers (e.g. time inconsistency) and better mobilize savings. The authors’ findings raised an interesting discussion and many questions from the floor.

The third conference day focused on mortgages and bankruptcy. The first session was opened by **Laurent Calvet** (HEC Paris). **Umit G. Gurun** (University of Texas at Dallas, Naveen Jindal School of Management) presented a study that shows a strong positive relationship between the intensity of local advertising and the expensiveness of mortgages extended by lenders. **Michael Ziegelmeyer** (Banque Centrale du Luxembourg) and **Cristian Badarinza** (Said Business School – University of Oxford) discussed the factors that affect the choice between adjustable interest rate mortgages (ARMs) and fixed interest rate mortgages (FRMs).

Joao Cocco (London Business School, CFS, and CEPR) launched the last conference session. **Barry Scholnick** (University of Alberta School of Business) presented a paper dealing with the question whether the choice of the legal mechanism of default is impacted by the default choices of close neighbors. His findings suggest that defaulters from low bankruptcy neighborhoods try to avoid the stigma associated with the public nature of bankruptcy by choosing less financially advantageous, but more private default mechanisms.

The conference program ended with the concluding word of the Program Committee and with the invitation to the next year meeting in Stockholm.

Mariya Melnychuk (SAFE)

Increasing the Impact of Risk Management on Senior Management’s Decision-Making

7 October 2013

On 22 March 2013 a CFS workshop on increasing the impact of risk management on senior management’s decision-making took place at the House of Finance. It was organized jointly by Thomas Kaiser (Goethe University and KPMG) and Sebastian Fritz-Morgenthal (Booz & Co).

A small group of senior representatives of banks, regulators and academia met in

October to discuss the kind of information required by senior management for decision making. The question was raised which information could and should be provided by the risk management function to decision-makers at various levels of hierarchy.

Participants agreed that risk information provided to the senior management should always be regarded jointly with the corresponding profit and loss statement, balance sheet and liquidity figures. Thus, the degree of standardization of management reports is limited. While information overload should be avoided in general, drill-down facilities are needed to satisfy information needs in case specific questions arise. Among workshop participants, the views as to the amount of information which should be provided varied though. While some participants favoured a strict up-front selection of risk drivers to be included in a report, others felt it more appropriate to leave it to the senior management to make that choice. A key success factor in crisis situations seems to be a quick adaptation of reporting contents to significantly changed environments. Furthermore, data integrity was identified as a key requirement to be met before applying any kind of advanced modeling to such data.

Thomas Kaiser (Goethe University and KPMG)

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House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
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Fax: +49 69 798 30077
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CFS Lectures

- Andreas Rödder: *Primacy of politics? The origin of the European Monetary Union*
- Josef Huber: *Sovereign Money*
- Martin Hellwig: *Public Finance, Banks and Monetary Policy – What is the Role of the Central Bank?*

The Path to a Common Currency

On 25 November, Andreas Rödder, Professor for Modern History at the University of Mainz, illustrated the history of the creation of the euro on the invitation of the Center for Financial Studies and the Institut für bankhistorische Forschung. His lecture was entitled: "Primacy of Politics? The Origins of the European Monetary Union".

Rödder started his journey through history in the early 1970s. During this time, Europe had experienced many changes triggered by the oil crisis and the collapse of the Bretton Woods monetary system. The post-war boom, promoted by cheap oil and fixed exchange rates, had come to a sudden end. Most European countries had

returned to a system of floating exchange rates which, however, did not prove stable either.

From 1982 onwards, the continuous growth of the Federal Republic of Germany had become a real boom and, among other European countries, the desire had grown to integrate the German strength into a pan-European project through a common currency and an independent central bank. Whereas Germany had not only been interested in a common currency but also in a political union, the interest of Great Britain had been first of all focused on a single European market. In 1985, France and Germany had started negotiations about the establishment of a monetary union.

Rödder pointed out that there had been two opposite parties in the discussion about a common currency: economists and monetarists. The first group was convinced that the common currency should only be introduced after a sufficient economic convergence had been achieved. In Germany, the Deutsche Bundesbank and the Federal Finance Ministry shared this opinion. The monetarists, on the other hand, wanted to introduce the common currency as soon as possible. The economic convergence of member countries should then come as a result of the monetary union.

The Madrid European Council of July 1989 had adopted the “Delors Plan” on the introduction of the Economic and Monetary Union. Part of the plan had been to establish an independent common central bank. The next step towards a common currency had to be made at an intergovernmental conference. France had already wanted the European Council in Straßburg in December 1989 to agree on holding this conference in order to introduce the common currency as soon as possible. Germany had initially objected to this idea. On the one hand, because the German Chancellor at that time, Helmut Kohl, had first wanted to push the political union in Europe and, on the other hand, because assuring stability had been regarded as a priority. Kohl had been concerned about stability because of the high budget deficits of some European member countries and had thus wanted to postpone the decision about holding an intergovernmental conference.

Due to the fall of the Berlin Wall in November 1989, the position of Germany in Europe had changed. In exchange for the French vote in favor of the German reunification, Kohl had agreed on holding the intergovernmental conference one year later on the summit in Straßburg. Next to this concession, Kohl had to abandon the idea of a political union and to agree on a more monetarist approach which was not focused on stability. In 1992, the member countries had passed the European Monetary Union with the Maastricht Treaty.

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According to Rödder, the monetary union had been an economic project for policy purposes, namely the greater integration of Germany into Europe. In the end, political motives had taken precedence over economic concerns. Thus, creating the monetary union there had indeed been a primacy of politics. Finally, Rödder stressed that the common currency had been a leap into the dark: The consequences of the introduction had been completely unclear at that time.

Ina Christ

Joseph Huber Votes for a Sovereign Money Reform

Sovereign money instead of commercial bank money: On 12 November, Joseph Huber, Professor for economic and environmental sociology at the Martin Luther University of Halle-Wittenberg, pleaded for a sovereign money system. His talk was part of the CFS Lecture series on the Order of Money hosted by Thomas Mayer, CFS Senior Fellow.

Huber explained that the existing money system (the reserve system) allowed banks to create deposit money, theoretically in unlimited amounts. The resulting money supply was several times higher than the reserves that banks were obliged to hold with the central bank. For example, a bank needs only around three percent coverage with the central bank to credit 100 currency units to a bank account. Due to increasing non-cash transactions central banks had virtually lost the control over money supply, Huber said.

Huber criticized that the reserve system was unstable and amplified crises because of regularly overshooting credit and deposit creation: There was a constant creation of money without real economic production of a comparable size. According to Huber, the true monetary cause of the present financial crisis was this excess money. He explained that the money supply M1 – currency in circulation and demand deposits of individuals or companies with banks – increased by 189 percent between 1999 and 2008 whereas the nominal gross domestic product only grew by 51 percent. As a consequence, inflation and asset inflation rose as well as indebtedness, also by states. Moreover, Huber warned that money in bank accounts, which is to a great extent uncovered, was unsafe because it could simply disappear in case of a banking crisis.

Therefore, Huber recommended that the state should regain the money monopoly in order to better control the money supply. He suggested a transition from commercial bank money to sovereign money. In contrast to commercial bank money, sovereign money is valid unlimitedly and stable and can only be issued by the central bank. Accounts from bank customers should be converted into money accounts that are kept off the banks' balance sheets to separate the banks' money from their customers' money. As a result, the money of bank customers will be safe again. Huber explained that the state currency sovereignty would be regained by this reform, the creation of

deposit money would be no longer possible and thus no overshooting money supply could arise. A further advantage would be, according to Huber, that the government would get all profits from money supply growth – the so-called seignorage – and could use it to finance part of its state budget because only the state has full sovereignty to create money.

Ina Christ

Monetary and Fiscal Policy cannot be Separated

Martin Hellwig, Director of the Max Planck Institute for Research on Collective Goods, gave a lecture about "Public Finance, Banks and Monetary Policy – What is the Role of the Central Bank?" at the Center for Financial Studies on 21 October.

Hellwig opposed the criticism that the current monetary policy was too expansive. Although central bank money has roughly doubled since 2008 and interest rates have been extremely low, this money has not been used for lending to the real economy. Instead, banks in the euro area have been holding more reserves with the Central Bank since 2008, Hellwig explained. They have lost confidence in the interbank market, which had previously been used by banks for short term financing. Therefore, the amount of money that really gets to the real economy and affects investments cannot be equated with central bank money. Hellwig explained that, instead, the money supply M1 – currency in circulation and demand deposits of an individual or company with banks – has to be considered. The decrease in money supply M1 as a result of higher reserves of banks with the Central Bank was only compensated by the rise in central bank money. As long as this situation did not change, the monetary policy of the European Central Bank (ECB) should not be considered expansive.

