NEWS

CENTER FOR FINANCIAL STUDIES

2/03

Volker Wieland

In addition to the appointment of Volker Wieland as a new CFS Director, Michael Binder joined our research team in June as a Program Director for the macroeconomic department.
Both Wieland and Binder have years of international research experience at various universities and economic policy institutions to their credit. Wieland completed his Ph.D. at the University of Stanford under the supervision of John B. Taylor (author of the Taylor rule and now the current Under Secretary for International Affairs in the US Department of Treasury), and has also spent time at the Federal Reserve Board and the ECB. Binder was at the University of Maryland as well as the International Monetary Fund (IMF) and the World Bank. They both hold a chair at the Goethe-University of Frankfurt.
With these appointments we aim to strengthen practice-oriented research at the CFS and are able to reinforce our much sought-after consulting services to the Frankfurt financial center, to central banks and economic policymakers.

Michael Binder

editorial

Dear Members, Colleagues and Interested Parties,

Under the heading of "imaginary fears" the Börsen-Zeitung quoted Otmar Issing, Chief Economist of the European Central Bank, as saying at the CFSresearch conference "The ECB and its Watchers V – The First Four Years" on 11 July 2003, "We are not complacent as far as the risk of deflation is concerned. However, at this stage wanting to try to prevent deflation in the Euro zone would be like wanting to commit suicide today for fear of dying tomorrow".

That Issing was serious in denying any complacency, is supported by the intensive analysis of the possible risk of deflation carried out by the ECB research department together with Volker Wieland (Goethe-University, Frankfurt and CFS) and the CFS program area "Central Banking & Monetary Economics". The particular danger with respect to deflation is that the nominal interest rate will drop below zero, stripping the central bank of its ability to control liquidity via the interest rate. Thus, the nominal interest rate would no longer be available as a policy instrument for stabilizing the price level. Expectations of a further price fall would lead to a rise in the real rate of interest, in turn weakening economic growth and investment.

Studies by Wieland and the CFS fellows, Günter Coenen (European Central Bank, Frankfurt) and Athanasios Orphanides (Federal Reserve Board, Washington, D.C.), using modern macroeconomic models of the U.S., Japanese and Euro zone economies, allow the probability of such a scenario to be estimated, dependant on the central bank's inflation objective. Their analysis shows that an inflation target of 2% provides sufficient distance to the zero level, at least for as long as variations in the price level and economic activity remain within the range of the last 30 years.

In the light of these findings, the quantitative definition of the ECB's price stability target in the region of under but close to 2%, as was announced in May this year, represents a clear step in the right direction. Nevertheless, the question remains about what the central bank could do in the event that deflation does indeed occur and the nominal interest rate is driven down to zero. Coenen and Wieland demonstrate, using Japan as an example, that devaluation and exchange rate control by means of intervention in the currency market might provide a possible solution. A solution, however, that only remains viable as long as the three major economies do not all push up against the zero interest rate mark at the same time.

Best greetings,

Jan P. Krahnen *Antje Becker* *Volker Wieland*

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Notes from the latest Board Meeting

On 25th June, 2003 the Managing Board and the Board of Trustees Meeting as well as the Members′ General Meeting took place under the direction of Rolf-E. Breuer, Chairman of the Managing Board of the Gesellschaft für Kapitalmarktforschung e.V. We are pleased to be able to take this opportunity to introduce the following new Member of the Managing Board of the Gesellschaft für Kapitalmarktforschung e.V.:

Dr. Alois Rhiel, Minister of Economics, Transportation, Urban and Regional Development,

as well as the new Member of the Board of Trustees of the Gesellschaft für Kapitalmarktforschung e.V.:

Arnulf S. Manhold, Member of the Board of Managing Directors of J.P. Morgan AG.

CFS Stakeholder Analysis

The last edition of the CFS*newsletter* included a questionnaire, which aimed at supplying us with a better insight into our target group and their needs. We would like to thank the readers of this publication for returning such a large number of completed questionnaires for evaluation and are taking this opportunity to report to you our principle findings. On the basis of your answers we have been able to draw valuable conclusions, which will certainly be of service to future work at CFS. Furthermore we are pleased that we could welcome the winners of our seminar lottery as participants at one of our CFS*seminars*.

1. Events

The level of satisfaction relating to events, subjects discussed and general standards is very high (70 - 90% approval rating), and it is apparent that the more specific the choice of topic, the clearer expectations will be and thus the higher is the degree of satisfaction likely to be derived from a particular event. In response to the request expressed by you for more time for personal conversations before the start of our lectures, we will be scheduling the admission time to be somewhat earlier. In order to make more apparent the theoretical abstraction level of a particular event, we will in future differentiate between “technical” and “non-technical” lectures. In the events program for the next three years we will be offering more CFS*lectures* that are oriented toward a particular target group. The value of the Executive Development program was perceived to be particularly high. 85% of seminar participants and 87% of those attending Executive Development conferences said they had derived practical benefits from these events.

2. Public Relations and Publications

The majority of our readers (90%) expressed a favorable opinion of the CFS*newsletter*. Reports about research activities at the Center are met with widespread interest and will be extended in the future. The CFS*working papers* are regarded as useful by 58% of those questioned. For the first half of 2003 we can report an increase in the number of CFS*working papers* (26) published, so it would seem that we are moving in the right direction here. All CFS*working papers* can be found at www.ifk-cfs.de.

3. Contacts

Contacts to CFS are achieved via various channels and direct personal approaches. We are in regular contact with at least half of our target group via the Internet and since our homepage was given a very high evaluation, we hope to be able to increase this figure.

Please, make use of our homepage, pass our invitations on to your colleagues and be rest assured that we are always interested in any comments you have to make about our work.

CFS*colloquium series*

"Globalisation of Financial Markets – Risks and Opportunities"

US GAAP/ IAS: Do We Need Globally Harmonized Accounting Standards?

(original German title: „US-GAAP/IAS: Brauchen wir weltweit harmonisierte Rechnungslegungsregeln?")

On 12th February 2003 Harald Wiedmann, spokesman of the board for KPMG Deutsche Treuhand-Gesellschaft AG, gave a talk on the harmonization of accounting standards. He explained that against the background of international trade and global financial markets, the heterogeneity of accounting standards not only makes it difficult for firms to break into new markets but also to find willing investors. Everything speaks in favor of a worldwide harmonization. For example for investors and financial analysts harmonization would imply that less effort is required for the compiling and evaluation of financial data, there would be greater comprehensibility and thus more faith in financial statements. From the viewpoint of creditors and rating agencies, harmonization would also mean that less effort is required for evaluating financial statement data, it would be easier to make comparisons, and thus there would be an improvement in the quality of credit ratings.

With respect to the question about which accounting standards would be the most suitable as a global standard, Wiedmann said that the International Accounting Standards (IAS)/the International Financial Reporting System (IFRS) had definite advantages over the US GAAP. The IAS was conceived as a global standard in the first place and emerged during the course of a democratic development process. A further advantage lies in the fact that globally acceptable precepts are easier to devise and expand than a works of individual rules. In addition there already appears to be a large degree of global acceptance for IAS/IFRS; according to the "Convergence 2002" study just published, 90% of 59 leading accountancy firms from the countries analyzed in the study have already adopted IAS/IFRS, or plan to do so in the near future. However, for 51% of the countries the complexity of the regulations on financial instruments (IAS 39) represented too high a hurdle to allow a rapid total convergence to IAS/IFRS.

In the EU the decision has already been taken in favor of IAS. From the year 2005 listed companies will be obliged to use IAS/IFRS (for those firms currently using US-GAAP a transitional period until 2007 has been granted).

The question then, according to Wiedmann, is what will happen next? It would be ideal if a global standard were then to emerge. Definite progress can be observed in the efforts to converge between IAS and US GAAP. Thus, for example, IASB and FASB intend to coordinate the order in which necessary issues will be addressed. It could also be argued that the FASB has indeed made a move in the direction of IAS (which would have been inconceivable before the Enron case).

With respect to Germany, it can be said that (restrained) harmonization efforts are underway to covert from HGB to IAS. The German Accounting Standards Committee is supporting these efforts and has already started implementing them as far as possible in the accounting standards regulations relating to capital market-oriented firms. Considerably more progress, according to Wiedmann, has been made in the discussion on extending the application of IAS to individual financial accounts and unlisted firms. However, he conceded that if there were indeed two sets of standards in Germany, namely the HGB for small and medium-sized enterprises and IAS for all other companies then this would represent a competitive disadvantage for SMEs with respect to the modus operandi of banks and rating agencies in evaluating firms. *Stefanie Franzke (CFSresearch staff)*

The Magic of New Beginnings – First Experiences with a Single Regulator for Integrated Financial Services Supervision in Germany"

(original German title: „Jedem Anfang wohnt ein Zauber inne – erste Erfahrungen mit der Allfinanzaufsicht in Deutschland")

On 26th February 2003, as part of the CFS*colloquium series* "Globalization of Financial Markets – Risks and Opportunities", Jochen Sanio, President of the Federal Financial Supervisory Authority (BaFin – Bundesanstalt für Finanzdienstleistungsaufsicht) gave a talk entitled "The

Jochen Sanio

Magic of New Beginnings – First Experiences with a Single Regulator for Integrated Financial Services Supervision in Germany”. Sanio explained that with the setting up of the Federal Financial Supervisory Authority (BaFin) on 1 May 2002 in Germany a dual structure was established for financial supervision. In his view this type of supervision structure, which is new on the international stage, combines the advantages of the two competing supervision models (central bank supervision or bancassurance) practiced hitherto. The “modified single regulator” unites the full-scale overview of the banking, insurance and asset management markets provided by bancassurance supervision with the competence of the German Bundesbank in questions relating to financial stability and macroeconomics. Moreover, as Sanio emphasized, the costs of the new federal authority will be borne completely by the supervised enterprises and thus, despite the currently strained state of public sector finances, a considerable improvement in personnel resources will be achieved. He also made reference to the new areas of responsibility of the BaFin laid down by the 4th Financial Market Promotion Act. These include above all the expansion of powers with respect to the supervision of reinsurance companies and the prosecution of price manipulation in financial markets. In addition, he explained that the organizational structures within BaFin will also have to be modified step by step in order to achieve further improvements in efficiency. The three traditional offices for banking supervision, insurance supervision and securities management supervision have been subsumed in a completely new cross-sectoral institution which combines not only the sector-specific but also the cross-sectoral tasks of the BaFin. One of the three departments of this new body is Q1, the BaFin think tank. This department, which is currently still in the process of being set up, will be responsible for financial market issues, financial instruments and financial conglomerates, and with its new staff recruitments it will, in particular, reduce deficits in the scientific analysis of the financial sector and supervision topics. Furthermore, the department Q1 is intended to become a central coordination point enabling the BaFin through its experts to successfully keep abreast of the many and varied international supervisory forums. This is especially important in view of the imminent European financial market reforms. With respect to the organization of the single European capital market, which should be completed by the year 2005, the Directive on market abuse was passed in December 2002. Beside modifications to the law on insider dealings and ad hoc disclosure, this directive introduces for the first time binding regulations for the whole of Europe relating to market manipulation. Moreover, via the so-called Prospectus Directive a consistent securities listing standard, the “European Passport for Issuers” is to be introduced throughout Europe. Furthermore, the Directive on investment services in the securities field, on the basis of which in 1993 the fundamental regulations for the European stock exchanges and securities investment services were created, is to be completely revised and updated. Looking at the overall picture it can be said that the creation of a European financial market is well under way. Once the European action programs have been implemented the European capital market will, in Sanio's view, exhibit the necessary degree of harmonization and in particular will be subject to consistent protection standards. No further steps need to be taken nor, more specifically, is a uniform, centrally-steered supervision practice required, then this would not be able to do justice to the diversity in Europe, which will continue to exist in the future. Thus Sanio's answer to the question of whether there should be a European central financial supervision authority was an unequivocal no.

Elke Hahn (former CFSresearch staff)

TOWARDS INTEGRATION – Evolution of the Financial System of Accession Countries and their Integration with the EU Financial System

On 18th March, Leszek Balcerowicz, President of the National Bank of Poland, presented the results of recent empirical literature on the process of integration of those countries expecting to enter the European Union with the other Member States.

The findings of this branch of the literature support the thesis that the financial development of an economy influences its growth mainly through its impact on productivity increases. Conversely, the financial structure (as defined by the relative roles of banks and capital markets) has not been found to be relevant to economic expansion. Financial development itself is hampered by inflation and depends on the extent of protection that is granted to the rights of investors, both creditors and shareholders alike. Furthermore, large and persistent state ownership tends to block financial development and is associated with higher interest rate spreads, more concentrated credit allocation, less activity on the stock exchange and more financial instability.

One observation worth noting in the last 15 years was the phenomenon of financial deepening, i.e. the growth rates of financial assets, which have exceeded the respective GDP increases – be it in developed countries like Austria, Germany and Portugal, or in less developed countries like Malaysia or China. This has lead to the important question whether this is merely a result of the financial bubble, which became apparent in the late nineties, or whether it is the case that a more fundamental shift has taken place.

