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30 June 2014

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Michael Haliassos
Director, CFS

more

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn
- CFS Lecture: Adair Lord Turner of Ecchinswell

Research & Policy

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more

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more

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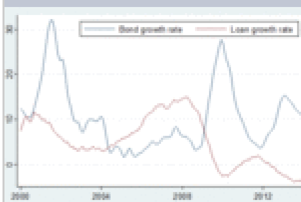

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more

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- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

more

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more

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more

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more

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International Research Forum on Monetary Policy

more

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more

Selected Upcoming Events

Please have a look at selected upcoming CFS events in the second half of 2014.

more

News

News

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more

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more

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
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Events

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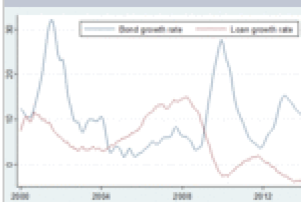

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- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

more

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Mistrust is often based on misunderstanding. A majority in the North is convinced that salaries and wages in the South are much too high to be competitive. Illuminating in this context is the competitiveness index regularly constructed by the European Central Bank, which takes into account changes in unit labor costs compared to other eurozone countries and their major trading partners. As Figure 1 shows, by the start of the fiscal crisis in 2009, all eurozone countries except for Germany and Austria had experienced deterioration in labor cost competitiveness relative to 1999 (blue bar). Among fiscally challenged countries Ireland and Greece were performing worst. Following the start of the fiscal crisis in 2009, the wage and salary cuts in Greece were so massive, that already by the second quarter of 2012, Greece was a eurozone champion, only second to Germany (green bar), further improving its rank in 2013 (purple bar).

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

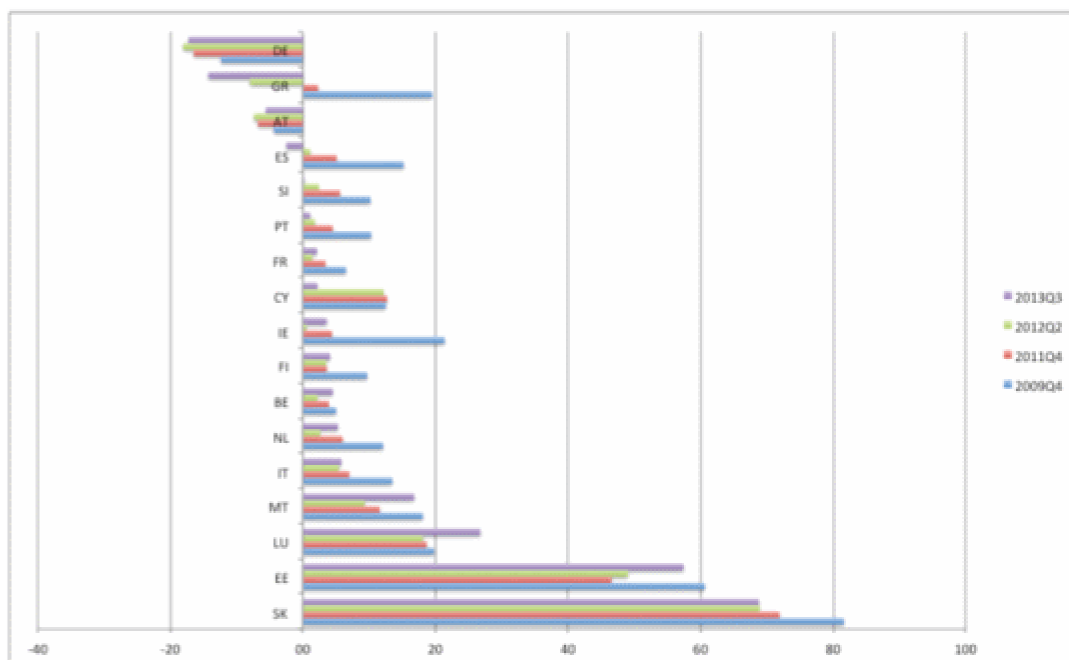

Figure 1: ECB Harmonized Competitiveness Index since Q1 1999. Source: ECB Statistical Data Warehouse

(click to enlarge)

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Cutting the Gordian Knot

How can the South cut the Gordian knot and propel itself to sustainable growth? In a nutshell, the South should focus on creating a dynamic, innovative, export-oriented productive base. It is imperative to promote entrepreneurship, research leading to innovation, and a lean public sector that fosters rather than hampering entrepreneurial initiatives.

What creates obstacles for entrepreneurship and innovation in the South? According to the World Economic Forum's Global Competitiveness Report (2013-14) the main obstacles in Greece were access to financing, inefficient government bureaucracy, tax regulations, and policy instability. Notice that high wage costs were not considered

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- Panel Discussion: Should Germany take a lead in Europe?
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- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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Figure 2: Question from the CFS Index Survey, April 2014

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What needs to be done

In Transparency International's Corruption Perception Index Greece finds itself in position 80 among 177 countries in 2013, just above Swaziland and Burkina Faso. According to the Ease of Doing Business 2014 report provided by the World Bank, Greece fell in the ranking of "enforcing contracts" from 91st to 98th place between 2013 and 2014. It now takes on average 1300 days to enforce contracts, compared to 529 days in the OECD. This is moving in the wrong direction!

Highly important for innovation is also the share of GDP contributed by the private and public sector to research and development. Greece and Italy find themselves in the lowest category in the European Union. By boosting such spending from about 0.7% to 1.5%, they can join Spain and Portugal at a much higher position.

But there is also good news: In the above mentioned Ease of Doing Business report, Greece's ranking in terms of "ease of starting a business" improved by 111 positions

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The analogy of the half-empty versus half-full bottle is well known. These statistics are not meant to discourage the South but to indicate what is possible to aim for. Greece should use the positive climate recently generated by the achievements on the deficit and bank recapitalization front and take big steps in the direction of reforms. Governments, but also industry and media in the North should help to break out of the vicious cycle of mistrust and to create a climate for more investment in the South.

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GO BACK
Return to content list

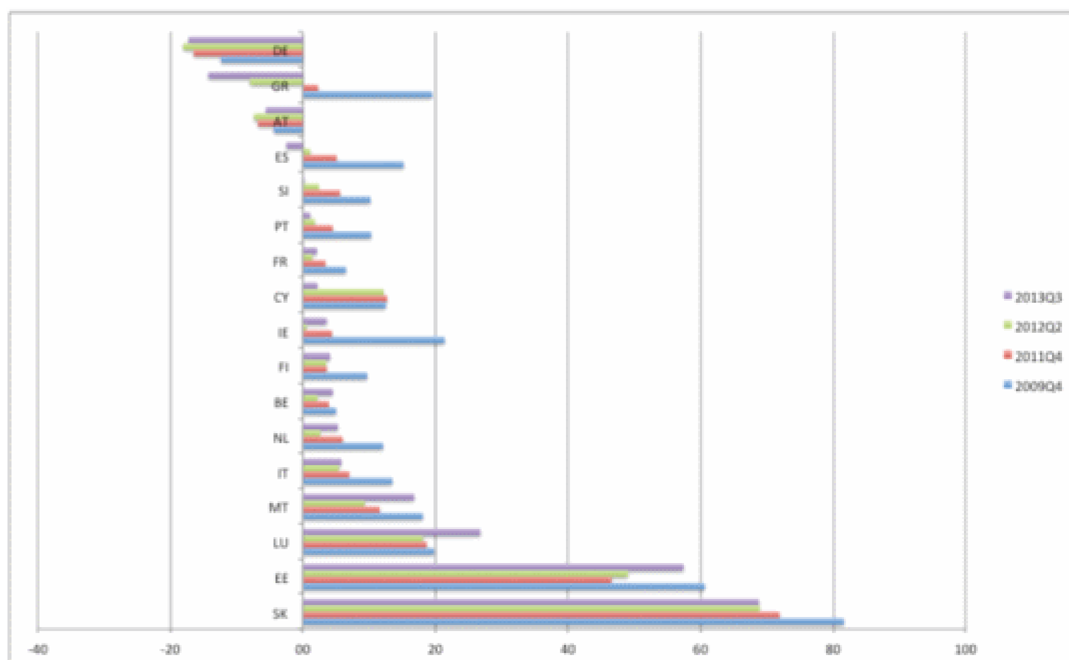
- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn



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- Panel Discussion: Should Germany take a lead in Europe?
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- Selected Upcoming Events

News

- News

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Monetary Policy and Balance Sheet Adjustment

by Otmar Issing, CFS President [1]

In the wake of the Global Financial Crisis that started in 2007, policymakers were forced to respond quickly and forcefully to a recession caused not by short-term factors, but rather by an over-accumulation of debt by sovereigns, banks, and households: a so-called "balance sheet recession." Though the nature of the crisis was understood relatively early on, policy prescriptions for how to deal with its consequences have continued to diverge.

Normal vs. balance sheet recessions

Already at an early stage of the crisis which erupted in 2007, a broad consensus emerged: all efforts had to be taken to avoid the mistakes of the past, and prevent the global economy from falling into a depression. Monetary policy and fiscal policy reacted quickly and forcefully.

However, it soon became evident that the major countries were not just confronted with a "normal" recession. Concerns of a panic in the financial system were visible in discussions about the threat of a "Minsky moment," that is, a sudden major collapse in asset values. Reinhart and Rogoff (2009) identified high indebtedness as the overriding characteristic of financial disasters in more than 60 countries over a period of eight

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

centuries. The worst case scenario is one where all three sectors—that is, the public, banking and private household sectors—accumulate unsustainable levels of debt, making an adjustment of balance sheets inevitable and necessary. The term "balance sheet recession," coined by Koo (2011), emphasizes this contrast to normal downturns. However, not all balance sheet recessions are the same. The main differences have to do with the number of sectors involved (Brunnermeier and Sannikov 2013a).

As short-term crisis management – at least so far – has been successful, discussions have shifted to the question of how long-term crisis resolution should be conducted. While there was a broad consensus as mentioned on the former, concerning the latter the harmony is gone and unusually strong disagreements have emerged (Borio 2014).

Divergent policy advice

What is the reason for a level of divergence in policy advice, which goes beyond what can be regarded as "usual"? For one, the crisis has revealed a dearth of models which are available to both analyze the emergence of the crisis and deliver substantiated advice for monetary policy actions (Bech et al. 2012). For a long time, even the "state of the art" macroeconomic models lacked a relevant financial sector. Improvements currently being presented are still far away from dealing adequately with a system that reacts to shocks in a non-linear and asymmetric fashion. Although there have been attempts to endogenize financial risk in dynamic stochastic general equilibrium models (Christiano et al. 2014), it is fair to conclude that this literature is still in its infancy and endogenous risk is therefore all too present (Brunnermeier and Sannikov 2014). As a consequence, there is a high risk in deriving recommendations for monetary policy based on insufficient or even wrong models (White 2009). Experience with balance sheet recessions in modern times is also quite limited, and its usefulness for us today is constrained by the fact that the financial system prevailing at the time of the Great Depression and the system of today differ substantially (Schularick and Taylor 2012).

Challenges for monetary policy

The key challenge for a central bank in crisis management is to prevent the economy from falling into deflation. The danger is not the negative inflation rate per se, but a process of accelerating deflationary expectations. Delaying purchases of goods today because of expectations of lower prices tomorrow is hardly observed. The biggest threat is a process of "debt deflation", as analyzed in all its stages and details by Irving Fisher (1932/2012).

A related phenomenon is the zero bound for the reduction of the central bank interest rate. True, avoiding the deflation trap is the foremost duty of the central bank. On the other hand, it is important to understand that disinflation is a necessary and positive corollary of the adjustment process. Disinflation (and even mild deflation) is not the original cause of the downturn, but rather the side effect of a correction process after the collapse of an unsustainable economic and financial boom.

For Hayek (1933/2012), an upswing is characterized by the buildup of distortions driven by credit expansion, and therefore the corresponding downswing has to bring about the necessary adjustments if a lasting recovery is to ensue: "To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it

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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

about…" (p. 21).

The biggest challenge for policy makers, meanwhile, is to find the right balance of smoothing the adjustment process, while not preventing it. As Praet (2013) puts it: "Crisis management has to complement, but should not obstruct, crisis resolution." The adjustment process following the identification of a balance sheet recession logically requires deleveraging, first and foremost of the financial sector. However, the need to both shrink the balance sheets of banks, and to react positively to low central bank interest rates by extending credit to non-financial firms, are in conflict with each other. Therefore, it is not surprising that, under these circumstances, monetary policy is less effective than in a normal recession (see e.g. White 2013).

A very low central bank interest rate opens up an opportunity for a kind of "stealth recapitalization" by banks (Brunnermeier and Sannikov 2013b), who can exploit the yield curve via purchases of government bonds. If, at the same time, the central bank lowers the conditions for the quality of collateral, it implements a reverse kind of Bagehot's lender of last resort scenario. In the extreme, "zombie banks" may be kept alive, which would in turn have two very unpleasant consequences. Firstly, it would interfere with the banking sector's much-needed self-correction process, which is necessary to return to a sustainable base. Secondly, zombie banks have a strong incentive to keep "zombie companies" alive to which they have given credit in the past. As a result, not only would the banking sector not be properly restructured, but neither would the non-financial sector, leading to what has been called the "Japanese disease." "Palliative measures" (Fisher 1932/2010) are simply no substitute for remedies.

In this context, it is interesting to note that for Fisher, the stability of the price level is an indispensable condition for a sustainable recovery, whereas Hayek argued that the "stabilizers" had already done harm enough. In our time, this issue is usually discussed under the headline: "is price stability enough?" when it comes to preserving or restoring financial stability.

This also raises the question of how long a policy of very low interest rates should be maintained. If the central bank uses the zero bound as a reason to justify a more accommodative monetary policy, and applies unorthodox measures of monetary easing, the problem becomes more acute. Even a huge increase in central bank money creation might not have the intended effect on the real economy. While the positive impact on the real economy declines, negative side effects will emerge and finally dominate (Borio 2014). The idea that an economy might have only a "corridor of stability" was developed by Leijonhufvud (2009). In such a case, the economy might enter the zone of instability when pushed too far, e.g. by an overly expansionary monetary policy.

Looking beyond the immediate management of the crisis, an orderly exit will be more daunting, the longer the expansionary monetary policy persists. Very low central bank interest rates induce banks to hold an increasing share of fixed income securities – mainly government bonds – which then makes them vulnerable to interest rate increases. A period of very low interest rates triggers a "search for yield" and, therefore, a high incentive to take higher risk.

The process of deleveraging is, if not stopped, at least heavily distorted. And new distortions are building up. There is, for example, the danger that the housing market—which had plunged during the downturn—will overreact, not least due to speculation in such a situation of very low interest rates. The extension of extremely easy monetary policy might end up leading to the repetition of past mistakes. Indeed, looking back over

more than two decades, White (2013) identifies a "serial bubble" problem (already identified to some extent by Hayek (1933/2012)).

A striking example is given by Blinder and Reis (2005), who argue that the "mop-up strategy" after the "mega bubble burst" in 2000 was a successful demonstration of how to deal with a financial crisis as no single sizable bank, brokerage or investment bank failed. The implication was clear: if the mopping-up strategy worked so well in the case of what they identify as a "mega-bubble burst," then it would also work after other, presumably smaller, bubbles burst in the future. But, what followed was instead the bursting of a much larger bubble. With this experience in mind, the lesson for the conduct of monetary policy after the collapse of financial markets should be quite different.

