



Editorial

Dear Members, Colleagues and Interested Parties,

The credit operations of German banks and savings institutes implies for many institutions increasingly serious problems with returns, extensive enough on occasions to pose a threat to their survival. Carelessness in the past with regard to assessing credit risks has contributed to this situation and it is an irony of fate that default rates are increasing now of all times, just when the financial sector has seriously begun to base its credit decisions on the actual risk of default.

This development is a challenge to most institutions. The zeal with which people are adapting to the expected BIZ guidelines (key word Basle II) gives cause for the hope that the financial sector will emerge considerably strengthened from the current crisis.

What will the financial landscape look like in the future? The increased awareness of risks will be accompanied by a boom in improved risk assessment methods. These instruments will influence the structure of prices and introduce greater differentiation. The sale and purchase of credit risks (either individually or as a part of a portfolio) will become a matter of course for companies and investors.

CFS intends to accompany this exciting process with the research program on the development of liquid financial markets started during the past year, thus making a scientific contribution to the development of Germany as a financial location.

As we now know, the neglect over many years of the costs of risks has not only been a problem in the financial markets alone, but is also still a problem in the labor market. There is no such thing as a free lunch which means that the pricing policy of cross subsidization has lead to a misallocation of resources, that is loan defaults in one area and unemployment in another.

The big challenges facing the economy and politics today demand individual prices for individual risks with the objective of more individual responsibility and an end to a socialization of individual risks. If these reforms mean icy times ahead, as many fear, then we shall have to dress up warmly. And above all make a start.



Jan P. Krahn



Antje Becker

Contents

Events	
Colloquium series	2-5
Lectures	5-6
Research conferences	7-11
Research Activities	12-16
RTD Network	12
▶ Special: ECB-CFS Research Network	13-15
Publications	16-17
Executive Development	17
Reports on seminars and conferences	17-20

Enclosure: Dates of forthcoming events

CFScolloquium series

“Globalization of Financial Markets –
Risks and Opportunities”

The Stabilization of the International Financial Markets – Challenges and Achieved Objectives

(original German title: *Stabilisierung der internationalen
Finanzmärkte – Herausforderung und bereits Erreichtes*)

On 6th November, 2002 **CAIO K. KOCH-WESER**, Permanent Secretary at the Ministry of Finance, gave a presentation entitled “The Stabilization of the International Financial Markets – Challenges and Achieved Objectives”. Against the backdrop of the latest “stress tests” (suspension of payment by Argentina and the loss of confidence following the accounting scandals in the USA), Koch-Weser gave a summary of what has been achieved since the Asian Crisis of 1997/98 with regard to the stabilization of international financial markets, and he talked about the challenges which would need to be met in the near future.

Koch-Weser began by pointing out the significance of international financial market stability for employment, growth and political stability, particularly in emerging economies, and he referred to the fact that the global situation is currently characterized by an unusual degree of uncertainty and a combination of down-side risks such as has not been the case for a long time. He referred to the current problems in the USA, Europe, Argentina, Brazil and Turkey, but emphasized that much has been achieved since the Asian Crisis and that the resilience apparent since



11th September last year is most certainly due to the reform measures which were introduced internationally in response to the Asian Crisis in 1997/98. In his account of these measures he differentiated between the field of crisis prevention and that of crisis resolution.

The former he attested good results and pointed out that specifically with respect to transparency (the transparency in the publication of country analyses and with respect to the adherence to standards and codes of practice) great progress had been made. Koch-Weser was less contented with the state of crisis resolution and graded the efforts made to date at the most as being satisfactory. He criticized

in particular the case-by-case approach often adopted in the past, whereby crisis resolution was dealt with on the basis of individual cases rather than by applying a transparent set of rules. He was optimistic that with the new G7 plan of action for strengthening crisis resolution an improvement would be achieved in this area. He also believed that the recently established International Stability Forum had already made important contributions to bringing about an improvement in crisis resolution. Furthermore, he said that owing to increased international cooperation considerable progress had been made with respect to combating international money laundering. Finally, the Permanent Secretary said that Europe ought to speak out much more loudly on the subject of stabilizing the international financial markets and must provide a counterbalance to American interests.

Günter Beck (CFSresearch staff)



The Development of Free- Market Financial Systems in Transition Countries – Innovative Approaches with the KfW

(original German title: *Aufbau marktwirtschaftlicher Finanzsysteme in Transformationsländern – innovative Ansätze der KfW*)

INGRID MATTHÄUS-MAIER, a Member of the Board of the KfW, accepted an invitation from CFS to speak at the colloquia held on 13th November 2002.

Matthäus-Maier first of all presented a survey of the consequences of the Balkan wars, depicting thereby the social and structural environment in which the KfW operates. She showed that the situation at the beginning of the 1990's in Bosnia and Herzegovina was particularly dramatic, gross domestic product having fallen by 40% in both the years 1993 and 1994. She explained that above all the region's central infrastructure (such as bridges, rail lines, water supply systems and electricity supply lines) has been severely impaired by the actions of war. Furthermore, the mismanagement over several decades in most of the region's countries is, according to Matthäus-Maier, responsible for the fact that public services are in such a desolate state. In addition the refugee situation caused by the wars has contributed considerably to the continuing social and ethnic tensions in several countries.

The German government has commissioned the KfW to start tackling the structural deficits in the South East European transition countries, especially in the financial systems sector. Particular significance from an economic development policy view is to be attached to the small and medium-sized enterprises in South East Europe. The KfW's involvement in the financial sector stems from recognition of the fact that it is the small and medium-sized enterprises which tend to suffer during a continuing crisis and would not, without some form of assistance, be in any way able to fulfil their growth potential. A fundamental obstacle for these enterprises is the dearth of financial services. The KfW, together with other international financial institutions, has now set up new micro banks for specific target groups which provide financial services for small businesses. In addition, these banks are also offering financial services for home owners from low income brackets since, according to Matthäus-Maier, this is the only way to finance the rebuilding of living accommodation which was destroyed during the civil war. In order to be able to provide financial services for small businesses in the first place, the good banks among those in existence will be given training in how to deal with these clientele groups. Furthermore, the KfW intends to bring about structural changes which should influence and stabilise the financial sector as a whole. This can only be done by improving the general conditions (banking legislation and supervision) and, for example, by creating competition between local banks. For this reason the KfW, whenever the opportunity arises, sponsors several promising local institutions at once using market-oriented practices.



Matthäus-Maier went on to illustrate how this type of sponsoring might appear in a specific case by looking at the European Fund for Bosnia and Herzegovina, which makes refinancing funds available to local banks and the Microbank in Kosovo.

She finished her presentation with the observation that the activities of the KfW are important particularly because they demonstrate that even under uncertain economic and political circumstances it is indeed possible to establish a healthy banking system. The KfW thus achieves a deliberate demonstration effect which should encourage domestic and foreign investors to commit themselves in the region once again.

Stefanie Franzke (CFSresearch staff)

We asked INGRID MATTHÄUS-MAIER:

In your industry/field, what is the most important technical qualification a junior high potential should have, or should try to acquire?

And she answered:

“Our successful candidates have usually studied business administration, economics or a combination of both and earned very good grades. They have a demonstrated interest in banking practice, many have participated in internships. We require strong language skills and the willingness to travel, both within Germany and abroad. Most of our trainees for Financial Cooperation have had some initial contact with developing countries, whereas trainees in our loan division have a solid background in banking.”

In your industry/field, what is the most valuable personal qualification a junior high potential should have, or strive to acquire?

And she answered:

“The most important personal qualifications include commitment and motivation as well as self-initiative. Applicants should be interested in further training and development and have strong social skills. Important criteria here are friendliness, the ability to communicate and flexibility. Good team players are able to integrate and show a high degree of collegiality.”