Balcerowicz illustrated his analysis of these issues by describing the initial conditions in transition economies around 12 years ago. These were dominated by state-ownership, and any market activity was eliminated through central planning, the most extreme form of nationalization. Being even more state-dominated than the banking sector in India and other emerging economies at that time, the financial sectors in the state-run economies could all be characterized as having had a monobank structure with no independent credit decisions and risk management, and a complete lack of any form of money markets, or even a currency that was convertible, either internally or externally.

The macroeconomic conditions at the outset of the transition varied greatly among economies especially with respect to price stability; whereas hyper-inflation prevailed in countries like Poland, the former Soviet Union and Slovenia, prices rose at far more contained rates in other nations, for example Czechoslovakia, Hungary and Romania. In the case of the first group of countries, this situation was closely associated with the presence of a monetary overhang, whereas the second group tended to follow a tighter monetary policy.

The consequent differences in financial sector developments, however, have had more to do with differences in the quality of general and sectoral policies as they developed than with the different conditions at the outset. First and foremost, the fast internal and external financial liberalization have made the accession countries very open to foreign investments, especially when compared to China, India and the so-called Asian Tigers. This development has been enhanced by the swift pace at which banks were privatized.

However, the relative size of the financial sector in accession countries is still much smaller than in EU member states and other developed economies, one possible reason being the disparity between the introduction of rights for creditors and small shareholders and their enforcement. The future of capital markets in accession countries is yet to be decided on. One possible solution would be their integration with trading platforms of EU member states. In this regard we are further down the road than might it may seem, as many banks in accession countries are controlled by EU domiciled institutions.

Tim Keilbar

www.ifk-cfs.de

We asked Leszek Balcerowicz about:

What do you think is the biggest plus point of the German government´s financial action plan (Finanzmarktförderplan 2006)?

And he answered: *"Finanzmarktförderplan 2006 contains proposals, which may contribute to the development of the capital market in Germany. Measures aimed at increasing the protection of investors' rights are of particular significance, since insufficient protection of investor's rights is a major barrier to the development of capital markets in Europe. A curb on the barriers to establishing and operating investment funds, as well as abolishing the favourable position of German funds, particularly in the area of tax law, will encourage the establishment of new economic operators, including foreign companies. This will enhance the competition and the development of the German capital market. Another important element of Finanzmarktförderplan 2006 are also the proposals aimed at unifying the European market and increasing its transparency, e.g. by standardising issuing prospectuses, which will make it easier for the investors to compare the results of different funds."*

What do you think is the biggest minus point of the German government´s financial action plan (Finanzmarktförderplan 2006)?

And he answered: *"It is not certain whether changes in Finanzmarktförderplan 2006 regulatory and organisational framework, particularly regarding investors' rights – will be sufficient to create a strong incentive to the development of the capital market. No doubt Frankfurt has, and will have, a strong position in the European financial system – at least due to the ECB headquarters' location in the city. However, excessive concentration of capital market operations in one financial centre is not desirable for Europe. Such a solution would hinder competition in the financial and capital markets, thus preventing their development."*

Leszek Balcerowicz

CFS*colloquium series*

"Finanzindustrie unter Reformzwang – Financial Industry under Pressure"

Too complex to fail? International Financial Conglomerates and the Design of National Insolvancy Regimes

Richard Herring

On 25th June 2003, Richard Herring visited CFS and gave a talk on the impact of the design of national insolvency regimes on bankruptcy among international financial conglomerates. Using the individual analysis of five past failures of financial intermediates, namely Herstatt, Drexel Burnham Lambert, BCCI, Barings and LTCM, Herring described the complexity of the legal, regulatory and geographic environment. In fact, these cases, which may be regarded as relatively simple by comparison to currently existing financial institutions, illustrate the complexity of the way in which bankruptcies of international financial conglomerates are likely to be managed in an integrated fashion along the lines of business. Herring emphasized that the absence of credible bankruptcy procedures may result in ill-considered bailouts because an international bank might become too big and too complex to fail. This in turn creates moral hazard concerns. The speaker aimed to stress the urgency of establishing a credible insolvency regime that addresses how the lines of business within financial conglomerates should be mapped onto legal entities. Furthermore, the bankruptcy procedure should promote the coordination of actions among the various functional regulators, within as well as across countries.

Richard J. Herring is the Jacob Safra Professor of International Banking and Professor of Finance at The Wharton School, University of Pennsylvania. He is also the Director of the Joseph H. Lauder Institute of Management and International Studies, Wharton School, and Co-Director of Wharton Financial Institutions. Herring is a member of the Research Advisory Council of the Center for Financial Studies. His research areas include international banking, international finance, and money and banking. His special interest is the regulation of financial conglomerates.

Issam Hallak (CFSresearch staff)

Small and Medium-Sized Businesses in a Credit Squeeze

(original German title: "Credit Squeeze im Mittelstand")

Never before have so many companies in Germany been forced to enter insolvency proceedings as has happened during the past year. With 37,700 registered bankruptcies in 2002, almost 16% more firms were faced with ruin than in the previous year. The significant slump in corporate investments alone indicates that the German economy is currently facing enormous problems. At the same time the banks have announced loan losses of several billion. The German banking sector is in the middle of a deep crisis with respect to costs and earnings. A fundamental cause of this crisis is frequently said to be the large reduction in the supply of credit in Germany. Banks have often come in for much public criticism for this reason. Are small and medium-sized businesses in Germany (the so-called Mittelstand) suffering from a credit squeeze? Hans Reich, Spokesman of the Board for KfW, focused on this question in his presentation given as part of the CFS*colloquium series* on the subject of "Finanzindustrie und Reformzwang – Financial Industry under Pressure" at HypoVereinsbank AG on 2 July 2003.

Hans Reich

By definition there is a credit squeeze or credit crunch when a significant reduction in the supply of credit occurs without any change taking place in the quality of borrowers, and when the real interest rate remains constant. In Reich's opinion no conclusive answer could be reached regarding the existence or otherwise of a credit squeeze for SMEs, even after taking into account the volume of credit outstanding to businesses and the self-employed, which according to bank statistics fell in comparison to the previous year by 1.4% in both the 4th quarter of 2002 and the 1st quarter of 2003. Thus problems exist not only with respect to identifying demand and supply effects on the one hand, but also because the credit statistics disregard the general economic environment on the other. A third problem concerns the distinction to be made between net and gross loan commitments. All these factors combine to make an assessment of the current situation on German financial markets difficult.

The KfW has confirmed on the basis of its own questionnaires and studies that German SMEs are facing increasingly serious problems with regard to financing. For example, 15% of those enterprises questioned in the third quarter of 2002 had a problem in obtaining any sort of credit at all. The banks, by way of explanation, point above all to higher risk ratings, which in turn are the result not only of the general economic situation, branch and company specific factors, and the recoverability of securities but also of higher refinancing costs of banks. KfW analysis indicates that the cyclical reduction in the demand for credit is superimposed by a structural cutback in the supply of credit. Even if the economy starts to make a recovery, according to Reich, the problems on the financial markets, particularly those faced by SMEs, are not likely to disappear. This is because the particular financing difficulties of German SMEs must be attributed above all to a stockholders' equity basis, which is, structurally speaking, too small. Under such circumstances it is the task of the KfW by means of appropriate instruments to bring about a lasting improvement in the financing conditions of new businesses and SMEs, providing support during the necessary adjustment and transition processes and facilitating the structural change.

In the subsequent discussion, Reich referred briefly to the KfW True Sale Initiative via which various banks from the three pillars of the German financial industry together intend to establish a uniform platform for the buying and selling of hitherto liquid funds. With the help of this securitization, banks would have another means of refinancing their portfolios on a broader basis and securing the outplacement of credit risks on the capital markets. In this way credit institutions would be in a position to provide new credit lines to SMEs. Reich said he was confident that this instrument was relevant not only for the large commercial banks but also for smaller banking institutes.

Stefanie Franzke (CFSresearch staff)

Basle II and German SMEs

(original German title: "Basel II und der Mittelstand")

In the final meeting on 16th July 2003 of the summer semester CFS*colloquium series* "Finanzindustrie unter Reformzwang – Financial Industry under Pressure", Edgar Meister (Member of the Board of the Deutsche Bundesbank) spoke on the subject of "Basle II and German SMEs". In his presentation, he focused on the potential effects of the new capital adequacy rules on the loan allocation policy of German commercial banks.

Edgar Meister

At the center of his analysis was the question to what extent Basle II is leading to changes in the financing conditions of loans to small and medium-sized enterprises (SME), which constitute 90% of all German companies, i.e. those with an annual turnover of up to €50 million. In this context Meister presented the results of the third impact study (QIS3), which includes for the first time the capital requirements for the whole of the Basle II Accord, i.e. both the credit risk including securitization requirements, as well as the operational risks were taken into account. The results of QIS3 make it clear that the capital requirements, in particular for SME loans, are decreasing significantly on average since, in keeping with the Basle II regulations, credits to small enterprises must under certain circumstances be treated like loans to private customers (retail credits).

Meister pointed out that the new Basle II stock holders' equity regulations are today already influencing indirectly the credit allocation practices of commercial banks with respect to SMEs. The debate about the new capital adequacy rules has increased awareness on the part of banks with respect to risks and returns and is thus likely to strengthen tendencies, which are already present, towards a greater differentiation in credit conditions. However, he explicitly pointed out that the results of QIS3 make it clear that Basle II does not imply a threat to the financing of small and medium-sized enterprises but rather in many cases, dependent on the individual credit risk rating, will enable easier access to capital.

Roman Kräussl (CFS fellow)

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, Tel.: +49-(0)69-242941-14 or by Email: paessler@ifk-cfs.de

www.ifk-cfs.de

CFS*research lectures*

Frankfurt as a Financial Center: Opportunities and Risks

(original German title: Finanzplatz Frankfurt: Chancen und Risiken)

On 28th April 2003, Paul Bernd Spahn (Goethe-University, Frankfurt) gave a talk at the CFS on the financial center at Frankfurt. Frankfurt's current standing as a financial center has not changed in international comparisons. Germany's most important financial center is still in third place after London and Paris in the ranking of the main European financial centers. This position has not altered since 1990, according to a survey of 500 executive boards of large European companies conducted by Cushman Wakefield, the real estate company.

Frankfurt is characterized by the headquarters of the European Central Bank, the Deutsche Bundesbank, and Deutsche Börse AG as well as by its highly efficient transport network. As a headquarter location for the world's largest banks, Frankfurt even ranks number two in Europe with 107 out of 500 institutions' head offices.

All these institutions apart from the ECB, however, are not always associated with Frankfurt – weak growth in Germany, the conservative structure of economic policy, the extremely precarious profit situation of the big banks and the increasing mobility of many financial services and products are leading to greater competition with respect to location and might hamper the development of Frankfurt as a financial center. For the significance of a financial center rests above all on the size and efficiency of the domestic economy. Moreover, according to Spahn, the significance of the ECB for the operational business of banking in Frankfurt has been overestimated.

In his study for the Hessian Ministry of Economics entitled "Position und Entwicklungsperspektiven des Finanzplatzes Frankfurt – The Position and Development Perspectives of Frankfurt as a Financial Center" (FEH-Report Nr. 645), Spahn makes the following recommendations. The BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht) headquarters must be moved to Frankfurt in order to be close to business. Frankfurt as a location for research and training must be strengthened, as must the development of the accompanying financial institutions such as rating agencies, law firms, information services etc. Promoting the Rhine-Main area as a site for economic integration must be given top priority.

Paul Bernd Spahn

Further internationalization, strategic partnerships, consolidation in the banking sector, as well as the stepping up of competition in the public banking sector area, are absolutely imperative from the view of the private sector. Frankfurt, in particular with respect to innovation development still has homework to attend to; product development must become more innovative, equity financing via mezzanine capital must be boosted and debt securitization for SMEs, together with retirement pension schemes, must be promoted. Overall, the further standardization of its products implies improved opportunities for the financial center.

Ulrike Lexis (CFSresearch management)

Realized Volatility in Theory and Practice

On 2nd June 2003, Francis X. Diebold visited the CFS and gave a lecture on a joint research with Torben Andersen (Kellog School of Management), Tim Bollerslev (University of Duke) and Paul Labys (University of Pennsylvania). The title of the research that has been published in March volume of the journal Econometrica is "Realized Volatility in Theory and Practice".

Francis X. Diebold

Investigation of return distribution was the focus of much research in empirical finance. Previous research in this field provided estimates for return volatilities and return distributions based on complicated parametric systems such as ARCH or some stochastic volatility models. The methodological contribution of this research is the development of a general framework for integration of high-frequency intra-day data and relatively simple traditional non-parametric time-series models into measurement, modelling and forecasting of daily return volatilities and daily return distributions. The basic intuition is quite simple – estimation of volatility by summing up intra-day squared returns.