Finally, the practice of quantitative easing via outright purchases of government bonds connects monetary policy and fiscal policy in a dangerous way. The cheap financing of public spending might be seen as an effective way to conduct deficit spending, since it makes the fiscal multiplier higher. However, there is a high risk that this situation would hardly create any incentives for fiscal consolidation. Fiscal dominance might be the consequence, which would make it extremely difficult for the central bank to get out of the trap. The independence of the central bank – de jure and/or de facto – would be under threat.

Some key lessons

It is always difficult not to be overwhelmed by the complexity of a problem, or get lost in its confusing intricacies, when it comes to giving operational policy advice. However, some conclusions for how monetary policy should deal with a post-bubble-bursting situation can be drawn[2]:

1. The immediate reaction of monetary and fiscal policy should be fast and forceful.

2. After successful crisis management, nevertheless, any idea of a "quick fix" is both dangerous and misleading.

3. Balance sheet adjustment is an indispensable element of an encompassing policy approach. However, the deleveraging has to be done in such a way that it strengthens the system. "Bad" or even "ugly" versions must be avoided (Cœuré 2013). Reduction of indebtedness must include all sectors involved. Deleveraging, or rather restructuring, the banking sector is the key to sustainable future development. For this purpose, recapitalization of solvable banks is essential, as well as the elimination of institutions without a viable business model.

4. In cases where the financial system is mainly based on bank credit, restructuring of the banking sector should be accompanied by financial innovations outside the banking sector, which could help mitigate the impact of deleveraging on the real sector.

5. The longer the central bank conducts a monetary policy of very low interest rates and applies measures of quantitative easing, the more negative side effects will emerge. As the positive effects decline and become harder to identify, the overall balance of continuing on such an expansionary course might become negative

sooner rather than later. Therefore, the central bank must increasingly consider the challenge of how to organize an orderly exit from the expansionary policy.

6. The notion of the central bank as the institution to solve all problems has dangerous implications for the independence of the central bank. To be seen as "the only game in town" might, over time, turn into the role of the scapegoat for anything that goes wrong. In addition, a policy which transgresses the mandate of the central bank, and/or the frontier between monetary and fiscal policy, might raise questions about the legitimacy of the central bank's actions.

7. Looking beyond the horizon of the current crisis, the fundamental challenge for monetary policy is to prevent – as far as possible – the emergence of new bubbles. This can only be achieved if the central bank rejects the "mopping-up-only" strategy and applies an symmetric approach (Issing 2012).

Notes

1 I am grateful for valuable suggestions to Allan Meltzer, Massimo Rostagno, and William White.

2 For the specific aspects in an EMU context, see Draghi (2014). The international dimension would need a deeper analysis than can be provided here. See e.g. Caruana (2014).

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Trust, Trustworthiness, and Selection into the Financial Industry

by Andrej Gill (Goethe University), Matthias Heinz (University of Cologne), Heiner Schumacher (Aarhus University)

Andrej Gill
Goethe University

Matthias Heinz
University of Cologne

Trust is an essential feature of every transaction in the financial industry. If trust in its actors (brokers, bankers, financial advisors) is low, investors will be more cautious in making their money available to financial institutions. Unfortunately, there seems to be a general lack of trust and trustworthiness in the financial industry. The General Social Survey of the U.S. National Opinion Research Center reveals that trust in banks and bankers declined sharply during the last financial crisis. According to the 8th Consumer Markets Scoreboard of the European Commission, the financial service sector is viewed by consumers as substantially underperforming. This distrust seems to be warranted. Many financial corporations have been repeatedly accused of defrauding their private, business, and government clients. Field experiments have shown that financial advisers frequently propose products that generate fees for themselves but, on average, hurt the customer.

In this project, we examine whether the financial industry attracts less trustworthy people. A nascent literature in organizational economics analyzes selection and matching effects between individuals and organizations according to social motivations. Besley and Ghatak (2005) show in a

GO BACK
Return to content list

Editorial

Research & Policy

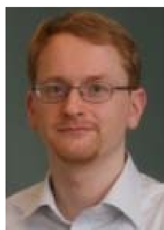
Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn



Heiner Schumacher
Aarhus University

principal-agent framework that workers who are motivated by a "mission" (such as saving lives, promoting justice or creating knowledge) self-select into occupations with moderate monetary incentives, while workers without such "mission motivation" choose occupations with steep incentives. It may therefore be the case that the financial industry with its materialistic values and high bonuses attracts rather selfish individuals.

Testing trust and selfishness

We invited students of business administration and economics from Goethe University Frankfurt to the experimental lab. They answered a number of survey questions, in particular, questions on professional preferences and experience, and played a trust-game. In the trust-game, a first-mover decides how much of an initial endowment she wants to send to the second-mover. This amount is tripled before reaching the second-mover. The second-mover then decides how much of the received amount she wants to send back to the first-mover. The final payoff for the first-mover is the amount she did not send plus the amount the second-mover sends back to her; the final payoff for the second-mover is the amount received minus the amount sent back to the first-mover. All subjects play the trust-game as first- and second-mover.

If both players were purely selfish, the second-mover would not return anything. Anticipating this, the first-mover would keep her initial endowment for herself. However, a large literature shows that this is not the usual outcome. In a typical study, first-movers send 50 percent of their endowment, and second-movers send back 95 percent of the first-mover's investment. Therefore, the first-mover's decision provides a measure for trust, and the second-mover's decision is a measure for trustworthiness.

The financial industry seems to attract less trustworthy individuals

Our experiment yields three main results. First, those with high interest in working in the financial industry (6 or 7 points on a Likert scale between 1 and 7) return 25 percent less than those with low finance interest (1 to 5 points on the Likert scale). This difference is mainly driven by a larger share of subjects who return nothing, regardless of the amount received, in the group of high finance interest subjects (36 percent) than in the group of low finance interest subjects (13 percent). As long as they return positive amounts, there is no difference in trustworthiness between high and low finance interest subjects.

Second, we observe that those with professional experience in finance (through vocational training or internships) return 25 percent less than those without such experience. However, the negative relationship between finance interest and trustworthiness also occurs in the subsample of subjects who do not have any professional experience in finance. We find no evidence that the extent of experience in the financial industry impacts on behavior. Thus, the financial industry seems to attract less trustworthy individuals, but working there does not necessarily corrupt one's character.

Third, we find no evidence that the financial industry actively screens out less

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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

trustworthy individuals in the hiring process. Those subjects with high finance interest, who applied for a job in the financial industry, but have (so far) no working experience in finance, are as trustworthy as those with finance experience.

A selection process costly for society

In a next step, we tried to find out whether the difference in trustworthiness between high and low finance interest subjects may explain the lack of trust in the financial industry. We invited students from all other faculties of Goethe-University Frankfurt to our experimental lab to play a prediction game that is strategically equivalent to the first-mover decision in a trust-game, against randomly chosen second-movers from the first experiment. Before subjects made their decision, they received information about their second-mover's professional preferences and experience. Thus, we can test whether there is a lack of trust in those fellow students who are interested in working in finance.

In this second experiment, we find that subjects trust those with high interest in working in finance significantly less than those with low interest. Second-movers with high finance interest receive 8 percent less than second-movers with low finance interest. Additional information about the second-mover's professional experience in the financial sector has no impact on the amount received. Hence, subjects on average correctly anticipate relative differences in trustworthiness. They seem to believe that the financial industry attracts less trustworthy individuals, but working there does not change a person's trustworthiness.

Given the importance of the financial industry for the economy, this selection process may be costly for society. There does not seem to be a simple solution. Regardless of previous professional experience, the share of least trustworthy individuals is largest in the group of those with high interest in working in finance, i.e., those most likely to apply for jobs there. Thus, hiring applicants with professional experience in other industries is not a solution. Making employment in the financial industry less attractive in terms of monetary rewards could be one way to change the pool of applicants. Indeed, one of the few significant differences in personal characteristics between low and high finance interest subjects is a relatively higher valuation of income in the latter group.

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The study was published as CFS Working Paper No. 458 and can be downloaded ***here****.*

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The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

by Orcun Kaya (Deutsche Bank Research) and Lulu Wang (CFS)

Corporate bond issuance in Europe became a focus of attention in the aftermath of the financial crisis. As Figure 1 shows, in the post-Lehman era, the growth rate of bonds peaked around 27% whereas the growth rate of bank loans – having reached a high at about 11% shortly before – even became negative at the same time. However, unlike in the United States – where tapping the bond market is inherent – debt capital market access in the eurozone is underdeveloped and corporations rely heavily on bank loans for financing.

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

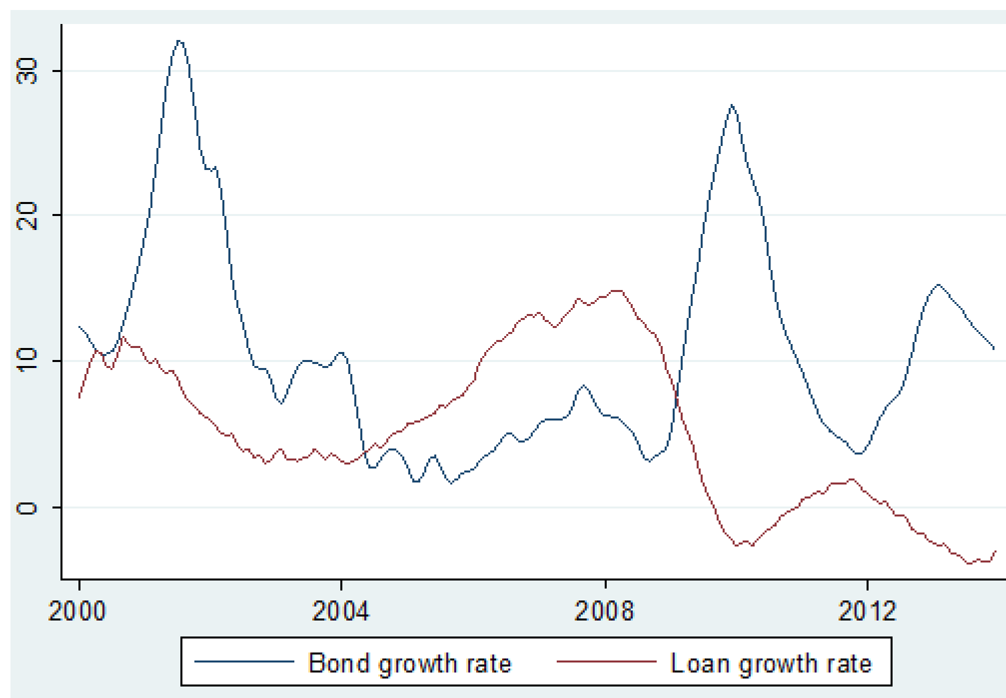

Figure 1: Annual growth rate of non-financial corporations' securities in the EU (%)

In this paper, we focus on the relation between the volume of non-financial corporations' (NFC) tapping the bond market and the availability of bank loans in the eurozone on an aggregate level using the bank lending survey of the European Central Bank.

The impact of bank loan tightening on corporate bond issuance

In a first step, we analyze the impact of bank loan tightening on corporate bond issuance in the eurozone. We concentrate on long term loans and loans to large enterprises for two reasons. The first is that availability of long term loans is an economically relevant measure as loans are usually supported by a company's collateral in the form of its assets and contain restrictive covenants detailing what the company can and cannot do financially during the term of the loan. Consequently, a change in the availability of this measure may create an impetus for bond issuance which also requires long term commitments such as annual coupon payments. The second reason is that there is a fixed cost of entering bond markets which makes it easier for large companies to obtain bond financing than small ones.

There are various triggers of bank loan tightening which require particular attention: (i) deleveraging in the banking sector which represents a constraint on banks' balance sheets and may affect the liquidity positions of banks; (ii) a sharp decline in bank profitability and deterioration of their capital cushions limiting banks' access to wholesale funding; (iii) a change in the banking sector's perception of risk which may curb banks willingness to provide credits. In this respect, changes in bank lending conditions and terms reflected by specific obligations agreed upon between banks and NFCs also need

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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

to be taken into account.

In a second step, we distinguish between different aspects of bank loan tightening and analyze their impact on corporate bond issuance. We focus on the cost of funds and balance sheet constraints of banks, banks' perception of risk as well as the restrictions on the conditions and terms for approving loans to enterprises. Specifically, we test whether the bank's capital positions, market financing rates and liquidity positions are determining factors in boosting bond issuance. We also test whether general economic activity, industry firm outlook and risk on collateral have a role on NFCs' use of the bond market. Moreover, we focus on whether tightening of other factors such as non-interest charges, the size of a loan, amount of collateral required, and loan covenants are relevant in determining the level of the bond issuance in the eurozone.

Cross-country heterogeneity in bank loan dependence and corporate bond issuance in Europe

Thirdly, we address the cross-country heterogeneity in the bank loan dependence and corporate bond issuance in Europe. Indeed, bond market volumes in peripheral eurozone economies such as Spain and Portugal are small compared to core countries like Germany and France. Therefore, a tradeoff between bank loans and corporate bond issuance could differ between core and peripheral countries and thus requires further attention.

To summarize, in a sample period of 2003 to 2013, we document that bank lending tightening played a central role in bond issuance in the eurozone. A 1 percentage point (pp) increase in banks' reporting considerable tightening on long term loans leads to an increase of about 7% in bond issuance in the eurozone. Similar figures are observable for a change in balance sheet constraints of banks or banks anticipating risks on general economic activity: A 1pp increase in banks' reporting considerable tightening in one of these factors points to a 5% to 17% increase in bond issuance. With regard to tightened terms, non-interest rate charges have the most significant impact: A 1pp increase in banks reporting considerable tightening leads to almost 20% increase in bond issuance. It is important to note, however, that changes in these factors do not usually reach the 1pp level. For instance, 40% of the banks, who report considerable tightening during the observation period, reported a change of less than 1pp which indicates that a 1pp increase in tightening is actually a considerable amount in this setting.

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CFS Presidential Lecture: Hans-Werner Sinn

"The real side of the crisis and the safety net of the ECB"

The crisis is not over and the ways that lead out of it are all miserable. This was the

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

message that Hans-Werner Sinn, President of the ifo Institute in Munich, conveyed to a large audience at Goethe University Frankfurt on February 26th. CFS President Otmar Issing had invited Sinn to give his talk "The real side of the crisis and the safety net of the ECB" as part of the CFS Presidential Lecture series.

Based on many numbers and comparative statistics, Sinn, at the outset, demonstrated that the current situation in crisis countries, which may seem to have calmed down, continues to be serious: shrinking current account balances are a result of decreasing imports, industrial production continues to be depressed, and unemployment is still high. Competitiveness is nowhere improving, with the exception of Ireland. The crisis countries in Southern Europe are still too expensive. This problem, which is not new, has grown from the time of the EU's eastern enlargement: salaries in Spain or Italy were double or threefold those in Poland or the Czech Republic. This difference is not justified by higher productivity, Sinn said.

Four miserable options

According to Sinn, there are only four options – all of them miserable – to make crisis countries competitive again: 1. A transfer union. 2. A real depreciation: crisis countries would need to implement even more drastic austerity programs; these would lead to insolvencies and mass unemployment which would induce salaries to sink and, in turn, improve competitiveness. No country would be able to undertake such a scenario, Sinn judged. 3. Inflation in the core countries, especially Germany: in Sinn's view, this option is not possible either. According to some calculations, Germany would need to appreciate by 70 percent. On the one hand, nobody knows how to achieve such a goal, on the other hand, the ECB would need to accept inflation rates higher than two percent for a longer period, which would be against its mandate. 4. Some member states exit the EU.

