NEWS

CENTER FOR FINANCIAL STUDIES

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Editorial

Towards a socialization of losses?

by Jan Pieter Krahnen

As the financial crisis continues into its third year, it is time to consider the lasting impact it may have on our society. Will we see a drift towards more government-led economic activity, a tendency towards the rolling back of markets and private enterprise? As a recent debate at a CFS-Luncheon succinctly asked: how much instability is capitalism able to bear? Discussions in the public arena have begun increasingly to question the political fundament of our market economy. In contrast to earlier economic crises, an impressive joint course of action among all major governments has been initiated. The G-20 meetings set the pace, creating a high level of expectations around the world. By and large, governments, ⇒

the European Commission, and central banks have lived up to these expectations. Will this continue? When the crisis is over, and we review the actions taken to fight it, will we still have a strong and innovative financial industry?

In his seminal book on Capitalism, Socialism and Democracy, first published in 1942, Joseph Schumpeter argues that despite all its achievements in terms of efficiency and innovation, private, entrepreneurial industry will eventually relinquish control to the guided hand of socialist planning. A weakening of market powers via government intervention will smooth business cycles associated with the imbalances and instabilities perceived to be inherent to capitalist market economies. If enterprises become large and manager-run, rather than owner-run, the rise of public ownership will apparently have no dramatic consequences on innovation and efficiency. While Schumpeter's analysis leaves many issues unresolved, including, for example, the issue of corporate governance in large firms, the role of small and medium industry, and the potential of firms to remain innovative and efficient, he nevertheless proves to be accurate in predicting an increased role for government in volatile and – with hindsight – systemic industries such as that of banking.

Macroeconomists would describe the current crisis as an extreme shock to the economy that forces firms and households to adjust their plans downward. Nevertheless, the devastating impact of instability emanating from a crisis is cushioned in many ways, shifting much of the burden over time. This cushioning includes, amongst other things, not only short-time work for entire industries and a higher level of unemployment benefits, but also a counter-cyclical fiscal policy (the 'stimulus'), and a benign monetary policy (the 'easing').

Frederick Deligne, Le Pelerin, France (www.caglecartoons.com)

There is, however, a second form of instability that has to be distinguished from the market-driven instabilities just described. It is that of crisis-related policy instability, pertaining to the basic governance rules of our so-called 'capitalist' system. Today's economic system must, in fact, be regarded as a mixture of capitalist and socialist elements, if the extensive role of publicly-owned firms and institutions, particularly in services and banking, is considered. The fundamental question, therefore, remains: do the remedies offered by policy-makers to fight the financial crisis comply with the ground rules of our economic system? The respect for private property plays an important, defining role with respect to these basic tenets. The frequently voiced critique of an accommodating public policy that accepts the socialization of losses, while permitting private owners' entitlement to accruing profit, is that it – if shown to be true – will be a strong, politically destabilizing factor in a market economy.

The current situation in Germany, with large amounts of public money earmarked for intervention in faltering markets and firms, challenges the fundamental rules of the economic system – and erodes the common understanding that an inherent component of private ownership is indeed the potential to risk of losing everything, in exchange for retaining the decision rights and an entitlement to residual profits.

The rise in interventionist policy-making, ranging from the taking over of toxic assets in the banking industry to the engineering of corporate restructuring in the car industry, or in other industries, is highly alarming. It is likely to frustrate structural changes, which are badly needed in order to defend tomorrow's competitiveness of these industries.

Current public economic policy is, therefore, structurally conservative, and is likely to impose large losses on society as a whole in the longer run. In the interest of long-term welfare, government money should be strictly limited to fighting systemic risks in banking. And even then, government money should not be used to prevent restructuring, and a change of ownership and control at the firm level. In this sense, a consistent 'capitalist' public policy towards systemic risks will respect private ownership – and insist on wiping out equity before taking over losses.