This method is mostly suitable for very liquid financial assets such as currencies. Implementation of the method on the Deutsche Mark/Dollar and Yen/Dollar spot exchange rates reveals very interesting results. The research finds that the return volatility is lognormal distributed and highly persistent. Moreover the returns standardized by realized volatility are approximately Gaussian. Combining these results, one can conclude that currency returns can be characterised by a lognormal-normal mixture model. This finding can be implemented in forecasting and indeed this mixture model provides better forecasts for out-of-sample return volatilities comparing to other models such as GARCH or RiskMetrics.

The lecture was followed by a discussion by Gerhard Stahl from Bundesanstalt für Finanzdiensleistungsaufsicht (BaFin). In his discussion suggested Stahl a few interesting applications of this model. According to Stahl, this model can be useful for estimating return distribution of new instrument and also for market conformity checks by regulators.

While this model comes to fill the gap between academy and practice, there is still a need for the practitioners to fine-tune the model for their needs.

Francis X. Diebold is Professor of Economics, Finance and Statistics, at the University of Pennsylvania. He is also a Research Associate at the National Bureau of Economic Research. Diebold works in econometrics, forecasting, finance and macroeconomics. He has published extensively and has served on the editorial boards of numerous journals, including Econometrica and Review of Economics and Statistics. He is also a Fellow of the Econometric Society.

Koresh Galil (CFSresearch staff)

The Knowledge Brokers: Venture Capitalists, Tacit Knowledge and Regional Development

As part of the program area "Venture Capital & the New Markets in Europe", the CFS was pleased to welcome Matthew Zook, who gave a CFS*lecture* on the geographic development of venture capitalists. One of the great paradoxes of the 21st century is that as the economy globalizes, spatial proximity retains its importance in economic development. In this context, Zook examined the significance of the role played by spatial proximity in a global environment in the diffusion of knowledge (know-how) and the construction of networks (know-who) through which information is transferred.

On the basis of empirical tests, the speaker analyzed the spatial structure of the information used by venture capitalists during the development of the Internet industry and how it contributed to the clustering of dot-com companies. He concluded that the role played by venture capitalists is dependent upon systems of personal contacts and networks via which information that is difficult to acquire on technology, companies, strategies and markets is compiled and quickly exchanged. Zook finds that in this process, proximity remains a central factor even in the era of the global economy.

Matthew Zook is an Assistant Professor at the University of Kentucky and Visiting Fellow of the Public Policy Institute of California. He received his Ph.D. from the University of California, Berkeley. Matthew Zook is a leading researcher on the geography of the Internet and the role of capital and finance (especially venture capital) in regional development.

Issam Hallak (CFSresearch staff)

Unless otherwise stated, all lectures take place at 5:30 p.m. in the "Vortragssaal der Hauptverwaltung der Deutschen Bundesbank", Frankfurt, Taunusanlage 6, ground floor. For further information please contact Birgit Pässler, Tel. +49-(0)69-242941-14, Email: paessler@ifk-cfs.de,

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 as those at the assistant and 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 Goethe-University, Frankfurt and CFS).

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

8 Jan 03	**Frank de Jong** *(University of Amsterdam)* **"The Microstructure of EuroMTS"** (Co-Authors: Yiu Chung Cheung, University of Amsterdam; Barbara Rindi, Bocconi University, Milan)
15 Jan 03	**Paul Söderlind** (Stockholm School of Economics) **"Taylor Rules and the Predictability of Interest Rates"** (Co-Authors: Ulf Söderström & Anders Vredin, Sveriges Riksbank, Stockholm)
22 Jan 03	**James Dow** (London Business School) **"Interest Rates, Asset Pricing and the Separation of Ownership and Control"**
29 Jan 03	**Allan D. Brunner** (International Monetary Fund) **"Trade Costs, Market Integration, and Macroeconomic Volatility"** (Co-Author: Kanda Naknoi, Stanford University)
5 Feb 03	**Michael Burkart** (Stockholm School of Economics) **"In-Kind Finance"** (Co-Author: Tore Ellingsen, Stockholm School of Economics)
12 Feb 03	**Campbell Leith** (University of Glasgow) **Interactions Between Monetary and Fiscal Policy Under Flexible "Exchange Rates"** (Co-Author: Simon Wren-Lewis, University of Exeter)
19 Feb 03	**Mario Padula** (University of Salerno) **"Retirement Expectations and Pension Reforms"** (Co-Authors: Renata Bottazzi, The Institute for Fiscal Studies (IFS), London & Tullio Jappelli, University of Salerno)
26 Feb 03	**Steven Ongena** (Tilburg University) **"Distance, Lending Relationships, and Competition"** (Co-Author: Hans Degryse, K.U.Leuven and CentER, Tilburg University)
5 Mar 03	**Alfred Maussner** (University of Augsburg) **"Is the technology driven business cylcle really dead? Evidence from Germany"** (Co-Author: Julius Spatz, Kiel Institute of World Economics)
12 Mar03	**Maria Demertzis** (Bank of the Netherlands) **"Aiming for the Bull's Eye: Inflation Targeting under Uncertainty"** (Co-Author: Nicola Viegi, University of Strathclyde)
19 Mar03	**Dario Focarelli** (Bank of Italy) **"Are Mergers beneficial to Consumers? Evidence from the Market for Bank Deposits"**
26 Mar 03	**Timothy Van Zandt** (INSEAD, Fontainebleau) **"Market Contingent Managerial Hierarchies"**
2 Apr 03	**Federico Ravenna** (University of California – Santa Cruz) **"The road to adopting the euro: monetary policy and exchange rate regimes in EU candidate countries"** (Co-Author: Fabio Natalucci, New York University)
9 Apr 03	**Dieter Nautz** (University of Frankfurt) **"Bidder Behavior in Repo Auctions without Minimum Bid Rate: Evidence from the Bundesbank"**
16 Apr 03	**Günter Coenen** (European Central Bank) **"The Zero-Interest-Rate Bound and the Role of the Exchange Rate for Monetary Policy in Japan"**
23 Apr 03	**Erland Nier** (Bank of England) **"Market Discipline, Disclosure and Moral Hazard in Banking"**
30 Apr 03	**Markus Reitzig** (The Copenhagen Business School) **"Validating Indicators for Patent Value - Empirical Evidence from the Chemical Industry"**
07 May 03	**Christian Haefke** (University Pompeu Fabra, Barcelona) **"Product Market Deregulations and Labour Market Outcomes"**
14 May 03	**Frank Kleibergen** (University of Amsterdam) **"Testing Parameters in GMM without assuming that they are identified"**
21 May 03	**Beatrice Weder** (University of Mainz) **"Estimating Private Returns to Emerging Markets Lending, 1970-2000"**
28 May 03	**Michael Goldberg** (Universities of New Hampshire and Copenhagen) **"Imperfect Knowledge, Dynamic Propsect Theory and Uncertainty Premia on Foreign Exchange: Towards a General Theory of Asset-Price Dynamics"**
04 June 03	**Klaus Adam** (Goethe-University of Frankfurt and CFS) **Optimal Monetary Policy under Commitment with a Zero Bound on Nominal Interest Rates** (Co-Author: Roberto Mario Billi, Goethe-University of Frankfurt)
11 June 03	**Ramon Marimon** (Universitat Pompeu Fabra, Barcelona) **"Nominal Debt as a Burden on Monetary Policy"** (Co-Authors: Javier Días-Giménez, Universidad Carlos III, Madrid; Giorgia Giovannetti, University of Florence; Pedro Teles, Banco de Portugal)
18 June 03	**Winfried Koeniger** (University of Bonn) **"Employment Protection and Product Market Regulation"** (Co-Author: Andrea Vindigni, Princeton University)
25 June 03	**Etienne Wasmer** (ECARES, Brussels) **"Interpreting Europe and US Labor Markets Differences: the Specificity of Human Capital Investments"**

CFS*research conferences*

Pensions and Long-Run Investment, 20th March 2003

The conference took place on 20 March 2003 at CFS in Frankfurt. The presentations and discussions included the following topics:

Juan Yermo from the OECD addressed "The Role of Private Pensions in OECD Countries". After summarizing the objectives of retirement systems, different definitions concerning the "three pillars" in retirement systems, and current regulations in selected OECD countries, he presented the new OECD definition of private pension plans and some statistical data on the size of pension funds assets in OECD countries. He also addressed the question of pension fund investment strategies and regulations as well as the role of accounting and funding rules.

Frank Baumeister from the German Federal Ministry of Health & Social Security gave an overview of "Occupational Pension Schemes in Germany" after the 2001 pension reform. He compared the different forms of occupational pension schemes in terms of their structure and relevance. Moreover, he addressed questions concerning the implementation and revocation of pension schemes as well as the issue of employees leaving their employers.

Florence Legros from CEPII presented her findings from a study on the "Construction and Impact of a Buffer Fund within the French PAYG Pension Scheme". Using a simple demographic model with macroeconomic links, she studied the consequences of building up a buffer fund by increasing the retirement age. Among other things, she found that (compared to the development under the current legislation) such a buffer fund would increase actuarial yields for retirees 30 years from now, while reducing these yields for those that retire before this date.

Raimond Maurer and Christian Schlag from the Goethe-University, Frankfurt addressed the topic of "Capital Requirements for Investment-Based Pension Accounts: Evidence from the German Pension Reform". A brief outline of the German pension reform in 2001 preceded an in-depth scrutiny of the regulatory framework and possible investment strategies for coping with the mandatory "money-back" guarantee in the new pensions act. They found that investment management companies can provide these "money-back" guarantees by themselves, but not without confronting the issues of restrictions in product design, the need for a reliable risk management, and significant administrative demands.

David McCarthy from Oxford University discussed "Annuities for an Aging World". Among others, he addressed the question of Adverse Selection, the consideration of utility, and the future determinants of the Annuity market.

Bernd Scherer from Deutsche Asset Management presented the "Financial Economists Perspective on ALM". He criticized common arguments of actuaries like "equities are less risky in the long run", "it is enough to focus on the long run", "pension costs can be reduced by shifting into equities", and "actuarial discount rates can replace market rates" and revealed their shortcomings.

Thomas G. Stephan from Allianz Dresdner Asset Management addressed the problem of "Asset Allocation for Guaranteed Long Term Investments". On the basis of fundamental analysis he showed that error-correction or co-integration models are suitable for building simulation models for financial market returns. He then gave an example of how to apply these models to evaluating asset allocation strategies for guaranteed long-term investments.

Klaus Grünbaum from the Danish Financial Supervisory Authority presented aspects of the European "Pensions Directive on the Activities and Supervision of Institutions for Occupational Retirements Provisions". Using several articles of the Directive as an example, he showed the difficulties involved in finding a balanced compromise for regulations in the European Union.

Raimond Maurer (Goethe-University, Frankfurt)

Liquidity Concepts and Financial Instabilities, 12th –14th June 2003

The CFS*research conference* on „Liquidity Concepts and Financial Instabilities", organised by Franklin Allen (Financial Institutions Center at the Wharton School, University of Pennsylvania), Jan P. Krahnen (Goethe-University, Frankfurt and CFS) and Marcel Tyrell (Goethe-University, Frankfurt/University of Trier), sponsored by the Deutsche Bundesbank "Stiftung Geld und Währung", took place from 12th to 14th June, 2003 in Eltville.

The introductory remarks were given by Franklin Allen, who described the conference as an attempt to contribute to the understanding of liquidity related questions of financial instabilities, both from a theoretical and a data-based point of view. He emphasised that indeed the largest congregation of economists working on liquidity related aspects to be imagined actually participated in the conference – a fact that allowed for exciting discussions.

The first session on theoretical concepts of liquidity was chaired by Richard Herring (Financial Institutions Center, University of Pennsylvania). Andrea Eisfeldt (Northwestern University) presented her research results on "Endogenous Liquidity in Asset Markets". She showed that in a model in which long-term risky assets are illiquid due to adverse selection, higher productivity initiates more risky projects, such that, following highly risky incomes, more sales of claims to high quality projects causes liquidity to rise. Afterwards, Franklin Allen reported on his results from joint work with Douglas Gale on "Financial Fragility, Liquidity and Asset Prices". They found that endogenously chosen liquidity in a model combined with extrinsic uncertainty under certain conditions gives rise to asset price volatility and financial crises. Finally, Viral Acharya (London Business School and CEPR) presented a paper by him and Tanju Yorulmazer (New York University) on "Information Contagion and Inter-Bank Correlation in a Theory of Systemic Risk". Their study concluded that, due to systematic factors in bank loan returns, information contagion may lead to ex-ante herding by banks. If, however, the depositors of a failed bank can migrate to a surviving bank, herding incentives are reduced and a pro-cyclical pattern in the correlation of bank loan returns arises. In his discussion of the three papers, Enrico Perotti (University of Amsterdam) highlighted the different approaches to analyse liquidity related aspects in economic theory and gave a broader overview of this strand of the literature.