At the moment, the EU has embarked upon a path directed towards a transfer union seeking its "rescue in the printing press", Sinn said. This has been made possible by the system of Emergency Liquidity Assistance (ELA) as part of the European System of Central Banks (ESCB). Every central bank in the ESCB has been allowed to provide liquidity to national financial institutions at its own risk. Through this back door, Sinn said, central banks in the crisis countries have created huge amounts of money during the last years that have helped their economies to repay loans and maintain their standard of living. The money has been transferred to the core countries by consumption or the repayment of credits which has led to a significant rise in the so called "target" balances in the ESCB. "All money circulating in Germany at the moment was created in the crisis countries", Sinn explained.

According to his calculations, these indirect transfers add up to EUR 589 billion. Altogether, EUR 1,029 billion have flown from north to south since the beginning of the crisis – more than 30 "Marshall Plans". Only 38 percent of this was legitimated by

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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

parliamentary decisions, whereas the ECB alone is responsible for the remaining 62 percent, by granting ELA and (previously) by buying government bonds. This is a huge problem for democracy, Sinn argued.

An imminent constitutional crisis

It is only because of the ECB's OMT Program (Outright Monetary Transactions) and the promise to buy government bonds of crisis countries without limit, in case of emergency, that the current situation has calmed down, Sinn said. He reviewed, in detail, the decision of the German Constitutional Court (GCC) in early February. The Court has not, as many have written, delegated the decision to the European Court of Justice (ECJ), Sinn emphasized. In contrast, it has stated very clearly that the OMT Program is against the law, he said. In his view, the ECJ will not be able to decide against the GCC without provoking a constitutional crisis in Germany. The German Parliament would not be allowed to accept that the ECB – as a foreign power – would take control over the German budget. Therefore, Sinn assumes that both Courts will try to find a solution that, in the end, will set limits to the OMT. In his view, this is urgently necessary. The ECB should not reduce the steering potential of financial markets by buying government bonds. The spread of interest rates is a fundamental element of a monetary union. The Euro will never flourish without, he predicted.

As a way out of the crisis, Sinn demanded relief for government debt, bank debt and target debt at the expense of creditors. Nevertheless, it may not be avoidable, he argued, that some countries – he mentioned Greece – will need to temporarily leave the euro area. Not least, national central banks should give up some of their rights, in order to stop the increase in emergency credits. According to Sinn, the current path towards a transfer union will come to a dead end: "We are turning the countries of Europe into creditors and lenders. This is no policy of peace."

Muriel Büsser

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House of Finance | Goethe University Frankfurt
Grüneburgplatz 1 | 60323 Frankfurt | Germany
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CFS Lecture: Adair Lord Turner of Ecchinswell

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

On 10 February 2014, Adair Lord Turner of Ecchinswell, Senior Fellow of the CFS and the Institute for New Economic Thinking, gave a lecture on "Escaping the debt addiction: monetary and macro-prudential policy in the post crisis world". He argued that the financial crisis and the slow post-crisis recovery were first of all caused by excessive private credit creation. Up to now, the measures taken to combat the crisis have focused on public debt levels rather than on private ones. Therefore, Turner thinks that the currently introduced reforms are valuable but not addressing the fundamental cause of the crisis, the rising levels of private debt, which lead to economic and financial instability.

"Over several decades prior to 2008, private credit grew faster than GDP in most advanced economies and leverage therefore grew. That was a major cause of the crisis and the main reason why the post crisis recession was so deep and the recovery so slow and weak," the former Chairman of the Financial Services Authority said. Since the crisis, indebted private households and companies have decreased their consumption and investment expenditures to reduce their debt. As a result, growth has slowed down and public debt has risen.

According to Turner, the dilemma is that additional credit seemed essential to boost growth. But the question is whether a stable growth path is possible or whether growth is bound to generate harmful instability. Turner argued that more stable growth was possible but would require new policy approaches far beyond the reforms that have been introduced up to now. He explained that growth had become more credit intensive because of three factors: 1) increasing inequality between rich and poor, 2) global imbalances driven in part by a structural tendency towards excessive savings in some surplus countries and 3) extended credit growth to finance the purchase of existing assets (in particular real estate) whose price is then influenced endogenously by the quantity of the extended credit. Turner stressed that future financial reforms would have to address each of these three factors in order to restore stability.

Links:

Lecture presentation
Lecture text
References

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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Monetary Policy and Balance Sheet Adjustment

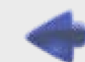
by Otmar Issing, CFS President [1]

In the wake of the Global Financial Crisis that started in 2007, policymakers were forced to respond quickly and forcefully to a recession caused not by short-term factors, but rather by an over-accumulation of debt by sovereigns, banks, and households: a so-called "balance sheet recession." Though the nature of the crisis was understood relatively early on, policy prescriptions for how to deal with its consequences have continued to diverge.

Normal vs. balance sheet recessions

Already at an early stage of the crisis which erupted in 2007, a broad consensus emerged: all efforts had to be taken to avoid the mistakes of the past, and prevent the global economy from falling into a depression. Monetary policy and fiscal policy reacted quickly and forcefully.

However, it soon became evident that the major countries were not just confronted with a "normal" recession. Concerns of a panic in the financial system were visible in discussions about the threat of a "Minsky moment," that is, a sudden major collapse in asset values. Reinhart and Rogoff (2009) identified high indebtedness as the overriding characteristic of financial disasters in more than 60 countries over a period of eight



GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

centuries. The worst case scenario is one where all three sectors—that is, the public, banking and private household sectors—accumulate unsustainable levels of debt, making an adjustment of balance sheets inevitable and necessary. The term "balance sheet recession," coined by Koo (2011), emphasizes this contrast to normal downturns. However, not all balance sheet recessions are the same. The main differences have to do with the number of sectors involved (Brunnermeier and Sannikov 2013a).

As short-term crisis management – at least so far – has been successful, discussions have shifted to the question of how long-term crisis resolution should be conducted. While there was a broad consensus as mentioned on the former, concerning the latter the harmony is gone and unusually strong disagreements have emerged (Borio 2014).

Divergent policy advice

What is the reason for a level of divergence in policy advice, which goes beyond what can be regarded as "usual"? For one, the crisis has revealed a dearth of models which are available to both analyze the emergence of the crisis and deliver substantiated advice for monetary policy actions (Bech et al. 2012). For a long time, even the "state of the art" macroeconomic models lacked a relevant financial sector. Improvements currently being presented are still far away from dealing adequately with a system that reacts to shocks in a non-linear and asymmetric fashion. Although there have been attempts to endogenize financial risk in dynamic stochastic general equilibrium models (Christiano et al. 2014), it is fair to conclude that this literature is still in its infancy and endogenous risk is therefore all too present (Brunnermeier and Sannikov 2014). As a consequence, there is a high risk in deriving recommendations for monetary policy based on insufficient or even wrong models (White 2009). Experience with balance sheet recessions in modern times is also quite limited, and its usefulness for us today is constrained by the fact that the financial system prevailing at the time of the Great Depression and the system of today differ substantially (Schularick and Taylor 2012).

Challenges for monetary policy

The key challenge for a central bank in crisis management is to prevent the economy from falling into deflation. The danger is not the negative inflation rate per se, but a process of accelerating deflationary expectations. Delaying purchases of goods today because of expectations of lower prices tomorrow is hardly observed. The biggest threat is a process of "debt deflation", as analyzed in all its stages and details by Irving Fisher (1932/2012).

A related phenomenon is the zero bound for the reduction of the central bank interest rate. True, avoiding the deflation trap is the foremost duty of the central bank. On the other hand, it is important to understand that disinflation is a necessary and positive corollary of the adjustment process. Disinflation (and even mild deflation) is not the original cause of the downturn, but rather the side effect of a correction process after the collapse of an unsustainable economic and financial boom.

For Hayek (1933/2012), an upswing is characterized by the buildup of distortions driven by credit expansion, and therefore the corresponding downswing has to bring about the necessary adjustments if a lasting recovery is to ensue: "To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it

about…" (p. 21).

The biggest challenge for policy makers, meanwhile, is to find the right balance of smoothing the adjustment process, while not preventing it. As Praet (2013) puts it: "Crisis management has to complement, but should not obstruct, crisis resolution." The adjustment process following the identification of a balance sheet recession logically requires deleveraging, first and foremost of the financial sector. However, the need to both shrink the balance sheets of banks, and to react positively to low central bank interest rates by extending credit to non-financial firms, are in conflict with each other. Therefore, it is not surprising that, under these circumstances, monetary policy is less effective than in a normal recession (see e.g. White 2013).

A very low central bank interest rate opens up an opportunity for a kind of "stealth recapitalization" by banks (Brunnermeier and Sannikov 2013b), who can exploit the yield curve via purchases of government bonds. If, at the same time, the central bank lowers the conditions for the quality of collateral, it implements a reverse kind of Bagehot's lender of last resort scenario. In the extreme, "zombie banks" may be kept alive, which would in turn have two very unpleasant consequences. Firstly, it would interfere with the banking sector's much-needed self-correction process, which is necessary to return to a sustainable base. Secondly, zombie banks have a strong incentive to keep "zombie companies" alive to which they have given credit in the past. As a result, not only would the banking sector not be properly restructured, but neither would the non-financial sector, leading to what has been called the "Japanese disease." "Palliative measures" (Fisher 1932/2010) are simply no substitute for remedies.

In this context, it is interesting to note that for Fisher, the stability of the price level is an indispensable condition for a sustainable recovery, whereas Hayek argued that the "stabilizers" had already done harm enough. In our time, this issue is usually discussed under the headline: "is price stability enough?" when it comes to preserving or restoring financial stability.

This also raises the question of how long a policy of very low interest rates should be maintained. If the central bank uses the zero bound as a reason to justify a more accommodative monetary policy, and applies unorthodox measures of monetary easing, the problem becomes more acute. Even a huge increase in central bank money creation might not have the intended effect on the real economy. While the positive impact on the real economy declines, negative side effects will emerge and finally dominate (Borio 2014). The idea that an economy might have only a "corridor of stability" was developed by Leijonhufvud (2009). In such a case, the economy might enter the zone of instability when pushed too far, e.g. by an overly expansionary monetary policy.

Looking beyond the immediate management of the crisis, an orderly exit will be more daunting, the longer the expansionary monetary policy persists. Very low central bank interest rates induce banks to hold an increasing share of fixed income securities – mainly government bonds – which then makes them vulnerable to interest rate increases. A period of very low interest rates triggers a "search for yield" and, therefore, a high incentive to take higher risk.

The process of deleveraging is, if not stopped, at least heavily distorted. And new distortions are building up. There is, for example, the danger that the housing market—which had plunged during the downturn—will overreact, not least due to speculation in such a situation of very low interest rates. The extension of extremely easy monetary policy might end up leading to the repetition of past mistakes. Indeed, looking back over

more than two decades, White (2013) identifies a "serial bubble" problem (already identified to some extent by Hayek (1933/2012)).

A striking example is given by Blinder and Reis (2005), who argue that the "mop-up strategy" after the "mega bubble burst" in 2000 was a successful demonstration of how to deal with a financial crisis as no single sizable bank, brokerage or investment bank failed. The implication was clear: if the mopping-up strategy worked so well in the case of what they identify as a "mega-bubble burst," then it would also work after other, presumably smaller, bubbles burst in the future. But, what followed was instead the bursting of a much larger bubble. With this experience in mind, the lesson for the conduct of monetary policy after the collapse of financial markets should be quite different.

Finally, the practice of quantitative easing via outright purchases of government bonds connects monetary policy and fiscal policy in a dangerous way. The cheap financing of public spending might be seen as an effective way to conduct deficit spending, since it makes the fiscal multiplier higher. However, there is a high risk that this situation would hardly create any incentives for fiscal consolidation. Fiscal dominance might be the consequence, which would make it extremely difficult for the central bank to get out of the trap. The independence of the central bank – de jure and/or de facto – would be under threat.

Some key lessons

It is always difficult not to be overwhelmed by the complexity of a problem, or get lost in its confusing intricacies, when it comes to giving operational policy advice. However, some conclusions for how monetary policy should deal with a post-bubble-bursting situation can be drawn[2]:

1. The immediate reaction of monetary and fiscal policy should be fast and forceful.

2. After successful crisis management, nevertheless, any idea of a "quick fix" is both dangerous and misleading.

3. Balance sheet adjustment is an indispensable element of an encompassing policy approach. However, the deleveraging has to be done in such a way that it strengthens the system. "Bad" or even "ugly" versions must be avoided (Cœuré 2013). Reduction of indebtedness must include all sectors involved. Deleveraging, or rather restructuring, the banking sector is the key to sustainable future development. For this purpose, recapitalization of solvable banks is essential, as well as the elimination of institutions without a viable business model.

4. In cases where the financial system is mainly based on bank credit, restructuring of the banking sector should be accompanied by financial innovations outside the banking sector, which could help mitigate the impact of deleveraging on the real sector.

5. The longer the central bank conducts a monetary policy of very low interest rates and applies measures of quantitative easing, the more negative side effects will emerge. As the positive effects decline and become harder to identify, the overall balance of continuing on such an expansionary course might become negative

sooner rather than later. Therefore, the central bank must increasingly consider the challenge of how to organize an orderly exit from the expansionary policy.

6. The notion of the central bank as the institution to solve all problems has dangerous implications for the independence of the central bank. To be seen as "the only game in town" might, over time, turn into the role of the scapegoat for anything that goes wrong. In addition, a policy which transgresses the mandate of the central bank, and/or the frontier between monetary and fiscal policy, might raise questions about the legitimacy of the central bank's actions.

7. Looking beyond the horizon of the current crisis, the fundamental challenge for monetary policy is to prevent – as far as possible – the emergence of new bubbles. This can only be achieved if the central bank rejects the "mopping-up-only" strategy and applies an symmetric approach (Issing 2012).

Notes

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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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Monetary Policy and Balance Sheet Adjustment

by Otmar Issing, CFS President [1]

In the wake of the Global Financial Crisis that started in 2007, policymakers were forced to respond quickly and forcefully to a recession caused not by short-term factors, but rather by an over-accumulation of debt by sovereigns, banks, and households: a so-called "balance sheet recession." Though the nature of the crisis was understood relatively early on, policy prescriptions for how to deal with its consequences have continued to diverge.

Normal vs. balance sheet recessions

Already at an early stage of the crisis which erupted in 2007, a broad consensus emerged: all efforts had to be taken to avoid the mistakes of the past, and prevent the global economy from falling into a depression. Monetary policy and fiscal policy reacted quickly and forcefully.

However, it soon became evident that the major countries were not just confronted with a "normal" recession. Concerns of a panic in the financial system were visible in discussions about the threat of a "Minsky moment," that is, a sudden major collapse in asset values. Reinhart and Rogoff (2009) identified high indebtedness as the overriding characteristic of financial disasters in more than 60 countries over a period of eight

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

centuries. The worst case scenario is one where all three sectors—that is, the public, banking and private household sectors—accumulate unsustainable levels of debt, making an adjustment of balance sheets inevitable and necessary. The term "balance sheet recession," coined by Koo (2011), emphasizes this contrast to normal downturns. However, not all balance sheet recessions are the same. The main differences have to do with the number of sectors involved (Brunnermeier and Sannikov 2013a).

As short-term crisis management – at least so far – has been successful, discussions have shifted to the question of how long-term crisis resolution should be conducted. While there was a broad consensus as mentioned on the former, concerning the latter the harmony is gone and unusually strong disagreements have emerged (Borio 2014).