Research Networks

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

The Macro Model Data Base project is part of the EU-sponsored joint initiative on "Modelling and Implementation of Optimal Fiscal and Monetary Policy Algorithms in Multi-Country Econometric Models" (MONFISPOL).

This initiative is supported by a three-year funding through the Seventh Framework Programme for Research (FP7) of the European Commission's Socio-economic Sciences and Humanities (SSH) Program.

The MONFISPOL projects focus on the evaluation of macroeconomic policy, specifically the analysis of optimal fiscal and monetary policy. This includes the development of optimal policy models to analyze the strategic interactions between monetary policy and fiscal policies in a monetary union, the analysis of the dynamics of public debt, as well as the construction of the Macro Model Data Base, a data base of macroeconomic models that allows for systematic models comparison. In addition, new numerical tools will be developed and implemented in Dynare, a public domain platform for the simulation and estimation of dynamic stochastic general equilibrium models.

The partners collaborating in this joint initiative are Michel Juillard (Centre pour la Recherche Economique et ses Applications, Paris), Joseph Pearlman (London Metropolitan University), Paul Levine (University of Surrey), Albert Marcet (Consejo Superior de Investigaciones Científicas, Madrid), Volker Wieland (Center for Financial Studies at the Goethe University of Frankfurt), and Riccardo Girardi (European Commission – Joint Research Centre).

The Macro Model Data Base project headed by Volker Wieland and carried out at CFS aims for building an archive of macroeconomic models based on a common computational platform and providing various tools for systematic model comparison. While in the past such comparison projects have been infrequent and costly initiatives, the Macro Model Data Base provides a new approach that enables individual researchers to conduct model comparisons easily, frequently, at low cost and on a large scale. The broad range of macroeconomic models incorporated in the first version of the Macro Model Data Base include some fairly small models that focus on explaining output, inflation and interest rate dynamics such as the New Keynesian models of Clarida et al. (1999) and Rotemberg and Woodford (1997), many medium scale models covering key economic aggregates like Smets and Wouters (2003, 2007) and Christiano, Eichenbaum and Evans (2005), and some fairly large models like John Taylor's (1993) model of the G7 economies. Researchers can easily include new models in the data base and compare the effects of novel extensions to established benchmarks.

The first version of the Macro Model Data Base will be made available in the course of this year, so that users can then employ the archive for their own research or policy analysis projects.

A detailed introduction to the new comparative approach facilitated by the Macro Model Data Base can be found in Wieland, Cwik, Müller, Schmidt, and Wolters (2009).

Two recent papers by Taylor and Wieland (2009) and Cogan, Cwik, Taylor, and Wieland (2009) employ this new approach to model comparison. Taylor and Wieland (2009) look at three monetary models, used to evaluate monetary policy in the U.S. economy and contained in the Macro Model Data Base to compare the monetary transmission process of these models and evaluate the robustness of optimal policy rules. Cogan, Cwik, Taylor, and Wieland (2009) examine the robustness of models currently used in practice to evaluate fiscal policy stimulus proposals in the U.S. with a particular focus on the implied government spending multipliers.

Sebastian Schmidt and Volker Wieland (CFS)

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RICAFE 2
The Project and Its Policy Implications

The Regional Comparative Advantage and Knowledge-Based Entrepreneurship (RICAFE 2) Research program was launched on 1 March 2006. Over a three-year period, the program resulted in intensive research interactions among the researchers involved. The program led on from the successful RICAFE project completed in April 2005. Under RICAFE 2, the original network of RICAFE was expanded to include new European partners from Amsterdam, Latvia, and Lugano as well as research institutions from India and Israel. Overall, the CFS team working on entrepreneurial finance played a very active role not only with respect to research, but also regarding the exchange of researchers. The European Commission, DG-Research, has acted as sponsor of RICAFE 2. The network has conducted research into the economics of the risk capital financing of innovative companies and has offered informed and insightful research advice to the Commission. The results were presented at RICAFE 2 conferences in London (2006), Riga (2007), and Amsterdam (2008).