The second session on theoretical liquidity concepts featured the presentations of Gary Gorton (The Wharton School, University of Pennsylvania) and Charles Kahn (University of Illinois-Champaign). The talk by Gary Gorton summed up the results of a research project with Lixin Huang (City University of Hong Kong) on "Liquidity, Efficiency and Bank Bailouts". Their study showed that governments may efficiently bailout banking systems in distress by providing liquidity via issuing government securities. Even though private liquidity provision would allow valuable reallocations, it also carries significant costs because of the more efficient investment opportunities ex ante. Charles Kahn and Joao Santos (Federal Reserve Bank of New York) in their paper on "Endogenous Financial Fragility and Prudential Regulation" departed from a slightly different point of view. As Charles Kahn explained, universal mutual insurance by banks increases the social costs from a joint failure of the whole banking system compared to a failure of only some banks. This finding provides a justification for a regulatory intervention by the government. The discussion of the two papers was given by Adriano Rampini (Northwestern University).

The third session on "Money, Liquidity and Banks" was held on 13 June, chaired by Franklin Allen. It started with a presentation of Guido Lorenzoni (Princeton University) on "The Costs of Credit Booms". He argued that in a phase of credit expansion, entrepreneurs tend to underestimate the social costs of financial volatility following from a possible negative shock to their net worth, which then leads to overborrowing and overinvestment. He concluded that regulatory capital requirements are more efficient than contractionary monetary policy to reduce excess volatility on financial markets, as it does not reduce the level of investment during the credit boom. The second talk in this session was given by Christian Hellwig (University of California in Los Angeles), who presented joint work with Guido Lorenzoni on "Bubbles and Private Liquidity". Their study compared the role of private and public liquidity provision in a model with limited enforcement of financial contracts and in the absence of lump-sum taxation. While public and private liquidity are equivalent as long as information is symmetric, private liquidity provision leads to a Pareto-improvement once that information asymmetries hold. Finally, Nobuhiro Kiyotaki (London School of Economics) reported on insightful new results from a joint paper with John Moore (London School of Economics and University of Edinburgh) on "Liquidity, Business Cycle, and Monetary Policy". Their model's objective was to explain the role of money in an economy without restricting its existence to cash-in-advance constraints or to savings motives. Rather, they presented money as a means of liquidity-in-advance with a flavour of a Walrasian world, which linked the monetary economy to the real business cycle. In the discussion of the presented work in this session, Rafael Repullo (CEMFI) commented on the different viewpoints that the papers took and tried to reconcile the various approaches.

The fourth session covered some more work on "Money, Liquidity and Banks". The first presentation was given by Juan Cordoba (Rice University), entitled "Collateral Constraints in a Monetary Economy", joint work with Marla Ripoll (University of Pittsburgh). They studied the impact of collateral constraints on transforming small monetary shocks into large persistent output fluctuations. The amplitude of these fluctuations was found to depend on whether or not debt contracts are contingent. The final talk in the fourth session was held by Robert Marquez (University of Maryland) on a joint paper with Giovanni Dell'Ariccia (IMF) entitled "Competition among Regulators and Credit Market Integration". Their study analysed the incentives for independent domestic bank regulators to coordinate their regulatory policies when the jurisdiction under their authority are financially integrated. The study arrived at the conclusion that a centralized regulator will be preferred for a homogeneous group of countries if it sets higher regulatory standards than each of the individual regulators would. The very detailed discussion of the two presented papers was given by Gerhard Illing (University of Munich).

The fifth session, "Contagion Effects in Financial Crises and Central Bank Intervention", was chaired by Jan P. Krahnen. Amil Dasgupta (London School of Economics) gave the first presentation, entitled "Financial Contagion through Capital Connections: A Model of the Origin and Spread of Bank Panics". He explored how the cross holding of deposits motivated by imperfectly correlated regional liquidity shocks can lead to contagion effects in the economy as a whole, conditional on the failure of a financial institution. In addition, he was able to identify a direction of flow for contagion effects, which provides a rationale for localized financial panics. Raghuram Rajan (University of Chicago) presented the second paper on "Money in a Theory of Banking", a joint study with Douglas Diamond (University of Chicago). They analyzed the connection between money, banks and aggregate credit in a model where illiquidity problems stem from the inalienability of human capital. In their model, banks can eliminate one layer of illiquidity by financing with demand deposits, but the demandability leaves the banks exposed to aggregate real liquidity shortages and real contagion can occur. They showed that introducing money in such a model can insure the banks against aggregate real liquidity, but may also expose them to aggregate financial illiquidity as a result of a shortage of money. This established a liquidity version of the lending channel for the transmission of monetary policy. Finally, Xavier Vives (INSEAD) presented new insights on the optimal policy of the "lender of last resort", based on a joint paper with Jean-Charles Rochet (London School of Economics and Université de Sciences Sociales Toulouse), entitled "Coordination Failures and the Lender of Last Resort: Was Bagehot Right After All?". They argued that the classical doctrine of the lender of last resort, elaborated by Bagehot (1873), which asserts that the central bank should lend to illiquid but solvent banks, is still valid today. To this end, they built a model of banks` liquidity crises and showed that with a positive probability a solvent bank will not be able to find liquidity assistance in the market. They derived policy implications for banking regulation and interventions of the lender of last resort as well as for central bank disclosure policy. Ernst-Ludwig von Thadden (University of Lausanne) gave a very detailed discussion, especially on the first and second papers of this session.

The sixth session on "Contagion effects in Financial Crises and Central Bank Intervention" comprised two presentations. The first talk was given by Xavier Freixas (Universitat Pompeu Fabra) on "Interbank Market Integration under Asymmetric Information", based on joint work with Cornelia Holthausen (European Central Bank). They developed a model where banks need to cope with liquidity shocks by borrowing or by liquidating assets. In this framework they studied the scope for international interbank market integration with unsecured lending when cross-country information is noisy. They showed that the integration of markets does not always yield a more efficient outcome. In the second talk on "Estimating Bilateral Exposures in the German Interbank Market: Is there a Danger of Contagion?", based on joint work with Andreas Worms (Deutsche Bundesbank), Christian Upper (Deutsche Bundesbank) summed up the results of an empirical research project on the danger of contagion in the German banking system. The authors used balance sheet information to estimate the matrix of bilateral credit relationships and test whether the break down of a single bank can lead to contagion. They found that the financial safety net in Germany considerably reduces the danger of contagion, but even so the failure of a single bank could lead to the breakdown of up to 15% of the banking system in terms of assets. A perceptive discussion of the two papers was given by Viral Acharya (London Business School).

In the seventh session on "Financial Crises and Currency crises", which was held on 14 June and chaired by Marcel Tyrell, three papers were presented. Arvind

Krishnamurthy (Northwestern University) reported the results of joint work with Ricardo Caballero (MIT) on "A Vertical Analysis of Monetary Policy in Emerging Markets". They argued that during emerging market crises domestic agents may be unable to borrow from foreigners because the country as a whole lacks international collateral. In this case the (ex-post) optimal central bank response to an external crisis is to tighten monetary policy in order to support the exchange rate, however, this in turn reduces the already insufficient private sector's incentives to insure against external crises, thereby creating a dilemma for monetary policy. The second presentation was given by Itay Goldstein (Duke University) on "Strategic Complementarities and The Twin Crises". In emphasizing the role of strategic complementarities in generating banking crises and currency crises, he presented a model where strategic complementarities exist not only within a group of creditors or within a group of speculators, but also between the two groups. He was able to show that this additional type of strategic complementarity generates a vicious cycle between banking crises and currency crises. The last very thought-provoking presentation of this session by Jean Tirole (Université de Sciences Sociales Toulouse) on "Inefficient Foreign Borrowing: A Dual-and Common –Agency Perspective" also dealt with the wake of the recent twin currency and banking crises. Tirole first looked at the question whether and when countries borrow too much or too little on aggregate. Then he shifted his attention to structural issues and analyzed whether and when equity portfolio investments, international portfolio diversification, domestic currency denomination and longer term maturities enhance borrowing countries` access to international lending. In his discussion, Hyun Song Shin (London School of Economics) related the presented papers to each other and pinpointed the similarities and differences.

The last session of the conference on "Financial Crises and Currency Crises" featured the presentation of two papers. Unfortunately, Olivier Jeanne could not attend the conference for health reasons. However, Haibin Zhu (Bank for International Settlements) did a great job in preparing at short notice a presentation of Jeanne`s paper on "Debt Maturity and the International Financial Architecture". In this paper, a theory of the maturity of international sovereign debt is developed in which short-term debt dissuades countries from deviating from good policies, but makes them vulnerable to unwarranted self-fulfilling rollover crises. This model was used to discuss the impact of a number of institutions or measures in the debate on the reform of the "international financial architecture", such as an international lender of last resort, an international bankruptcy court, renegotiation-friendly clauses in debt contracts, or capital controls. Philipp Hartmann (European Central Bank), Stefan Straetmans (University of Maastricht) and Caper de Vries (Erasmus University of Rotterdam) gave the final talk of the conference on their joint work, "The Breadth of Currency Crises". To study the spreading of crises in global foreign exchange markets, they used new statistics based on multivariate extreme value theory. Contradictory to a number of widely held beliefs about currency contagion, they found for instance that emerging market currency crashes do not spread more widely and frequently than is the case among major currencies. In addition, with respect to the emergence of a widespread crisis, industrial countries are more at risk from emerging markets than the other way around.

In his concluding remarks, Marcel Tyrell thanked all the presenters, discussants and participants for making the conference a success. He emphasized that this conference was a unique opportunity to become acquainted with all the exciting new research going on in this important field. He thanked the Deutsche Bundesbank Stiftung "Geld und Währung" for sponsoring the event and finished by saying that CFS will be organizing a second conference on liquidity issues in two years time.

Christina E. Bannier (Goethe-University, Frankfurt and CFS),
Marcel Tyrell (Goethe-University, Frankfurt)

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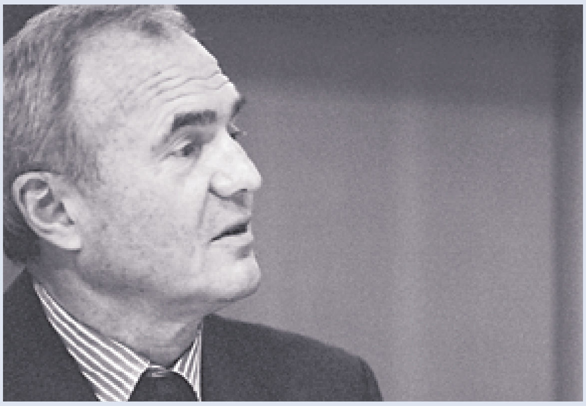
Axel A. Weber

The ECB and Its Watchers V, 11th July 2003

The CFS*research conference*, "The ECB and Its Watchers – The First Four Years", organised by Axel A. Weber (University of Cologne and CFS) took place on 11 July 2003. The conference attracted more than 150 participants. In three panels, academics, market participants, and the press discussed several topics including the ECB's recent monetary policy strategy revision, the transparency and predictability of the ECB's monetary policy, and the Bank's communication strategy.



Otmar Issing

In his opening remarks, Otmar Issing (European Central Bank) talked about the review of the ECB's monetary policy strategy, the two most debated aspects of which concern the definition of price stability and the role of money, or the "two-pillar structure" of the strategy. Issing emphasized that the ECB was not dissatisfied with the strategy. It was only natural that, after a period, the Council would want to go back and reflect on the accumulated experience in a systematic way. Issing pointed out that several steps were required to conduct an evaluation of the strategy. The key role here was played by the staff of the ECB and of the National Central Banks who investigated and scrutinized a number of issues relevant to the strategy, including among others the transmission of monetary policy, the determinants of prices, and the leading indicator properties of money, credit and other key variables. Issing concluded that the ECB's reflection on monetary policy strategy is an ongoing process, and therefore the ECB will continuously reexamine its performance.

Otmar Issing and Daniel Gros

The first panel, "The Academics as ECB Watchers", was chaired by Axel A. Weber (University of Cologne and CFS) with Daniel Gros (Centre for European Policy Studies), Manfred J.M. Neumann (University of Bonn), and Niels Thygesen (EPRU and University of Copenhagen) as experts on the panel.

In his presentation, Daniel Gros pointed out that fiscal policy should adjust to leaner times and reduce deficits in order to avoid excessive debt accumulation. He also argued that the ECB's monetary pillar should become a "financial stability pillar". According to Gros, there is little danger of deflation in the Euro area and monetary policy has not tried to keep inflation below the official ceiling of 2 percent. With respect to the Euro, he found the exchange rate to be more important for the Euro zone than is generally believed. Niels Thygesen agreed with Daniel Gros on the latter point and recommended that movements in the Euro exchange rate should be taken more rigorously into account by the ECB. Manfred J.M. Neumann did not share this view and emphasized that the external value of the Euro is a secondary issue, while the stability of the internal

Daniel Gros

value of the Euro remains the most important aspect of the ECB's monetary policy. Neumann criticized the rotation scheme of the Governing Council as a move back toward re-nationalization and pointed out that the rotation scheme does not address the efficiency problem. Thygesen also underlined the importance of efficiency in the decision-making process of the Governing Council.

In his response to the academic experts, Otmar Issing emphasized the importance of asset prices and monetary policy stability issues in conducting monetary policy. He also raised the point that the ECB is very thorough in its consideration of risks to price stability in both directions and as such is currently not worried about possible deflation.