Divergent policy advice

What is the reason for a level of divergence in policy advice, which goes beyond what can be regarded as "usual"? For one, the crisis has revealed a dearth of models which are available to both analyze the emergence of the crisis and deliver substantiated advice for monetary policy actions (Bech et al. 2012). For a long time, even the "state of the art" macroeconomic models lacked a relevant financial sector. Improvements currently being presented are still far away from dealing adequately with a system that reacts to shocks in a non-linear and asymmetric fashion. Although there have been attempts to endogenize financial risk in dynamic stochastic general equilibrium models (Christiano et al. 2014), it is fair to conclude that this literature is still in its infancy and endogenous risk is therefore all too present (Brunnermeier and Sannikov 2014). As a consequence, there is a high risk in deriving recommendations for monetary policy based on insufficient or even wrong models (White 2009). Experience with balance sheet recessions in modern times is also quite limited, and its usefulness for us today is constrained by the fact that the financial system prevailing at the time of the Great Depression and the system of today differ substantially (Schularick and Taylor 2012).

Challenges for monetary policy

The key challenge for a central bank in crisis management is to prevent the economy from falling into deflation. The danger is not the negative inflation rate per se, but a process of accelerating deflationary expectations. Delaying purchases of goods today because of expectations of lower prices tomorrow is hardly observed. The biggest threat is a process of "debt deflation", as analyzed in all its stages and details by Irving Fisher (1932/2012).

A related phenomenon is the zero bound for the reduction of the central bank interest rate. True, avoiding the deflation trap is the foremost duty of the central bank. On the other hand, it is important to understand that disinflation is a necessary and positive corollary of the adjustment process. Disinflation (and even mild deflation) is not the original cause of the downturn, but rather the side effect of a correction process after the collapse of an unsustainable economic and financial boom.

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- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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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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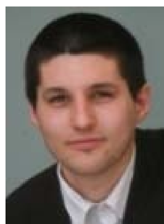
Trust, Trustworthiness, and Selection into the Financial Industry

by Andrej Gill (Goethe University), Matthias Heinz (University of Cologne), Heiner Schumacher (Aarhus University)

Andrej Gill
Goethe University



Matthias Heinz
University of Cologne

Trust is an essential feature of every transaction in the financial industry. If trust in its actors (brokers, bankers, financial advisors) is low, investors will be more cautious in making their money available to financial institutions. Unfortunately, there seems to be a general lack of trust and trustworthiness in the financial industry. The General Social Survey of the U.S. National Opinion Research Center reveals that trust in banks and bankers declined sharply during the last financial crisis. According to the 8th Consumer Markets Scoreboard of the European Commission, the financial service sector is viewed by consumers as substantially underperforming. This distrust seems to be warranted. Many financial corporations have been repeatedly accused of defrauding their private, business, and government clients. Field experiments have shown that financial advisers frequently propose products that generate fees for themselves but, on average, hurt the customer.

In this project, we examine whether the financial industry attracts less trustworthy people. A nascent literature in organizational economics analyzes selection and matching effects between individuals and organizations according to social motivations. Besley and Ghatak (2005) show in a

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

Heiner Schumacher
Aarhus University

principal-agent framework that workers who are motivated by a "mission" (such as saving lives, promoting justice or creating knowledge) self-select into occupations with moderate monetary incentives, while workers without such "mission motivation" choose occupations with steep incentives. It may therefore be the case that the financial industry with its materialistic values and high bonuses attracts rather selfish individuals.

Testing trust and selfishness

We invited students of business administration and economics from Goethe University Frankfurt to the experimental lab. They answered a number of survey questions, in particular, questions on professional preferences and experience, and played a trust-game. In the trust-game, a first-mover decides how much of an initial endowment she wants to send to the second-mover. This amount is tripled before reaching the second-mover. The second-mover then decides how much of the received amount she wants to send back to the first-mover. The final payoff for the first-mover is the amount she did not send plus the amount the second-mover sends back to her; the final payoff for the second-mover is the amount received minus the amount sent back to the first-mover. All subjects play the trust-game as first- and second-mover.

If both players were purely selfish, the second-mover would not return anything. Anticipating this, the first-mover would keep her initial endowment for herself. However, a large literature shows that this is not the usual outcome. In a typical study, first-movers send 50 percent of their endowment, and second-movers send back 95 percent of the first-mover's investment. Therefore, the first-mover's decision provides a measure for trust, and the second-mover's decision is a measure for trustworthiness.

The financial industry seems to attract less trustworthy individuals

Our experiment yields three main results. First, those with high interest in working in the financial industry (6 or 7 points on a Likert scale between 1 and 7) return 25 percent less than those with low finance interest (1 to 5 points on the Likert scale). This difference is mainly driven by a larger share of subjects who return nothing, regardless of the amount received, in the group of high finance interest subjects (36 percent) than in the group of low finance interest subjects (13 percent). As long as they return positive amounts, there is no difference in trustworthiness between high and low finance interest subjects.

Second, we observe that those with professional experience in finance (through vocational training or internships) return 25 percent less than those without such experience. However, the negative relationship between finance interest and trustworthiness also occurs in the subsample of subjects who do not have any professional experience in finance. We find no evidence that the extent of experience in the financial industry impacts on behavior. Thus, the financial industry seems to attract less trustworthy individuals, but working there does not necessarily corrupt one's character.

Third, we find no evidence that the financial industry actively screens out less

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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A selection process costly for society

In a next step, we tried to find out whether the difference in trustworthiness between high and low finance interest subjects may explain the lack of trust in the financial industry. We invited students from all other faculties of Goethe-University Frankfurt to our experimental lab to play a prediction game that is strategically equivalent to the first-mover decision in a trust-game, against randomly chosen second-movers from the first experiment. Before subjects made their decision, they received information about their second-mover's professional preferences and experience. Thus, we can test whether there is a lack of trust in those fellow students who are interested in working in finance.

In this second experiment, we find that subjects trust those with high interest in working in finance significantly less than those with low interest. Second-movers with high finance interest receive 8 percent less than second-movers with low finance interest. Additional information about the second-mover's professional experience in the financial sector has no impact on the amount received. Hence, subjects on average correctly anticipate relative differences in trustworthiness. They seem to believe that the financial industry attracts less trustworthy individuals, but working there does not change a person's trustworthiness.

Given the importance of the financial industry for the economy, this selection process may be costly for society. There does not seem to be a simple solution. Regardless of previous professional experience, the share of least trustworthy individuals is largest in the group of those with high interest in working in finance, i.e., those most likely to apply for jobs there. Thus, hiring applicants with professional experience in other industries is not a solution. Making employment in the financial industry less attractive in terms of monetary rewards could be one way to change the pool of applicants. Indeed, one of the few significant differences in personal characteristics between low and high finance interest subjects is a relatively higher valuation of income in the latter group.

References

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Trust, Trustworthiness, and Selection into the Financial Industry

by Andrej Gill (Goethe University), Matthias Heinz (University of Cologne), Heiner Schumacher (Aarhus University)

Andrej Gill
Goethe University

Matthias Heinz
University of Cologne

Trust is an essential feature of every transaction in the financial industry. If trust in its actors (brokers, bankers, financial advisors) is low, investors will be more cautious in making their money available to financial institutions. Unfortunately, there seems to be a general lack of trust and trustworthiness in the financial industry. The General Social Survey of the U.S. National Opinion Research Center reveals that trust in banks and bankers declined sharply during the last financial crisis. According to the 8th Consumer Markets Scoreboard of the European Commission, the financial service sector is viewed by consumers as substantially underperforming. This distrust seems to be warranted. Many financial corporations have been repeatedly accused of defrauding their private, business, and government clients. Field experiments have shown that financial advisers frequently propose products that generate fees for themselves but, on average, hurt the customer.

In this project, we examine whether the financial industry attracts less trustworthy people. A nascent literature in organizational economics analyzes selection and matching effects between individuals and organizations according to social motivations. Besley and Ghatak (2005) show in a

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

Heiner Schumacher
Aarhus University

principal-agent framework that workers who are motivated by a "mission" (such as saving lives, promoting justice or creating knowledge) self-select into occupations with moderate monetary incentives, while workers without such "mission motivation" choose occupations with steep incentives. It may therefore be the case that the financial industry with its materialistic values and high bonuses attracts rather selfish individuals.

Testing trust and selfishness

We invited students of business administration and economics from Goethe University Frankfurt to the experimental lab. They answered a number of survey questions, in particular, questions on professional preferences and experience, and played a trust-game. In the trust-game, a first-mover decides how much of an initial endowment she wants to send to the second-mover. This amount is tripled before reaching the second-mover. The second-mover then decides how much of the received amount she wants to send back to the first-mover. The final payoff for the first-mover is the amount she did not send plus the amount the second-mover sends back to her; the final payoff for the second-mover is the amount received minus the amount sent back to the first-mover. All subjects play the trust-game as first- and second-mover.

If both players were purely selfish, the second-mover would not return anything. Anticipating this, the first-mover would keep her initial endowment for herself. However, a large literature shows that this is not the usual outcome. In a typical study, first-movers send 50 percent of their endowment, and second-movers send back 95 percent of the first-mover's investment. Therefore, the first-mover's decision provides a measure for trust, and the second-mover's decision is a measure for trustworthiness.

The financial industry seems to attract less trustworthy individuals

Our experiment yields three main results. First, those with high interest in working in the financial industry (6 or 7 points on a Likert scale between 1 and 7) return 25 percent less than those with low finance interest (1 to 5 points on the Likert scale). This difference is mainly driven by a larger share of subjects who return nothing, regardless of the amount received, in the group of high finance interest subjects (36 percent) than in the group of low finance interest subjects (13 percent). As long as they return positive amounts, there is no difference in trustworthiness between high and low finance interest subjects.

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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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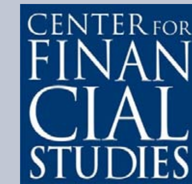

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The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

by Orcun Kaya (Deutsche Bank Research) and Lulu Wang (CFS)

Corporate bond issuance in Europe became a focus of attention in the aftermath of the financial crisis. As Figure 1 shows, in the post-Lehman era, the growth rate of bonds peaked around 27% whereas the growth rate of bank loans – having reached a high at about 11% shortly before – even became negative at the same time. However, unlike in the United States – where tapping the bond market is inherent – debt capital market access in the eurozone is underdeveloped and corporations rely heavily on bank loans for financing.

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

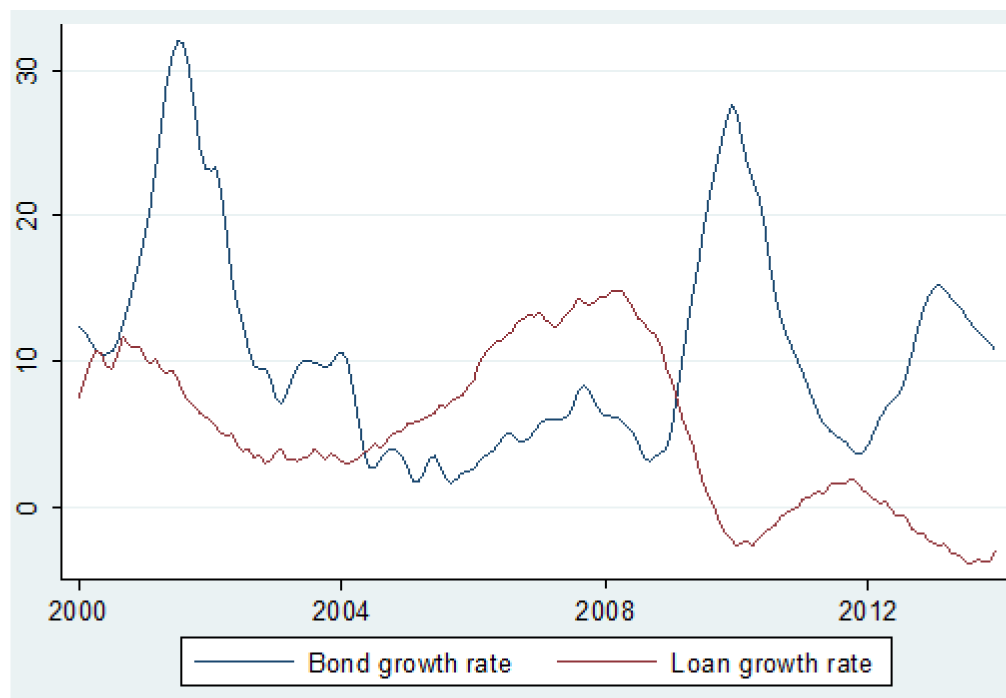

Figure 1: Annual growth rate of non-financial corporations' securities in the EU (%)

In this paper, we focus on the relation between the volume of non-financial corporations' (NFC) tapping the bond market and the availability of bank loans in the eurozone on an aggregate level using the bank lending survey of the European Central Bank.

The impact of bank loan tightening on corporate bond issuance

In a first step, we analyze the impact of bank loan tightening on corporate bond issuance in the eurozone. We concentrate on long term loans and loans to large enterprises for two reasons. The first is that availability of long term loans is an economically relevant measure as loans are usually supported by a company's collateral in the form of its assets and contain restrictive covenants detailing what the company can and cannot do financially during the term of the loan. Consequently, a change in the availability of this measure may create an impetus for bond issuance which also requires long term commitments such as annual coupon payments. The second reason is that there is a fixed cost of entering bond markets which makes it easier for large companies to obtain bond financing than small ones.

There are various triggers of bank loan tightening which require particular attention: (i) deleveraging in the banking sector which represents a constraint on banks' balance sheets and may affect the liquidity positions of banks; (ii) a sharp decline in bank profitability and deterioration of their capital cushions limiting banks' access to wholesale funding; (iii) a change in the banking sector's perception of risk which may curb banks willingness to provide credits. In this respect, changes in bank lending conditions and terms reflected by specific obligations agreed upon between banks and NFCs also need

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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In a second step, we distinguish between different aspects of bank loan tightening and analyze their impact on corporate bond issuance. We focus on the cost of funds and balance sheet constraints of banks, banks' perception of risk as well as the restrictions on the conditions and terms for approving loans to enterprises. Specifically, we test whether the bank's capital positions, market financing rates and liquidity positions are determining factors in boosting bond issuance. We also test whether general economic activity, industry firm outlook and risk on collateral have a role on NFCs' use of the bond market. Moreover, we focus on whether tightening of other factors such as non-interest charges, the size of a loan, amount of collateral required, and loan covenants are relevant in determining the level of the bond issuance in the eurozone.

Cross-country heterogeneity in bank loan dependence and corporate bond issuance in Europe

Thirdly, we address the cross-country heterogeneity in the bank loan dependence and corporate bond issuance in Europe. Indeed, bond market volumes in peripheral eurozone economies such as Spain and Portugal are small compared to core countries like Germany and France. Therefore, a tradeoff between bank loans and corporate bond issuance could differ between core and peripheral countries and thus requires further attention.

To summarize, in a sample period of 2003 to 2013, we document that bank lending tightening played a central role in bond issuance in the eurozone. A 1 percentage point (pp) increase in banks' reporting considerable tightening on long term loans leads to an increase of about 7% in bond issuance in the eurozone. Similar figures are observable for a change in balance sheet constraints of banks or banks anticipating risks on general economic activity: A 1pp increase in banks' reporting considerable tightening in one of these factors points to a 5% to 17% increase in bond issuance. With regard to tightened terms, non-interest rate charges have the most significant impact: A 1pp increase in banks reporting considerable tightening leads to almost 20% increase in bond issuance. It is important to note, however, that changes in these factors do not usually reach the 1pp level. For instance, 40% of the banks, who report considerable tightening during the observation period, reported a change of less than 1pp which indicates that a 1pp increase in tightening is actually a considerable amount in this setting.