The Alternative Risk Transfer: Reinsurance in Competition with the Capital Markets: Rivalry or meaningful Expansion?

(original German title: Alternativer Risikotransfer: Rückversicherung im Wettbewerb mit dem Kapitalmarkt oder sinnvolle Ergänzung?)

In November 2002, as part of the research collaboration with the Munich Re Group within the framework of the CFS program area “The Reinsurance Industry and the Capital Markets”, CFS hosted the first CFS *Scolloquium* in Frankfurt on the topic of reinsurance. HANS-JÜRGEN SCHINZLER, Chairman of the Board of Management of the Munich Re Group discussed under the aspect of alternative risk transfers (ART), the issue of “Reinsurance in Competition with the Capital Markets: Rivalry or meaningful Expansion?”

The alternative risk transfer, under which the transfer of insurance risks is subsumed in the capital markets, represents a product example of the convergence of the financial sector, that is a form of synthesis of the reinsurance and capital markets. The word “alternative” in this context does not mean “either (reinsurance) or (capital market transfer)”, but is rather to be understood in the sense of a supplement to other types of risk management, thus allowing, for example, an extension of existing capacity limits.

Risk transfer also takes place in the other direction from the capital markets to the insurance market, namely with respect to the insuring of credit risks.

Reinsurance means the insurance cover for the original insurer. It exists in order, among other things, to allow an extension of the cover provision offered by the original insurer and in order to smooth external (damage claim-induced) performance fluctuations. The reinsurer on the basis of the extent, the geographic spread and diversification in the timing and type of risks in his business is at an advantage vis-a-vis the original insurer. An important characteristic of the relationship between the reinsurer and the original insurer is the individual tailoring of the reinsurance cover and the associated common adventure partition. In this respect the question presents itself whether ART products and reinsurance can be considered to belong to the same equivalence class.

There are many reasons for the emergence of alternative products to be found not only in the case of banks, in-

vestment companies and suppliers of specific assets searching for new income sources, but also in the increasing competition within the liberalized insurance markets and the change in the structure of demand. Economic units with growing financial strength demand different products and, in addition to original insurers, captives are appearing as the demanders of insurance cover. An important driving force with respect to the volume, frequency, associated capacity shortages and price increases is certainly to be seen in the increase in damage claims on the grounds of natural disasters.

The start of ART dates back to the first series of catastrophe futures and options at the CBOT in 1992. The loan volume of US\$ 9 billion and the contribution of derivatives to the amount of US\$ 4 million, which have in the meantime accumulated, represent however less than 1% of the reinsurance industry's coverage capacity already provided. An extension of the transfer of insurance risks in the capital markets, which to date has mainly taken place in low frequency and high severity risks (above all natural catastrophes), to frequency risks seems most probable in the life insurance industry. On the basis of its outstanding expertise in the field of damages and experience in the ART area (for example as the sponsors of such transactions the reinsurers control 2/3 of the so-called CatBond market) the reinsurance industry assumes a bridging function between the capital markets on one hand and the issuers and demanders of collateral security on the other.

By comparison to the transfer of insurance risks in the capital markets, the development of the transfer of financial risks in the insurance market (especially in the form of loan insurance and loan derivatives) has been much more dynamic. Via loan insurance and derivatives respectively, the different equity requirements can be exploited for the loan and insurance sector. A danger for the insurance industry with respect to the underwriting of loan risks lies in a pricing policy which is possibly too low.

Further demand for a synthesis of capital market and insurance products will result from the increasingly widespread integrated risk management approaches.

In conclusion it can be said that cooperation and meaningful expansion are the key words for the intersection of insurance and capital markets.

Anke Leiser (CFSresearch staff)

We asked HANS-JÜRGEN SCHINZLER:

In your industry/field, what is the most important technical qualification a junior high potential should have, or should try to acquire?

And he answered:

"We are mainly looking for economists, business analysts and mathematicians specializing in business and economics, industrial engineers, lawyers with international backgrounds provided that their subjects and professional experience relate a certain extent to our business.

In addition, we are looking for graduates who have successfully completed their studies and have first theoretical or practical experience in finance. In all cases we set special value on excellent analytical skills, a commanding knowledge of English and good knowledge of one further language.



Special experience in reinsurance is not absolutely necessary, because during our 18-month graduate trainee programme, trainees will receive on-the-job training in specially created positions in the various underwriting divisions.

Graduate trainees are given an individual training plan based on their defined training objectives. This also includes a course package specially designed for graduate trainees and containing different seminars on underwriting, methodological and social skills (for example, Introduction to Reinsurance Business, Communications, Successful Negotiation)."

In your industry/field, what is the most valuable personal qualifications a junior high potential should have, or strive to acquire?

And he answered:

"Especially the personal qualifications are very important. That is the reason, why our graduate trainees are selected not only by interview but also based on a one-day group selection process. During this process candidates can demonstrate their social and methodological skills in a variety of situations (e.g. discussions, meetings with clients, presentations).

They should be sensitive to other cultures and countries, ideally by having studied or worked for a certain period in a foreign country. Further, we seek candidates with excellent communication skills, a strong ability to work in a team and a distinctive customer orientation."

Please note, that, unless otherwise stated, the admission to the lectures is only possible with a valid ticket. For further information please contact Birgit Pässler, Email paessler@jfk-cfs.de, Tel. +49-(0)69-242941-14.

CFSresearch lectures

Contracts and Exits in Venture Capital Finance

On 30th January 2003, DOUGLAS CUMMING visited the CFS and gave a lecture on the "Contracts and Exits in Venture Capital Finance." Venture capital (VC) contracts are heterogeneous regarding the selected securities, control rights, veto rights among other things, depending on the characteristics of the transacting parties. VC exit decisions are also heterogeneous since a disposition may involve an initial public offering or an acquisition, and venture capital contracts typically specify which party has control over the exit decision. It is widely recognized, however, that a venture capitalist's decision to invest in an entrepreneurial firm is based on exit potential.

Douglas Cumming examined a hand-collected dataset involving contracts and exits from 179 investment rounds in 132 entrepreneurial firms by 17 European VC funds. In a nutshell, he first finds evidence that the securities used are not functional equivalents in venture capital contracts. Whether contracts other than convertible preferred equity are used depends on the definition of venture capital. Second, the allocation of control rights, board seats, etc., depends on the allocation of cash flow rights through the use of different securities. Third, the selected exit vehicle and the returns to venture capital significantly depend on the allocation of cash flow and control rights in specific venture capital investments.

The lecture attracted a large audience of interested venture capitalists and investment banking specialists. Also, the seminar gave rise to an interesting discussion between the lecturer and participants. Among other questions, the speaker was asked whether, given the market conditions, he observed a shift over time in the contract design associated with the shift in exit expectations. Douglas Cumming somewhat confirmed the trend.

Douglas Cumming is Professor Assistant of Finance, Economics and Law at the University of Alberta School of

Business. His research is primarily focused on venture capital, with a focus on international differences in a wide range of venture capital markets, including the European, North American and Australasian venture markets. The research presented at the CFS was previously presented at the American Finance Association (Washington, DC, 2003), and the European Financial Management Association (London, 2002), among others. *Issam Hallak (CFSresearch staff)*

Unless otherwise stated, all lectures take place at 5:30 p.m. in the "Vortragssaal" of the "Hauptverwaltung der Deutschen Bundesbank" in Hessen, Taunusanlage 6, ground floor, Frankfurt.

For further information please contact Birgit Pässler, Email paessler@ifk-cfs.de, Tel. +49-(0)69-242941-14.