Gert Jan Hogeweg

The second panel, "Market Participants as ECB Watchers", was chaired by Matthew Canzoneri (Georgetown University). The opening statement was made by Gert Jan Hogeweg (ECB) and the experts on this panel were Joachim Fels (Morgan Stanley), John Lipsky (JP Morgan), Thomas Mayer (Deutsche Bank), Paul Mortimer-Lee (BNP Paribas), Thorsten Polleit (Barclays Capital) and Angel Ubide (Tudor Investment).

In his opening statement, Hogeweg stressed that the ECB's transparent framework increased the effectiveness of financial markets, saying that a more transparent structure allows expectations to be formed more precisely and thus helps to improve predictability and also credibility. Joachim Fels, on the other hand, found an inverse relationship between transparency and predictability. According to his analysis, transparent central banks are less predictable. He pointed out that in the past two years the ECB has become more like the Fed, which he regarded as a less transparent but broadly predictable institution. According to Paul Mortimer-Lee, predictability avoids wrong decisions, the misallocation of resources and unnecessary asset price volatility, and protects the reputation of the central bank. He also pointed out that the ECB's monetary policy framework is still not as transparent as it could be. In the interests of more transparency, Mortimer-Lee suggested publishing the minutes and quarterly projections. Thorsten Polleit emphasized the close link between predictability and credibility, both of which are important virtues for a modern central bank. With regard to recent monetary policy decisions, Thomas Mayer argued that ECB staff forecasts have acquired a more prominent role in interest rate decisions, and he pronounced the recent interest rate decisions to be well in line with what the Taylor rule - a widely followed gauge of central bank policy - recommended. John Lipsky, however, found recent ECB rate cuts to have exceeded Taylor rule guidelines, while Fed cuts have matched them. Fels doubted the reliability of estimated Taylor rules and pointed to theoretical as well as empirical reservations against Taylor rules. Mayer, in his analysis using a wide range of indicators, including actual inflation, inflation expectations, monetary and credit developments, or the output gap, did not detect any signs of deflation in the Euro area. Angel Ubide, on the other hand, warned that deflation represents a potential risk in the Euro area and therefore any deflationary bias should be corrected. Like all panel members, Ubide commented that the ECB's communication with financial markets and signaling of policy intentions had improved a lot during the past year.

Matthew Canzoneri

The third panel, "The Press as ECB Watchers", was chaired by Lars Svensson (Princeton University) and included Bernhard Winkler (ECB), Christian Burckhardt (Börsen-Zeitung), Jörg Eigendorf (Die Welt), Beda Romano (I1 Sole-24 Ore) and Pam Woodall (The Economist) as panelists.

In his opening statement, Bernhard Winkler talked about communication and the ECB's monetary policy strategy. He argued that effective communication depends on a variety of factors, such as the quality and quantity of information released. Winkler provided several examples of how a central bank could communicate. In his examples, Winkler distinguished between qualitative versus quantitative, standardized versus flexible, simple versus detailed, ex ante versus ex post, individualistic versus collective, and unscripted versus edited communication. According to Beda Romano, the review of monetary policy strategy had helped to improve the ECB's communication process during the past two years. As an example of good communication, Romano pointed to the timely statement made after the September 11 attacks which was well perceived by market participants. Nevertheless, Romano said that there was still room for improvement, and he argued that the best possible way to improve on a lasting basis the communication of the ECB would be to shift the responsibility for monetary policy to a smaller rate-setting council and publish the minutes summarizing the monetary policy discussion in the Governing Council. Christian Burckhardt suggested that the ECB should, after every decision on interest rates, publish a comprehensive and timely summary without mentioning names, but preferably stating the number of yes and no votes. Pam Woodall had the impression that the ECB was communicating too much. In particular, she questioned why, on more than one occasion, the statement following the monetary policy meeting of the Governing Council had been not quite consistent with the following press conference held by ECB President Wim Duisenberg. Jörg Eigendorf raised the point that the image of the ECB as a young institution to the broad public is of importance and emphasized the ECB's success in creating a "brand".

Lars Svensson

In his concluding remarks, Vitor Gaspar (ECB) pointed out that although it could not draw on a track record as a new institution, the ECB's ability to secure price stability, given an extraordinary list of events and uncertainties that it had been confronted by during the past four years, can be considered as a remarkable achievement.

Vitor Gaspar

Axel A.Weber (University of Cologne and CFS),
Ibrahim Chowdhury (University of Cologne)

Dates of forthcoming CFSresearch conferences can be found in the insert to this issue.

CFS*executive development*

We are very pleased with the contributions to this newsletter from the CFS*seminar* faculty, whom we had asked to report on current issues, including among others the topics under discussion in their respective seminars.
The complete seminar program for 2003/2004 can be found in the insert to this newsletter.

The Art of Analyzing Economic Indicators

by Conrad Mattern,
Activest Investmentgesellschaft mbH

Conrad Mattern

Virtually every day economic indicators, which in part are followed very closely by the markets, are published. The influence provoked exerted by these indicators is felt not only in the country of their origin. Markets are interconnected on a worldwide basis and thus, for example, attention is also paid in Europe to data published in the USA and vice versa. Prior to the publication of an economic indicator, expectations are formed in the markets with respect to the value to be published so that the expectations themselves already make an impact on the markets. If a shock occurs, expectations are adapted accordingly and acute price reactions may then result.

In the short term such announcements influences not only prices but also the volume traded, the price spread, and volatility. However, several studies have shown that even in the event of large deviations from market expectations (which are calculated regularly by news agencies), the markets usually return to their “normal” trends within 20 to 30 minutes. This focusing of the markets on expectations, or rather deviations from expectations, does, however, also have long term effects. Thus, for example, the stock markets do not begin to improve just as economic indicators, and thus the conditions for profits, improve. Instead the rise in the market usually starts in the preliminary stages, when expectations start to circulate that an improvement in the economic situation is impending. Hence US stock markets on average reach their cyclical trough six months before the economic trough. This is also the reason why it is so difficult to make inferences about market trends on the basis of developments in economic indicators alone.

In the financial markets, therefore, attention is paid above all to the so-called leading indicators, as well as in part to the coincident indicators. Leading indicators have the property that they signal economic turning points before the hard facts, such as industrial production or economic growth data, become available. Coincident indicators move largely in line with the economy and thus serve to confirm the signals delivered by the leading indicators.
In view of the flood of data and the danger of information overkill, it becomes necessary to identify those indicators that can usefully serve as leading indicators. Such indicators, which also include for example the ISM Purchasing Managers’ Index in the USA or the ifo business climate index in Germany, are characterized on the one hand by the fact that they deliver a lot of previously unknown information. On the other hand, they are derived from a relatively large sample, are published promptly, revised only to a limited extent and are closely correlated to the variables that are to be explained.

The art of analyzing economic indicators consists of identifying those indicators among the many published on which the market focus rests, extracting and interpreting the relevant pieces of information as well as recognizing the connections between the individual indicators. In order to be able to accomplish this, the most important questions in this context will be addressed and analyzed in the CFS*seminar* “Euroland- und US-Wirtschaftsindikatoren als Market Movers”. These questions include among others the following:

- *What connections are there between the individual indicators?*
- *What do these indicators tell us about economic developments?*
- *How are they calculated?*
- *On what details does the market focus?*
- *Which indicators can be meaningfully interpreted?*
- *Where do the usual traps associated with interpreting indicators lie?*

CFS*seminar* “Euroland- und US-Wirtschaftsindikatoren als Market Movers”, 20/21 November 2003 as well as 6/7 May 2004.

What Security and Return is Provided by the Asset-Funded Retirement Pensions? On the Issue of Risk Evaluation

by Raimond Maurer
Goethe-University, Frankfurt

Raimond Maurer

The “generation contract” of the state retirement pension scheme has reached its capacity limits. Thus the "first pillar" of old age security which is based on this pay-as-you-go scheme has begun to falter. The increasing aging of society is to blame, together with the persistently high level of unemployment that is leading to enormous contribution deficits. It is already the case today that pension payments are covered only up to about 75% by the social insurance contributions of the working population; the rest has to be financed by general tax revenues. Faced with such prospects, increasingly fewer young people are prepared to accept rising pension contributions and continually lower benefits. Can supplementary asset-funded old age security provision absorb these deficits? And how are the numerous concepts for private pension schemes to be evaluated?

In addition to the attempts to repair the state pension system, the expansion of the “second” (company-based) and “third” (private-based) pillars of retirement pensions plays a central role. This involves a asset-funded pension system whereby all individuals accumulate during the course of their working life a stock of capital with which their pension benefits will later be financed. There are various advantages attached to a supplementary asset-funded pension system. It is less susceptible to demographic changes than the pay-as-you-go state system and the broad product spectrum offers greater flexibility since individual aspects, such as age, risk and time preferences, can be better taken into account. Moreover, it is likely that a retirement pension scheme which is linked to the development of the asset, interest rate and real estate markets will achieve a higher level of benefits.

In the case of an asset-funded pension scheme, individuals are responsible for devising from the abundant range of products on offer from banks, investment and insurance companies a suitable retirement pension program for themselves. This means weighing up the chances and risks, comparing acquisition and commission fees, insisting on product transparency, inquiring about flexibility and disposition arrangements and being aware of one's own degree of willingness to take risks. All this requires a high level of individual responsibility with respect to questions of finance, which is still foreign to many people but can be learned. There should be no fear of this new responsibility as the following analogy shows. If you want to learn to drive a car, you must first of all learn both the theory and the practice. When buying a car you must engage in complicated cost/benefit analysis, and if you are finally in a position to enjoy the advantages of driving, you must exhibit caution and responsibility in order to avoid as far as possible the “risk of damage”. Who today despite the effort and risk involved is prepared to do without private cars and only use public transport?

CFS is meeting the need for greater knowledge and better understanding in this area and in the seminar on “Rendite und Risiken langfristiger Investments – Returns and Risks of Long-Term Investments” provides in-depth knowledge about the relevant scientific insights particularly with respect to the theoretical principles, investigative concepts and analytical methods for long-term investments in different asset classes.

CFS*seminar*
“Rendite und Risiken langfristiger Investments”, together with Christian Schlag (Goethe-University, Frankfurt), 14 November 2003.

Credit Derivatives and Securitisation are Important Instruments for any Efficient Portfolio Management

by Dirk Jens F. Nonnenmacher, Dresdner Bank AG

Dirk Jens F. Nonnenmacher

One of the greatest challenges in commercial banking has always been the effective management of assumed credit risk. Since approximately 1999 the traditional, more passive risk mitigation techniques such as syndication, collateralization and sector analysis have been supplemented by an active, liquid credit derivatives market. These instruments permit the hedging of individual credit names, without endangering the existing customer relationship. Further applications comprise the effective management of concentration risks, proprietary trading and professional firm-wide portfolio management. Hedging strategies for single credit names are complemented by securitization techniques, whereby entire portfolios such as state-promoted loans granted by banks are placed on the markets with investors.

The True Sale Initiative, currently being discussed, of some German banks coordinated by the KfW must be viewed against the background of increased volume and the establishment of a liquid secondary market. A profound understanding of modeling, pricing, risk management, as well as regulatory and accounting treatment are essential, also with a view to Basle II, for the successful application of these types of instruments.

The CFS*seminar* on "Kreditderivate, ABS und ihre Einsatzmöglichkeiten im Kreditrisikomanagement", scheduled for 13-15 November 2003 as well as for 17-19 June 2004 teaches the necessary know-how for understanding and using such instruments and addresses related institute-specific challenges.

*More information on all CFSseminars can be found under www.ifk-cfs.de **or in the timetable enclosed**.*

CFS*research activities*

ECB-CFS Research Network

CFS takes part in three international research networks. Through the networks it is possible to cooperate directly with research centers, universities and central banks in Europe and abroad, to enable early stage researchers to join the international scientific community easily. One of these networks, the ECB-CFS Research Network, aims at coordinating 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 linkages to the financial systems of the United States and Japan.

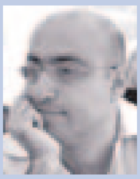
On 11 and 12 March 2003, the Second Workshop of the ECB-CFS Research Network took place in Helsinki, hosted by the Bank of Finland. The workshop was centered around the topic of "Capital Markets and Financial Integration in Europe". The conference site chosen was the House of the State, the former seat of parliament in Helsinki – a beautiful location to be selected for discussing European integration processes. In the opening remarks, Sinikka Salo, Executive Board Member of the Bank of Finland, emphasized the close connection between the theme of this workshop and the first pillar of the Bank`s research strategy, which is based on European financial market integration. She expressed her hopes that the Bank of Finland by both hosting the congress and actively conducting research can contribute to answering some of the questions still open in this field.