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GO BACK
Return to content list

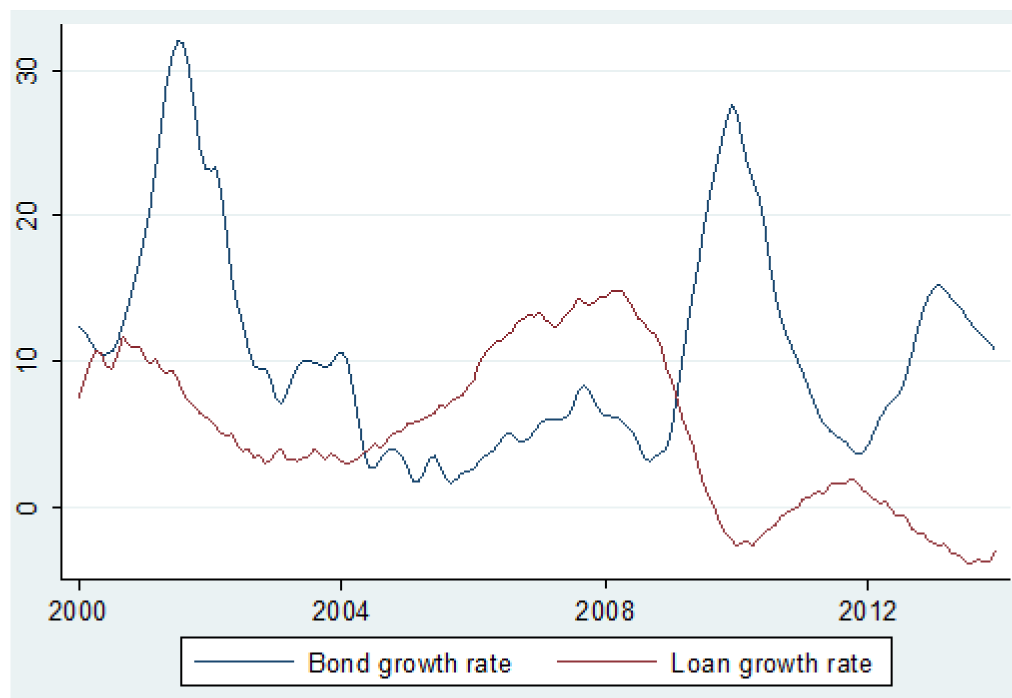
- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn



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- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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CFS Presidential Lecture: Hans-Werner Sinn

"The real side of the crisis and the safety net of the ECB"

The crisis is not over and the ways that lead out of it are all miserable. This was the

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

message that Hans-Werner Sinn, President of the ifo Institute in Munich, conveyed to a large audience at Goethe University Frankfurt on February 26th. CFS President Otmar Issing had invited Sinn to give his talk "The real side of the crisis and the safety net of the ECB" as part of the CFS Presidential Lecture series.

Based on many numbers and comparative statistics, Sinn, at the outset, demonstrated that the current situation in crisis countries, which may seem to have calmed down, continues to be serious: shrinking current account balances are a result of decreasing imports, industrial production continues to be depressed, and unemployment is still high. Competitiveness is nowhere improving, with the exception of Ireland. The crisis countries in Southern Europe are still too expensive. This problem, which is not new, has grown from the time of the EU's eastern enlargement: salaries in Spain or Italy were double or threefold those in Poland or the Czech Republic. This difference is not justified by higher productivity, Sinn said.

Four miserable options

According to Sinn, there are only four options – all of them miserable – to make crisis countries competitive again: 1. A transfer union. 2. A real depreciation: crisis countries would need to implement even more drastic austerity programs; these would lead to insolvencies and mass unemployment which would induce salaries to sink and, in turn, improve competitiveness. No country would be able to undertake such a scenario, Sinn judged. 3. Inflation in the core countries, especially Germany: in Sinn's view, this option is not possible either. According to some calculations, Germany would need to appreciate by 70 percent. On the one hand, nobody knows how to achieve such a goal, on the other hand, the ECB would need to accept inflation rates higher than two percent for a longer period, which would be against its mandate. 4. Some member states exit the EU.

At the moment, the EU has embarked upon a path directed towards a transfer union seeking its "rescue in the printing press", Sinn said. This has been made possible by the system of Emergency Liquidity Assistance (ELA) as part of the European System of Central Banks (ESCB). Every central bank in the ESCB has been allowed to provide liquidity to national financial institutions at its own risk. Through this back door, Sinn said, central banks in the crisis countries have created huge amounts of money during the last years that have helped their economies to repay loans and maintain their standard of living. The money has been transferred to the core countries by consumption or the repayment of credits which has led to a significant rise in the so called "target" balances in the ESCB. "All money circulating in Germany at the moment was created in the crisis countries", Sinn explained.

According to his calculations, these indirect transfers add up to EUR 589 billion. Altogether, EUR 1,029 billion have flown from north to south since the beginning of the crisis – more than 30 "Marshall Plans". Only 38 percent of this was legitimated by

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

parliamentary decisions, whereas the ECB alone is responsible for the remaining 62 percent, by granting ELA and (previously) by buying government bonds. This is a huge problem for democracy, Sinn argued.

An imminent constitutional crisis

It is only because of the ECB's OMT Program (Outright Monetary Transactions) and the promise to buy government bonds of crisis countries without limit, in case of emergency, that the current situation has calmed down, Sinn said. He reviewed, in detail, the decision of the German Constitutional Court (GCC) in early February. The Court has not, as many have written, delegated the decision to the European Court of Justice (ECJ), Sinn emphasized. In contrast, it has stated very clearly that the OMT Program is against the law, he said. In his view, the ECJ will not be able to decide against the GCC without provoking a constitutional crisis in Germany. The German Parliament would not be allowed to accept that the ECB – as a foreign power – would take control over the German budget. Therefore, Sinn assumes that both Courts will try to find a solution that, in the end, will set limits to the OMT. In his view, this is urgently necessary. The ECB should not reduce the steering potential of financial markets by buying government bonds. The spread of interest rates is a fundamental element of a monetary union. The Euro will never flourish without, he predicted.

As a way out of the crisis, Sinn demanded relief for government debt, bank debt and target debt at the expense of creditors. Nevertheless, it may not be avoidable, he argued, that some countries – he mentioned Greece – will need to temporarily leave the euro area. Not least, national central banks should give up some of their rights, in order to stop the increase in emergency credits. According to Sinn, the current path towards a transfer union will come to a dead end: "We are turning the countries of Europe into creditors and lenders. This is no policy of peace."

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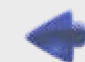
Panel Discussion: Should Germany take a lead in Europe?

Star investor George Soros, the President of the Kiel Institute of the World Economy Dennis Snower as well as Otmar Issing, President of the Center for Financial Studies, held a debate about the ongoing euro crisis and the role Germany should take in it on March 19. The panel discussion was presented by Michael Haliassos, CFS Director.



GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

While financial markets have recently calmed down, a solution to the sovereign debt crisis is still due. In his introductory remarks, Michael Haliassos reminded that the situation in Southern Europe is continually dramatic. Austerity programs and cuts have been implemented but no investments in innovation, growth or small businesses. As a result, high potentials have preferred to leave their country instead of vigorously trying to strengthen growth and exports.

The situation in the south is a collective problem for the whole of Europe and, therefore, needs to be dealt with collectively, George Soros demanded. In the recent past, he had promoted two options for Germany: take a lead in Europe or leave the monetary union. Now, in his view, only the first option is still on the table. Germany needs to accept its role as a benevolent hegemon in Europe. It must find a way to help the indebted countries out of the trap into which they had fallen. Soros suggested to impose a European corporate tax and use the revenues for programs against unemployment. This would result in a transfer that would decrease when economic adjustment increases.

According to Otmar Issing, it would be critical for Germany to take a leading role in Europe for historic reasons. Germany could lead as an example, not more. Soros sympathized with this position but said that Germany, de facto, already has this leading role. He did not agree with Issing with regard to Germany giving a good example. In his view, Germany imposed its policy on other countries but what was good for Germany might be inappropriate for the special situation of the crisis countries.

Dennis Snower argued against Issing's view that the crisis countries had caused their problems by their own policy mistakes and therefore were responsible for solving them. In some countries, it had been the private sector that had caused bubbles, others had suffered from spillover effects, Snower said. Therefore, crisis countries needed support. But the implementation of rules was also needed in order to lead to a sustainable situation in the long run. Issing agreed on that. It is not possible to find a solution to the deep problems of crisis countries in a rush, he said. But, for a single currency, you need rules and some kind of agreement. The objective must be to find a balance for the future.

Muriel Büsser

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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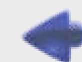
The ECB and Its Watchers XV

In the fifteenth year of the "The ECB and Its Watchers" conference, there are still many topics that are hotly debated among policy makers and market participants. In his opening remarks, Volker Wieland, co-organizer with Günter Beck, for the first time welcomed the participants at Goethe University's Westend Campus. The conference was jointly organized by CFS and the Institute for Monetary and Financial Stability (IMFS).



GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

Current issues in and challenges for central bank communication

The first session of the conference focused on central bank communication. Peter Praet (photo), member of the Governing Council of the European Central Bank (ECB), pointed out in his speech that opinions had fundamentally changed within the ECB. Since the ECB wants to benchmark the discussion, Praet connects his monthly presentations of monetary policy proposals with proposals on communication, he explained. Nevertheless, in the future the ECB does not plan on publishing the names of the members in the Governing Council, revealing who took which position in a discussion.

Charles Goodhart of the London School of Economics interpreted Praet's suggestions regarding greater transparency as an indication that the ECB was moving towards an individualistic committee rather than a collegial committee as it had asked to be from the outset (presentation).

Paul Sheard, Chief Global Economist of Standard and Poor's, emphasized the differences in the issues the various central banks had to face. Whereas the Federal Reserve and the Bank of England had been dealing with a "plain vanilla financial crisis", the ECB had to face existential questions whether the euro area as a construct would actually survive. According to Sheard, the complexity is much higher for the ECB.

Donald Kohn of Brookings Institution highlighted central bank communication as a key way to influence inflation expectation and financial conditions. "When the policy interest rate is extremely low, central banks are increasingly relying on words to influence financial conditions," he said. After the crisis, central banks needed to explain themselves better. However, they also needed to recognize the limits of communication, Kohn added.

Current challenges for the conduct of monetary policy in the euro area

Whether we were back to the "new normal" in the euro area now, ECB board member Benoit Cœuré (photo) deliberated on during the conference's second session, putting emphasis on the new set of questions that have arisen with inflation being low and remaining low (presentation).

Lucrezia Reichlin of London Business School particularly pointed out some of the key problems in the euroarea nowadays, looking at the fragility of banks and financial segmentation. "Although we are in a recovery, nominal GDP is still very weak", Reichlin warned. In her opinion the ECB has to experiment with new tools and clarify its view on the tradeoffs (presentation).

Whether the ECB does have enough policy measures Lars E.O. Svensson of Stockholm University discussed during his presentation, indicating the big difference that might occur between the official policy rate and the Eonia rate. "Why not have a smaller corridor?" Svensson suggested, citing the Riksbank's fine-tuning system as an example. Concerning negative interest rates Svensson appealed to the ECB not to be nervous about experimenting.

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

John B. Taylor (photo) of Stanford University especially focused on the consequences of unconventional monetary policy. Looking at the Federal Reserve, forward guidance had been unpredictable Taylor pointed out. Analyzing possible exit strategies, Taylor called for a more rules-based system with the central banks explaining the deviations. Most of all, "an exit should include a statement about the policy strategy in the future", Taylor said (presentation).

Challenges for the ECB resulting from its double role as monetary policy maker and financial supervisor

The challenges the ECB has to face as banking supervisor were in the center of the conference's third session. In this regard, ECB board member Yves Mersch referred to the protection of the monetary policy independence as the first objective. Furthermore, talking about individual corporations and decisions, Mersch mentioned confidentiality as another objective.

In his speech, Stefan Gerlach, Deputy Governor of the Bank of Ireland, reminded the participants of the fact that central banks had been the original supervisors and that supervision was not a new activity for central banks. According to Gerlach, separation of monetary policy and supervision is done very differently in various countries. "There is no one size fits all", Gerlach added.

For Nouriel Roubini, however, there is a much bigger dilemma for central banks than the separation of banking supervision and monetary policy. "All central banks were created in the first place to achieve financial stability," he said. Thus, central banks have to deal with two goals, price stability and financial stability. "But central banks do not know if they have the second instrument to do it right," he concluded.

As the ECB is taking on the responsibilities of banking supervision, for Dirk Schoenmaker of Duisenberg School of Finance the ECB is now becoming a full central bank. From the experience in the Netherlands, Schoenemaker gave the advice that the head of banking supervision should appear on television and in parliament if something happened in the banking sector, not the governor of the central bank, thus, avoiding reputational risks (presentation).

After these discussions, co-organizer and IMFS research fellow Günter Beck, who will take over the responsibilities as sole organizer of the next ECB watcher conference, saw off the participants.

Natascha Lenz

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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International Research Forum on Monetary Policy

March 21-22, 2014 | Federal Reserve Board | Washington, D.C.

Sponsored by: European Central Bank, Federal Reserve Board, Georgetown Center for Economic Research, Center for Financial Studies

International Research Forum on Monetary Policy

The papers presented at the eighth conference of the **International Research Forum on Monetary Policy** (IRFMP) focused on a broad set of themes which included various facets of the interaction between monetary, macroprudential and fiscal policies; the role of financial intermediaries in the economy; and on the causes and consequences of the protracted recovery from the Great Recession. The conference was co-sponsored by the Federal Reserve Board (FRB), the European Central Bank (ECB), the Georgetown Center for Economic Research (GCER) at Georgetown University and the Center for Financial Studies.

Constraints on interest rate adjustment by central banks – due either to the zero lower bound, or currency union membership – have played an important role in accounting for a grindingly slow recovery from the financial crisis. The conference paper entitled "The Role of Macroprudential Policies" highlighted how such constraints may make it desirable to adopt macroprudential policies that limit the scope for borrowing by households, firms, or sovereigns. The paper "Credit Spreads and Credit Policies" showed how an activist fiscal policy – using credit subsidies to offset the impact of weak credit conditions – could be an effective stabilization tool when monetary policy was constrained.

Potential sources of inflation risk

Two other papers drew attention to potential sources of inflation risk. In particular, "When Does a Central Bank Balance Sheet Require Fiscal Support?" examines conditions

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

under which a central bank balance sheet expansion associated with unconventional monetary policy actions may cause inflation expectations to become unanchored. "Coordination and Crisis in a Monetary Union" shows how the incentives of the monetary authority in a currency union to run inflation above target depend on the debt of member states, and argues that debt limits on sovereigns may be desirable keeping inflation low and stable.

Several other papers focused on the role of financial intermediaries both in the transmission of shocks and of monetary policy. "Bank Leverage Cycles" analyzed the channels through which a rise in macroeconomic volatility could lead to a tightening of credit conditions, while "Booms and Banking Crises" modeled how a buildup of leverage during a boom can sow the seeds of a subsequent bust. "Banks, Liquidity Management, and Monetary Policy" developed a framework analyzing the portfolio choice of banks between making loans and holding reserves, and considered implications for monetary policy.