With regard to the criticism of the ECB's bond purchasing program, Hellwig pointed out that although the Central Bank was not allowed to directly finance states, it could carry out open market operations without any restrictions. Therefore, it is legally uncertain if the ECB has been allowed or not to indirectly support states via secondary market purchases. A strict separation of fiscal and monetary policy was not possible anyway, Hellwig said, because monetary policy always has distributional effects and thus fiscal consequences. According to Hellwig, it was the European Court of Justice who is responsible to clarify whether the ECB is acting within the scope of its mandate. For this reason, it was unfortunate that the corresponding case is now pending before the German Constitutional Court.

Hellwig also criticized that the focus in Karlsruhe was on the Outright Monetary Transactions (OMT) program rather than on the significantly larger long-term refinancing operations (LTRO). Because the ECB – as the only institution in the euro area that had the power to act – was forced to help banks during the crisis, politicians were able to get indirect access to the Central Bank's printing press. Thus, politicians have not been interested in regulating the banking sector.

According to Hellwig, the banking union would be a step in the right direction, however a restructuring authority was still needed. Also, he considered it as window dressing that the banking sector would pay for itself in case of a crisis. When banks get into trouble, a fiscal backstop would definitely be necessary which in the end would be again paid by European taxpayers.

Ina Christ

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Selected Upcoming Events

26 Feb 2014	*CFS Presidential Lecture* **Hans-Werner Sinn**, *Ifo Institute* *"Die reale Seite der Krise und der Rettungsschirm der EZB"*
05 Mar 2014	*CFS Colloquium* **Joe Kaeser**, *Siemens AG* "Auswirkung der Finanzkrise und der Niedrigzinspolitik auf die Finanzierung in der Industrie"

12 Mar 2014	*CFS & IMFS Conference* **The ECB and Its Watchers XV**
08 Oct 2014	*CFS Colloquium* **Maximilian Zimmerer,** *Allianz SE* "Herausforderungen für Investoren in Zeiten niedriger Zinsen"
05 Nov 2014	*CFS Colloquium* **Adair Turner,** *CFS & Institute for New Economic Thinking* "Risk: The Global Perspective"

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Fama and Shiller are not Poles Apart

The Nobel Prize in Economics 2013 is going to three economists whose work has influenced not only the way we view stock market pricing, but also something far broader: our current thinking about how the market economy functions as a whole. It is no exaggeration to state that this year's prize has been awarded for the fundamental evaluation of our society's asset markets.

Asset markets – the markets for shares, mortgages, loans – are the place where corporate and economic policy decisions become visible to individual citizens: by altering their private wealth, which may be held in the form of shares, funds or real estate, for example. Eugene Fama and Robert Shiller are united by their shared passion for describing actual market pricing data. Since their descriptions are so different – Fama established the market efficiency theory, while Shiller views the same prices as evidence of irrational exuberance – they tend to be characterized as antagonists, an impossible match.

The third laureate, Lars Peter Hansen, has made equally vital contributions regarding techniques for evaluating stock market price movements. However, since he focused less on interpreting actual prices and more on econometric evaluation, he has received somewhat less attention in the discussion of this year's prize.

Instead, many commentators have conveyed the view that Fama and Shiller should be regarded as polar opposites in the economic debate. This characterization is based on the idea that Fama, with his thesis that all available information is fully priced into the stock markets, occupies a position that naturally opposes Shiller's. He has managed to find deviations from a fundamentally justifiable value in long series of price data where

the over- or undervaluation was not quickly corrected. Indeed, such deviations can persist for long periods, says Shiller, thus leading to price bubbles, which often end abruptly and trigger larger crises as, for example, at the start of the financial crisis in 2007, when US house prices collapsed, driving many borrowers, banks and other investors worldwide into insolvency.

In his diagnosis of excessive house prices, Shiller relies on a series of house price indexes that he himself compiled. It was only after he made this information available that a long-term, differentiated examination of house prices was even possible. While most economists still have difficulty diagnosing price bubbles – i.e. differences between the observed market price and the fundamental value of the asset – this ability has always come easily to Shiller. Even at the start of his career he attempted to demonstrate that the observable stock market price movements could not be explained through the value theory that was popular among macroeconomists at the time: prices are too volatile to be rational and conform to a theory, Shiller said.

Fama also commented frequently on the existence of price bubbles – yet he comes to an entirely different conclusion. In 1970, Fama introduced the term “market efficiency” into the literature and developed an evaluation method that is still recognized today. Fama posited that competition among stock market investors results in all the data available at a given moment being processed very quickly. As such, Fama's concept allows the efficiency of a market to be measured according to the availability of information and how rapidly it is priced into the market.

At the scientific level there is no real difference between Fama and Shiller – one (Fama) develops an evaluation method, the other (Shiller) builds upon this method and applies it to his own theory of fundamental values. Fama, on the other hand, does not use a fundamental theory. Instead, his assessment uses historic data exclusively, applying the factor model he co-developed with Kenneth French.

In conclusion, Fama and Shiller are not divided by the question of whether the efficient market hypothesis is valid (both believe it is), but by the question of whether a theoretically justifiable fundamental value exists (only Shiller believes it does).

Those who view this almost philosophical distinction as insignificant should note that both of the researchers have given rise to distinct schools within the discipline. Further, they have both made various contributions to the ways their findings are applied in our everyday lives. The a-theoretical factor model of Fama (and French), in numerous variations, dominates the daily practice of fund managers, investment bankers and financial advisors worldwide – including your local savings bank. For many years Fama has been chairman of the Center for Research in Security Prices (CRSP) at the University of Chicago, which laid the foundation for the vast majority of all empirical studies produced by financial market researchers over the last 40 years.

Similarly, Shiller has created a database that allowed real estate investments, as the most important component of household wealth, to be incorporated into research and therefore into asset planning and portfolio management for the first time. This year's Nobel Prize celebrates, in the most positive sense, two figureheads of capital market research. Their achievements were already recognized in 2005 and 2009 when they

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received the Deutsche Bank Prize in Financial Economics by the Center for Financial Studies.

Jan Pieter Krahnen

A German version of this text appeared in the November 2013 issue of the Zeitschrift für das Gesamte Kreditwesen.

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Deutsche Bank Prize 2013: Award Ceremony in honor of Raghuram Rajan

Michael Haliassos, Raghuram Rajan, Jürgen Fitschen (l. to r.)

Michael Haliassos, Chairman of the Jury of the prize, CFS Director and Professor of

Economics at Goethe University, opened the Award Ceremony and the Symposium in honor of Raghuram G. Rajan, Governor of Reserve Bank of India since September 2013. Previously, Rajan was Chief Economic Adviser in the Finance Ministry, Government of India, and Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago's Booth School of Business. Governor Rajan is the fifth recipient of the Deutsche Bank Prize in Financial Economics. Michael Haliassos stressed the high quality of the academic selection process and its independence from the funding side, and he summarized the view of the international Jury: "Professor Rajan's work spans a remarkably broad range of areas in financial economics most important to the development of economies worldwide, ranging from the central role of banks in creating liquidity and the role of finance in economic growth to the nature of corporations and their financing. His work develops novel empirical and theoretical approaches with significant policy implications."

Award Ceremony

Jürgen Fitschen, Co-Chief Executive Officer of Deutsche Bank AG, in honoring Raghuram Rajan's work focused mainly on the policy implications of his work and the lessons that can be learnt by the banking industry. He suggested that Rajan's research would prove particular important for the current process of redesigning a financial regulation that contributes to the development of a stable, efficient and productive financial system aimed at better serving society.

He cited his path breaking studies on the relationship between financial sector and economic growth, a complex relationship that cannot be simplified by the ratio of financial sectors over GDP.

He also remembered Rajan's extensive work on corporate governance especially of a modern firm whose business model is based on intangible assets and human capital. Consequently, owners of specialist knowledge can exert a disproportional pressure to receive a larger share of revenues. This should offer a key to understand the serious governance problems faced by financial institutions prior to the crisis.

Finally, in his book with Luigi Zingales, "Saving Capitalism from the Capitalists", Rajan explained the benefits of the capital system and the challenges of policy makers in designing institutional frameworks that allow markets to be more effective.

In congratulating Rajan, Fitschen praised him not only for his relevant path breaking empirically-based research, but also because he always tackled real world complex policy issues and never shied away from speaking the inconvenient truth, such as in his 2005 Jackson Hall speech warning about the built up of unsustainable imbalances in the financial system.

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In the laudatory speech, **Douglas Diamond,** Merton H. Miller Distinguished Service Professor of Finance at the University of Chicago Booth School of Business, emphasized the important impact that Rajan's work had not only on other people's research in economics and finance but also on policy making. In fact, Rajan has always focused on important topics using a wide range of methodologies with the objective of having a positive impact on the world. This was also the reason why he accepted the position of Research Director at the IMF and, now, Governor of the Reserve Bank of India.