The project's key objective was to look at how the various European models of social, legal, and economic institutions affect the patterns of regional economic growth. Furthermore, it aimed to analyze how knowledge-based entrepreneurship (KBE) contributes to shifting patterns of regional comparative advantage, and how it shapes policy options and priorities. In addition to the analysis of the economic factors behind these questions, the project aimed to discuss policy implications and propose new policies.

Our research enabled a better understanding of the entrepreneurial process in various important ways that can be divided into two distinct overarching topics. The first theme explored the interplay between social, legal and economic factors, making use of scientific findings from the fields of economics, psychology, and sociology. The second theme analyzed the link between knowledge-based entrepreneurship and regional dynamics with respect to economic activity as well as regional structural change. For this we looked at the experience of knowledge-based entrepreneurship not only in Western Europe but also in accession countries, as well as in the three fast growing emerging economies Israel, India, and Brazil. Our research on entrepreneurship gave rise to several interesting policy implications.

Motivations for initiating entrepreneurial activities and promoting innovation

The first set of policy implications pertain to the psychological aspects of entrepreneurial initiatives. Earnings alone cannot explain why individuals start their own businesses, especially given the lower (average) earnings derived from entrepreneurial activities or self-employment. We showed how over-confidence, risk aversion, social capital and networks can explain this puzzle and the existence of regional disparity in knowledge-based entrepreneurship.

While entrepreneurs tend to be over-optimistic, it is also true that in order to become an entrepreneur, many of them must leave a well-paid executive job, and may be reluctant to do so. Palomino and Peyrache (RICAFE 2 WP38) showed that offering a job-back guarantee can strictly increase the incentive of potential entrepreneurs to invest in generating ideas. Consequently, job-back-guarantees can have a positive effect on the efficiency of labor markets and can also enhance social welfare, whenever the project entails large positive spillover effects for the rest of society.

Social capital and social networks may also have important effects on capital allocation. Evidence from Dutch companies has suggested that education is a key element for successful entrepreneurship. Parker and van Praag (RICAFE 2 WP 33) provided quantitative estimates of the effect of human capital on entrepreneurial performance. In addition, the empirical evidence shows that capital allocation seems to be driven by favoritism and connections rather than by market mechanisms and information on future expected returns.

How financing aspects can promote entrepreneurial activities

In the political arena, the financing constraints of entrepreneurial activity are often considered to be most important. Katrin Tinn (RICAFE 2 WP48) challenged the traditional view that the role of financial markets is confined solely to financing innovations. Her analysis suggested that financial markets can stimulate adoption of technological innovation by providing exit opportunities to entrepreneurs and venture capitalists investing in technology. This analysis has some interesting implications for policymakers in the new member states. An important result is that policymakers should not strive to ensure full transparency to investors, even if they are capable of doing so.

Organizational aspects of innovative companies

Large and small companies differ markedly in their ability to spawn entrepreneurial activity. Over the years small companies have become able to generate more innovative activity in the U.S. because of a relaxation of the liquidity constraints in the 1990s. This suggests that the deepening of financial structures in Europe should encourage this source of entrepreneurship and help to overcome the risk-aversion that prevents individuals from working for riskier, but more innovative start-ups.

Innovative firms rely greatly on the quality of intellectual property (IP) rights and corporate regulations to help build successful companies and improve their performance. In terms of promoting innovation, Llobet and Suarez (RICAFE 2 WP52) showed that IP rights are a double-edged sword: they prolong the expected duration of the monopoly position of successful innovators, but they also increase the hurdle for success. Strikingly, Llobet and Suarez found that the protection of incumbents against future innovators has an overall negative effect on innovation. In other words, the (negative) effect channeled through the entry hurdle dominates the (positive) effect on post-entry profits. The results crucially depend on whether entrepreneurs have access to venture capital.