Finally, several papers considered the impact of the Great Recession for labor market developments, productivity, and inflation. "Slow Recoveries, Worker Heterogeneity, and the Zero Lower Bound" examined how deep recessions can leave long-lasting scars on the labor market and impair job-matching efficiency. "Reallocation in the Great Recession: Cleansing or Not?" showed that productivity growth associated with reallocation of factors (including labor) to more efficient firms slowed markedly during the Great Recession, in contrast to the pattern of previous recessions dating to the early 1980s. "Inflation Dynamics during the Financial Crisis" shows how balance sheet constraints affected the price-setting decisions of firms, and helped account for some of the resilience of inflation in light of the severe output downturn.

Transitional and longer-term challenges for monetary policy

The conference also fostered exchange between researchers and policymakers by featuring a panel discussion on the topic of "transitional and longer-term challenges for monetary policy" and two keynote speeches. The panelists Stephen Cecchetti (Brandeis University), Spencer Dale (Bank of England), Narayana Kocherlakota (Federal Reserve Bank of Minneapolis), and Lars Svensson (Stockholm University), focused their discussion on the use of forward guidance by central banks, and the question whether and when financial stability risks should be addressed through interest rate policy. Stephen Cecchetti argued that while monetary policy in principle could be used to curtail risk-taking behavior, available evidence suggested that it was not likely to be very efficacious in practice. Spencer Dale portrayed forward guidance as a tool to provide information to the public about how a central bank was likely to resolve tradeoffs between conflicting objectives. By emphasizing the economic conditionality, forward guidance can serve as a vehicle for explaining the central bank's reaction function, thereby enhancing the effectiveness of monetary policy by helping the public anticipate the response of monetary policy to unforeseen events.

Concerning the use of the central bank's interest rate tool to address incipient threats to financial stability, Narayana Kocherlakota framed the question as what level of macroeconomic underperformance (such as higher unemployment) the central bank ought to accept in order to reduce the probability of a financial crisis occurring. This depended on the economic damage in the event that a crisis occurred, and the effect of a change in interest rates on the crisis probability. He argued that the evidence at this time suggested that policymakers should be willing to sacrifice very little in terms of

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

macroeconomic performance for the sake of reducing the probability of a renewed crisis. Lars Svensson argued that the Swedish Riksbank's policy of raising interest rates in 2010 to lean against rising household debt-to-income ratios had been very costly insofar as it had boosted unemployment and caused inflation to run below target, while doing little to promote financial stability.

The appropriate monetary policy response to financial stability risks

The appropriate monetary policy response to financial stability risks was also the topic of the keynote speech by Federal Reserve Board Governor Jeremy Stein, who emphasized that greater attention be paid to interest rate spreads to measure financial market vulnerabilities to complement the focus on measures of leverage that has dominated the literature since the financial crisis. Large negative returns on certain assets give rise to financial stability risks, but there are many empirical studies showing that a large fraction of these returns is predictable. Thus, from a policymaker's perspective, predictors of future negative returns could provide useful inputs for the monetary policy framework. The keynote speech by ECB Vice President Vitor Constâncio returned to the theme of forward guidance by explaining recent innovations in ECB communications. He also highlighted recent progress on the path towards a banking union in the euro area.

Thomas Laubach (FRB & CFS)

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 Lecture Series on "The Order of Money"

The Great Depression of the 1930s stimulated an intensive and extremely fruitful debate in the field of economics. In 1933, economists from Chicago around Henry Simons, Frank Knight and Irving Fisher presented a radical plan to abolish the fractional reserve banking system. Their approach went down in history as the “Chicago Plan”. Three years later, John Maynard Keynes published his “General Theory of Employment, Interest and Money”. Both Joseph Schumpeter’s “Capitalism, Socialism, and Democracy” (1942) and Friedrich August von Hayek’s “Road to Serfdom” (1944) were also affected by the events of that time. In contrast, the debate after the financial crisis of 2007 to 2009 has been rather modest. Economists have largely stuck to well-established principles and have shied away from a discussion with social groups and heterodox economists who have drawn far-reaching lessons from the financial crisis. With the CFS Lecture Series on the Order of Money we have tried to escape this narrow “mainstream” debate by discussing unconventional ideas to improve our monetary and financial system.

The European Central Bank is too weak

In June 2013, the series started with Jesus Huerta de Soto, Professor of the Rey Juan Carlos University, who defended the euro from the perspective of the Austrian School of Economics. According to Huerta de Soto, the reason for the instability of our monetary system is the constructivist monetary policy of central banks and the fractional reserve system of commercial banks. In the European Monetary Union (EMU), the European Central Bank (ECB), established as a supra-national central bank independent from

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

politics, would have provided the opportunity to, at least, correct the first defect of our monetary system. If the ECB had taken its mandate seriously, it could have acted as a catalyst for necessary structural adjustments and could have caused greater economic stability. Unfortunately, the ECB did not take this opportunity and, thus, has not protected the euro area against the global glut of credit and money which has been created by the U.S. Federal Reserve since 2001.

Martin Hellwig (Max Planck Institute for Research on Collective Goods) outlined the role of monetary policy in the conflict between price stability, financial stability and the burden for tax payers. His main topics were (i) the role of the banking system in the context of the monetary system and the importance of financial stability for monetary policy, (ii) the significance of central bank policy for the budgetary interests of states and (iii) the importance of central bank independence. Hellwig considered the future of the EMU rather critical. In his view, the ECB's position is too weak to successfully defend itself against governments that try to blackmail it to help themselves or "their" banks. Even the banking union will not solve this problem, Hellwig said.

Like Huerta de Soto, Joseph Huber (Martin Luther University of Halle-Wittenberg) criticized the present policies of central banks and the fractional reserve system that, in his view, leads to the recurring problem of excessive money creation. As a solution to this problem, he pleads for replacing deposit money, which is created by banks in collaboration with central banks, with "sovereign money". Huber defines sovereign money as unlimitedly valid legal tender that is issued by an independent central bank. In such a system, the central bank would de facto be upgraded to a fourth state authority, a "monetative authority", which executes the sovereign right to issue money and to receive the seigniorage gains.

Safe bank deposits and parallel currencies

Daniel Gros (Centre for European Policy Studies) and Thomas Mayer (CFS) discussed the prospects for implementing the planned banking union. Do we need a "euro state" to continue on the currently chosen way? Do we get stuck half-way if European citizens refuse to further transfer sovereignty rights from the national to the EU level? Is it possible to create a banking union without a further communitarisation of risks? While Gros, in general, agrees with the way chosen by European politicians, Mayer votes for a different solution which is based on a "safe bank deposit" completely covered with central bank money.

Roland Vaubel (University of Mannheim) considered parallel currencies as a contribution to solve the euro crisis. With parallel currencies, groups of countries could adjust their international competitiveness by depreciating or appreciating against the euro without formally leaving the EMU. In general, parallel currencies

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

would provide money consumers with more freedom of choice , so that they could better protect themselves against inflation. Also, a currency "market", on which central banks would have to compete against each other, would limit inflationary monetary policy.

In his lecture, Helge Peukert (University of Erfurt) presented basic elements for a stable financial system. Like Huber, Peukert voted for a sovereign money system. Furthermore, he pleaded for a strict regulation of the financial sector that should include (i) shrinking the sector and large institutes; (ii) separating commercial and investment banking; (iii) introducing a 30 percent equity ratio; (iv) prohibiting certain financial products (e.g. Credit Default Swaps); (v) introducing financial transaction taxes and (vi) a wealth tax on capital income above 50,000 euro.

Different views on how to reform the monetary system

Stephan Balling (bibliomed) looked into the works of four influential economists – von Hayek, Walter Eucken, Milton Friedman and Joseph Schumpeter – and their views on the order of money. He compared the "neoliberal" economists Hayek, Eucken and Friedman to the development economist Schumpeter. While the neoliberals regarded the credit money system more or less as critical, Schumpeter considered credit creation out of nothing as the "monetary counterpart of an innovation". He wrote: "In the capitalist society, the issuing of newly created money for innovations corresponds to the order of the central bureau in a socialist state, because our companies have no own assets and – so far – no savings."

Thorsten Polleit (Degussa Goldhandel) agreed with Huerta de Sotos' criticism of the fractional reserve system by outlining the Austrian business cycle theory. An increase in money supply through higher credit supply leads to a rise in the production of capital goods which cannot be financed with the available macroeconomic savings in the economy. Therefore, a boom leads inevitably to a bust. Hence, economic stability is not possible in a credit money system.

In his "Notes on how to institutionally ensure a stable value of the currency", Otmar Issing (CFS) recalled several proposals on how to reform the monetary system. Although Issing considered the economic models, on which central banks base their current monetary policy strategy, rather critical, he was not convinced that the known proposals on reforms of the money system would provide a viable alternative to our existing system.

Timm Gudehus, consultant, researcher and author, discussed the concept of a

monetary system with security accounts, which would be completely covered with reserves at the central bank. He outlined how the introduction of these security accounts could lead to a smooth transition to a money system without deposit money. The process would result in a new money system that would correspond to the 100%-money-concept by Henry Simons/Irving Fisher, the sovereign money reform by Joseph Huber and James Robertson and similar proposals by Maurice Félix Charles Allais, Milton Friedman and Walter Eucken.

Macroprudential policies cannot solve all problems

Finally, Valerie Herzberg (member of the cabinet of EU President Herman van Rompuy) discussed the role of macroprudential policy to supplement monetary policy in the goal of achieving financial stability. Herzberg cautioned, that not too much should be expected from macroprudential policy. In the end, interest rate policy remained a very powerful instrument. Hence, macroprudential policy could only succeed when it is deployed with, and not against interest rate policy.

During the last twelve months the seminar series has become a forum for critical discussion about our existing monetary system and reform proposal. As there still remains a lot to be discussed even after eleven lectures, future events in this series are already planned.

Thomas Mayer (CFS Senior Fellow)

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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Selected Upcoming Events

08 July 2014	*CFS Colloquium* **Prof. Dr. Christian Leuz**, *University of Chicago Booth School of Business* "Accounting Standards and Financial Stability: Need for Reform?"
10 Sep 2014	*CFS Presidential Lecture* **Prof. Dr. Axel A. Weber**, *UBS* "Zukunftsperspektiven des Europäischen Bankensystems:

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

	"Herausforderungen und Chancen"
08 Oct 2014	*CFS Colloquium* **Dr. Maximilian Zimmerer**, *Allianz SE* "Herausforderungen für Investoren in Zeiten niedriger Zinsen"
22 Oct 2014	*CFS Colloquium* **Prof. Dr. Martin Hellwig**, *Max-Planck-Institut zur Erforschung von Gemeinschaftsgütern* "Warum reichen die bisherigen Reformen der Bankenregulierung nicht aus?"
05 Nov 2014	*CFS Colloquium* **Adair Lord Turner of Ecchinswell**, *CFS & Institute for New Economic Thinking* "Risk: The Global Perspective"
03 Dec 2014	*CFS Colloquium* **Prof. Harold James, Ph.D.**, *Princeton University* "Handling the risks of sovereign defaults: An alternative"

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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News

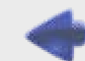
CFS cooperates with Fudan University, Shanghai

On 23 May 2014, Fudan University, Shanghai, and the Center for Financial Studies co-organized the 2014 Shanghai-Frankfurt International Finance Forum. Conference participants, including a number of speakers from CFS and Goethe University Frankfurt, exchanged views on “Financial Innovation and Financial Stability: The European Experience and the Choice of China”. The conference was followed by the 2014 Shanghai Forum, a three-day-event dealing with the transformation processes in Asia. The speakers included ECB Board Member Yves Mersh and Nobel laureate Robert J. Shiller.

The next conference co-organized by CFS and Fudan University's Financial Research Center will be held in Frankfurt in September 2015 – prospectively under the headline of “Integration”. There will be an open part that should bring together academics, practitioners, policy makers and central bankers and a closer academic session that offers researchers from Shanghai and Frankfurt the opportunity to present recent papers, exchange views and share information about data access.

Athansios Orphanides talks about “The Yellen Fed”

On 5 May 2014, CFS Senior Fellow Athanasios Orphanides gave a talk about current developments and challenges in the U.S. monetary policy on


GO BACK
Return to content list

Editorial

Research & Policy

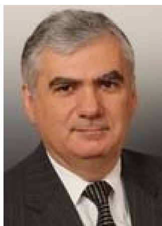
Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn



the occasion of the recent inauguration of Janet Yellen as President of the Federal Reserve Board. Athanasios Orphanides is a CFS senior fellow and Professor at the MIT Sloan School of Business. He is a former member of the Governing Council of the European Central Bank and Senior Adviser to the Federal Reserve Board. The event was exclusive to CFS supporting members on board level.

Conference on "Corporate Restructuring – Perspectives 2014"

On 18 March 2014, the CFS hosted a conference for practitioners on corporate restructuring organized by Volker Brühl, CFS Managing Director, and Burkard Göpfert, Partner with Baker &McKenzie Munich. More than 50 decision-makers from banking, consultancy and international law firms discussed current trends in corporate restructuring. Experts from Roland Berger, Alix Partners, Macquarie Capital, Baker & McKenzie, Dentons as well as Schulze & Braun presented case studies of new developments in financial corporate restructuring and shared their experiences with the ESUG (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen). Furthermore, legal and economic characteristics of complex cross-border insolvency cases were discussed.

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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info@ifk-cfs.de | www.ifk-cfs.de

Editor: Dr. Muriel Büsser, Head of Communication

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CFS Presidential Lecture: Hans-Werner Sinn

"The real side of the crisis and the safety net of the ECB"

The crisis is not over and the ways that lead out of it are all miserable. This was the

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

message that Hans-Werner Sinn, President of the ifo Institute in Munich, conveyed to a large audience at Goethe University Frankfurt on February 26th. CFS President Otmar Issing had invited Sinn to give his talk "The real side of the crisis and the safety net of the ECB" as part of the CFS Presidential Lecture series.

Based on many numbers and comparative statistics, Sinn, at the outset, demonstrated that the current situation in crisis countries, which may seem to have calmed down, continues to be serious: shrinking current account balances are a result of decreasing imports, industrial production continues to be depressed, and unemployment is still high. Competitiveness is nowhere improving, with the exception of Ireland. The crisis countries in Southern Europe are still too expensive. This problem, which is not new, has grown from the time of the EU's eastern enlargement: salaries in Spain or Italy were double or threefold those in Poland or the Czech Republic. This difference is not justified by higher productivity, Sinn said.

Four miserable options

According to Sinn, there are only four options – all of them miserable – to make crisis countries competitive again: 1. A transfer union. 2. A real depreciation: crisis countries would need to implement even more drastic austerity programs; these would lead to insolvencies and mass unemployment which would induce salaries to sink and, in turn, improve competitiveness. No country would be able to undertake such a scenario, Sinn judged. 3. Inflation in the core countries, especially Germany: in Sinn's view, this option is not possible either. According to some calculations, Germany would need to appreciate by 70 percent. On the one hand, nobody knows how to achieve such a goal, on the other hand, the ECB would need to accept inflation rates higher than two percent for a longer period, which would be against its mandate. 4. Some member states exit the EU.

At the moment, the EU has embarked upon a path directed towards a transfer union seeking its "rescue in the printing press", Sinn said. This has been made possible by the system of Emergency Liquidity Assistance (ELA) as part of the European System of Central Banks (ESCB). Every central bank in the ESCB has been allowed to provide liquidity to national financial institutions at its own risk. Through this back door, Sinn said, central banks in the crisis countries have created huge amounts of money during the last years that have helped their economies to repay loans and maintain their standard of living. The money has been transferred to the core countries by consumption or the repayment of credits which has led to a significant rise in the so called "target" balances in the ESCB. "All money circulating in Germany at the moment was created in the crisis countries", Sinn explained.