He remembered how Rajan was promoted directly from Assistant Professor to full Professor at the University of Chicago, something very rare, and how well respected he has always been in the department. Diamond acknowledged that Rajan's research is outstanding and incredibly broad. In particular, he remembered his path-breaking paper "Finance Dependence and Growth", coauthored with Luigi Zingales, in which they present the effects of financial constraints and limited financial development on growth analyzing the cost of external financing of firms.

Moreover, he remembered his important policy work and contributions: in India, at the IMF, with the Swan Lake Group, his widely cited Jackson Hall speech in which he forewarned of the roots of the crisis and his work with Jeremy Stein and Anil Kashyap in which they made the first coherent call for the use of contingent capital.

Diamond focused on Rajan's work on banking, short-term debt and monetary policy. In an earlier paper, "Insiders and Outsiders: The Choice between Informed and Arm's length debt", one of the first to relate financial contracting to the strength of bargaining power between borrowers and lenders, he showed that short-term debt is preferable if the bargaining power of the borrower is higher than the lender, while long-term debt in the opposite case. This idea developed in a series of paper coauthored with Mitchell Petersen on the value of having some exclusivity and monopoly power in bank lending.

In the work Diamond coauthored with Rajan, they analyze the liquidity mismatch between short-term deposit financing long-term illiquid assets. They show that an unstable financial structure subject to runs induces banks discipline and allows financial institutions to raise a bigger percentage of the value against an illiquid asset at least for a very short period of time than any more stable capital structure.

He concluded by pointing out that this line of research could be used to analyze the issue of banks' capital structure, which is naturally short-term debt with a reasonable sized capital buffer. If unregulated, banks choose too much short-term debt and a capital requirement is needed. However, more empirical work is required on the effects of capital requirement before assessing the impact of its increase on the health and stability of the financial system.

In his acceptance speech**, Raghuram Rajan** thanked all his co-authors, in particular Douglas

Diamond, Mitchell Petersen, Luigi Zingales, Viral Acharya, Randy Kroszner, Anil Kashyap, Stewart Myers and Jeremy Stein, all his mentors and colleagues at MIT and at the University of Chicago, and the vibrant intellectual environment in those institutions. He also thanked his wife Radica Puri for all her support, his two children and his parents and expressed his honor in receiving this important prize.

Laura Moretti

About the Deutsche Bank Prize in Financial Economics

The prize, awarded every two years and established by the Center for Financial Studies and Goethe University in 2005, aims to honor an internationally renowned researcher who has made influential contributions in the fields of finance, money and macroeconomics, and whose work has led to practice- and policy- relevant results. It is sponsored by the Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft*, a charitable foundation, and carries a cash award of €50,000.

The nomination process was extensive and involved a total of 4,000 economists from universities, central banks and research centers from 60 countries who made 265 nominations. It was up for the Jury, to select the prize winner in January 2013. The Jury itself consisted of leading international experts thereby ensuring exceptional academic standards are maintained and enhancing the credibility and reputation of the prize.

The previous recipients of the prize were Eugene Fama of the University of Chicago for “developing and investigating the concept of market efficiency – a cornerstone in the area of finance”, Michael Woodford of Columbia University for his fundamental contributions to “the theory and practical analysis of monetary policy”, Robert Shiller of Yale University for his “pioneering research in the field of financial economics, relating to dynamics of asset prizes and their metrics” and Kenneth Rogoff of Harvard University for “his work on sovereign default and debt restructuring, global imbalances, and the history of financial crises which is highly relevant for understanding and addressing today‘s global challenges.”

** Deutsche Bank Donation Fund in the Donor's Association for German Science*

For further information on the DB Prize please click on the following link:
www.db-prize.org

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Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS with new Managing Director

On 1 October 2013, Volker Brühl took over the newly created position of a Managing Director of the Center for Financial Studies. He will drive forward the Center's strategic development together with the Academic Directors Michael Haliassos, Jan Pieter Krahnen und Uwe Walz.

With his broad banking background Brühl will contribute to strengthening the profile of the CFS as a financial research center with a clear focus on applied research while, at the same time, stimulating the Center's successful role as a research based platform for a dialogue between academia, politics and industry – on an international scale.

Brühl has many years of experience as a top manager in banking: He was Partner at McKinsey & Company in Frankfurt between 2011 and 2013 and, before, Divisional Board Member of WestLB in Düsseldorf and Managing Director at Dresdner Kleinwort in Frankfurt. From 1997 to 2000, Brühl was Associate Partner at Roland Berger in Munich, and between 1993 and 1996 he worked for the Deutsche Bank in Frankfurt and London. Brühl earned his doctoral degree from the University of Gießen.

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Phone: +49 69 798 30050
Fax: +49 69 798 30077
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CFS Colloquium: Jean-Claude Trichet

Is the Euro at Risk?

On 4 December 2013, Jean-Claude Trichet, Honorary Governor of the Banque de France, gave a lecture at the CFS Colloquium series addressing the question whether the euro is at risk. The former President of the European Central Bank (ECB) expressed the opinion that the euro as a currency is not at risk. On the contrary, the euro remained surprisingly stable during the financial crisis, he said, and, in his view, it will continue to exist in even more member countries over the coming decades. The lecture, which was chaired by Otmar Issing, President of the CFS, was part of the CFS Colloquium series "Political and Financial Impulses between Austerity and Growth: A Silver Bullet for Europe?".

Trichet stressed that the euro as a currency had proved to be resilient even during the worst financial crisis

since World War II. Since its implementation in 1999, the value of the euro vis-à-vis the US dollar has remained at a stable level. Furthermore, when the epicenter of the crisis moved across the Atlantic to the euro area, the euro has remained credible in the eyes of investors all over the world. Trichet highlighted that the ECB had managed remarkably well to keep the inflation rate close to the ECB's inflation rate definition of below two percent but close to two percent and, thus, to preserve price stability. In addition, the volatility of inflation expectation was lower in the euro area than in other major currency areas, Trichet said.

So, it is not the currency which is at stake, but the economic and fiscal governance of the euro area which did not function correctly. Euro area economies have been faced with very acute challenges since the epicenter of the global crisis has moved from the United States to the euro zone when it turned from a private into a public debt crisis. During this time the weaknesses of the single currency area have been revealed. Trichet stressed that the Stability and Growth Pact had not been correctly implemented by the will of the governments. It was a major weakness since the fiscal framework was necessary in a currency union where there was no full fledge political union and therefore no federal budget. Furthermore, a divergence of the competitiveness of the economies in the currency area had already been observed and stressed by the ECB systematically since 2005, long before the crisis.

Trichet also warned that there was a high correlation between the creditworthiness of states and that of banks for many reasons, in particular because the backstop for banks was usually the state. This would lead to a virtuous circle in countries with a good creditworthiness but at the same time to a vicious circle in countries with a bad one. This problem, which was observed in all advanced economies, was particularly hard to

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manage in a single currency area and had revealed an additional weakness of the euro zone. Also to be mentioned was the fact that no crisis management tool had been created at the beginning of the euro area and therefore had to be invented on the spot. On top of the previous weaknesses which were specific to the euro area member countries, Trichet stressed two additional weaknesses that were shared by all 28 member countries of the European Union (EU): the fact that the single market had not been achieved and the absence of active implementation of the structural reforms that are overdue in the EU. These weaknesses of the 28 member countries were particularly grave for the 17 euro area countries which needed a full fledge highly flexible single market for facilitating the necessary competitiveness adjustment within the area.

Trichet underlined that, in the context of the crisis, these weaknesses have actively started being corrected. For example, the new Treaty on Stability, Coordination and Governance as well as the Macroeconomic Imbalance Procedure (MIP) were established, which he considered both extremely important. Trichet highlighted the currently planned banking union as a further improvement. Especially with the Single Supervisory Mechanism, which will be installed very close to the ECB, good progress has already been made. Trichet said that savers and investors worldwide recognized the improvements in governance that are being made and had also realized the remarkable adjustments in crisis countries which are now, looking at all five countries, that had been under market stress, taken together, back to a slight surplus from a consolidated current account deficit of more than eight percent of the GDP four years ago.

Finally, Trichet argued that the euro zone has already come very far in terms of a de facto political union, for example when deciding on fiscal issues like the improvement of the Stability and Growth Pact, or monitoring macroeconomic policy through the MIP procedure. He suggested that it was now time to reinforce the democratic legitimacy of this de facto political union in the making. He suggested that the European Parliament, which is democratically elected by European citizens, should take a significantly bigger role in the democratic process in the future.

Ina Christ

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
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Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Deutsche Bank Prize 2013: CFS Symposium in Honor of Raghuram Rajan

Leading academic economists discussed Rajan's highly influential contributions in a broad range of research areas in financial economics. Policy panel members addressed topical

policy issues relating to Rajan´s work.