Joint Lunchtime Seminars

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

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

The Joint Lunchtime Seminars are organized by Philipp Hartmann (European Central Bank), Heinz Herrmann (Deutsche Bundesbank), Volker Wieland and Klaus Adam (both University of Frankfurt and CFS).

Presentations in Monetary Economics, International Macroeconomics, Financial Economic and Econometrics:

7 Aug 02	Michael Devereux (University of British Columbia) "Endogenous Exchange Rate Pass-through" (Co-Authors: Charles Engel, University of Wisconsin and Peter Ejler Storgaard, Danmarks National Bank)
14 Aug 02	James Yetman (University of Hong Kong) "Publishing Central Bank Forecasts"
21 Aug 02	Matthew Braham (University of Hamburg) Frank Steffen (University of Hamburg & Hamburg Institute of International Economics). "Power in Hierarchical Structures"

28 Aug 02	Kaushik Mitra (University of London) "Performance of Monetary Policy with Internal Central Bank Forecasting"
4 Sept 02	Hans Christian Kongsted (University of Copenhagen) "Analyzing I(2) Systems by Restricted Vector Autoregressions" (Co-Author: Heino Bohn Nielsen, University of Copenhagen)
11 Sept 02	Evi Pappa (The London School of Economics and Political Science) "Do the ECB and the FED really need to cooperate? Optimal Monetary Policy in a Two-Country World"
18 Sept 02	Marco da Rin (University of Turin) "Europe's "new" stock markets"
25 Sept 02	Gianluca Benigno (London School of Economics) "Equilibrium Exchange Rate and Supply Side Performance"
2 Oct 02	Garry Young (Bank of England) "Hunky Dory?: Financial Pressure and Balance Sheet Adjustment by UK Firms" (Co-Author: Andrew Benito, Banco de Espana)
9 Oct 02	David Vestin (European Central Bank) "Interpreting Implied Risk-Neutral Densities: The Role of Risk Premia"
16 Oct 02	Bill Russell (University of Dundee) "The Long-run Relationships Among Relative Price Variability, Inflation and the Markup"
23 Oct 02	Jagjit Chadha (University of Cambridge) "On Ensuring Nominal Determinacy under Ricardian Fiscal Plans"
30 Oct 02	Jean-Pierre Danthine (University of Lausanne) "Intangible Capital, Firm Valuation and Asset Pricing" (Co-Author: Xiangrong Jin, University of Lausanne)
6 Nov 02	Hans Dewachter (Catholic University of Leuven) "Macro-factors and the Term Structure of Interest Rates" (Co-Author: Marco Lyrio, Erasmus University, Rotterdam)
13 Nov 02	Erkki Koskela (University of Helsinki) "Profit Sharing and Unemployment: An Approach with Bargaining and Efficiency Wage Effects"
20 Nov 02	Torben M. Andersen (University of Aarhus) "The Macroeconomic Policy Mix in a Monetary Union with Flexible Inflation Targeting"
27 Nov 02	Thorsten Hens (University of Zurich) "Soft Landing of a Stock Market Bubble. An Experimental Study"
4 Dec 02	Jürgen von Hagen (Center for European Integration Studies, Bonn) "The Choice of Exchange Rate Regimes in Transition Economies" (Co-Author: Jizhong Zhou, University of Bonn)
11 Dec 02	Horst Entorf (Darmstadt University of Technology) "Dance with the Dollar: Exchange Rate Exposure on European and German Stock Markets" (Co-Author: Gösta Jamin, McKinsey & Company, Munich)
18 Dec 02	Luisa Lambertini (University of California at Los Angeles)



CFSresearch conferences

International Research Forum on Monetary Policy, 5-6 July 2002, Frankfurt



This annual conference, organized jointly by the European Central Bank, the Board of Governors of the Federal Reserve System, the Center for German and European Studies at Georgetown University and the CFS, brings together policymakers and academics from both sides of the Atlantic. It provides an opportunity for discussing theoretical and empirical research relevant to monetary policy.

In his opening address, **WIM DUISENBERG** (ECB) distinguished three categories of research to be presented at this conference: first, issues at the heart of monetary policy-making such as inflation persistence and financial integration, second cross country comparisons and, finally, the international dimension of monetary policy-making.

EDWARD GRAMLICH (Federal Reserve Board) said in his remarks that the alleged wide gap between economic research and real world policy decisions is not present between monetary policy and research in monetary economics. He also suggested that other regions can learn a lot from Europe's experience in setting up a monetary union.

ALAN SUTHERLAND (University of St. Andrews) presented his paper on "International Monetary Policy Co-ordination and Financial Market Integration". In a two-country model with sticky prices the gains from monetary policy co-ordination depend mainly on the degree of risk sharing. The welfare gains are largest when there is risk sharing and the elasticity of substitution between home and foreign goods is greater than unity.

SIMON GILCHRIST (Boston University), **JEAN-OLIVIER HAIRAULT** and **HUBERT KEMPF** (both Université Paris-I Pantheon-Sorbonne) looked at "Monetary Policy and the Financial Accelerator in a Monetary Union". Financial market imperfections introduce important cross-country

transmission mechanisms in asymmetric shocks to supply and demand. The paper finds that the use of a single currency has a significant impact on the international propagation of exogenous shocks.

GIANCARLO CORSETTI (University of Rome) and **LUCA DEDOLA** (Bank of Italy) presented a two-country model in order to discuss real and monetary transmission in the presence of international price discrimination by firms. Interestingly, they found that international policy co-operation is redundant when goods markets are competitive, even when there is no asset trading, the law of one price does not hold and there is no optimal risk sharing.

PHILIPPE BACCHETTA (Study Center Gerzensee) and **ERIC VAN WINCOOP** (University of Virginia) presented a new open economy model where the currency in which prices are set is endogenous. It was shown that the higher the market share of an exporting country in an industry and the more differentiated its goods, the more likely its exports will be priced in the exporter's currency.

Basing their analysis on the estimation of New Phillips Curves for five major countries, **PIERPAOLO BENIGNO** (New York University) and **DAVID LÓPEZ-SALIDO** (Bank of Spain) found substantial differences in the degree of nominal rigidities across the EMU. Furthermore, their paper showed that it is welfare-enhancing to target an average inflation where the country with higher rigidities carries a higher weight.

CHRISTOPHER J. ERCEG and **ANDREW T. LEVIN** (both Federal Reserve Board) investigated the implications of the differences in the interest sensitivity of durable and non-durable goods for optimal monetary policy. They showed that a broad class of commonly-presented policy rules perform very poorly in terms of social welfare, especially rules that put a relatively high weight on inflation stabilisation. By contrast certain rules which react only to aggregate variables may yield a welfare level close to the optimum given a typical distribution of the shocks.

MARGARIDA DUARTE and **ALEXANDER L. WOLMAN** (both Federal Reserve Bank of Richmond) addressed the behaviour of regional inflation in a currency union, in particular the extent to which regional fiscal policy is able to influence the behaviour of regional inflation. For a symmetric version of a general equilibrium model calibrated to Germany, they found that productivity shocks alone generate somewhat more variation in inflation across countries

than has been observed between France and Germany. Government spending shocks do not account for a significant portion of inflation variation.