According to his calculations, these indirect transfers add up to EUR 589 billion. Altogether, EUR 1,029 billion have flown from north to south since the beginning of the crisis – more than 30 "Marshall Plans". Only 38 percent of this was legitimated by

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

parliamentary decisions, whereas the ECB alone is responsible for the remaining 62 percent, by granting ELA and (previously) by buying government bonds. This is a huge problem for democracy, Sinn argued.

An imminent constitutional crisis

It is only because of the ECB's OMT Program (Outright Monetary Transactions) and the promise to buy government bonds of crisis countries without limit, in case of emergency, that the current situation has calmed down, Sinn said. He reviewed, in detail, the decision of the German Constitutional Court (GCC) in early February. The Court has not, as many have written, delegated the decision to the European Court of Justice (ECJ), Sinn emphasized. In contrast, it has stated very clearly that the OMT Program is against the law, he said. In his view, the ECJ will not be able to decide against the GCC without provoking a constitutional crisis in Germany. The German Parliament would not be allowed to accept that the ECB – as a foreign power – would take control over the German budget. Therefore, Sinn assumes that both Courts will try to find a solution that, in the end, will set limits to the OMT. In his view, this is urgently necessary. The ECB should not reduce the steering potential of financial markets by buying government bonds. The spread of interest rates is a fundamental element of a monetary union. The Euro will never flourish without, he predicted.

As a way out of the crisis, Sinn demanded relief for government debt, bank debt and target debt at the expense of creditors. Nevertheless, it may not be avoidable, he argued, that some countries – he mentioned Greece – will need to temporarily leave the euro area. Not least, national central banks should give up some of their rights, in order to stop the increase in emergency credits. According to Sinn, the current path towards a transfer union will come to a dead end: "We are turning the countries of Europe into creditors and lenders. This is no policy of peace."

Muriel Büsser

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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CFS Lecture: Adair Lord Turner of Ecchinswell

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

On 10 February 2014, Adair Lord Turner of Ecchinswell, Senior Fellow of the CFS and the Institute for New Economic Thinking, gave a lecture on "Escaping the debt addiction: monetary and macro-prudential policy in the post crisis world". He argued that the financial crisis and the slow post-crisis recovery were first of all caused by excessive private credit creation. Up to now, the measures taken to combat the crisis have focused on public debt levels rather than on private ones. Therefore, Turner thinks that the currently introduced reforms are valuable but not addressing the fundamental cause of the crisis, the rising levels of private debt, which lead to economic and financial instability.

“Over several decades prior to 2008, private credit grew faster than GDP in most advanced economies and leverage therefore grew. That was a major cause of the crisis and the main reason why the post crisis recession was so deep and the recovery so slow and weak,” the former Chairman of the Financial Services Authority said. Since the crisis, indebted private households and companies have decreased their consumption and investment expenditures to reduce their debt. As a result, growth has slowed down and public debt has risen.

According to Turner, the dilemma is that additional credit seemed essential to boost growth. But the question is whether a stable growth path is possible or whether growth is bound to generate harmful instability. Turner argued that more stable growth was possible but would require new policy approaches far beyond the reforms that have been introduced up to now. He explained that growth had become more credit intensive because of three factors: 1) increasing inequality between rich and poor, 2) global imbalances driven in part by a structural tendency towards excessive savings in some surplus countries and 3) extended credit growth to finance the purchase of existing assets (in particular real estate) whose price is then influenced endogenously by the quantity of the extended credit. Turner stressed that future financial reforms would have to address each of these three factors in order to restore stability.

Links:

Lecture presentation
Lecture text
References

- CFS Lecture: Adair Lord Turner of Ecchinswell
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News

- News

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CFS Lecture: Adair Lord Turner of Ecchinswell

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

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Panel Discussion: Should Germany take a lead in Europe?

Star investor George Soros, the President of the Kiel Institute of the World Economy Dennis Snower as well as Otmar Issing, President of the Center for Financial Studies, held a debate about the ongoing euro crisis and the role Germany should take in it on March 19. The panel discussion was presented by Michael Haliassos, CFS Director.

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

While financial markets have recently calmed down, a solution to the sovereign debt crisis is still due. In his introductory remarks, Michael Haliassos reminded that the situation in Southern Europe is continually dramatic. Austerity programs and cuts have been implemented but no investments in innovation, growth or small businesses. As a result, high potentials have preferred to leave their country instead of vigorously trying to strengthen growth and exports.

The situation in the south is a collective problem for the whole of Europe and, therefore, needs to be dealt with collectively, George Soros demanded. In the recent past, he had promoted two options for Germany: take a lead in Europe or leave the monetary union. Now, in his view, only the first option is still on the table. Germany needs to accept its role as a benevolent hegemon in Europe. It must find a way to help the indebted countries out of the trap into which they had fallen. Soros suggested to impose a European corporate tax and use the revenues for programs against unemployment. This would result in a transfer that would decrease when economic adjustment increases.

According to Otmar Issing, it would be critical for Germany to take a leading role in Europe for historic reasons. Germany could lead as an example, not more. Soros sympathized with this position but said that Germany, de facto, already has this leading role. He did not agree with Issing with regard to Germany giving a good example. In his view, Germany imposed its policy on other countries but what was good for Germany might be inappropriate for the special situation of the crisis countries.

Dennis Snower argued against Issing's view that the crisis countries had caused their problems by their own policy mistakes and therefore were responsible for solving them. In some countries, it had been the private sector that had caused bubbles, others had suffered from spillover effects, Snower said. Therefore, crisis countries needed support. But the implementation of rules was also needed in order to lead to a sustainable situation in the long run. Issing agreed on that. It is not possible to find a solution to the deep problems of crisis countries in a rush, he said. But, for a single currency, you need rules and some kind of agreement. The objective must be to find a balance for the future.

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- CFS Lecture: Adair Lord Turner of Ecchinswell
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- The ECB and Its Watchers XV
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News

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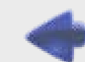
GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

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News

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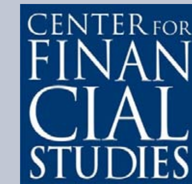

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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

Current issues in and challenges for central bank communication

The first session of the conference focused on central bank communication. Peter Praet (photo), member of the Governing Council of the European Central Bank (ECB), pointed out in his speech that opinions had fundamentally changed within the ECB. Since the ECB wants to benchmark the discussion, Praet connects his monthly presentations of monetary policy proposals with proposals on communication, he explained. Nevertheless, in the future the ECB does not plan on publishing the names of the members in the Governing Council, revealing who took which position in a discussion.

Charles Goodhart of the London School of Economics interpreted Praet's suggestions regarding greater transparency as an indication that the ECB was moving towards an individualistic committee rather than a collegial committee as it had asked to be from the outset (presentation).

Paul Sheard, Chief Global Economist of Standard and Poor's, emphasized the differences in the issues the various central banks had to face. Whereas the Federal Reserve and the Bank of England had been dealing with a "plain vanilla financial crisis", the ECB had to face existential questions whether the euro area as a construct would actually survive. According to Sheard, the complexity is much higher for the ECB.

Donald Kohn of Brookings Institution highlighted central bank communication as a key way to influence inflation expectation and financial conditions. "When the policy interest rate is extremely low, central banks are increasingly relying on words to influence financial conditions," he said. After the crisis, central banks needed to explain themselves better. However, they also needed to recognize the limits of communication, Kohn added.

Current challenges for the conduct of monetary policy in the euro area

Whether we were back to the "new normal" in the euro area now, ECB board member Benoit Cœuré (photo) deliberated on during the conference's second session, putting emphasis on the new set of questions that have arisen with inflation being low and remaining low (presentation).

Lucrezia Reichlin of London Business School particularly pointed out some of the key problems in the euroarea nowadays, looking at the fragility of banks and financial segmentation. "Although we are in a recovery, nominal GDP is still very weak", Reichlin warned. In her opinion the ECB has to experiment with new tools and clarify its view on the tradeoffs (presentation).

Whether the ECB does have enough policy measures Lars E.O. Svensson of Stockholm University discussed during his presentation, indicating the big difference that might occur between the official policy rate and the Eonia rate. "Why not have a smaller corridor?" Svensson suggested, citing the Riksbank's fine-tuning system as an example. Concerning negative interest rates Svensson appealed to the ECB not to be nervous about experimenting.

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

John B. Taylor (photo) of Stanford University especially focused on the consequences of unconventional monetary policy. Looking at the Federal Reserve, forward guidance had been unpredictable Taylor pointed out. Analyzing possible exit strategies, Taylor called for a more rules-based system with the central banks explaining the deviations. Most of all, "an exit should include a statement about the policy strategy in the future", Taylor said (presentation).

Challenges for the ECB resulting from its double role as monetary policy maker and financial supervisor

The challenges the ECB has to face as banking supervisor were in the center of the conference's third session. In this regard, ECB board member Yves Mersch referred to the protection of the monetary policy independence as the first objective. Furthermore, talking about individual corporations and decisions, Mersch mentioned confidentiality as another objective.

In his speech, Stefan Gerlach, Deputy Governor of the Bank of Ireland, reminded the participants of the fact that central banks had been the original supervisors and that supervision was not a new activity for central banks. According to Gerlach, separation of monetary policy and supervision is done very differently in various countries. "There is no one size fits all", Gerlach added.

For Nouriel Roubini, however, there is a much bigger dilemma for central banks than the separation of banking supervision and monetary policy. "All central banks were created in the first place to achieve financial stability," he said. Thus, central banks have to deal with two goals, price stability and financial stability. "But central banks do not know if they have the second instrument to do it right," he concluded.

As the ECB is taking on the responsibilities of banking supervision, for Dirk Schoenmaker of Duisenberg School of Finance the ECB is now becoming a full central bank. From the experience in the Netherlands, Schoenemaker gave the advice that the head of banking supervision should appear on television and in parliament if something happened in the banking sector, not the governor of the central bank, thus, avoiding reputational risks (presentation).

After these discussions, co-organizer and IMFS research fellow Günter Beck, who will take over the responsibilities as sole organizer of the next ECB watcher conference, saw off the participants.

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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

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- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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International Research Forum on Monetary Policy

March 21-22, 2014 Federal Reserve Board Washington, D.C. | Sponsored by: European Central Bank, Federal Reserve Board, Georgetown Center for Economic Research, Center for Financial Studies | International Research Forum on Monetary Policy

The papers presented at the eighth conference of the **International Research Forum on Monetary Policy** (IRFMP) focused on a broad set of themes which included various facets of the interaction between monetary, macroprudential and fiscal policies; the role of financial intermediaries in the economy; and on the causes and consequences of the protracted recovery from the Great Recession. The conference was co-sponsored by the Federal Reserve Board (FRB), the European Central Bank (ECB), the Georgetown Center for Economic Research (GCER) at Georgetown University and the Center for Financial Studies.

Constraints on interest rate adjustment by central banks – due either to the zero lower bound, or currency union membership – have played an important role in accounting for a grindingly slow recovery from the financial crisis. The conference paper entitled "The Role of Macroprudential Policies" highlighted how such constraints may make it desirable to adopt macroprudential policies that limit the scope for borrowing by households, firms, or sovereigns. The paper "Credit Spreads and Credit Policies" showed how an activist fiscal policy – using credit subsidies to offset the impact of weak credit conditions – could be an effective stabilization tool when monetary policy was constrained.

Potential sources of inflation risk

Two other papers drew attention to potential sources of inflation risk. In particular, "When Does a Central Bank Balance Sheet Require Fiscal Support?" examines conditions

GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

under which a central bank balance sheet expansion associated with unconventional monetary policy actions may cause inflation expectations to become unanchored. "Coordination and Crisis in a Monetary Union" shows how the incentives of the monetary authority in a currency union to run inflation above target depend on the debt of member states, and argues that debt limits on sovereigns may be desirable keeping inflation low and stable.

Several other papers focused on the role of financial intermediaries both in the transmission of shocks and of monetary policy. "Bank Leverage Cycles" analyzed the channels through which a rise in macroeconomic volatility could lead to a tightening of credit conditions, while "Booms and Banking Crises" modeled how a buildup of leverage during a boom can sow the seeds of a subsequent bust. "Banks, Liquidity Management, and Monetary Policy" developed a framework analyzing the portfolio choice of banks between making loans and holding reserves, and considered implications for monetary policy.

Finally, several papers considered the impact of the Great Recession for labor market developments, productivity, and inflation. "Slow Recoveries, Worker Heterogeneity, and the Zero Lower Bound" examined how deep recessions can leave long-lasting scars on the labor market and impair job-matching efficiency. "Reallocation in the Great Recession: Cleansing or Not?" showed that productivity growth associated with reallocation of factors (including labor) to more efficient firms slowed markedly during the Great Recession, in contrast to the pattern of previous recessions dating to the early 1980s. "Inflation Dynamics during the Financial Crisis" shows how balance sheet constraints affected the price-setting decisions of firms, and helped account for some of the resilience of inflation in light of the severe output downturn.

Transitional and longer-term challenges for monetary policy

The conference also fostered exchange between researchers and policymakers by featuring a panel discussion on the topic of "transitional and longer-term challenges for monetary policy" and two keynote speeches. The panelists Stephen Cecchetti (Brandeis University), Spencer Dale (Bank of England), Narayana Kocherlakota (Federal Reserve Bank of Minneapolis), and Lars Svensson (Stockholm University), focused their discussion on the use of forward guidance by central banks, and the question whether and when financial stability risks should be addressed through interest rate policy. Stephen Cecchetti argued that while monetary policy in principle could be used to curtail risk-taking behavior, available evidence suggested that it was not likely to be very efficacious in practice. Spencer Dale portrayed forward guidance as a tool to provide information to the public about how a central bank was likely to resolve tradeoffs between conflicting objectives. By emphasizing the economic conditionality, forward guidance can serve as a vehicle for explaining the central bank's reaction function, thereby enhancing the effectiveness of monetary policy by helping the public anticipate the response of monetary policy to unforeseen events.

Concerning the use of the central bank's interest rate tool to address incipient threats to financial stability, Narayana Kocherlakota framed the question as what level of macroeconomic underperformance (such as higher unemployment) the central bank ought to accept in order to reduce the probability of a financial crisis occurring. This depended on the economic damage in the event that a crisis occurred, and the effect of a change in interest rates on the crisis probability. He argued that the evidence at this time suggested that policymakers should be willing to sacrifice very little in terms of

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

macroeconomic performance for the sake of reducing the probability of a renewed crisis. Lars Svensson argued that the Swedish Riksbank's policy of raising interest rates in 2010 to lean against rising household debt-to-income ratios had been very costly insofar as it had boosted unemployment and caused inflation to run below target, while doing little to promote financial stability.

The appropriate monetary policy response to financial stability risks

The appropriate monetary policy response to financial stability risks was also the topic of the keynote speech by Federal Reserve Board Governor Jeremy Stein, who emphasized that greater attention be paid to interest rate spreads to measure financial market vulnerabilities to complement the focus on measures of leverage that has dominated the literature since the financial crisis. Large negative returns on certain assets give rise to financial stability risks, but there are many empirical studies showing that a large fraction of these returns is predictable. Thus, from a policymaker's perspective, predictors of future negative returns could provide useful inputs for the monetary policy framework. The keynote speech by ECB Vice President Vitor Constâncio returned to the theme of forward guidance by explaining recent innovations in ECB communications. He also highlighted recent progress on the path towards a banking union in the euro area.