Plenary Lecture: “Financial Dominance”

Markus Brunnermeier, Edwards S. Sanford Professor of Economics at Princeton University, presented his views on financial dominance, which refers to the situation in which a central bank is unable to raise interest rates because it would drive the financial sector into difficulties.

An important issue in a financial crisis is who, between the government and the banking sector, is better equipped to hold liquidity risk. In fact, government shoulders liquidity risk when it borrows short-term and faces rollover risk. Instead, if it issues long-term bonds the liquidity risk is shifted onto banks. However, the banking sector provides the service of maturity transformation and liquidity insurance only if it well capitalized, otherwise the risk will fall back onto the government sector later on.

The role of monetary policy is to reduce the amplification effects of an adverse shock to the repaying capacity of borrowers. Nevertheless, there are two different views on how to achieve it: the money view and the credit view. In the money view, the deflationary pressure is contrasted by increasing money supply and debtors benefit from this policy intervention. In contrast, the credit view suggests recapitalizing healthy banks in order to restore credit.

Monetary policy could be seen as an insurance scheme that increases the value of long-term bonds in bad times, when interest rates are cut, and acts as a tax in good times by decreasing the value of long-term bonds, when interest rates are raised. Therefore, it is essential to have good bank regulation in order to limit moral hazard. In this way, it is possible to stabilize the economy and switch off all the amplification mechanisms.

However, when long-term government bonds bear also default risk, a negative credit shock reduces credit, GDP, and tax revenues and, as a consequence, the government is less balanced. There could be fiscal dominance if the government refuses to balance the budget in the long run, or monetary dominance if the central bank refuses to accommodate. If nobody blinks, the only outcome is default of the government bond, which would hurt bank sustainability. However, if the central bank accommodates, there is inflationary uncertainty as a result of the opposite forces of deflation, due to the recession, and inflation, due to the accommodative monetary policy.

He concluded by pointing out the importance of preventive monetary policy and of paying attention to early warning signals, such as credit growth, imbalances, periods of low volatility and intensive financial innovation.

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The authors analyze a situation in which governments continue to service their debt even though a debt restructuring would be more beneficial for the long-run growth perspective of the country. Their proposed explanation stems from the assumption that governments are myopic and suffer from short-termism because they are constraint by elections. In fact, short-horizon governments do not care about the accumulation of debt that needs to be serviced because they can pass it on future governments, but they are interested in the current cash flow. As long as the new borrowing exceeds the service of the current debt, they are willing to continue servicing the debt. In fact, default, even though in some cases might be beneficial for the long run growth perspective of the country, it would only reduce the current availability of cash.

Moreover, they analyze the mechanism that leads to the entanglement of the financial sector with sovereign debt. In fact, ownership by domestic banks of government bonds raises the cost of defaulting. Anticipating this, foreign lenders will continue to service the debt. At the same time, myopic governments would not be worried about debt accumulation as long as they are able to roll over the accumulated debt plus an extra.

In the light of this model, Acharya discussed the current emerging of home bias in Europe in government bond holding. Moreover, he pointed out the need of a mechanism to break the sovereign-financial sector nexus. Bruegel think-tank proposed the creation of two kinds of bonds: “Blue” bonds, held by domestic banks and guaranteed by the euro area, and “Red” bonds, guaranteed by the issuing country and not held by domestic banks. However, there would be a lack of commitment in repaying “Red” bonds giving the absence of entanglement with the domestic financial sector.

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The first reaction to the crisis was to fix the financial sector and markets adopting a variety of measures that worked well. Moreover, central banks aggressively cut interest rates and implemented unconventional policies when interest rates reached the zero lower bound. In fact, given fiscal constraint and the difficulty in implementing structural

reforms, the focus turned to monetary policy as a way to restore growth. Since the real interest rate of equilibrium is negative, central banks lowered interest rates in order to promote consumption and investment. However, in a post-crisis environment there might be other factors, such as policy uncertainty and lack of available credit, that constrain investment.

Moreover, demand suffers also from the fact that people with high level of consumption before the crisis are now too highly indebted to increase spending. Households who saved before the crisis might not be willing to increase their consumption either despite the low interest rates. In fact, if they saved to reach a certain target, which was reduced by the crisis, they might want to increase savings even further. Hence, lowering interest rates might not have the desired expansionary effect.

Since the debt-fueled demand was highly localized, the post crisis disruption is also local. Therefore, Rajan raised the question of whether monetary policy interventions might be too blunt and not targeted enough, while fiscal policy might be better suited for interventions in the most hit areas, even though he recognized the potential (political) difficulties in its implementation.

Assuming monetary policy was the only answer to the crisis, the Federal Reserve has implemented ultra-low interest rates without raising inflationary expectations by forward guidance, with which the Fed has signaled that it will keep interest rates low for long. However, one important issue is the degree of commitment of such policy and its credibility. The other tool used aiming to lower long-term real interest rates was large-scale asset purchases.

Then, Rajan discussed the unintended consequences of unconventional monetary policy. In particular, the increase in risk taking in an environment of low interest rates and the spillover effects with capital flow and asset price booms particularly in emerging markets. Moreover, central banks by stepping in and offering a viable solution to the crisis, have taken the pressure away from politicians to implement the needed reforms. An important issue is the exit from unconventional monetary policy and the repercussion that this might have especially on emerging markets, which were the recipients of large capital

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One of the benefits of LTROs is that the future absorption of liquidity in excess would be easier, because banks have to repay their borrowings at maturity. He also added that, given the improved situation, European banks have already repaid 362 billion euro, or 64% of the net increase of 500 billion euro, and excess liquidity, which reached a peak of 813 billion euro in March 2012, has now fallen to 218 billion euro. The ECB is therefore exiting quietly and smoothly from an extraordinary phase of high central bank liquidity provision.

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Jeremy Stein discussed his recent work with Sam Hanson of Harvard Business School on the monetary transmission mechanism.[1] They document that changes in the stance of monetary policy have surprisingly strong effects on long-term forward real interest rates. These findings are at odds with standard New Keynesian macro models in which a change in monetary policy rates should have no effects on forward real rates at long horizons such as 10 years. Moreover, they suggest that monetary policy may have a stronger effect than implied by standard models because it affects long-term real interest rates (TIPS), which influence a variety of investment decisions.

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Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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Deutsche Bank Prize 2013: CFS Symposium in Honor of Raghuram Rajan

Leading academic economists discussed Rajan's highly influential contributions in a broad range of research areas in financial economics. Policy panel members addressed topical

policy issues relating to Rajan´s work.

Plenary Lecture: “Financial Dominance”

Markus Brunnermeier, Edwards S. Sanford Professor of Economics at Princeton University, presented his views on financial dominance, which refers to the situation in which a central bank is unable to raise interest rates because it would drive the financial sector into difficulties.

An important issue in a financial crisis is who, between the government and the banking sector, is better equipped to hold liquidity risk. In fact, government shoulders liquidity risk when it borrows short-term and faces rollover risk. Instead, if it issues long-term bonds the liquidity risk is shifted onto banks. However, the banking sector provides the service of maturity transformation and liquidity insurance only if it well capitalized, otherwise the risk will fall back onto the government sector later on.

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However, when long-term government bonds bear also default risk, a negative credit shock reduces credit, GDP, and tax revenues and, as a consequence, the government is less balanced. There could be fiscal dominance if the government refuses to balance the budget in the long run, or monetary dominance if the central bank refuses to accommodate. If nobody blinks, the only outcome is default of the government bond, which would hurt bank sustainability. However, if the central bank accommodates, there is inflationary uncertainty as a result of the opposite forces of deflation, due to the recession, and inflation, due to the accommodative monetary policy.

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Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Presidential Lecture: Rolf E. Breuer

"On the Development of Financial Markets – Observations of a Contemporary Witness"

"Crises do not automatically produce the right remedies for themselves."
(Daniel Cohn-Bendit)

Five years after the collapse of the US investment bank Lehman Brothers, the peak of the financial crisis, it is time to reconsider if progress has been made in overcoming the crisis. On the one hand, the reforms of the European financial sector that have been introduced so far should be seen in a positive light. They are steps in the right direction. However, the addressed topics are only the "low-hanging fruit". Moreover, the reform approaches have been mechanistic. They aim at reforming the structure of financial markets, whereas the fundamental questions have been left out so far. The central problem is the loss of confidence of citizens, taxpayers and customers, not in a single person or institution, but in the whole financial system.

In retrospect, the "Big Bang" on 27 October 1986 in Great Britain, as well as the orientation towards investment banking along with the dissolution of the Deutschland AG appear to be the milestones for the change, both positive and negative.

Looking ahead, there are two crucial reforms that have to restore confidence: a European deposit guarantee and supervision of the sustainability of business models.