GÜNTER COENEN (ECB) and **VOLKER WIELAND** (University of Frankfurt) used a three-country model to investigate inflation dynamics and international linkages for the United States, the Euro area and Japan. Explaining inflation dynamics in the Euro area and Japan by Taylor-style contracts and those in the United States by Buiter-Jewitt/Fuhrer-Moore contracts, they evaluated the role of the exchange rate for monetary policy and found there to be little gain from a direct policy response to the exchange rate. *Marco Hoeberichts (former CFSresearch staff)/Elke Hahn (CFSresearch staff)*

The complete program, including papers and discussions, can be found on www.ecb.int/events/conf/intforum/

CFSsummer school

The CFSsummer school offers a stimulating environment for young doctoral students to discuss intensively common objectives and concerns on topics presented by an international faculty, helps doctoral fellows in the positioning of their work in relation to international research. Through systematic interaction participants will be encouraged to compare their approaches and examine their research work. In particular the opportunity to present own work will be given, to be discussed by the faculty. The summer school facilitates the establishment of contacts between young researchers coming from various universities and research institutions throughout Europe.



The Summer School 2003 will take place from 12-19th August at the Education Center of the Deutsche Bundesbank in Eltville/Rhine. We will keep you informed via our homepage www.ifk-cfs.de as soon as the program has been established.



Participants report on the Summer School 2002 in Monetary Economics:

*"In the macro part of the CFSsummer school courses were given by **JORDI GALI** (Universitat Pompeu Fabra, Barcelona), **LAWRENCE J. CHRISTIANO** (Northwestern University, Evanston) and **ATHANASIOS ORPHANIDES** (Board of Governors of the Federal Reserve System, Washington DC).*

Gali provided an introduction to the recent literature on optimising models with nominal rigidities. The modelling of staggered prices (and wages) allows consideration to be given to the output-inflation dynamics present in the data, i.e., the observation that prices react with a degree of inertia to changes in the real economy. The second part of the lectures were devoted to key implications for monetary policy in both closed and open economies.

Christiano introduced additional features of a general equilibrium model which enable the study of alternative monetary policies and then proposed an econometric strategy for estimating such models. The approach outlined offered an explanation of the dynamic response of an economy to changes in monetary policy. The tools of public finance used for studying the implications of staggered price setting for optimal monetary and fiscal policy were also reviewed.

Orphanides discussed the various views in the literature on the role of monetary policy and how to interpret monetary policy



practice. The magnitude of informational problems associated with the implementation and interpretation of simple monetary policy rules in historical perspective were examined and, using Taylor's rule as an example, it was shown that the reliance on real-time data is essential for the analysis of monetary policy rules.”

Roberto Mario Billi/Kai Christoffel (both University of Frankfurt)

The summer school therefore started in a very friendly atmosphere, work however started next day. Days were split into teaching sessions in the morning and students presentations in the afternoon.



Collegium
Glashütten,
a company of
the Commerz-
bank-Group

and on the Summer School 2002 in Financial Economics:

“CFS organized its yearly Summer School in Finance at the Collegium in Glashütten, nearby Frankfurt, from 13th to 20th August 2002. On 12th August evening the organizers, **JAN P. KRAHNEN** and **CHRISTIAN SCHLAG**, greet the 28 young researchers coming from all over Europe as well as the faculty, **PATRICK BOLTON** (Princeton University) and **ERNST-LUDWIG VON THADDEN** (Lausanne University), **GALI**, **CHRISTIANO** and **ORPHANIDES** from the macro part.

Participants
and faculty
of the
CFSsummer
school 2002

This year, the topic of focus was Financial Contracting. In the first set of lectures, von Thadden and Bolton presented the main concepts and models of financial contracting in the first lecture. The quality of the teaching permitted beginners to learn fundamentals of this essential research area of finance, and better skilled students to revise their knowledge thoroughly. In the second stage, they exposed frontier research of innovative and rapidly expanding areas. The lectures involved latest work on banking crises, sovereign debt, and the political economics.



Ernst
Ludwig von
Thadden,
Patrick
Bolton

Afternoons were dedicated to students presentation of their own research and common work consisting in discussing the research. The summer school was therefore an excellent opportunity given to young researchers to have active participation of the audience followed by private discussions with the faculty. Interestingly, provided the background diversity, the organisers were able to schedule interesting papers related to each of the morning sessions. The quality of the summer school was broadly acknowledged by students and faculties. The human contact and the friendly atmosphere certainly contributed to its success.”

Issam Hallak (CFSresearch staff)

JEDC Editors' Workshop on Heterogeneous Agent Models in Macro- economics and Finance

On 13th September, 2002 the JEDC Editors' Workshop on Heterogeneous Agent Models in Macroeconomics and Finance took place in Frankfurt. The background to this event was the editors' meeting of the internationally acknowledged Journal of Economic Dynamics and Control (JEDC), the editorial board of which has been headed by **VOLKER WIELAND** (University of Frankfurt and CFS) since January 2002. The subject of the workshop was the use of models with heterogeneous market participants in the field of macroeconomic and financial research. Particular focus was on the numerical implementation of complex algorithms for solving such models. The workshop was led by Volker Wieland and **KLAUS ADAM** (University of Frankfurt and CFS), with presentations and discussions by **WOUTER J. DEN HAAN** (University of California, San Diego and London Business School, London), **MICHAEL REITER** (Universitat Pompeu Fabra, Barcelona), **CARS H. HOMMES** (CeNDEF and Tinbergen Institute, Amsterdam) and **MICHAEL BINDER** (University of Maryland).

In his welcoming speech Volker Wieland emphasized the importance of incorporating heterogeneity on the part of market participants in macroeconomic and finance models, in order for them to constitute a realistic representation of the real world. However, the inclusion of heterogeneity implies a considerable increase in the complexity of such models which explains why the methods necessary for solving the models are in part highly complex. Fortunately, considerable progress has been made in this area over the last few years and it was the aim of this workshop to also make its contribution in this respect.



Wouter J.
den Haan

In his presentation on "The Importance of the Number of Different Agents in a Heterogeneous Asset-Pricing Model", Wouter J. den Haan emphasized that in standard asset pricing models the heterogeneity of agents is only taken into account insofar as two different types of agents are analyzed. For this reason it is important to look at the extent to which models that include a greater, more realistic number of different agents confirm the results of the (simpler) models with just two types of agent. Using a

model of market uncertainty den Haan showed that uneven wealth distribution in an economy with two types of agents is considerably greater than is the case in a model with several different types of agent. Furthermore, the latter also exhibits a significantly lower volatility of real interest rates. A further consequence with respect to the presence of several different agent types is that, owing to the subsequently more complex asset market, it is possible to lessen fluctuations in income.

Michael Reiter presented a paper on the subject of "Recursive Computation of Heterogeneous Agent Models" in which he introduced a method for the stepwise solution of models with a continuum of individuals. The problem of adequately modeling the wealth distribution within an economy was solved by Reiter by using a highly flexible functional form (step function densities). This method makes it possible to increase the model's accuracy by using information which arises from the simulation of the wealth distribution generated by the model. According to Reiter theoretical considerations and practical experience suggest that this methodology exhibits very good convergence properties. He verifies this assumption using a standard model with heterogeneous economic agents with which he is indeed able to demonstrate the high degree of modeling accuracy with reasonable computational effort.



Michael
Reiter

Cars H. Hommes presented joint work carried out with Williams A. Brock (University of Wisconsin) and Florian O.O. Wagener (University of Amsterdam), in which a theoretical framework for evolutionary markets with heterogeneous trading agents is developed. In this research paper entitled "Evolutionary dynamics in markets with many trader types" the authors devise a marginal value concept which they term the "Large-Type Limit" and which describes the dynamic behavior of markets with different trading agents. When this concept is applied to analyzing the consequences of heterogeneity within a simple evolutionary financial market model, it can be seen that an increase in the diversity of market opinions implies model dynamics which deviate from those obtained in a model with rational expectations. In addition, the phenomenon of excess volatility in asset earnings might arise. Concluding his presentation, Hommes emphasized the usefulness of the model for shedding light empirically on the issues being discussed.