Another important policy implication is that IP protection against imitation is not unambiguously a good thing. This is contrary to conventional wisdom, which ignores the effect of imitation on competition and maintains that imitation essentially dilutes profits from innovation and, therefore, discourages it.

All in all, the protection against imitation (or against entrants in general) should be lower when the access to funding is easier. This has implications for the optimal system of protection of IP and explains how it should be adapted according to the severity of financial constraints. IP policy that fits a given industry, region and time period might need to change as institutions for entrepreneurial financing develop: in effect, if financial constraints are relaxed, then IP protection should diminish.

Location choice of high-tech firms in intra-metropolitan areas

The development of technological innovation depends mainly on a production environment that encourages a high level of local innovation and the synergy of different factors to create regional competitive advantages. An innovative production environment reduces the uncertainty and risk that a firm might face in the process of being innovative.

In RICAFE 2 WP61, Frenkel examined the considerations of high-tech firms when choosing a location within a metropolitan region. He studied competition among intra-metropolitan locations for attracting high-tech firms in the Tel-Aviv metropolitan region.

The findings suggest that differences between zones are associated not with their distance from the metropolis' core, but with advantages found in the local and metropolitan environment. The results indicate that a location's attractiveness is of the utmost importance to small firms that rely on a skilled labor force and on R&D activities. This finding is important, since small firms are usually less well established and more sensitive to costs. Nevertheless, he found that the relatively high costs resulting from local taxes do not necessarily harm the attractiveness of employment zones. Small, R&D active plants prefer to locate in an environment that supplies supportive infrastructure, including a strong human capital pool, supporting networks, and technological innovativeness.

Government policy and knowledge-based entrepreneurship

A lot of government activity is directed towards entrepreneurial activity. Therefore, the role of tax policy is decisive: can tax policy foster the creation of new companies? To answer this question, Da Rin, Di Giacomo and Sembenelli assembled a novel country-industry level panel database with entry data of European companies between 1997 and 2004 (RICAFE 2 WP53). They computed effective tax rates and explored the effect of corporate taxation policy on entry rates.

The results imply that corporate taxation has an effect on entry rates that is statistically significant and economically relevant. Two results stand out. They found that the effect of a tax reduction is at work only below a given initial threshold tax level. The effect is economically non-negligible. For example, a reduction of the corporate tax rate from the median (30.08%) to the first quartile (27.57%) implies a 0.880 percentage point increase in the entry rate. Interestingly, they also found that a reduction in corporate tax rates is more effective in countries with a better institutional infrastructure, as measured by the quality of accounting standards. This suggests that a reduction in the corporate tax rate would stimulate the creation of companies in countries where it is more difficult to hide profits by manipulating the profit and loss accounts.

Steffen Juranek and Uwe Walz (CFS)

At CFS, Program Director **Uwe Walz** is in charge of this network; **Steffen Juranek** is supporting him as a research assistant.

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WP 33 Simon Parker and Mirjam van Praag, "Schooling, Capital Constraints and Entrepreneurial Performance: The Endogenous Triangle".

WP 38 Frédéric Palomino and Eloic-anil Peyrache, "Job-Back Guarantees".

WP 48 Katrin Tinn, "Technology adoption with exit in imperfectly informed equity markets".

WP 52 Gerard Llobet and Javier Suarez, "Financially Constrained Innovation, Patent Protection, and Industry Dynamics".

WP 53 Marco Da Rin, Marina Di Giacomo and Alessandro Sembenelli, "Firm entry dynamics and the taxation of corporate profits: Evidence from firm-level data".