But first, let us go back to the 80s of the previous century. It was the time of Ronald Reagan and Margaret Thatcher and the time of the political shift towards neo-liberalism. Major trends were the deregulation of financial markets, liberalization and globalization. The strengthening of capital markets, the rise of London to a global financial center as well as product innovations, such as derivatives, also caused a reorientation in corporate finance. In the Federal Republic of Germany, this development had various consequences. "Rhine capitalism", a variation that combines a capitalistic system with

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social partnership and state coordination, seemed outdated. Regarded equally old-fashioned was a financial system that was based on universal banks and that only hesitantly used the capital markets. The so-called “Deutschland AG”, characterized by an intermeshing of capital and people between large companies, was dissolved. Banks turned towards investment banking to counteract the competitive pressure from foreign institutes for top mandates. A shortcoming was the lack of manpower. Up until then, universities had not educated investment bankers. Therefore, the creation of investment banking was carried out by acquisitions.

In this way, different core values were introduced: those of Anglo-American financial capitalism. The result was convincing: a tremendous economic upswing, technological progress, increased growth, more competitiveness, more jobs, and more prosperity. In these successful years, the United States as well as Great Britain began to claim the absoluteness of their approach. They no longer regarded their system as one option among others but, very plainly, as the only truth. Liberalism and deregulation became a philosophy of life, and the successful Anglo-Saxon model became “law”. Helmut Schmidt called this “predatory capitalism”. On the European continent itself, this type of politics was taken up and the initial model of a “social market economy”, of a balance between competition and order, was eroded. Whenever the state claimed a regulatory role, it was considered more an impediment than an agent of support.

Looking at the financial markets in particular, financial investors were to determine the direction of events. The most recent result of this trend being a shareholder activism focused on pure returns only. Indeed, a shareholder value philosophy arose that misunderstood this concept as it was developed by Alfred Rappaport. It should not go unrecognized that this development also had some very positive effects. The pressure on the rate of return induced companies to examine their processes, structures and strategies. In general, this was extremely beneficial – especially for German industry, whose brilliant comeback to the world markets in the middle of the decade would hardly have been possible without this vigorous restructuring. On the other hand, a constant eye on quarterly reports, the anticipation of reactions by analysts, investors or the interested public, as well as the influence of institutional investors on corporate policy introduced a certain short-term orientation within the overall strategy.

The crisis of confidence has its roots in exaggerations: excesses, disproportionate payments, dubious advice as well as “toxic” and complex products.

In order to solve the crisis, different measures were taken with regard to capitalization, liquidity, the leverage ratio, isolation of risky business and the shadow banking sector. This was right and necessary, but not enough. Furthermore, the general public does not understand many of the reform proposals and topics. People are not interested in technical terms like “leverage ratio” or “shadow banking”.

People, however, are interested in the prospective European deposit guarantee, which is the third pillar of the European banking union where little progress has been made so far. Here, it must be said that political communication during the Cyprus crisis was strikingly mismanaged. It was a serious mistake to put the security of savings of less than EUR 100,000 into question. This only confirmed public distrust in the financial system. Therefore, a European deposit guarantee would be an important signal to savers that the system will protect them in a crisis situation. A European deposit guarantee would help solve cross-border problems, decrease costs and increase the viability of the system for each country. An argument raised against a European deposit guarantee is that differently structured deposit guarantee schemes are already in operation all over

Europe. Also, practical difficulties in managing a common fund structure are mentioned. Weaker arguments include possible reservations about credibility due to a lack of local representation and an increased administrative burden. In my opinion, a European deposit guarantee has to be part of the effort to consolidate the banking union and to establish the single European banking supervision entity.

The sustainability of business models should also be reviewed. Even before the financial crisis there were doubts about this. Sachsen LB and IKB offer examples of the extensive use of the substitution of debtors with all of the well-known consequences. Therefore, the conclusion that has to be drawn is: the supervisory authority has to assess the sustainability of business models and to regularly ask which assumptions are crucial for the model's success and which adjustments have been made. This examination is a demanding task for the banking supervision authority because it includes legal and economic aspects, and the supervisor has to be at least as good as its counterpart.

Five years ago, the collapse of Lehman Brothers was a shock to the world's financial markets. Today, many of the people involved have forgotten how deeply this event and its consequences have undermined confidence in the financial system. We have to talk about a profound structural change that will not come free of charge. The "golden age" of the financial markets is over and some of today's actors will not survive in their current shape.

Rolf-E. Breuer

The author is former Speaker and Chairman of the Management Board and former Chairman of the Supervisory Board of Deutsche Bank AG as well as Chairman of the Managing Board and the Steering Committee of the Gesellschaft für Kapitalmarktforschung e.V.

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

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social partnership and state coordination, seemed outdated. Regarded equally old-fashioned was a financial system that was based on universal banks and that only hesitantly used the capital markets. The so-called “Deutschland AG”, characterized by an intermeshing of capital and people between large companies, was dissolved. Banks turned towards investment banking to counteract the competitive pressure from foreign institutes for top mandates. A shortcoming was the lack of manpower. Up until then, universities had not educated investment bankers. Therefore, the creation of investment banking was carried out by acquisitions.

In this way, different core values were introduced: those of Anglo-American financial capitalism. The result was convincing: a tremendous economic upswing, technological progress, increased growth, more competitiveness, more jobs, and more prosperity. In these successful years, the United States as well as Great Britain began to claim the absoluteness of their approach. They no longer regarded their system as one option among others but, very plainly, as the only truth. Liberalism and deregulation became a philosophy of life, and the successful Anglo-Saxon model became “law”. Helmut Schmidt called this “predatory capitalism”. On the European continent itself, this type of politics was taken up and the initial model of a “social market economy”, of a balance between competition and order, was eroded. Whenever the state claimed a regulatory role, it was considered more an impediment than an agent of support.

Looking at the financial markets in particular, financial investors were to determine the direction of events. The most recent result of this trend being a shareholder activism focused on pure returns only. Indeed, a shareholder value philosophy arose that misunderstood this concept as it was developed by Alfred Rappaport. It should not go unrecognized that this development also had some very positive effects. The pressure on the rate of return induced companies to examine their processes, structures and strategies. In general, this was extremely beneficial – especially for German industry, whose brilliant comeback to the world markets in the middle of the decade would hardly have been possible without this vigorous restructuring. On the other hand, a constant eye on quarterly reports, the anticipation of reactions by analysts, investors or the interested public, as well as the influence of institutional investors on corporate policy introduced a certain short-term orientation within the overall strategy.

The crisis of confidence has its roots in exaggerations: excesses, disproportionate payments, dubious advice as well as “toxic” and complex products.

In order to solve the crisis, different measures were taken with regard to capitalization, liquidity, the leverage ratio, isolation of risky business and the shadow banking sector. This was right and necessary, but not enough. Furthermore, the general public does not understand many of the reform proposals and topics. People are not interested in technical terms like “leverage ratio” or “shadow banking”.

People, however, are interested in the prospective European deposit guarantee, which is the third pillar of the European banking union where little progress has been made so far. Here, it must be said that political communication during the Cyprus crisis was strikingly mismanaged. It was a serious mistake to put the security of savings of less than EUR 100,000 into question. This only confirmed public distrust in the financial system. Therefore, a European deposit guarantee would be an important signal to savers that the system will protect them in a crisis situation. A European deposit guarantee would help solve cross-border problems, decrease costs and increase the viability of the system for each country. An argument raised against a European deposit guarantee is that differently structured deposit guarantee schemes are already in operation all over

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Europe. Also, practical difficulties in managing a common fund structure are mentioned. Weaker arguments include possible reservations about credibility due to a lack of local representation and an increased administrative burden. In my opinion, a European deposit guarantee has to be part of the effort to consolidate the banking union and to establish the single European banking supervision entity.

The sustainability of business models should also be reviewed. Even before the financial crisis there were doubts about this. Sachsen LB and IKB offer examples of the extensive use of the substitution of debtors with all of the well-known consequences. Therefore, the conclusion that has to be drawn is: the supervisory authority has to assess the sustainability of business models and to regularly ask which assumptions are crucial for the model's success and which adjustments have been made. This examination is a demanding task for the banking supervision authority because it includes legal and economic aspects, and the supervisor has to be at least as good as its counterpart.

Five years ago, the collapse of Lehman Brothers was a shock to the world's financial markets. Today, many of the people involved have forgotten how deeply this event and its consequences have undermined confidence in the financial system. We have to talk about a profound structural change that will not come free of charge. The "golden age" of the financial markets is over and some of today's actors will not survive in their current shape.

Rolf-E. Breuer

The author is former Speaker and Chairman of the Management Board and former Chairman of the Supervisory Board of Deutsche Bank AG as well as Chairman of the Managing Board and the Steering Committee of the Gesellschaft für Kapitalmarktforschung e.V.