Cars H.
Hommes

Michael
Binder

Michael Binder held the last paper in the workshop talking about the topic of “Aggregation and Asset Price Dynamics”. In his presentation he described a model of financial markets which highlighted the causes of some widely reported empirical features of stock markets.

Among these features is the occasional predictability of excess (compared to fundamental data) returns using publicly available information, excess volatility of security returns and the predictability of trading volume and volatility. The model suggested by Binder further attempts to assess the role of traders' beliefs about the prevailing market opinion on asset earning dynamics. Possible applications of the proposed model are given by all those situations in which the decisions of market participants depend on the – for them – unobservable decisions of their observed peer group. Finally, Binder compares the quantitative predictions made on the basis of the model about asset market dynamics with the actual values of the US stock market in order to demonstrate the goodness of fit of his model.

Günter Beck (CFSresearch staff)

Forthcoming CFSresearch conferences:

Pensions and Long-Run Investment

The conference on “Pensions and Long-Run Investment” aims to bring together researchers, financial market practitioners and regulators who are familiar with the new types of pension instruments. In Germany these financial products, or more precisely that portion which are associated with old age pensions, are collectively known as the Riester retirement pension scheme (Riester Rente). Leading representatives of multinational institutions such as the OECD will discuss the development of such capital market-based elements of retirement pensions, whilst regulators will comment on the current regulations in Germany with respect, for example, to the nominal maintenance of capital. Practitioners will present for discussion the products and strategies developed by their companies, and academics from various European Universities (e.g. **DAVID BLAKE**, Birkbeck College, University of London, **RAIMOND MAURER** and **CHRISTIAN SCHLAG**, both from Goethe University, Frankfurt) will discuss in detail the risk return profile of such long-run investment strategies and

the problems associated with the accumulation and payout phase of saving plans. This event is intended for all management personnel from the field of asset and portfolio management, company pension schemes as well as wealth and investment counseling services, who would like to be concisely informed about the most recent developments in the fields mentioned. The aim is to provide participants with an overview without resorting to a great deal of technical or institutional detail. *Christian Schlag (University of Frankfurt)*

Dates of other forthcoming CFSresearch conferences can be found in the timetable enclosed or on our website.

Staff

The Center for Financial Studies is pleased to announce that **ULRIKE LEXIS** joined our staff on 3rd February 2003 as Head of Research Management.

Lexis studied modern languages at the International Business School Lippstadt and later economics at the University of Kiel with an emphasis on macroeconomics. Her professional career includes a year at the Ministry of Economics, Kiel and more than six years as a program manager at Bertelsmann Stiftung, Gütersloh. Her latest project there was the establishment of an online degree-course in economics for teachers. Her task at the Center for Financial Studies extends from the enhancement of public relations to coordination and focussing of research.

Tel.: +49(0)69-242941-17

Email: lexis@ifk-cfs.de

Ulrike
Lexis

CFSquestionnaire

In order to ensure that our program at CFS is designed to match the interests of our target group, we are asking you to complete the attached 3-pages-questionnaire and return it to us by fax.

The names of all returnees (who have fully completed the questionnaire) will be entered for a draw. There are five seminar places from the Executive Development area for 2003 to be won. For more information about the forthcoming seminars please see attached timetable or visit us under www.ifk-cfs.de



CFSresearch activities

The start of a new pan European, EU-financed “Research and Technological Development” Network at the CFS

During a constituent meeting at the CFS on 30th November, 2002 at which CFS and three European partners, namely the Financial Market Group of the London School of Economics, the HEC Paris and the University of Turin, were present, a new EU-financed “Research and Technological Development Network” (RTD) was established on the subject of “Risk Capital and the Financing of European Innovative Firms” (RICAFE). This research network fits in directly with the CFS research program “Venture Capital and New Markets in Europe”, which investigates the relationship between venture capital financing, innovations and new capital markets in Europe.

The objective of this research network, which is financed by the European Commission, is to encourage and enable the exchange of research on a common complex of subjects between various renowned European research institutions. The EU funding which will finance the Network over the course of three years, thus not only allows the intensive exchange between researchers of the institutions involved as well as the financing of academic research assistants, but also the organization of various workshops and conferences with internationally renowned academics and practitioners. The RTD Network thus provides the researchers at the CFS with an excellent opportunity for working together with highly respected academics. The visibility of the CFS as one of the institutions active in this field will be considerably increased in this context.

The aim of this project as regards content is a detailed analysis and evaluation of the relationship between the availability of venture capital and the innovative ability of European enterprises. In this context the details of the European venture capital industry and the new venture capital markets will be examined and any emerging common factors or differences respectively, from the established Anglo-American countries will be taken into consideration and evaluated. The research groups’ studies will focus, among other things, on the compilation of an in-

depth empirical stocktaking of the market mechanisms for venture capital in Europe.

The project comprises three sections. The first section will be devoted to examining the ability of the European financial systems for making venture capital available to young, innovative enterprises. These studies will include among other things an analysis of the structure of financing for young, innovative enterprises in Europe as well as the determinants of supply with respect to risk capital, in particular venture capital.

A second section will look at the extent to which and in what form venture capital affects the innovative ability of young enterprises, in other words the relationship between innovation and venture capital will be looked at more closely. The influence and the significance of venture capital for the success of young enterprises will be assessed, as will the role played by public incentives and subventions in this process. Furthermore, the structures of the VC industry (contract and compensation structures) and their effects on the success of venture capital investments will be analyzed. Overall, the aim is to produce a very precise picture of the role of venture capital in the framework of the informed society, which at the end of the day forms the basis for long-term growth.

The aim of the third section, which brings together the analyses and studies of the first two sections, is to draw up the implications for policy measures already in existence and for possible future measures. Thus, a broad spectrum of different aspects of the relation between venture capital and innovation will be examined. These aspects are in the long run not only vital for the development of this important segment of the capital market, but also for the European economies as a whole.

During the course of this initial meeting of the Network between CFS, LSE (Financial Markets Group), the HEC Paris and the University of Turin on 30th November, 2002 in Frankfurt, the various possibilities for collaboration were already easy to recognize so that in the future there will certainly be interesting and high quality research results as well as events to report on from this network.

Uwe Walz (University of Frankfurt and CFS)



www.ifk-cfs.de

SPECIAL: ECB-CFS RESEARCH NETWORK

The Research Network “Capital Markets and Financial Integration” is a joint initiative by the European Central Bank (ECB) and the CFS. It is organized together by both academics, including FRANKLIN ALLEN (Wharton School, University of Pennsylvania), GIANCARLO CORSETTI (University of Rome III and Yale University), JEAN-PIERRE DANTHINE (University of Lausanne), JAN P. KRAHNEN (CFS and University of Frankfurt), MARCO PAGANO (University of Salerno), AXEL WEBER (University of Cologne, Member of the German Council of Economic Experts, CFS) and central bankers, among whom are VÍTOR GASPÁR (ECB), and PHILIPP HARTMANN (ECB). The Network took up its activities with a launching workshop at the ECB in Frankfurt in April 2002 (we reported on it in the last Newsletter 2/02). The launching workshop was aimed at setting an agenda for the future development of the Network and resulted in a detailed “roadmap”. This roadmap highlights the main areas of priority in research focussing on the principle topics of the current and future structure and the integration of the European financial system and its international linkages. It is intended to provide guidelines for the Network’s future activities.