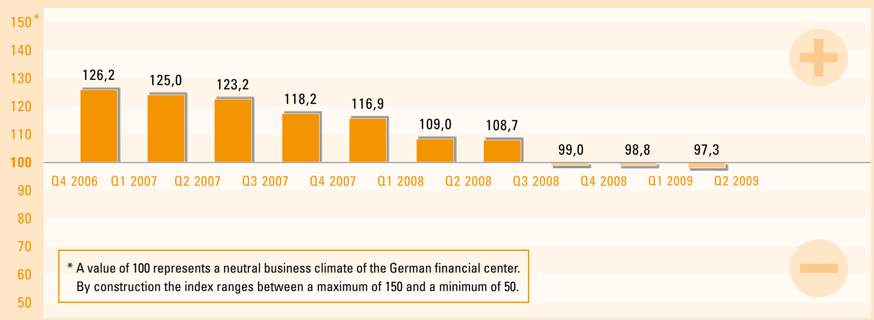
WP 61 Amnon Frenkel, "The Intra-Metropolitan Competition for Attracting High-Tech Firms".

→ All papers are available on www.lse.ac.uk/collections/RICAFE/

CFS Financial Center Index continues to fall

Project Team: Christian Knoll & Corinna Wolf (CFS)

CFS FINANCIAL CENTER INDEX



SOURCE: CENTER FOR FINANCIAL STUDIES (CFS)

DO YOU BELIEVE THAT THE FOLLOWING MEASURES WILL BE EFFECTIVE IN PREVENTING FUTURE FINANCIAL CRISES? (1: NOT EFFECTIVE – 5: VERY EFFECTIVE)

Regulating rating agencies	Banks only	**3,5**
	Full panel excl. banks	**3,9**
Regulating hedge funds	Banks only	**3,5**
	Full panel excl. banks	3,6
Reducing the procyclicality of the financial system	Banks only	3,2
	Full panel excl. banks	3,1
Compiling a risk map	Banks only	2,7
	Full panel excl. banks	2,8
Introducing a global credit register	Banks only	2,5
	Full panel excl. banks	2,9

THE GERMAN FEDERAL GOVERNMENT PLANS TO TAKE A MORE PREVENTIVE STANCE IN FINANCIAL SUPERVISION AND TO INCREASE THE NATIONAL SUPERVISORY AUTHORITIES' POWER TO ACT. SUPPORT FOR THE FOLLOWING MEASURES:

Qualification requirements for members of supervisory boards	Banks only	**71%**
	Full panel excl. banks	67%
Stricter capital requirements	Banks only	52%
	Full panel excl. banks	**69%**
Competence to control business models of banks	Banks only	48%
	Full panel excl. banks	55%

The CFS Financial Center Index is a quarterly index measuring the evaluation and expectations of financial market agents for Germany as a financial center. The index is based on surveys of leading executives from the financial community in Frankfurt and Munich. The maximum attainable index value is 150, the minimum index value 50. An index value of 100 indicates a neutral business sentiment.

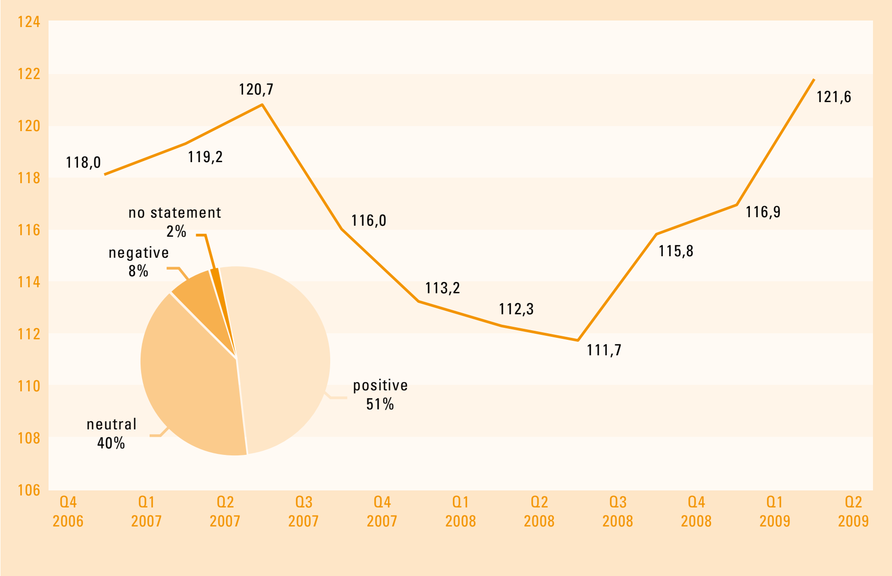
The latest CFS Financial Center Index survey, which was conducted during the first and second quarter of 2009, shows a continuing negative trend. The index value currently stands at 97.3 and is 1.5 points lower than the previous index value of 98.8. This time the continuing decline reflects the negative business sentiment registered in the group of financial sector service providers, particularly in the accounting and consulting business. This group's rather pessimistic view is mainly determined by negative profit expectations and planned staff reductions. The other core group of financial institutions, insurances and brokerage firms, has a more cautiously optimistic view of their profit and job situation. "While financial institutions in Germany apparently succeed in overcoming the financial crisis by means of drastic restructurings, the financial service providers are now being hit by the crisis with a half year delay", explained CFS Director Jan Pieter Krahnen.