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Conferences

European Conference on Household Finance

19-21 September 2013
Rome, Italy

The European Conference on Household Finance took place for the fourth time in September 2013. It was organized by the Center for Financial Studies/Center of Excellence SAFE, the Einaudi Institute for Economics and Finance (EIEF) and the Swedish House of Finance (SHoF), with additional support from the Sloan Foundation. It was hosted by EIEF in Rome. The objective of the conference was to present empirical research on household behavior and its responses to governmental policies and changes in

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The conference program was opened by **Daniele Terlizzese** (EIEF, Banca d'Italia) and started with the session "Preferences, Experience and Financial Decisions". The first talk was by **Kim Peijnenburg** (Bocconi University) who presented empirical evidence for the effects of ambiguity aversion on household portfolio choice. **Elias Henrikki Rantapuska** (Aalto University) showed that a negative shock to employment has a long-run effect on households' portfolio choice. In particular, it decreases investment in risky assets. **Fei Wu** (Shanghai Advanced Institute of Finance, Shanghai Jiao Tong University) presented an empirical work showing that people are very likely to change their investment strategy after experiencing regret over their most recently executed action. **Marieke Bos** (SIFR, Stockholm University) attributed to the discussion on whether credit bureaus should restrict the length of time during that negative credit information can be retained. Her results suggest the idea that forgetting defaults tends to make credit scores more accurate and therefore might be welfare enhancing.

The second conference day was opened by **Michael Haliassos** (Goethe University Frankfurt, CFS, and CEPR) who chaired a session on "Fraud and Trading". The first presentation of **Keith Jacks Gamble** (DePaul University) focused on how cognitive changes associated with aging impact financial literacy and financial confidence. He found that a decrease in cognition also implies a decrease in financial literacy. Therefore, overconfidence about one's financial knowledge among elderly people is a significant risk factor for being victimized by financial fraud. **Yigitcan Karabulut** (Goethe University Frankfurt), using a unique dataset containing stock holdings of each German bank and of the corresponding retail clients, demonstrated that banks deliberately push stocks from their proprietary portfolios into the portfolios of their retail customers. Those stocks subsequently underperform, and retail clients of banks with proprietary trading earn lower long-term portfolio returns than do retail clients of less conflicted banks.

The next session on "Household Finance and Macroeconomics" was held by **Tullio Jappelli** (University of Naples Federico II, CSEF and CEPR). **Wenlan Qian** (National University of Singapore) studied how consumers responded to an exogenous unanticipated positive income shock. His findings suggest that consumption rose significantly while debt only decreased moderately. **Alexander Michaelides** (University of Cyprus, CEPR, CFS and Netspar) presented a life-cycle portfolio choice model with estimated structural parameters that generate limited stock market participation and plausible holdings of money, bonds and stocks. The model predicts an increase in bond holdings over the life cycle, and a declining share of money in portfolios as wealth increases.

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The afternoon session on “Complexity, Insurance and Financial Strain” was held by **Paolo Sodini** (Stockholm School of Economics and SHoF). It started with a presentation by **Boris Vallée** (HEC Paris) who documented that financial complexity has been steadily increasing, even after the recent financial crisis, and showed that financial institutions strategically use complexity to escape competition. **Silvia H. Barcellos** (RAND, USC) presented empirical evidence that suggested that the US health insurance program Medicare offers the elderly significant protection against medical expenditure risk and financial strain. **Emily Breza** (Columbia Business School) presented the results from an on-going project where she investigates how existing peer networks might help individuals to mitigate psychological barriers (e.g. time inconsistency) and better mobilize savings. The authors’ findings raised an interesting discussion and many questions from the floor.

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The conference program ended with the concluding word of the Program Committee and with the invitation to the next year meeting in Stockholm.

Mariya Melnychuk (SAFE)

Increasing the Impact of Risk Management on Senior Management’s Decision-Making

7 October 2013

On 22 March 2013 a CFS workshop on increasing the impact of risk management on senior management’s decision-making took place at the House of Finance. It was organized jointly by Thomas Kaiser (Goethe University and KPMG) and Sebastian Fritz-Morgenthal (Booz & Co).

A small group of senior representatives of banks, regulators and academia met in

October to discuss the kind of information required by senior management for decision making. The question was raised which information could and should be provided by the risk management function to decision-makers at various levels of hierarchy.

Participants agreed that risk information provided to the senior management should always be regarded jointly with the corresponding profit and loss statement, balance sheet and liquidity figures. Thus, the degree of standardization of management reports is limited. While information overload should be avoided in general, drill-down facilities are needed to satisfy information needs in case specific questions arise. Among workshop participants, the views as to the amount of information which should be provided varied though. While some participants favoured a strict up-front selection of risk drivers to be included in a report, others felt it more appropriate to leave it to the senior management to make that choice. A key success factor in crisis situations seems to be a quick adaptation of reporting contents to significantly changed environments. Furthermore, data integrity was identified as a key requirement to be met before applying any kind of advanced modeling to such data.

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Phone: +49 69 798 30050
Fax: +49 69 798 30077
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CFS Lectures

- Andreas Rödder: *Primacy of politics? The origin of the European Monetary Union*
- Josef Huber: *Sovereign Money*
- Martin Hellwig: *Public Finance, Banks and Monetary Policy – What is the Role of the Central Bank?*

The Path to a Common Currency

On 25 November, Andreas Rödder, Professor for Modern History at the University of Mainz, illustrated the history of the creation of the euro on the invitation of the Center for Financial Studies and the Institut für bankhistorische Forschung. His lecture was entitled: "Primacy of Politics? The Origins of the European Monetary Union".

Rödder started his journey through history in the early 1970s. During this time, Europe had experienced many changes triggered by the oil crisis and the collapse of the Bretton Woods monetary system. The post-war boom, promoted by cheap oil and fixed exchange rates, had come to a sudden end. Most European countries had

returned to a system of floating exchange rates which, however, did not prove stable either.

From 1982 onwards, the continuous growth of the Federal Republic of Germany had become a real boom and, among other European countries, the desire had grown to integrate the German strength into a pan-European project through a common currency and an independent central bank. Whereas Germany had not only been interested in a common currency but also in a political union, the interest of Great Britain had been first of all focused on a single European market. In 1985, France and Germany had started negotiations about the establishment of a monetary union.

Rödder pointed out that there had been two opposite parties in the discussion about a common currency: economists and monetarists. The first group was convinced that the common currency should only be introduced after a sufficient economic convergence had been achieved. In Germany, the Deutsche Bundesbank and the Federal Finance Ministry shared this opinion. The monetarists, on the other hand, wanted to introduce the common currency as soon as possible. The economic convergence of member countries should then come as a result of the monetary union.

The Madrid European Council of July 1989 had adopted the “Delors Plan” on the introduction of the Economic and Monetary Union. Part of the plan had been to establish an independent common central bank. The next step towards a common currency had to be made at an intergovernmental conference. France had already wanted the European Council in Straßburg in December 1989 to agree on holding this conference in order to introduce the common currency as soon as possible. Germany had initially objected to this idea. On the one hand, because the German Chancellor at that time, Helmut Kohl, had first wanted to push the political union in Europe and, on the other hand, because assuring stability had been regarded as a priority. Kohl had been concerned about stability because of the high budget deficits of some European member countries and had thus wanted to postpone the decision about holding an intergovernmental conference.

Due to the fall of the Berlin Wall in November 1989, the position of Germany in Europe had changed. In exchange for the French vote in favor of the German reunification, Kohl had agreed on holding the intergovernmental conference one year later on the summit in Straßburg. Next to this concession, Kohl had to abandon the idea of a political union and to agree on a more monetarist approach which was not focused on stability. In 1992, the member countries had passed the European Monetary Union with the Maastricht Treaty.

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According to Rödder, the monetary union had been an economic project for policy purposes, namely the greater integration of Germany into Europe. In the end, political motives had taken precedence over economic concerns. Thus, creating the monetary union there had indeed been a primacy of politics. Finally, Rödder stressed that the common currency had been a leap into the dark: The consequences of the introduction had been completely unclear at that time.

Ina Christ

Joseph Huber Votes for a Sovereign Money Reform

Sovereign money instead of commercial bank money: On 12 November, Joseph Huber, Professor for economic and environmental sociology at the Martin Luther University of Halle-Wittenberg, pleaded for a sovereign money system. His talk was part of the CFS Lecture series on the Order of Money hosted by Thomas Mayer, CFS Senior Fellow.

Huber explained that the existing money system (the reserve system) allowed banks to create deposit money, theoretically in unlimited amounts. The resulting money supply was several times higher than the reserves that banks were obliged to hold with the central bank. For example, a bank needs only around three percent coverage with the central bank to credit 100 currency units to a bank account. Due to increasing non-cash transactions central banks had virtually lost the control over money supply, Huber said.