The roadmap is organized into two broad dimensions, which define the scope of the Network, identify the set of research areas and highlight particularly promising and necessary issues for new research. In this respect, the roadmap distinguishes between the segments of a financial system as the

first dimension, and the most important research sections as the second. Among the financial system segments, the roadmap mentions financial intermediaries such as banks, insurance companies or securities firms, the characteristics of different financial markets, for example equity, fixed income or foreign exchange markets, and finally the interactions between the financial system and the economy in general. The most important research sections as the second dimension of the roadmap are concerned with financial system structures in Europe, and aspects of financial integration in Europe as

well as their financial linkages to the United States and Japan. Both empirical and theoretical research which falls within the scope of these two dimensions is welcome as a contribution to the Network.

The roadmap also specifies a number of key factors and research approaches which should be addressed when dealing with any of the indicated research issues. In this respect, studies will be appreciated which look at how to overcome the difficulties of measuring and describing economic and financial phenomena observed in the integration process of the European



Eurotower
and CFS,
Frankfurt/M

financial system. Furthermore, the importance is emphasized of deriving both drivers and obstacles in this process. Generally, the studies aim at giving a clear picture of the efficiency and stability effects on European financial convergence, and as such, should allow relevant policy implications to be drawn.

The Network's main priority of coordinating and stimulating top-level, policy-relevant research along the lines of the roadmap is to be pursued in several ways. Future workshops will aim at addressing the most important research areas. In 2003, two workshops are planned. In March 2003, the second workshop of the ECB-CFS Research Network will be held in Helsinki, and will be concerned with "European Equity Markets", "Bank Competition and the Geographical Scope of Banking Activities" and "International Portfolio Choices and Asset Market Linkages between Europe, the United States and Japan". The third workshop in November 2003 will take place in Athens. It will concentrate on "European Securities Settlement Systems", "Start-up Financing and 'New Markets'", and "European Bond Markets". The closing date for submitting research papers on these topics is 15th September, 2003.

The purpose of the workshops is to provide an interested audience, comprising central bankers, practitioners and academics, with the opportunity to discuss the respective topics from both their personal and institutional points of view. Workshop results are therefore expected to be extremely varied and thus lead to interesting insights into the observed and

anticipated process of European financial integration.

In addition, the ECB-CFS Research Network aims at promoting research in the indicated areas by granting fellowships particularly to young researchers. In 2003, five "Lamfalussy Research Fellowships" will be distributed by the ECB to young researchers under the age of 36. Each fellowship will be endowed with an honorarium of € 10.000. Lamfalussy fellows, who are to be selected by February 2003, will present their research results at the Network's conferences and workshops and are expected to publish their work in high profile journals. The fellowships are named after Baron Alexandre Lamfalussy. He was the first President of the European Monetary Institute and one of the leading central bankers of our time. He has become one of the main proponents for a single capital market within the European Union. Recently, he chaired the "Committee of Sages on the Regulation of European Securities Markets", which proposed a reform of the EU regulatory process in order to strengthen the system and adapt it to rapidly changing financial markets. Apart from these policy-oriented tasks, Baron Lamfalussy has also taught at the University of Louvain and Yale University and authored numerous research articles and books on economic policy.

The year 2003 also sees the launch of a new internet website for the ECB-CFS Research Network. In order to make the Network's internet site more easily accessible and to strengthen its appearance in the world wide web, the website presenting the Network moved to the new domain [http://www.eu-](http://www.eu-financial-system.org)

[financial-system.org](http://www.eu-financial-system.org). The new website gives a concise overview of the Network's purpose and main research areas, its organization and structure and also of past and upcoming events. A large part of the website is dedicated to presenting the Network's research results in the form of working papers or conference and workshop proceedings. In addition, it presents a comprehensive collection of links to institutions providing information, in particular with regard to key facts and statistics in the development of the European financial system. As such, links are included to descriptive information of the European market's history, regulatory aspects of the integration process, policy documents and economic statistics. Finally, the website is intended to provide individuals as well as institutional contributors with the opportunity to state their objective and interest in the Network, thereby facilitating contact between researchers. It will furthermore include a collection of links to various ongoing initiatives that are of interest to the Network.

Apart from these recent projects of the ECB-CFS Research Network, one initiative directed more to the long-term future considers collecting research papers on the Network's main areas of interest, either from Network members, Lamfalussy fellows or workshop participants, and publishing them in a special volume. This collection will be dedicated to the structure and integration of European financial markets and their international linkages and is intended to represent part of the Network's achievements in this area of research.

Christina Metz (University of Frankfurt and CFS)



We asked Vítor Gaspar about:

CFS: What are the main actors of the network (central bankers, academics,...) and how do you assess their assignment?

Gaspar: "The main actors of the network are researchers working in National Central Banks, academia or institutional organizations. Our goal is to facilitate networking between them. By gathering together bright people with different backgrounds, we want to create the conditions to exploit latent synergies and favor cross-fertilisation. On the one side, the Network can benefit from the expertise and knowledge that researchers of National Central Banks are uniquely able to provide. On the other, academics will contribute by bringing rigorous thinking and promoting our research agenda among their colleagues. The Research Network will thus act as a catalyst and will provide a forum where the issues of European financial market integration can be discussed from a variety of perspectives."

CFS: How are the research topics chosen with respect to their policy relevance?

Gaspar: "The ECB-CFS research network aims at co-ordinating and stimulating top-level and policy-relevant research that significantly contributes to our understanding of the current and future structure and integration of the financial system in Europe and its international linkages.

The focus will be on:

- ▶ The progress of European financial integration
- ▶ The structure of the European financial system
- ▶ Financial linkages between Europe, the U.S. and Japan.

The organizers believe that these issues are presently under-researched and therefore not well understood. The results of the network are expected to be of interest to policy makers and financial market participants throughout Europe. More detailed information about the scope and research priorities of the network can be found in the network road map, available on the Network web site, <http://www.eu-financial-system.org>."

CFS: What are the main future plans of the network?

Gaspar: "During 2003, there will be two more workshops. The second workshop of the ECB-CFS Research Network will be held at the Bank of Finland on 11-12th March. It will deal with European equity markets, bank competition and the geographical scope of banking activities, and international financial linkages. The third workshop will be at the Bank of Greece, on 20-21th November. The focus will be on European securities settlement systems, start-up financing and European bond markets. In early 2004, we plan to have a conference at the ECB, whose main purpose is to summarize what we learned so far and draw some tentative conclusions. After that, we will reconsider the scope and further activities of the Network."



Vítor Gaspar is Director General Research at the ECB. The Directorate General Research (DG-R) is the ECB business area responsible for conducting theoretical and empirical research relevant to the conduct of monetary policy and for providing information on how research results may have a bearing on policy decisions. DG-R takes a leading role in fostering interaction with other research centres and with the academic community and in contributing to the external visibility of the ECB through the publication of research findings. He is also one of the Steering Committee members of the ECB-CFS Research Network and Member of the Advisory Council of the CFS.

compiled by Barbara Kleiner (CFScommunications)

CFSresearch staff AT (INTER)NATIONAL RESEARCH CONFERENCES

The 17th Annual Congress of the European Economic Association (EEA) and the 57th Econometric Society European Meeting (ESEM) took place in Venice on 21st - 28th August, 2002. Both these events are held on an annual basis and are regarded as the most important platform at the European level for economists and econometricians

from which to present the results of their research. In order to maintain high standards all submitted research papers undergo a strict selection process and only a specific fraction are finally chosen for presentation. It was

therefore gratifying that the working paper "Economic Integration and the Exchange Rate Regime: How Damaging are Currency Crises?" jointly written by GÜNTER BECK (CFS) and AXEL A. WEBER (University of Cologne, Member of the German Council of Economic Experts and CFS) as part of the CFSprogram area "Local Prices and Aggregate Monetary Policy" was accepted for presentation at both events.