The workshop was divided into three main parts with one key lecture preceding the contributions sessions, which dealt with various aspects of the workshop`s main objective. The first key lecture on "The Impact of Technology and Regulation on the Geographical Scope of Banking Activities: Theory and Evidence" was given by Steven Ongena (Tilburg University). In his talk, which drew on a joint paper with Hans Degryse, he examined closely the impact that distance and borders have on banking activities. Economic borders in this respect can be thought of as being either "endogenous", stemming from informational or relationship aspects, or "exogenous", when related to legal, supervisory, political or cultural border issues. One way to overcome these borders can be found in cross-border bank M&A`s, which enables banks to lend across larger distances. For the current state of the EU, Ongena and Degryse`s study finds that whereas regulatory borders are largely removed, other economic borders still remain. In particular, individual supervision practices and different corporate governance standards hamper the geographical scope of banking activities. Furthermore, endogenous informational borders also still exist. This situation is exacerbated by the slow speed with which new lending technologies are being adopted in the banking sector. Steven Ongena therefore stressed the importance of developing policies to facilitate expected cross-border bank M&A`s and to create an environment in which the selection of European supervisory rules for cross-border banks can be simplified.

This first key lecture was then followed by two parallel sessions on "Bank Consolidation and its Implications" and "European Equity Markets and Corporate Governance". In the first of these sessions, chaired by Rune Stenbacka (Swedish School of Economics, Helsinki), the effects of banking consolidation and bank mergers as well as bank exits were discussed. The second session, chaired by David Mayes (Bank of Finland) dealt with various aspects of corporate governance in Europe, among them the impact of the Euro on firms` investment and financing behavior, the role of cross-listings for European firms, and investor stock pricing.

The second part of the workshop began in the afternoon with a key lecture by Tullio Jappelli (University of Salerno) on "Financial Market Integration, Corporate Financing and Economic Growth". In his talk, Jappelli stated that a positive correlation can be found between financial development and growth in the Euro-area, while there still remains a considerable dispersion with respect to financial development across the EU. Furthermore, he claimed that countries with weak financial structures should benefit most from financial integration. However, he argued that developed countries should still have a strong interest in promoting financial integration due to financial services, level and spillover effects that might strengthen their domestic financial markets and the existing financial corporations as well. The second key lecture was again followed by two parallel sessions. The first session analyzed the "Financing Structures of Firms". Chaired by Jan P. Krahnen (Goethe-University, Frankfurt and CFS), it concentrated solely on theoretical issues, examining information and liquidity premiums as determinants of capital structure, efficient interbank arrangements, and equilibrium models of financial markets with adverse selection. The second session, chaired by Harry Huizinga (Tilburg University and Economic Advisor to the European Commission) dealt with the "Integration of Equity Markets". In this session, aspects of household stockholdings, indus-

Staff



Koresh Galil

Koresh Galil studied Economics and Accounting at the University of Tel-Aviv. After serving five years as an officer and heading the planning team in a budgeting department of the Israeli public sector services, he returned to the academic world. He completed his M.A. in Economics and began studying toward a Ph.D. degree. The title of his thesis is "Quality of Credit Rating: an Empirical Investigation". Galil's fields of interest are credit risk and empirical finance. During his Ph.D studies Galil also worked as a lecturer in both Economics and Finance at the University of Tel-Aviv – a job he enjoyed very much. Galil joined the CFS in March 2003 and is currently working on the Research Training Network-Project: **"Understanding Financial Architecture: Legal and Political Frameworks and Economic Efficiency"**, in which the CFS participates since 2000.

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try and country effects on EMU equity markets, and competition issues between different exchanges were discussed.

The second day of the workshop commenced with Geer Rouwenhorst's (Yale School of Management) lecture on "International Financial Linkages". Taking a long-term perspective, he analyzed the benefits of international diversification. From his extensive study of both European and global equity markets, he concluded that international financial linkages have grown steadily stronger, in particular over the last 30 years, even though the world has not yet become a global place. Learning from developments over the last century, he claimed that financial integration generally expands the set of investment opportunities and, by reducing correlations between countries, offers compensation for investors seeking to diversify their portfolios globally.

The third contributed session which followed on "International Portfolio Choice and Asset Market Linkages", was chaired by Philipp Hartmann (ECB), with papers presented on a variety of aspects. One paper dealt with the interdependence of news effects between US and European markets and found that Europe reacts to US announcements much more strongly than vice versa. A second paper in this session looked at a market microstructure approach to explaining exchange rates and tried to link the order flow as a major determinant of a macroeconomic environment. A third discussion paper centered on international diversification effects through direct cross-border lending by banks in order to reduce risk and gain access to more profitable investment opportunities.

The workshop ended with a policy panel on "The Future of Exchanges: Competition or Consolidation?", conducted by Niall Bohan (European Commission, Brussels), Peter Gomber (Deutsche Börse AG), Hannu Halttunen (Nordea, Finland) and Andre Went (Euronext, Paris). In the concluding remarks, Vitor Gaspar (ECB) expressed his thanks for the participants` contributions to the increasingly important topic of financial market integration. Furthermore, he commented on the recent achievements of the ECB-CFS-Network initiative, among them the new website (www.eu.financial-system.org) and the Lamfalussy fellowship. Several of the recently selected Lamfalussy fellows had actively participated in the workshop as either presenters or discussants. Vitor Gaspar closed the workshop by announcing the next workshop on "European Bond Markets", "European Securities Settlement Systems" and "Start-up Financing and New Markets" in November of this year in Athens.

Christina E. Bannier (Goethe-University, Frankfurt and CFS)

New Program Director

In June Prof. Michael Binder joined the research team at CFS as the sixth Program Director.

Michael Binder

Binder brings with him to Frankfurt years of experience in research at various universities and international institutions. In addition to his work at CFS, Binder heads the Chair for International Macroeconomics and Macroeconometrics, which is part of the Monetary Economics research group at the Goethe-University, Frankfurt.

At CFS Binder is taking on the **program area "International Economics"**, with the main focus being on "Exchange Rate Dynamics" and "Sources and Determinants of Cross-Country Variations in Macroeconomic Performance". After undergraduate studies at the University of Kiel and receiving a Ph.D. from the University of Pennsylvania, Binder began his academic career at the University of Maryland. He has been a visiting fellow/professor at the University of Cambridge, at the Banco de España in Madrid, at the International Monetary Fund (IMF) and the World Bank in Washington, and also at CESifo in Munich. Binder is an Associate Editor of the *"Journal of Economic Dynamics and Control"*, and organises conference activities for the Society of Computational Economics in the areas of "Computational Macro Modelling" and "Computational Econometrics".
Further information can be found at www.ifk-cfs.de

research

Research Activities

Rotary Prize

On May 21st Klaus Adam, a CFS fellow and assistant professor at the Faculty of Economics at the Goethe-University of Frankfurt, received the Rotary Prize from the European University Institute in Florence. This prize was awarded for the best Ph.D. thesis in Economics defended during 1999-2002 at the Institute.

In his analysis Klaus Adam focused mainly on the influence of expectations and the modeling of learning behavior in dynamic decision settings. He used learning mechanisms to model business cycles and the study the stability of monetary equilibria. Several excerpts from his work have already been published in leading international academic journals such as the Journal of Economic Theory and The Review of Economic Studies. The relevance of learning processes for the plausibility of economic equilibria has recently become the focus of increased attention in academic research. Learning processes are particularly relevant in situations where coordination problems between a large number of economic agents may generate more than one possible equilibrium outcome. For example, if agents are optimistic about the future economic developments, they might take decisions that cause the economy to have a boom. The outcome then confirms their optimistic expectations. Conversely, however, the economy might go into recession if all agents are pessimistic about the future. Analyzing which of these equilibria can be learned when agents become more or less optimistic based on the observed economic outcomes often allows to exlude some these equilibria and thereby sharpen the predictions of economic models and economic forecasts.


Klaus Adam

Research in the field of learning and expectations formation was initially more theoretically oriented but has become increasingly policy oriented in recent years. Learning processes play a key role, for example in monetary policy analysis, as they ultimately ensure that economic agents coordinate on the intended outcomes of monetary decisions. Klaus Adam's more recent work focuses on the monetary policy area where he collaborated with leading international researchers in this field.

Ramon Marimon and Yves Meny praised Klaus Adam's thesis on the occasion of the award ceremony saying that he has made a substantial contribution to modeling realistic expectations formation processes and has profitably applied this research to economically relevant issues.

Staff

Marc Escrihuela-Villar was born in Barcelona in 1974. He took his Bachelor's Degree in Economics at the University of Barcelona. Afterwards he moved to Alicante where he joined the Ph.D. program in Quantitative Economics. His Ph.D. studies included a period of study at the University of Vienna. For six years, he served as a research assistant, teaching Microeconomics in the undergraduate program at the University of Alicante. The research he has undertaken so far has focused mainly on industrial organization, in particular on anti-competitive practices. His research at the CFS (from July 2003 on) will concentrate on the contribution of innovations to change in the market structures of the financial sector.

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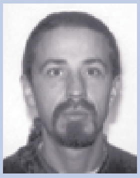
Marc Escrihuela-Villar

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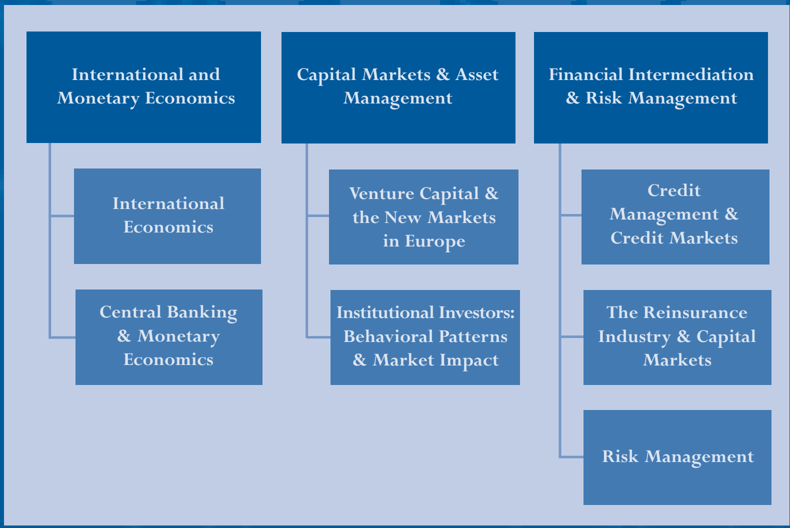
Newsletter Special

Of the 7 program areas planned at CFS, which were introduced in the CFS*newsletter* 2/02, 6 are now up and running. Each one is led by a Program Director who designates the research topics for which he is responsible. The Program Directors are also in charge of publicizing results by arranging events and executive development activities. The program area that we have set up most recently is “International Economics” led by Michael Binder. Within the program areas, researchers work independently within their networks. With the help of the CFS they organise open and closed events aimed at the different abstraction levels of various target groups and thus appearing in various formats.



All Program Directors gather the results of their research in the portfolio of events and use their contacts to attract prominent researchers to cooperate on new and exciting topics. In all program areas research conferences of several days´duration are held regularly, and in part shorter research workshops are arranged with an international forum.

Furthermore, all program areas contribute to the growing output of CFS*working papers*. During the first half of 2003, 26 working papers have appeared. The record shows that many CFS*working papers* will be published in leading academic journals.

CFS fellows themselves are evidence of the international orientation of research at CFS, and in this vein Stefan Mittnik, Program Director for “Risk Management” was successful in engaging Francis Diebold (University of Pennsylvania), as a new fellow. Practitioners are involved in the work at CFS in various aspects thus, for example, several practitioners are participating in the “Risk Management and VC” program. A regular co-operation takes place with the Deutsche Bundesbank and the ECB in the form of the Joint Lunchtime seminar series, during the course of which the most recent research results are discussed directly at the central banks. Leading practitioners also meet on an annual basis for the Multinational Banking Seminar that took place this year from 26 – 28 June. This event which is organised by Friedrich Kübler, Richard Herring (Financial Institution Center, Wharton School) and Jan P. Krahnen focuses on financial topics of an explosive nature, which are discussed in a confidential non-open session.

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Program Area "International Economics"

Research Activities

The aim of this program area is to contribute both methodologically and empirically to the advancement of the research frontier in international macroeconomics and macroeconometrics. The research undertaken as part of this program will seek to contribute to dynamic macroeconomic theory, computational economics, econometrics, and empirical macroeconomic modeling with methods and findings that can be readily put to practical use. Beyond the academic presentation and publication of the research findings, short courses for those working on a regular basis with macroeconomic and financial panel data will also be organized as part of the program.

Research will focus on three main areas:

- Econometric Approaches to Cross-Country Panel Data Sets
- Exchange Rate Dynamics and Their Policy Implications
- Sources and Determinants of Cross-Country Variations in Macroeconomic Performance

Econometric Approaches to Cross-Country Panel Data Sets

Work in these fields will be concerned with the investigation of econometric techniques suitable for the analysis of (large) cross-country data sets. A hallmark of such data sets are the differing economic and legal regulations and institutions present across different countries, which make it non-trivial to devise more reliable estimation and testing procedures for these panel data sets than is feasible on the basis of time-series data only.