Special Survey

The special survey conducted this time dealt with the effects of the G20 meeting in London on 2 April 2009. It also focused on the German financial market authorities and the stability of the German financial system. The majority of participants in the survey rate the measures taken at the G20 meeting positively. However, there is no clear view on whether these measures will be successful in bringing back investor confidence. Regulating rating agencies and hedge funds are seen as effective measures to prevent future crises. The respondents also endorse the strengthening of financial market supervision. Krahnen sees this as a clear demand by the finance industry for more regulation, not only with respect to measures that are directed towards short-term crisis management, but also regarding preventative measures.

Germany as a financial center has gained credence. Two thirds of the interviewees believe that the German financial system is more stable than other financial centers, thanks to its regulatory framework, the German universal banking system, and its three-pillar structure. The future prospects of Germany as an important financial center are growing constantly. "It is conceivable that the expected increase in regulation will have a positive effect on Germany as a financial center", said Krahnen.

EVALUATING THE FUTURE INTERNATIONAL SIGNIFICANCE OF GERMANY AS A FINANCIAL CENTER



→ Further details can be found at www.financialcenterindex.com

Towards a New Financial Order
The work by the Issing Committee

How can financial stability be restored and how should the international financial markets be more efficiently regulated and supervised to prevent severe financial crises in the future? To answer these questions, expert groups in various countries have been entrusted with finding long-term solutions for an enhanced supervisory and regulatory framework. Otmar Issing, President of the Center for Financial Studies, and Jan Pieter Krahnen, CFS Director, were appointed to the Expert Commission to advise the German government on financial crisis prevention. Through these appointments, the Center for Financial Studies has started to broaden its core activities towards providing advice to policymakers.

Origins of the crisis

What by mid-2007 appeared to be a defined problem in a special segment of the U.S. mortgage market, notably the U.S.-subprime market, in the meantime has grown into an unprecedented global financial crisis and one of the worst recessions in modern times. As the crisis unfolds, it becomes more and more clear that the problems we observe are the consequences of a dynamic interaction between factors in the macro and the micro side of the economy. At the root of the crisis had been a combination of massive liquidity and low interest rates, which led to sharp increases in asset prices, especially in the housing sector of many countries. In an environment of inadequate regulation and important gaps in supervisory oversight, inappropriate incentive structures have promoted short-termism and encouraged the production of complex financial instruments. Supported by high degrees of leverage, the overall situation in booming financial markets became more and more unsustainable. It needed only a trigger to collapse. This trigger was delivered when house prices in the U.S. started to fall with the expectation that this would continue for an extended period of time. While academics, policy makers and market participants still come to terms with what has happened, political leaders around the world are challenged to solve the most pressing problems. Meanwhile, initial steps have been made to lay the foundations for a post crisis financial order.