At two of the conference group meetings on the subject of "Currency Crises" Günter Beck presented and discussed the results of this study. Particular interest was generated by the finding that the global integration of goods markets has not – in contradiction to the generally held belief about the globalization which took place during the nineties – particularly increased over the last decade, but rather more, especially in the emerging markets affected by currency crises (Mexico, Malaysia, Indonesia, the Philippines and Brazil), has tended to decrease. From an economic policy point of view the finding was also significant which suggested that intermediate exchange rate regimes such "crawling pegs" or simple fixing tend to exhibit particularly negative results, supporting the hypothesis of the vanishing intermediate regime put forward among others by the IMF in the wake of the Asian Crisis.

Günter Beck (CFSresearch staff)

PUBLICATIONS

CFSworking paper series

The CFSworking paper series presents the result of scientific research on selected topics in the field of money, banking and finance. The authors were either participants in the Centers' Research Fellow Program or members of one of the Centers' Program Areas.

Copies of working papers are available at the CFS (Christine Ruhland, Tel. +49(0)69-242941-80) or can be downloaded from our homepage www.ifk-cfs.de.

- | | |
|---------|---|
| 2002/09 | Marco Hoeberichts
The Credibility of Central Bank Announcements |
| 2002/10 | Markus Haas
Stefan Mittnik
Marc S. Paoella
Mixed Normal Conditional Heteroskedasticity |
| 2002/11 | Elke Hahn
Core Inflation in the Euro Area: An Application of the Generalized Dynamic Factor Model |
| 2002/12 | Yunus Aksoy
Hanno Lustig
On the Short and Long Term Real Effects of Nominal Exchange Rates |
| 2002/13 | Andreas A. Jobst
Collateralised Loan Obligations (CLOs) – A Primer |
| 2002/14 | Andreas A. Jobst
The Pricing Puzzle: The Default Term Structure of Collateralised Loan Obligations |
| 2002/15 | Athanasios Orphanides
Activist Stabilization Policy and Inflation:
The Taylor Rule in the 1970s |
| 2002/16 | Stefanie A. Franzke
Christian Schlag
Over-Allotment Options in IPOs on Germany's Neuer Markt – An Empirical Investigation – |
| 2003/01 | Klaus Adam
Learning to Forecast and Cyclical Behavior of Output and Inflation |
| 2003/02 | Klaus Adam
On the Relation between Robust and Bayesian Decision Making |
| 2003/03 | Klaus Adam
Learning and Equilibrium Selection in a Monetary Overlapping Generations Model with Sticky Prices |

 www.ifk-cfs.de

BEITRÄGE ZUM CFSScolloquium

The "Beiträge zum CFSScolloquium" is a German language publication, documenting the CFSScolloquium series. Over forty volumes now exist, reflecting the remarkable development of the German and international financial markets over the past three decades.

The current edition is now available at book stores. This double volume offers a series of new and relevant interpretations of monetary policy for various fields of application from European monetary policy through to traditional commercial banking and insurance company assessment management. The contributions in this volume, which were held as presentations by OTMAR ISSING, ERWIN GUNST, KLAUS-PETER MÜLLER, THOMAS KABISCH, ROLF-E. BREUER, HEINZ-JOACHIM NEUBÜRGER, HESSEL LINDENBERGH and KLAUS MANGOLD during the CFSScolloquium series 2000/2001 and 2001/2002 in Frankfurt, focus on the themes of "Financial Markets and E-Commerce" as well as "Cross Border Financial Integration – Trends, Strategies and Lessons Learned."



CFSSexecutive development

CFS makes its contribution towards Executive Development and qualification training in the field of financial markets, financial intermediaries and monetary economics in the form of one to four day seminars as well as in-house events. Well-known university lecturers, leading practitioners and a network of international partners impart high-quality knowledge as well as the methods and instruments for translating this knowledge into practice. The seminars and conferences are aimed in particular at top and middle level managers as well as specialists from banks, insurance companies, trade and industry. They take place under ideal conditions at the training centre of the Commerzbank AG, in Glashütten-Oberems (Taunus), the training centre of the Deutsche Bundesbank in Eltville and at Commerzbank Auditorium in Frankfurt. Special terms are available for all participants from member firms.

CFS is offering amongst other things the opportunity to acquire qualifications in the following subjects: (the complete timetable is enclosed)

CFSSeminars

Emerging Markets Economies: Risks and Opportunities for Banks and Investors on 23/24th May, 2003

(Course language will be either English or German depending on the majority of participants)

At a time when there has been a harsh correction of world stock markets, the emerging market asset class has on average performed relatively well. But cross-country differences are very marked. In Latin America the default of Argentina was the biggest in history. Brazil's debt sustainability is not assured, despite some encouraging developments on the political front. In Eastern Europe, Russia has outperformed the expectations of most observers after

the default of 1998, but the sustainability of growth at lower oil prices remains uncertain. EU accession seems to be an assured event for 8 countries in Central Europe, but how would the markets react to a “no vote” on EU accession, for example in Poland? Will currency risk continue to be a source of uncertainty until these countries join EMU? In South-East Asia, the emerging economies seem to have recovered from the Asian Crisis in 1997/1998, but to what extent have they reformed their economic structures?

Banks and investors have to discriminate between countries which are likely to prosper and meet their obligations and others which might default on their external debt. The country ratings assigned by the major credit agencies provide some orientation, but as recent experience has shown, the agencies are often lagging behind and do not give prior warning of financial crises. There is clearly the need for banks to assess internally the underlying risks of their emerging market exposure. On the credit risk side, internal ratings affect calculations of risk-adjusted returns. On the market risk side, stress testing of emerging market positions ought to account for currency risk, credit spread risk and domestic interest rate risk. Investors (institutional and retail) should also analyze country risk in the emerging markets in order to check, for example, whether sovereign spreads in the bond market adequately reflect sovereign risk. What is required is a balanced judgment of both the risks and opportunities for investing in these markets, since the high returns have to be weighed against the potentially higher risks. A systematic approach to country risk allows a comparison to be made of countries in quite different regions of the world, with different political systems and different levels of economic development. Banks and investors also have to consider the time profile of country risk (short-term versus medium and long-term) depending on their investment horizon.

What alternative risk indicators are available for these assessments? Can the analysis of the history of financial crises in emerging market economies help to predict future crises? How do policymakers react to such crises and how does official intervention in the markets affect investors and financial institutions? What have international financial institutions learnt from the events in Mexico, Asia and Russia, and, more recently, in Argentina?

These are only a few of the questions that will be analyzed extensively in a seminar lead by an experienced asset manager (**HARALD EGGERSTEDT**, Cominvest Asset Management), an academic expert (**AXEL A. WEBER**, University of

Cologne, Member of the German Council of Economic Experts and CFS) and a financial market practitioner in country risk (**ROLAND BECK**, Deutsche Bank Research). Their in-depth coverage of theories, facts and empirical insights combined with a hands-on case-studies approach and practical tools for country risk assessments will provide a unique account of our current understanding of the causes and consequences of financial crises in emerging market economies.

Roland Beck (Deutsche Bank Research)

Faculty



AXEL A. WEBER is Professor for International Economics at the University of Cologne, Germany since 2001 and Member of the German Council of Economic Experts since 2002. He was appointed Director of the CFS and Professor of Monetary Economics at the University of Frankfurt in 1998. He has been active as a consultant for numerous policy institutions, including the European Commission, the European Parliament, the European Central Bank, the Austrian National Bank and the Hungarian National Bank. He has been a Visiting Fellow at the Brookings Institution and the Research Department of the International Monetary Fund, and is currently an Associate Editor of the *European Economic Review* and a Research Fellow at the Center for Economic Policy Research (CEPR) in London. Weber has published extensively in the field of macroeconomics, with articles appearing in journals such as the “*European Economic Review*”, “*Economic Policy*” and the “*Carnegie Rochester Conference Series on Public Policy*”.