Exchange Rate Dynamics and Their Policy Implications

Work in this area will examine the interaction between exchange rates and domestic and foreign prices on the one hand, and other key features of a country's macroeconomic environment on the other. Such an approach necessitates working with a cross-country panel data set spanning a broad range of macroeconomic environments. The program's work in this area will aim to identify separately both the commonalities and heterogeneities in such data, and uncover the link between exchange rate dynamics and macroeconomic policies.

Sources and Determinants of Cross-Country Variations in Macroeconomic Performance

Work in this area will examine the short and long-run dynamics in key real macroeconomic variables shaping the world income distribution. It is critically important in this respect to distinguish between the correlates and the determinants of fluctuations and growth in the variables of interest. The program's work in this area will aim to address the simultaneity problem that has been plaguing empirical work on this issue, and to help identify promising policies for stimulating medium and long-term economic growth.

Planned Activities

- Research Conference on Cross-Country Studies in Macroeconomics, CFS, Summer/Fall 2004
- 5-Day-Training Course on "Dynamic Panel Data Econometrics – Cross Country Studies in Macroeconomics", Spring/Summer 2004 (similar course taught at the World Bank and IMF)
- CFS Summer School on International Macroeconomics, August 2004

Researchers

Fellows

- Lutz Hendricks (Iowa State University)
- Lutz Kilian (University of Michigan)
- Peter Zadrozny (Bureau of Labor Statistics)

Collaborators

- Chang Hsiao (University of Southern California)
- Jan Mutl (Goethe-University, Frankfurt)
- M. Hashem Pesaran (University of Cambridge)
- Hossein Samiei (International Monetary Fund)
- Sunil Sharma (International Monetary Fund)

Michael Binder, Program Director

Program Area "Central Banking and Monetary Economics"

Research Activities

In this program area three main topics for research have been identified.
In "Monetary Policy Strategy" we are studying questions related to optimal policymaking with the focus on the implications of uncertainties and non-linearities for the design of monetary policies. Research on the topic of "Economic Fluctuations and Expectations" seeks to enhance our understanding of the source of economic fluctuations and will place special emphasis on themes related to learning and the formulation of expectations. Finally, research related to the topic of "Computational Approaches" will develop and apply computational methods for studying issues related to monetary policymaking. Research will be conducted within the framework of international collaborations with researchers from universities and central banks. Beyond the presentation and publication of the research results obtained, we also wish to initiate a dialogue with researchers and practitioners from banks and central banks through CFS*seminars*, *workshops* and *conferences*.

Researchers

Fellows

- Klaus Adam (Goethe-University, Frankfurt and CFS)
- Guenter Coenen (European Central Bank)
- Athanasios Orphanides (Federal Reserve Board, Washington D.C.)

Collaborators

- Wouter Denhaan (London Business School and University of California, San Diego)
- Cars Hommes (CeNDEF and Tinbergen Institute)
- Seppo Honkapohja (University of Helsinki)
- Ken Judd (Hoover Institution, Stanford)
- Andrew Levin (Federal Reserve Board)
- Mario Padula (University of Salerno)
- Berc Rustem (Imperial College)
- John Williams (Federal Reserve Bank of San Francisco)

Events/Planned Activities

Conferences

- CFS*workshop*: "Heterogenous Agents Models in Macro and Finance" (September 2002) Organizers: Wieland, Adam (Goethe-University, Frankfurt and CFS)
- CFS*research conference* with Deutsche Bundesbank: "Expectations, Learning and Monetary Policy" (August 2003) Organizers: Orphanides (Federal Reserve Board, Washington, D.C.), Williams (Federal Reserve Board, San Francisco), Herrmann (Deutsche Bundesbank), Wieland (Goethe-University, Frankfurt and CFS)

Planned activities

- CFS*research conference*: "Contracts and Institutions in Models with Heterogeneous Agents" (November 2003) Organizers: Judd (Hoover Institute, Stanford University), Denhaan (London Business School and University of California, San Diego), Juillard (CEPREMAP, Paris), Wieland (Goethe-University, Frankfurt and CFS)
- Workshop "Implementing Monetary Policy", November 2003 Organization: Dieter Nautz (Goethe-University, Frankfurt)

Summer Schools:

- CFS*summer school* 2003: "Empirical Methods For Building Macroeconomic Models", 11-18 August, 2003 Instructors: Canova (Universitat Pompeu Fabra, Barcelona), Eichenbaum (Northwestern University, Evanston Illinois), Williams (Federal Reserve Board, San Francisco)

Publications

- *American Economic Review (forth.): The Performance of Forecast-Based Monetary Policy Rules under Model Uncertainty, A. Levin, J. Williams, V. Wieland (in collaboration with the ECB)*
- *European Economic Review: (forth.) A Small Estimated Euro Area Model with Rational Expectations and Nominal Rigidities, G. Coenen, V. Wieland, (with the ECB)*
- *Journal of Monetary Economics: (forth.), The Zero-Interest-Rate Bound and the Role of the Exchange Rate for Monetary Policy in Japan, G. Coenen, V. Wieland, (with the ECB)*
- *Journal of Economic Dynamics and Control (2002): Learning and Control in a Changing Economic Environment, V. Wieland, G. Beck*
- *Review of Economic Studies (forth.), Learning and Equilibrium Selection in a Monetary Overlapping Generations Model with Sticky Prices, K. Adam*
- *Kluwer 2002: Georges Zaccour (ed.), Decision and Control in Management Science, A Continuous Minimax Problem and its Application to Inflation Targeting, V. Wieland, B. Rustem, S. Zakovic*

Volker Wieland, Program Director

Program Area "Venture Capital & the New Markets"

RESEARCH ACTIVITIES

Research activities are currently focusing on the issue of exit timing (i.e. when do VC enterprises usually choose to disinvest, what form has exit timing assumed on the German market in recent years?). Initial papers are already available and further studies (with a strong empirical orientation) will follow shortly.
In the course of collaborations with several well-known VC companies, work is also currently in progress on the CFS research group's VC contract project. In connection with this, a data base on the central elements of contracts between VC companies and their portfolio firms is to be compiled and analyzed..
An important milestone of this project is the planned collaboration with KfW. The corresponding arrangements are nearing their completion.

EVENTS/PLANNED ACTIVITIES

On 25 June 2003 Matthew A. Zook (University of Kentucky) gave a CFS*lecture* entitled "The Knowledge Brokers: Venture Capitalists, Tacit Knowledge and Regional Development".

On 16/17 October 2003 the Program Directors Uwe Walz and Mark Wahrenburg are hosting a Ph.D. workshop at which Ph.D. students from Germany and other European countries will be presenting their work on the subject of "Venture Capital and Private Equity". This event, together with exchange visits by junior academics on this subject, is also intended to produce an overview of existing data sources in Europe with respect to the VC industry.

On 22 January 2004 a research conference will be taking place at CFS on "The Future of the Venture Capital industry after the New Markets" in cooperation with the Deutsche Aktieninstitut (DAI). The objective of this meeting is to enable the exchange of ideas and experiences between academia and practice. Renowned academics in this field will be presenting their empirical research results and the implications to be derived, and important representatives from the world of practice will lead the discussion of these findings.

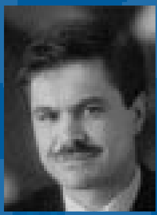
The first conference of the European RICAFE (Risk Capital and Financing of Innovative Firms) Network, funded by the EU, will be taking place at the London School of Economics in October this year.

The second international conference of the research network between CFS, London School of Economics, HEC Paris and the University of Turin is scheduled for October 2004 in Frankfurt/Main.
The program committees of both conferences will include leading researchers in this field from Europe as well as the US.

RESEARCHERS

At the start of 2004 (from January to April) Douglas Cumming (University of Alberta), who is one of the most prolific researchers to publish in the field of Venture Capital, will be visiting CFS. In the course of this research visit a series of research projects between CFS and Cumming are planned to start and are intended to continue beyond the duration of his stay.

Mark Wahrenburg,
Program Director



Uwe Walz,
Program Director

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Program Area “Credit Management and Credit Markets”

RESEARCH ACTIVITIES

This program area will bring together academic researchers (corporate finance and asset pricing) from leading German universities (Frankfurt, Konstanz, Mannheim) and professional experts from the major financial institutions and rating agencies covering the German market (phase I of the project) and the European market (phase II). The research aims at improving our understanding of securitisation and trading in credit risk markets. The emphasis will lie on contractual design, competitive market pricing and securities trading.

The envisaged research agenda comprises several interlinked questions.

1. Given the fundamental structural differences between loans (debtor-creditor lending relationship) and debt securities (non-customised tradable asset claims), what are determinants of efficient contractual design in the CLO/CDS market?
2. What methods can be applied in overcoming efficiency losses due to information asymmetries in loan securitisation, and what is their pricing impact?
3. To what extent does loan securitisation affect the composition of the loan book, and the credit terms imposed on debtors ?
4. What are the comparative advantages of traditional and synthetic CLOs with respect to risk management and pricing?
5. What are the systemic implications of primary and secondary CLO/CDS markets, and what are potential consequences for regulation ?

RESEARCHERS

Academia contact

- Wolfgang Bühler (University of Mannheim)
- Günter Franke (University of Konstanz)
- Jan P. Krahnen (Goethe-University, Frankfurt and CFS)
- Martin Weber (University of Mannheim)

Industry contact

- Ian Barbour (Commerzbank)
- Arnaud De Servigny (Standard and Poor´s)
- Claus Dülfer (West LB)
- Andreas Engel (DZ Bank)
- Isabel Hackenbroch (KfW)
- Markus Herrmann (HSBC)
- Markus Schaber (Deutsche Bank)
- Claudia Schneider (KfW)
- Birgit Specht (Dresdner Kleinwort Wasserstein)
- Thorsten Weinelt (HypoVereinsbank)

EVENTS/PLANNED ACTIVITIES

- September 2002: First Workshop Agenda: Pricing, Liquidity and Regulation of CDOs
- November 2002 Workshop: Credit Derivatives und CDOsAgenda: Presentation of research agenda
- July 2003 Workshop: Management, Regulation and liquidity of CDO/CDS Agenda: Status report on the data collection progress; preliminary results of data analysis

PUBLICATIONS

Jobst, A. (2002), “Collateralised Loan Obligations (CLO) – A Primer,” in:
- University of Frankfurt Working Papers Series, Working Paper No. 96.

Jobst, A. (2002), “Loan Securitisation: Default Term Structure and Asset Pricing Based on Loss Prioritisation,” Financial Markets Group (FMG) Discussion Paper Series, #422, London School of Economics (LSE), August.

Jobst, A. (2002), “The Pricing Puzzle: The Default Term Structure of Collateralised Loan Obligations,” Centre for Financial Studies (CFS) Working Papers Series 2002/16, Frankfurt

Jobst, A. (2002), “Loss Distribution Modelling of a Credit Portfolio Through Extreme Value Theory (EVT)”, Working Paper, December, available online at Securitization.Net™

Jan P. Krahnen, Program Director

Program Area "Risk Management"

Research Activities

The research activities in Financial Risk Management center around the development of techniques and practical tools for quantitative and empirical modeling of market, credit and operational risk. This includes research on the systematic identification and analysis of risk factors; the specification, estimation/calibration and validation of risk models; risk prediction; risk management; and the integration of risk models in ALM systems.Risk Management will also play an important role in this year's summer school in Eltville on 11-18 August. The course addresses issues in financial econometrics that are relevant to portfolio management. It will cover empirical methods for modeling portfolio returns and portfolio risk as required for static and dynamic portfolio optimization. Particular topics include shrinkage estimation, factor models, portfolio selection under VaR constraints, risk and VaR prediction, GARCH and alternative models, heavy tails and skewness, dynamic extreme-value methods, and quantile prediction.

The main topics will be:

1) empirical methods in portfolio analysis (Bayesian and shrinkage estimation, factor models, regression and principal component analysis);
2) portfolio selection with downside risk protection (Value-at-Risk, expected shortfall, lower partial moments);
3) modeling and prediction portfolio risk (univariate and multivariate GARCH models, volatility and VaR prediction, dynamic extreme-value models, quantile prediction).

Researchers

The activities involve experts from academia, industry and regulatory agencies and cover both methodological issues and applied problems.

Academia contact

- Manfred Deistler (Technical University of Vienna)
- Frank Diebold (University of Pennsylvania)
- Toker Doganoglu (University of Munich)
- Marc Paolella (University of Kiel/University of Zurich)
- Svetlozar Rachev (University of Karlsruhe & UC Santa Barbara)
- Eduardo Schwartz (UC Los Angeles)

Industry and Regulation

- Thomas Kaiser, KPMG
- Thorsten Neumann, Deka Bank
- Ludger Overbeck, Deutsche Bank
- Gerhard Stahl, Bafin
- Andrea Vathje, Sal. Oppenheim

Events/Planned Activities

June 2003:

- CFS*lecture* Modeling and Forecasting Realized Volatility
  Frank Diebold and Gerhard Stahl

November 2003:

- CFS*research conference* New Directions in Modeling Financial Risk
  Organization: F. Diebold and S. Mittnik

November 2003:

- CFS*lecture* Weather Derivatives: Theory, Empirics and Practice
  Andrea Vathje and Hans Esser (tbc)

Winter/Spring 2004:

- CFS*research conference* New Developments in Modeling Operational Risk
  Organization: Th. Kaiser and S. Mittnik

Stefan Mittnik, Program Director

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compiled by Ulrike Lexis (CFSresearch management)

Publications

CFS*working paper series*

The CFS*working paper series* presents the result of scientific research on selected topics in the field of money, banking and finance.