Huber criticized that the reserve system was unstable and amplified crises because of regularly overshooting credit and deposit creation: There was a constant creation of money without real economic production of a comparable size. According to Huber, the true monetary cause of the present financial crisis was this excess money. He explained that the money supply M1 – currency in circulation and demand deposits of individuals or companies with banks – increased by 189 percent between 1999 and 2008 whereas the nominal gross domestic product only grew by 51 percent. As a consequence, inflation and asset inflation rose as well as indebtedness, also by states. Moreover, Huber warned that money in bank accounts, which is to a great extent uncovered, was unsafe because it could simply disappear in case of a banking crisis.

Therefore, Huber recommended that the state should regain the money monopoly in order to better control the money supply. He suggested a transition from commercial bank money to sovereign money. In contrast to commercial bank money, sovereign money is valid unlimitedly and stable and can only be issued by the central bank. Accounts from bank customers should be converted into money accounts that are kept off the banks' balance sheets to separate the banks' money from their customers' money. As a result, the money of bank customers will be safe again. Huber explained that the state currency sovereignty would be regained by this reform, the creation of

deposit money would be no longer possible and thus no overshooting money supply could arise. A further advantage would be, according to Huber, that the government would get all profits from money supply growth – the so-called seignorage – and could use it to finance part of its state budget because only the state has full sovereignty to create money.

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Monetary and Fiscal Policy cannot be Separated

Martin Hellwig, Director of the Max Planck Institute for Research on Collective Goods, gave a lecture about "Public Finance, Banks and Monetary Policy – What is the Role of the Central Bank?" at the Center for Financial Studies on 21 October.

Hellwig opposed the criticism that the current monetary policy was too expansive. Although central bank money has roughly doubled since 2008 and interest rates have been extremely low, this money has not been used for lending to the real economy. Instead, banks in the euro area have been holding more reserves with the Central Bank since 2008, Hellwig explained. They have lost confidence in the interbank market, which had previously been used by banks for short term financing. Therefore, the amount of money that really gets to the real economy and affects investments cannot be equated with central bank money. Hellwig explained that, instead, the money supply M1 – currency in circulation and demand deposits of an individual or company with banks – has to be considered. The decrease in money supply M1 as a result of higher reserves of banks with the Central Bank was only compensated by the rise in central bank money. As long as this situation did not change, the monetary policy of the European Central Bank (ECB) should not be considered expansive.

With regard to the criticism of the ECB's bond purchasing program, Hellwig pointed out that although the Central Bank was not allowed to directly finance states, it could carry out open market operations without any restrictions. Therefore, it is legally uncertain if the ECB has been allowed or not to indirectly support states via secondary market purchases. A strict separation of fiscal and monetary policy was not possible anyway, Hellwig said, because monetary policy always has distributional effects and thus fiscal consequences. According to Hellwig, it was the European Court of Justice who is responsible to clarify whether the ECB is acting within the scope of its mandate. For this reason, it was unfortunate that the corresponding case is now pending before the German Constitutional Court.

Hellwig also criticized that the focus in Karlsruhe was on the Outright Monetary Transactions (OMT) program rather than on the significantly larger long-term refinancing operations (LTRO). Because the ECB – as the only institution in the euro area that had the power to act – was forced to help banks during the crisis, politicians were able to get indirect access to the Central Bank's printing press. Thus, politicians have not been interested in regulating the banking sector.

According to Hellwig, the banking union would be a step in the right direction, however a restructuring authority was still needed. Also, he considered it as window dressing that the banking sector would pay for itself in case of a crisis. When banks get into trouble, a fiscal backstop would definitely be necessary which in the end would be again paid by European taxpayers.

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Monetary and Fiscal Policy cannot be Separated

Martin Hellwig, Director of the Max Planck Institute for Research on Collective Goods, gave a lecture about "Public Finance, Banks and Monetary Policy – What is the Role of the Central Bank?" at the Center for Financial Studies on 21 October.

Hellwig opposed the criticism that the current monetary policy was too expansive. Although central bank money has roughly doubled since 2008 and interest rates have been extremely low, this money has not been used for lending to the real economy. Instead, banks in the euro area have been holding more reserves with the Central Bank since 2008, Hellwig explained. They have lost confidence in the interbank market, which had previously been used by banks for short term financing. Therefore, the amount of money that really gets to the real economy and affects investments cannot be equated with central bank money. Hellwig explained that, instead, the money supply M1 – currency in circulation and demand deposits of an individual or company with banks – has to be considered. The decrease in money supply M1 as a result of higher reserves of banks with the Central Bank was only compensated by the rise in central bank money. As long as this situation did not change, the monetary policy of the European Central Bank (ECB) should not be considered expansive.

With regard to the criticism of the ECB's bond purchasing program, Hellwig pointed out that although the Central Bank was not allowed to directly finance states, it could carry out open market operations without any restrictions. Therefore, it is legally uncertain if the ECB has been allowed or not to indirectly support states via secondary market purchases. A strict separation of fiscal and monetary policy was not possible anyway, Hellwig said, because monetary policy always has distributional effects and thus fiscal consequences. According to Hellwig, it was the European Court of Justice who is responsible to clarify whether the ECB is acting within the scope of its mandate. For this reason, it was unfortunate that the corresponding case is now pending before the German Constitutional Court.

Hellwig also criticized that the focus in Karlsruhe was on the Outright Monetary Transactions (OMT) program rather than on the significantly larger long-term refinancing operations (LTRO). Because the ECB – as the only institution in the euro area that had the power to act – was forced to help banks during the crisis, politicians were able to get indirect access to the Central Bank's printing press. Thus, politicians have not been interested in regulating the banking sector.

According to Hellwig, the banking union would be a step in the right direction, however a restructuring authority was still needed. Also, he considered it as window dressing that the banking sector would pay for itself in case of a crisis. When banks get into trouble, a fiscal backstop would definitely be necessary which in the end would be again paid by European taxpayers.

Ina Christ

Publisher: Center for Financial Studies
House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
Phone: +49 69 798 30050
Fax: +49 69 798 30077
info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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26 Feb 2014	*CFS Presidential Lecture* **Hans-Werner Sinn**, *Ifo Institute* *"Die reale Seite der Krise und der Rettungsschirm der EZB"*
05 Mar 2014	*CFS Colloquium* **Joe Kaeser**, *Siemens AG* "Auswirkung der Finanzkrise und der Niedrigzinspolitik auf die Finanzierung in der Industrie"

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Fama and Shiller are not Poles Apart

The Nobel Prize in Economics 2013 is going to three economists whose work has influenced not only the way we view stock market pricing, but also something far broader: our current thinking about how the market economy functions as a whole. It is no exaggeration to state that this year's prize has been awarded for the fundamental evaluation of our society's asset markets.

Asset markets – the markets for shares, mortgages, loans – are the place where corporate and economic policy decisions become visible to individual citizens: by altering their private wealth, which may be held in the form of shares, funds or real estate, for example. Eugene Fama and Robert Shiller are united by their shared passion for describing actual market pricing data. Since their descriptions are so different – Fama established the market efficiency theory, while Shiller views the same prices as evidence of irrational exuberance – they tend to be characterized as antagonists, an impossible match.

The third laureate, Lars Peter Hansen, has made equally vital contributions regarding techniques for evaluating stock market price movements. However, since he focused less on interpreting actual prices and more on econometric evaluation, he has received somewhat less attention in the discussion of this year's prize.

Instead, many commentators have conveyed the view that Fama and Shiller should be regarded as polar opposites in the economic debate. This characterization is based on the idea that Fama, with his thesis that all available information is fully priced into the stock markets, occupies a position that naturally opposes Shiller's. He has managed to find deviations from a fundamentally justifiable value in long series of price data where

the over- or undervaluation was not quickly corrected. Indeed, such deviations can persist for long periods, says Shiller, thus leading to price bubbles, which often end abruptly and trigger larger crises as, for example, at the start of the financial crisis in 2007, when US house prices collapsed, driving many borrowers, banks and other investors worldwide into insolvency.

In his diagnosis of excessive house prices, Shiller relies on a series of house price indexes that he himself compiled. It was only after he made this information available that a long-term, differentiated examination of house prices was even possible. While most economists still have difficulty diagnosing price bubbles – i.e. differences between the observed market price and the fundamental value of the asset – this ability has always come easily to Shiller. Even at the start of his career he attempted to demonstrate that the observable stock market price movements could not be explained through the value theory that was popular among macroeconomists at the time: prices are too volatile to be rational and conform to a theory, Shiller said.

Fama also commented frequently on the existence of price bubbles – yet he comes to an entirely different conclusion. In 1970, Fama introduced the term “market efficiency” into the literature and developed an evaluation method that is still recognized today. Fama posited that competition among stock market investors results in all the data available at a given moment being processed very quickly. As such, Fama's concept allows the efficiency of a market to be measured according to the availability of information and how rapidly it is priced into the market.