HARALD EGGERSTEDT is a portfolio manager at Cominvest Asset Management. Previously he was the head of Emerging Markets research within the Economics Department of Commerzbank AG in Frankfurt. He analysed developments in emerging financial markets, working closely with the bank's Global Securities division. From 1995 to 1998 he was the head of the country risk analysis group at Deutsche Bank Research. Reflecting Deutsche Bank's increasing involvement in the emerging securities market he reorganized the country risk department in 1997 and set up a separate event risk monitoring group. Before moving to the private sector, he worked for five years as a country economist at the World Bank in Washington DC, USA: He worked in the departments covering Turkey, Mexico and Pakistan where he was mainly in charge of macroeconomic programming.



ROLAND BECK is country economist for Eastern Europe within the Risk Analysis Group at Deutsche Bank Research. In his Ph.D. thesis at the CFS, he examined econometrically the role of country fundamentals on emerging market bond spreads. Within a part-time programme for Ph.D. students, Beck worked in the economics department at Commerzbank AG. He completed his undergraduate studies in economics and philosophy at the University of Freiburg. He then spent a year on a scholarship from the Studienstiftung des Deutschen Volkes (German National Merit Foundation) at the University of Maryland/USA. During his graduate studies at the University of Bonn, econometrics and international economics became his main focus of interest. In the course of his studies, Beck gained work experience as an intern at the United Nations, the Bundesbank and the World Bank.

ables such as the shortfall probability or the average expected shortfall, there will be a presentation of modern simulation methods for generating a large number of return scenarios, which then permit a sound analysis of long-run risks. A detailed discussion will then follow on the implications of these risk return profiles for portfolio management with long-run investment horizons, during which attention will also be paid to the problem of payment promises and guarantees. *Christian Schlag (University of Frankfurt)*

For registration or further information on other forthcoming seminars please visit our homepage www.ifk-cfs.de or contact Christiane Bauder, Tel. +49(0)69-242941-30, Email: bauder@ifk-cfs.de

Risk and Return on Long-Run Investments on 4th April, 2003

*(original German title: Rendite und Risiken
langfristiger Investments)*

(Course language will be German)

Since the nominal capital maintenance was legally stipulated for Riester products for retirement pension schemes, and following the extremely weak performance on the stock markets in the past few years, questions have often been raised about long-run returns and the risk potential of various types of assets. A more exact analysis of the statistical properties of such long-run investment strategies forms the focus of the one-day CFSseminar on "Risk and Return on Long-Run Investments", which will be held on 4th April, 2003 by Raimond Maurer and Christian Schlag. (both University of Frankfurt).

The main focus is on practically relevant information about the long-run risk return profile of different asset classes (stocks, bonds, real estate) as well as about the portfolios from these basic types of investment. Considerable attention will be given to the discussion on the choice of valid assessment criteria and the means of measurement for long-run risks. Standard approaches, based on a purely historical perspective, exhibit fundamental weaknesses which hinder or render impossible a sound analysis of long-run investment strategies. After an account of the alternative measures of risk, which tend to be based more on vari-

CFS executive conference

Advances in Behavioral Finance II 28th April, 2003

(Conference language will be German)

During the last five years the financial markets have become more of a riddle to their participants than ever before. Not only have the stock markets experienced an excessive boom period but they have also undergone one of the deepest slumps in history, which cannot be explained by fundamental factors alone. Younger market participants in particular lack the experience of dealing with drastically falling prices. Analysts and consultants alike have been at a loss to explain to clients that, which they themselves have frequently not been able to understand.

In these difficult times more than just one person has been forced to take leave of the financial markets. For some it has been because of real financial dire straits, for others it is because they have lost faith in the stock exchange. Irrespective of these decisions the world will continue to turn and it is precisely during an economic trough that it becomes all the more important to prepare yourself and your clients for better times ahead and to offer sound advice to those seeking it. This will not happen by sticking to standard economics arguments. Investors, wishing to invest their money in the stock exchange, want to know what really influences the markets. They often feel let down by their consultants who, by the nature of their profession, are not inclined to talk about losses.

For some years now in Europe a new branch of capital market analysis has been establishing itself in the area of tension between economics and psychology, namely behavioral finance. This research approach takes up insights from the field of psychology about the systematic mistakes in people's decision processes in order to be able to explain and predict more accurately events on financial markets. In this way market agents are helped in recognizing and avoiding their own mistakes, as well as in anticipating the "limited rational" behavior of other market participants and developing suitable strategies for profiting from their mistakes. Investment consultants also stand to benefit from behavioral finance insights since they become better able to put themselves in their client's position, which is a fundamental requisite for building far-reaching confidence. This confidence in turn generates business and earnings for both investors and consultants.

Although most market participants are convinced of their own rational behavior, the results of their decisions are often not what you would call optimal. However, as long as substantial profits are realized, at the end of the day there are no problems. It is when losses are incurred that systematic mistakes start to make themselves painfully felt, and it is then that it becomes apparent for the first time whether investors have earned sufficiently well during the good times to be able to do more than simply tide out the bad years.

For the first time in October 2002 the Nobel prize for economics went to a psychologist, Daniel Kahneman, confirming that a change in attitudes has taken place in this field – homo oeconomicus is now being given a breath of life.

The CFS has responded to the rapidly growing interest on the part of business practitioners in behavioral-oriented Financial Market Research by organizing various events. This one-day conference is part of this initiative. **JOACHIM GOLDBERG** (cognitrend GmbH) and **MARTIN WEBER** (University of Mannheim) will be in the chair. Both have made a name for themselves with their seminars on Behavioral Finance and regular publications are due evidence of their leading position in this field in Germany. Other experts from theory and practice will also speak on the latest research findings. As the opening speaker in 2003 the CFS shall be pleased to welcome **KLAUS-M. PATIG** (Commerzbank AG).

For registration or further information on the program and faculty please visit our homepage: www.ifk-cfs.de or contact Christiane Bauder, Tel. +49(0)69/242941-30, Email: bauder@ifk-cfs.de.

We asked **JOACHIM GOLDBERG**:

We asked Joachim Goldberg, Managing Director of cognitrend GmbH and organizer, together with Martin Weber (University of Mannheim), of the CFS executive conference "Advances in Behavioral Finance II" about:

CFS: How can Behavioral Finance help to evaluate the situation on the capital markets?

Goldberg: *"In contrast to traditional economic theory Behavioral Finance takes into account the psyche of financial market agents. This way it becomes clear why their decisions are not always based on rational behavior. Fortunately, this behavior is also systematic and therefore largely predictable."*

CFS: To what extent can conference participants make use of the insights they have gained? What are the benefits?



Goldberg: *"As was already the case at our first conference "Advances in Behavioral Finance I", the speakers have been chosen such that theory and practice will be equally represented. Thus, even the most recent findings in Behavioral Finance can be profitably applied*

in daily business.

In the seminars the basic principles of Behavioral Finance are presented, whereas the conference on "Advances in Behavioral Finance II" will be looking at the newest developments in this field of research. The interested participant will not just be faced with dry facts, but will rather be offered much by way of practical food for thought."

Publisher

Center for Financial Studies
at Johann Wolfgang Goethe-
University, Frankfurt
Taunusanlage 6
D-60329 Frankfurt/M.
Tel: +49-(0)69-242941-0
Fax: +49-(0)69-242941-77
<http://www.ifk-cfs.de>

Editor

Barbara Kleiner

Design

Dirk Stähling, Darmstadt