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.

2003/04 **Stefan Mittnik, Marc S. Paolella**
Prediction of Financial Downside-Risk with Heavy-Tailed Conditional Distributions

2003/05 **Volker Wieland**
Monetary Policy and Uncertainty about the Natural Unemployment Rate

2003/06 **Andrew Levin, Volker Wieland, John C. Williams**
The Performance of Forecast-Based Monetary Policy Rules under Model Uncertainty

2003/07 **Günter Coenen, Andrew Levin, Volker Wieland**
Data Uncertainty and the Role of Money as an Information Variable for Monetary Policy

2003/08 **Günter Coenen, Volker Wieland**
A Small Estimated Euro Area Model with Rational Expectations and Nominal Rigidities

2003/09 **Günter Coenen, Volker Wieland**
The Zero-Interest-Rate and the Role of the Exchange Rate for Monetary Policy in Japan

2003/10 **Stefan Reitz, Frank Westerhoff**
Nonlinearities and Cyclical Behavior: The Role of Chartists and Fundamentalists

2003/11 **Stefan Reitz, Ralf Ahrens**
Heterogeneous Expectations in the Foreign Exchange Market Evidence from the Daily Dollar/DM Exchange Rate

2003/12 **Klaus Adam**
Optimal Monetary Policy with Imperfect Common Knowledge

2003/13 **Günter Coenen, Athanasios Orphanides, Volker Wieland**
Price Stability and Monetary Policy Effectiveness when Nominal Interest Rates are Bounded at Zero

2003/14 **Raimond Maurer**
Institutional Investors in Germany: Insurance Companies and Investment Funds

2003/15 **Daniel Schmidt, Mark Wahrenburg**
Contractual Relations between European VC-Funds and Investors: The Impact of Reputation and Bargaining Power on Contractual Design

2003/16 **Christian Leuz, Jens Wüstemann**
The Role of Accounting in the German Financial System

2003/17 **Erik Theissen**
Organized Equity Markets in Germany

2003/18 **Roman Kräussl**
Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?

2003/19 **Karl-Herrmann Fischer, Christian Pfeil**
Organized Regulation and Competition in German Banking: An Assesment

2003/20 **Ralf Elsas, Jan Pieter Krahnen**
Universal Banks and Relationships with Firms

2003/21 **Günter Gebhardt, Rolf Reichardt, Carsten Wittenbrink**
Financial Instruments Fair Value Accounting for (not against) the Banking Industry

2003/22 **Roman Kräussl**
Do Changes in Sovereign Credit Ratings Contribute to Financial Contagion in Emerging Market Crises?

2003/23 **Roman Kräussl**
A Critique on the Proposed Use of External Sovereign Credit Ratings in Basel II

2003/24 **Tereza Tykvová**
Is the Behavior of German Venture Capitalists Different? Evidence from the Neuer Markt

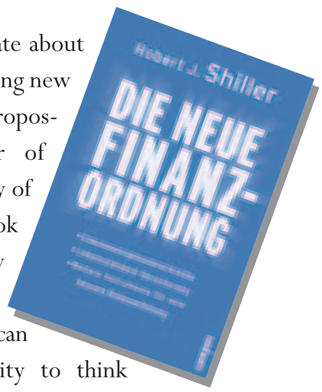
2003/25 **Tereza Tykvová**
The Role of the Value Added by the Venture Capitalists in Timing and Extent of IPOs

2003/26 **Stefanie Franzke, Stefanie Grohs, Christian Laux**
Initial Public Offerings and Venture Capital in Germany

Book Review
"The New Financial Order"
by Robert J. Shiller

More market for more social protection

Robert J. Shiller's new ideas



At long last the depressing debate about our social insurance systems is receiving new impetus from fundamentally new proposals! Robert J. Shiller, Professor of Financial Economics at the University of Yale, has presented us in his new book with innovative visions for a new financial order as well proposals for its instrumental design. The American economist with "the amazing ability to think ahead" (Manager Magazin) is convinced that an economically sound expansion of our social system is possible. Economic growth and social protection for everyone are not mutually exclusive, if we fundamentally rethink our risk management. The technical methods of risk management known to us today can be used to make the increasing economic risks controllable. This is the thesis that Shiller expounds in his new book "The New Financial Order", which appeared in the German version ("Die neue Finanzordnung") on 25 August, published by Campus Verlag.

Shiller believes our social order to be outdated and no longer adequate for dealing with modern risks. He calls for a new financial order, which will enable fair and contemporary risk management using the most modern methods. This implies extending the domain of existing financial instruments and institutions, i.e. the state, banks, insurances, and financial markets, in the pursuit of democratic risk management. In the foreword to the German version it says that “[I]f the German government were to adjust social insurance to meet today's needs and press ahead with the (…) democratization of risk management, then it would be able to reduce the economic risks for the country's citizens and at the same time create achievement incentives for the individual.”

Shiller calls for up-to-date risk hedging that goes beyond the hitherto standard insurance and takes into account the risks of daily life such as the loss of job and income, fluctuations in property values, or employment in an uncertain line of business. He calls for risk management to be extended to cover not only tangible assets but human capital as well, and he also demands that risk insurance be democratized in order to take particularly those with lower levels of income into account. A social security order that spreads individual risks via the free market transmission mechanism would not only prevent economic inequality, but would also stabilize the order of society and act as engine for prosperity. Being able to insure against economic risks leaves the individual free to make the most of his personal abilities and encourages creativity and the willingness to achieve – the very resources that are essential to healthy economic growth.

Shiller makes six concrete suggestions for a new financial order: 1. The introduction of a living standards insurance would enable workers to insure against the loss of income (beyond the means currently available), and home ownership capital insurance against the potential loss in the value of property. 2. The creation of global markets would enable the rating of entire national economies and, owing to the large volume of trade, would contribute considerably more to the distribution of risk than current financial markets. 3. Income-linked credits would provide security against insolvency and excessive indebtedness because debt repayment would be linked to the development of income. 4. A tax against income inequality would be an effective instrument against a widening of the gap between the rich and the poor. 5. A generation-compatible retirement insurance could spread risk equally between the younger and older generations. 6. International risk supervision would absorb the risks of national economies.

Shiller's book points the way out of the downward spiral of financial crises, social welfare cutbacks, fears about the loss of livelihood and caution in consumption, which are continually increasing pressure on the economy and society. Unlike other advocates of widespread social insurance, Shiller does not want to see free enterprise curtailed or even abolished, but rather used toward a more social world. The originality of his approach lies in the call for a moral-based reorganization of the financial order, i.e. more social protection on the basis of more free enterprise With this approach he has put his finger on the pulse of society.

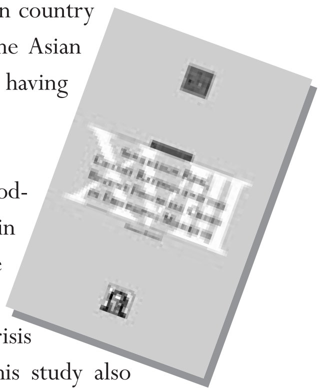
Robert J. Shiller is presenting his new book at a CFS*forum* in Frankfurt on 23 September 2003.

CFS*monographs*

The following CFS*publications* are published by Fritz Knapp Verlag, Frankfurt and are available at all bookstores:

Sovereign Risk, Credit Ratings and the Recent Financial Crises in Emerging Markets

The current publication (with a summary in German) analyzes in an empirical study the role of commercial credit rating agencies in international financial markets. In the wake of the financial crises in emerging markets during the second half of the nineties, the work of credit agencies came in for some criticism. On the one hand, the agencies were accused of having carried out changes in country ratings too late, particularly during the Asian Crisis 1997-98, and on the other of having turned out to be too extreme.



In addition to an historical and methodical overview, Roman Kräussl examines in an extensive econometric study the question whether the actions of rating agencies might accentuate a financial crisis in emerging markets. Furthermore, this study also analyzes whether changes in a country's rating lead to contagion effects beyond its own borders, affecting the financial markets of other emerging market countries. Both analyses use event study methodology and panel regressions in order to determine dynamic and continuous effects of changes in ratings. A crisis indicator is construed on the basis of daily changes in exchange rates, interest rates and the stock market index. In addition to dealing with the implemented changes of country rates, for the first time in a study credit watches and rating outlooks are treated separately.

The author provides evidence of a series of highly significant relationships between changes in rating evaluations and movements in the crisis indicator. Finally, the implications of these results are discussed in the context of the highly topical discussion on Basle II, the new capital adequacy regulation relating to the banking sector. The results of the econometric analysis make it clear that the implementation of Basle II will probably not lead to more stability, but is instead more likely to deepen financial crises in emerging market economies.

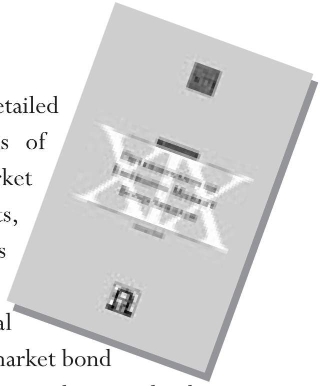
Roman Kräussl

Roman Kräussl was born on 25 September 1970 in Bielefeld. In 1998 he completed his graduate studies in Economics majoring in Econometrics and Empirical Economics at the University of Bielefeld. From 1998 to 2001 he was a member of the academic staff at the Center for Financial Studies affiliated to the Goethe University of Frankfurt. During the year 2000 he made a research visit to the University of Tel Aviv as part of the RTN Network on "The Analysis of International Capital Markets: Understanding Europe's Role in the Global Economy".

His empirically-oriented Ph.D. thesis entitled "On Sovereign Risk, Credit Ratings and the Recent Financial Crises in Emerging Markets: Empirical Analysis and Policy Implications" **(Fritz Knapp Verlag, ISBN: 3-8314-2610-4)** examines the potential influence of commercial credit rating agencies on the financial and currency crises of the 1990s. From 2001 until summer 2002 he was employed as the Head of Quantitative Research for the firm Cognitrend GmbH in Frankfurt/Main. Since summer 2002 he has been a Fellow at the Center for Financial Studies and has held a Marie Curie Post-Doc scholarship at the University of Crete in Rethymno. In his more recent studies Roman Kräussl has been analyzing the implications of behavioral finance on national and international financial markets.

Determinants of Emerging Market Bond Spreads

The present publication (with a summary in German) is concerned with the pricing of bonds issued by sovereign debtors in emerging markets. Generally, emerging market bonds yields in hard currency are higher than comparable securities issued by debtors with a prime rating. Theoretically, these spreads should compensate the additional country-specific risk of default. The author tests this hypothesis using a comprehensive data set of the most important issuers from Latin America and Asia for the period of 1994 to 2001 and examines the question to what extent non-fundamental factors play a systematic role.



The analysis begins with a detailed description of key characteristics of emerging bond markets such as market size and liquidity, market participants, and special financial instruments (Brady Bonds). Then, a survey of existing theoretical and empirical approaches for analyzing emerging market bond spreads is provided (chapters 1 and 2). Subsequently, the author develops an innovative model for the econometric estimation of fundamental and non-fundamental determinants of emerging market bond spreads (chapter 3). For the first time, actual market expectation data are used to model the expected risk of default. Non-fundamental determinants are taken into account in the form of an average "emerging market factor" and a measure of global risk aversion. The parsimonious utilization of parameters permits the estimation of dynamic panel (chapter 4) and vector autoregressive (VAR) models (chapter 5).

The results of this study demonstrate in a remarkably robust manner that in addition to country specific developments, the emerging market factor plays a decisive role. This is particularly relevant for bonds of smaller issuers where the costs of acquiring information are too high for investors. In terms of economic policy implications, the results suggest that international bonds issued by smaller countries are not always fairly priced. For the trading desks of banks and emerging market investors, the findings might possibly offer guides to profitable trading strategies, aimed at identifying mispriced securities of small issuers.

(Fritz Knapp Verlag, ISBN: 3-8314-2612-0)

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Roland Beck was born on 11 December 1970 in Frankfurt/Main. After studying at the University of Freiburg, the University of Maryland/USA and the University of Bonn he graduated in Economics in 1998. During the course of his studies, he gained his first taste of practical work experience as an intern at the United Nations (New York), the German Bundesbank (Frankfurt/Main) and the World Bank (Resident Mission Sarajevo). As a Ph.D. student he worked for a time as an analyst at Commerzbank AG and as a research assistant at the Center for Financial Studies.

Since the beginning of 2002, he has been employed by Deutsche Bank Research in the field of country risk analysis.