Thomas Laubach (FRB & CFS)

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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

under which a central bank balance sheet expansion associated with unconventional monetary policy actions may cause inflation expectations to become unanchored. "Coordination and Crisis in a Monetary Union" shows how the incentives of the monetary authority in a currency union to run inflation above target depend on the debt of member states, and argues that debt limits on sovereigns may be desirable keeping inflation low and stable.

Several other papers focused on the role of financial intermediaries both in the transmission of shocks and of monetary policy. "Bank Leverage Cycles" analyzed the channels through which a rise in macroeconomic volatility could lead to a tightening of credit conditions, while "Booms and Banking Crises" modeled how a buildup of leverage during a boom can sow the seeds of a subsequent bust. "Banks, Liquidity Management, and Monetary Policy" developed a framework analyzing the portfolio choice of banks between making loans and holding reserves, and considered implications for monetary policy.

Finally, several papers considered the impact of the Great Recession for labor market developments, productivity, and inflation. "Slow Recoveries, Worker Heterogeneity, and the Zero Lower Bound" examined how deep recessions can leave long-lasting scars on the labor market and impair job-matching efficiency. "Reallocation in the Great Recession: Cleansing or Not?" showed that productivity growth associated with reallocation of factors (including labor) to more efficient firms slowed markedly during the Great Recession, in contrast to the pattern of previous recessions dating to the early 1980s. "Inflation Dynamics during the Financial Crisis" shows how balance sheet constraints affected the price-setting decisions of firms, and helped account for some of the resilience of inflation in light of the severe output downturn.

Transitional and longer-term challenges for monetary policy

The conference also fostered exchange between researchers and policymakers by featuring a panel discussion on the topic of "transitional and longer-term challenges for monetary policy" and two keynote speeches. The panelists Stephen Cecchetti (Brandeis University), Spencer Dale (Bank of England), Narayana Kocherlakota (Federal Reserve Bank of Minneapolis), and Lars Svensson (Stockholm University), focused their discussion on the use of forward guidance by central banks, and the question whether and when financial stability risks should be addressed through interest rate policy. Stephen Cecchetti argued that while monetary policy in principle could be used to curtail risk-taking behavior, available evidence suggested that it was not likely to be very efficacious in practice. Spencer Dale portrayed forward guidance as a tool to provide information to the public about how a central bank was likely to resolve tradeoffs between conflicting objectives. By emphasizing the economic conditionality, forward guidance can serve as a vehicle for explaining the central bank's reaction function, thereby enhancing the effectiveness of monetary policy by helping the public anticipate the response of monetary policy to unforeseen events.

Concerning the use of the central bank's interest rate tool to address incipient threats to financial stability, Narayana Kocherlakota framed the question as what level of macroeconomic underperformance (such as higher unemployment) the central bank ought to accept in order to reduce the probability of a financial crisis occurring. This depended on the economic damage in the event that a crisis occurred, and the effect of a change in interest rates on the crisis probability. He argued that the evidence at this time suggested that policymakers should be willing to sacrifice very little in terms of

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

macroeconomic performance for the sake of reducing the probability of a renewed crisis. Lars Svensson argued that the Swedish Riksbank's policy of raising interest rates in 2010 to lean against rising household debt-to-income ratios had been very costly insofar as it had boosted unemployment and caused inflation to run below target, while doing little to promote financial stability.

The appropriate monetary policy response to financial stability risks

The appropriate monetary policy response to financial stability risks was also the topic of the keynote speech by Federal Reserve Board Governor Jeremy Stein, who emphasized that greater attention be paid to interest rate spreads to measure financial market vulnerabilities to complement the focus on measures of leverage that has dominated the literature since the financial crisis. Large negative returns on certain assets give rise to financial stability risks, but there are many empirical studies showing that a large fraction of these returns is predictable. Thus, from a policymaker's perspective, predictors of future negative returns could provide useful inputs for the monetary policy framework. The keynote speech by ECB Vice President Vitor Constâncio returned to the theme of forward guidance by explaining recent innovations in ECB communications. He also highlighted recent progress on the path towards a banking union in the euro area.

Thomas Laubach (FRB & CFS)

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

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The Great Depression of the 1930s stimulated an intensive and extremely fruitful debate in the field of economics. In 1933, economists from Chicago around Henry Simons, Frank Knight and Irving Fisher presented a radical plan to abolish the fractional reserve banking system. Their approach went down in history as the “Chicago Plan”. Three years later, John Maynard Keynes published his “General Theory of Employment, Interest and Money”. Both Joseph Schumpeter’s “Capitalism, Socialism, and Democracy” (1942) and Friedrich August von Hayek’s “Road to Serfdom” (1944) were also affected by the events of that time. In contrast, the debate after the financial crisis of 2007 to 2009 has been rather modest. Economists have largely stuck to well-established principles and have shied away from a discussion with social groups and heterodox economists who have drawn far-reaching lessons from the financial crisis. With the CFS Lecture Series on the Order of Money we have tried to escape this narrow “mainstream” debate by discussing unconventional ideas to improve our monetary and financial system.

The European Central Bank is too weak

In June 2013, the series started with Jesus Huerta de Soto, Professor of the Rey Juan Carlos University, who defended the euro from the perspective of the Austrian School of Economics. According to Huerta de Soto, the reason for the instability of our monetary system is the constructivist monetary policy of central banks and the fractional reserve system of commercial banks. In the European Monetary Union (EMU), the European Central Bank (ECB), established as a supra-national central bank independent from

GO BACK
Return to content list

Editorial

Research & Policy

Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn

politics, would have provided the opportunity to, at least, correct the first defect of our monetary system. If the ECB had taken its mandate seriously, it could have acted as a catalyst for necessary structural adjustments and could have caused greater economic stability. Unfortunately, the ECB did not take this opportunity and, thus, has not protected the euro area against the global glut of credit and money which has been created by the U.S. Federal Reserve since 2001.

Martin Hellwig (Max Planck Institute for Research on Collective Goods) outlined the role of monetary policy in the conflict between price stability, financial stability and the burden for tax payers. His main topics were (i) the role of the banking system in the context of the monetary system and the importance of financial stability for monetary policy, (ii) the significance of central bank policy for the budgetary interests of states and (iii) the importance of central bank independence. Hellwig considered the future of the EMU rather critical. In his view, the ECB's position is too weak to successfully defend itself against governments that try to blackmail it to help themselves or "their" banks. Even the banking union will not solve this problem, Hellwig said.

Like Huerta de Soto, Joseph Huber (Martin Luther University of Halle-Wittenberg) criticized the present policies of central banks and the fractional reserve system that, in his view, leads to the recurring problem of excessive money creation. As a solution to this problem, he pleads for replacing deposit money, which is created by banks in collaboration with central banks, with "sovereign money". Huber defines sovereign money as unlimitedly valid legal tender that is issued by an independent central bank. In such a system, the central bank would de facto be upgraded to a fourth state authority, a "monetative authority", which executes the sovereign right to issue money and to receive the seigniorage gains.

Safe bank deposits and parallel currencies

Daniel Gros (Centre for European Policy Studies) and Thomas Mayer (CFS) discussed the prospects for implementing the planned banking union. Do we need a "euro state" to continue on the currently chosen way? Do we get stuck half-way if European citizens refuse to further transfer sovereignty rights from the national to the EU level? Is it possible to create a banking union without a further communitarisation of risks? While Gros, in general, agrees with the way chosen by European politicians, Mayer votes for a different solution which is based on a "safe bank deposit" completely covered with central bank money.

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- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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In his lecture, Helge Peukert (University of Erfurt) presented basic elements for a stable financial system. Like Huber, Peukert voted for a sovereign money system. Furthermore, he pleaded for a strict regulation of the financial sector that should include (i) shrinking the sector and large institutes; (ii) separating commercial and investment banking; (iii) introducing a 30 percent equity ratio; (iv) prohibiting certain financial products (e.g. Credit Default Swaps); (v) introducing financial transaction taxes and (vi) a wealth tax on capital income above 50,000 euro.

Different views on how to reform the monetary system

Stephan Balling (bibliomed) looked into the works of four influential economists – von Hayek, Walter Eucken, Milton Friedman and Joseph Schumpeter – and their views on the order of money. He compared the "neoliberal" economists Hayek, Eucken and Friedman to the development economist Schumpeter. While the neoliberals regarded the credit money system more or less as critical, Schumpeter considered credit creation out of nothing as the "monetary counterpart of an innovation". He wrote: "In the capitalist society, the issuing of newly created money for innovations corresponds to the order of the central bureau in a socialist state, because our companies have no own assets and – so far – no savings."

Thorsten Polleit (Degussa Goldhandel) agreed with Huerta de Sotos' criticism of the fractional reserve system by outlining the Austrian business cycle theory. An increase in money supply through higher credit supply leads to a rise in the production of capital goods which cannot be financed with the available macroeconomic savings in the economy. Therefore, a boom leads inevitably to a bust. Hence, economic stability is not possible in a credit money system.

In his "Notes on how to institutionally ensure a stable value of the currency", Otmar Issing (CFS) recalled several proposals on how to reform the monetary system. Although Issing considered the economic models, on which central banks base their current monetary policy strategy, rather critical, he was not convinced that the known proposals on reforms of the money system would provide a viable alternative to our existing system.

Timm Gudehus, consultant, researcher and author, discussed the concept of a

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Macroprudential policies cannot solve all problems

Finally, Valerie Herzberg (member of the cabinet of EU President Herman van Rompuy) discussed the role of macroprudential policy to supplement monetary policy in the goal of achieving financial stability. Herzberg cautioned, that not too much should be expected from macroprudential policy. In the end, interest rate policy remained a very powerful instrument. Hence, macroprudential policy could only succeed when it is deployed with, and not against interest rate policy.

During the last twelve months the seminar series has become a forum for critical discussion about our existing monetary system and reform proposal. As there still remains a lot to be discussed even after eleven lectures, future events in this series are already planned.

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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

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Panel Discussion: Should Germany take a lead in Europe?
The ECB and Its Watchers XV
International Research Forum on Monetary Policy
CFS Lecture Series on "The Order of Money"
Selected Upcoming Events

News

News

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Selected Upcoming Events

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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

	Herausforderungen und Chancen"
08 Oct 2014	*CFS Colloquium* **Dr. Maximilian Zimmerer**, *Allianz SE* "Herausforderungen für Investoren in Zeiten niedriger Zinsen"
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GO BACK
Return to content list

- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn

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- CFS Lecture: Adair Lord Turner of Ecchinswell
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- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
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- Selected Upcoming Events

News

- News

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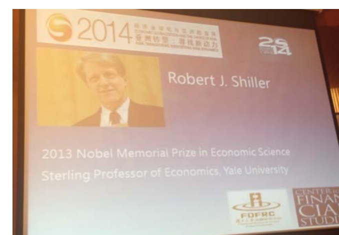
CFS cooperates with Fudan University, Shanghai

On 23 May 2014, Fudan University, Shanghai, and the Center for Financial Studies co-organized the 2014 Shanghai-Frankfurt International Finance Forum. Conference participants, including a number of speakers from CFS and Goethe University Frankfurt, exchanged views on “Financial Innovation and Financial Stability: The European Experience and the Choice of China”. The conference was followed by the 2014 Shanghai Forum, a three-day-event dealing with the transformation processes in Asia. The speakers included ECB Board Member Yves Mersch and Nobel laureate Robert J. Shiller.



The next conference co-organized by CFS and Fudan University’s Financial Research Center will be held in Frankfurt in September 2015 – prospectively under the headline of “Integration”. There will be an open part that should bring together academics, practitioners, policy makers and central bankers and a closer academic session that offers researchers from Shanghai and Frankfurt the opportunity to present recent papers, exchange views and share information about data access.

Athansios Orphanides talks about “The Yellen Fed”

On 5 May 2014, CFS Senior Fellow Athanasios Orphanides gave a talk about current developments and challenges in the U.S. monetary policy on

GO BACK
Return to content list

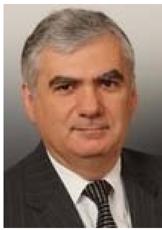
- Editorial

Research & Policy

- Monetary Policy and Balance Sheet Adjustment
- Trust, Trustworthiness, and Selection into the Financial Industry
- The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

- CFS Presidential Lecture: Hans-Werner Sinn



the occasion of the recent inauguration of Janet Yellen as President of the Federal Reserve Board. Athanasios Orphanides is a CFS senior fellow and Professor at the MIT Sloan School of Business. He is a former member of the Governing Council of the European Central Bank and Senior Adviser to the Federal Reserve Board. The event was exclusive to CFS supporting members on board level.

Conference on "Corporate Restructuring – Perspectives 2014"

On 18 March 2014, the CFS hosted a conference for practitioners on corporate restructuring organized by Volker Brühl, CFS Managing Director, and Burkard Göpfert, Partner with Baker &McKenzie Munich. More than 50 decision-makers from banking, consultancy and international law firms discussed current trends in corporate restructuring. Experts from Roland Berger, Alix Partners, Macquarie Capital, Baker & McKenzie, Dentons as well as Schulze & Braun presented case studies of new developments in financial corporate restructuring and shared their experiences with the ESUG (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen). Furthermore, legal and economic characteristics of complex cross-border insolvency cases were discussed.

- CFS Lecture: Adair Lord Turner of Ecchinswell
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- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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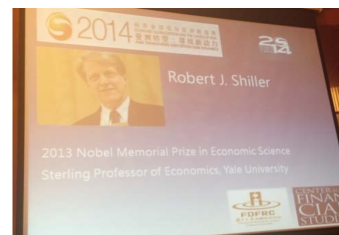

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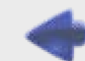

GO BACK
Return to content list

Editorial

Research & Policy

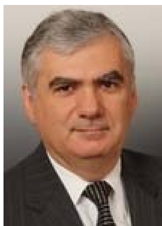
Monetary Policy and Balance Sheet Adjustment

Trust, Trustworthiness, and Selection into the Financial Industry

The Role of Bank Lending Tightening on Corporate Bond Issuance in the Eurozone

Events

CFS Presidential Lecture: Hans-Werner Sinn



the occasion of the recent inauguration of Janet Yellen as President of the Federal Reserve Board. Athanasios Orphanides is a CFS senior fellow and Professor at the MIT Sloan School of Business. He is a former member of the Governing Council of the European Central Bank and Senior Adviser to the Federal Reserve Board. The event was exclusive to CFS supporting members on board level.

Conference on “Corporate Restructuring – Perspectives 2014“
On 18 March 2014, the CFS hosted a conference for practitioners on corporate restructuring organized by Volker Brühl, CFS Managing Director, and Burkard Göpfert, Partner with Baker &McKenzie Munich. More than 50 decision-makers from banking, consultancy and international law firms discussed current trends in corporate restructuring. Experts from Roland Berger, Alix Partners, Macquarie Capital, Baker & McKenzie, Dentons as well as Schulze & Braun presented case studies of new developments in financial corporate restructuring and shared their experiences with the ESUG (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen). Furthermore, legal and economic characteristics of complex cross-border insolvency cases were discussed.

- CFS Lecture: Adair Lord Turner of Ecchinswell
- Panel Discussion: Should Germany take a lead in Europe?
- The ECB and Its Watchers XV
- International Research Forum on Monetary Policy
- CFS Lecture Series on "The Order of Money"
- Selected Upcoming Events

News

- News

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