At the scientific level there is no real difference between Fama and Shiller – one (Fama) develops an evaluation method, the other (Shiller) builds upon this method and applies it to his own theory of fundamental values. Fama, on the other hand, does not use a fundamental theory. Instead, his assessment uses historic data exclusively, applying the factor model he co-developed with Kenneth French.

In conclusion, Fama and Shiller are not divided by the question of whether the efficient market hypothesis is valid (both believe it is), but by the question of whether a theoretically justifiable fundamental value exists (only Shiller believes it does).

Those who view this almost philosophical distinction as insignificant should note that both of the researchers have given rise to distinct schools within the discipline. Further, they have both made various contributions to the ways their findings are applied in our everyday lives. The a-theoretical factor model of Fama (and French), in numerous variations, dominates the daily practice of fund managers, investment bankers and financial advisors worldwide – including your local savings bank. For many years Fama has been chairman of the Center for Research in Security Prices (CRSP) at the University of Chicago, which laid the foundation for the vast majority of all empirical studies produced by financial market researchers over the last 40 years.

Similarly, Shiller has created a database that allowed real estate investments, as the most important component of household wealth, to be incorporated into research and therefore into asset planning and portfolio management for the first time. This year's Nobel Prize celebrates, in the most positive sense, two figureheads of capital market research. Their achievements were already recognized in 2005 and 2009 when they

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Jan Pieter Krahnen

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Deutsche Bank Prize 2013: Award Ceremony in honor of Raghuram Rajan

Michael Haliassos, Raghuram Rajan, Jürgen Fitschen (l. to r.)

Michael Haliassos, Chairman of the Jury of the prize, CFS Director and Professor of

Economics at Goethe University, opened the Award Ceremony and the Symposium in honor of Raghuram G. Rajan, Governor of Reserve Bank of India since September 2013. Previously, Rajan was Chief Economic Adviser in the Finance Ministry, Government of India, and Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago's Booth School of Business. Governor Rajan is the fifth recipient of the Deutsche Bank Prize in Financial Economics. Michael Haliassos stressed the high quality of the academic selection process and its independence from the funding side, and he summarized the view of the international Jury: "Professor Rajan's work spans a remarkably broad range of areas in financial economics most important to the development of economies worldwide, ranging from the central role of banks in creating liquidity and the role of finance in economic growth to the nature of corporations and their financing. His work develops novel empirical and theoretical approaches with significant policy implications."

Award Ceremony

Jürgen Fitschen, Co-Chief Executive Officer of Deutsche Bank AG, in honoring Raghuram Rajan's work focused mainly on the policy implications of his work and the lessons that can be learnt by the banking industry. He suggested that Rajan's research would prove particular important for the current process of redesigning a financial regulation that contributes to the development of a stable, efficient and productive financial system aimed at better serving society.

He cited his path breaking studies on the relationship between financial sector and economic growth, a complex relationship that cannot be simplified by the ratio of financial sectors over GDP.

He also remembered Rajan's extensive work on corporate governance especially of a modern firm whose business model is based on intangible assets and human capital. Consequently, owners of specialist knowledge can exert a disproportional pressure to receive a larger share of revenues. This should offer a key to understand the serious governance problems faced by financial institutions prior to the crisis.

Finally, in his book with Luigi Zingales, "Saving Capitalism from the Capitalists", Rajan explained the benefits of the capital system and the challenges of policy makers in designing institutional frameworks that allow markets to be more effective.

In congratulating Rajan, Fitschen praised him not only for his relevant path breaking empirically-based research, but also because he always tackled real world complex policy issues and never shied away from speaking the inconvenient truth, such as in his 2005 Jackson Hall speech warning about the built up of unsustainable imbalances in the financial system.

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In the laudatory speech, **Douglas Diamond,** Merton H. Miller Distinguished Service Professor of Finance at the University of Chicago Booth School of Business, emphasized the important impact that Rajan's work had not only on other people's research in economics and finance but also on policy making. In fact, Rajan has always focused on important topics using a wide range of methodologies with the objective of having a positive impact on the world. This was also the reason why he accepted the position of Research Director at the IMF and, now, Governor of the Reserve Bank of India.

He remembered how Rajan was promoted directly from Assistant Professor to full Professor at the University of Chicago, something very rare, and how well respected he has always been in the department. Diamond acknowledged that Rajan's research is outstanding and incredibly broad. In particular, he remembered his path-breaking paper "Finance Dependence and Growth", coauthored with Luigi Zingales, in which they present the effects of financial constraints and limited financial development on growth analyzing the cost of external financing of firms.

Moreover, he remembered his important policy work and contributions: in India, at the IMF, with the Swan Lake Group, his widely cited Jackson Hall speech in which he forewarned of the roots of the crisis and his work with Jeremy Stein and Anil Kashyap in which they made the first coherent call for the use of contingent capital.

Diamond focused on Rajan's work on banking, short-term debt and monetary policy. In an earlier paper, "Insiders and Outsiders: The Choice between Informed and Arm's length debt", one of the first to relate financial contracting to the strength of bargaining power between borrowers and lenders, he showed that short-term debt is preferable if the bargaining power of the borrower is higher than the lender, while long-term debt in the opposite case. This idea developed in a series of paper coauthored with Mitchell Petersen on the value of having some exclusivity and monopoly power in bank lending.

In the work Diamond coauthored with Rajan, they analyze the liquidity mismatch between short-term deposit financing long-term illiquid assets. They show that an unstable financial structure subject to runs induces banks discipline and allows financial institutions to raise a bigger percentage of the value against an illiquid asset at least for a very short period of time than any more stable capital structure.

He concluded by pointing out that this line of research could be used to analyze the issue of banks' capital structure, which is naturally short-term debt with a reasonable sized capital buffer. If unregulated, banks choose too much short-term debt and a capital requirement is needed. However, more empirical work is required on the effects of capital requirement before assessing the impact of its increase on the health and stability of the financial system.

In his acceptance speech**, Raghuram Rajan** thanked all his co-authors, in particular Douglas

Diamond, Mitchell Petersen, Luigi Zingales, Viral Acharya, Randy Kroszner, Anil Kashyap, Stewart Myers and Jeremy Stein, all his mentors and colleagues at MIT and at the University of Chicago, and the vibrant intellectual environment in those institutions. He also thanked his wife Radica Puri for all her support, his two children and his parents and expressed his honor in receiving this important prize.

Laura Moretti

About the Deutsche Bank Prize in Financial Economics

The prize, awarded every two years and established by the Center for Financial Studies and Goethe University in 2005, aims to honor an internationally renowned researcher who has made influential contributions in the fields of finance, money and macroeconomics, and whose work has led to practice- and policy- relevant results. It is sponsored by the Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft*, a charitable foundation, and carries a cash award of €50,000.

The nomination process was extensive and involved a total of 4,000 economists from universities, central banks and research centers from 60 countries who made 265 nominations. It was up for the Jury, to select the prize winner in January 2013. The Jury itself consisted of leading international experts thereby ensuring exceptional academic standards are maintained and enhancing the credibility and reputation of the prize.

The previous recipients of the prize were Eugene Fama of the University of Chicago for “developing and investigating the concept of market efficiency – a cornerstone in the area of finance”, Michael Woodford of Columbia University for his fundamental contributions to “the theory and practical analysis of monetary policy”, Robert Shiller of Yale University for his “pioneering research in the field of financial economics, relating to dynamics of asset prizes and their metrics” and Kenneth Rogoff of Harvard University for “his work on sovereign default and debt restructuring, global imbalances, and the history of financial crises which is highly relevant for understanding and addressing today‘s global challenges.”

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CFS with new Managing Director

On 1 October 2013, Volker Brühl took over the newly created position of a Managing Director of the Center for Financial Studies. He will drive forward the Center's strategic development together with the Academic Directors Michael Haliassos, Jan Pieter Krahnen und Uwe Walz.

With his broad banking background Brühl will contribute to strengthening the profile of the CFS as a financial research center with a clear focus on applied research while, at the same time, stimulating the Center's successful role as a research based platform for a dialogue between academia, politics and industry – on an international scale.

Brühl has many years of experience as a top manager in banking: He was Partner at McKinsey & Company in Frankfurt between 2011 and 2013 and, before, Divisional Board Member of WestLB in Düsseldorf and Managing Director at Dresdner Kleinwort in Frankfurt. From 1997 to 2000, Brühl was Associate Partner at Roland Berger in Munich, and between 1993 and 1996 he worked for the Deutsche Bank in Frankfurt and London. Brühl earned his doctoral degree from the University of Gießen.

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CENTER FOR FINANCIAL STUDIES

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