Reactions to the spread of the financial crisis

When the financial crisis accelerated quickly after the collapse of Lehman Brothers in September 2008, policymakers around the world reacted with a twofold strategy: In order to stabilize the financial system, they immediately set up deposit guarantee schemes and developed plans to support the banking sector. Simultaneously, they called into action expert commissions to prepare proposals for long-term reforms of the international financial system.

In October 2008, Chancellor Angela Merkel called upon Otmar Issing and Jan Krahnen to join an expert commission to advise the government on issues relating to financial crisis prevention and financial market reform. While heading this national expert commission, Issing was also a member of a group of experts for the reform of financial markets in Europe set up by the President of the European Commission and headed by Jacques de Larosière. Together with their colleagues in the national expert commission Jörg Asmussen (Finance Ministry), Klaus Regling (formerly European Commission), Jens Weidmann (Federal Chancellery), and William White (formerly Bank for International Settlements), Issing and Krahnen were to consider different options for fundamentally reforming the world's financial architecture in order to prevent a repeat of the current crisis.

Commensurate with this goal, the *Issing Committee's* task was to explore alternative ways for increasing the efficiency of the regulatory and supervisory framework

Meeting at the Chancellery in Berlin on 28 October 2008 - Krahnen, Issing, Merkel, Regling, Steinbrück

in order to improve crisis prevention in financial markets. The commission started with an elaborate analysis of the causes of the current crisis to detect shortcomings in existing arrangements. At the core of their recommendations was the idea that supervision has to focus also on systemic risk rather than only on risk for individual institutions and market participants, and that early warning signals need to be backed up by reliable information on all financial market segments.

In order to voice their suggestions at the international stage, the Expert Commission prepared two reports for the international summits that followed the outbreak of the crisis, in particular the G20 meetings in Washington in November 2008 and in London in April 2009 along with a number of smaller summits at the EU level.

Recommendations by the Issing Committee

On 2 February 2009, about one month before the London Summit, Chancellor Angela Merkel, Finance Minister Peer Steinbrück and the members of the Issing Committee met in Berlin to present to the public the final recommendations of the experts. One of the novel ideas the experts had brought to Berlin received particular attention: The Issing Committee proposed to establish a detailed database on risk exposures by the financial sector. This project went by the telling title "Global Risk Map" owing to the fact that the proposed database could be used to visualize the amount and location of risks within the global financial system. The Risk Map would be designed to help shed light on the net exposures and interdependencies of individual institutions and make transparent the major risk factors behind them. A database of this kind, in combination with the right explorative tools, could thus serve as an effective instrument to alert policy makers of rising systemic risk. Ultimately, the Risk Map project involved collecting new data to fill current blind spots; such as off-balance sheet entities as well as credit risk transfer instruments. As an integral part of the Risk Map project, a centralized and harmonized 'Global Credit Register' should be introduced. The group emphasized that additional data would have to be collected systematically and with its ultimate use in mind – a concept the experts readily subsumed under the label of "intelligent transparency".

The Issing Committee furthermore recommended that the measure of

	April	G20 summit on financial markets and world economy in London.
		Lloyds Banking Group bail-out / 150 GBP bill. to heal UK economy / Drop in DJIA and S&P500 comparable to Great Depression.
		Crisis spreads to Eastern Europe / American Recovery and Reinvestment Act of $787 billion is signed.
2009	January	Blue Monday Crash / Government of Iceland collapses / Obama suggests federal spending bill of almost $1 trillion.
	December	Madoff ponzi scheme scandal erupts / Unemployment rate rises / NBER announces that USA is already 1 year in recession.
		G20 summit in Washington / US government rescues Citigroup / China creates stimulus plan.
	October	US Senate passes $700 billion bail-out / FED, ECB, central banks in England, China, Canada, Sweden and Switzerland cut rates / Large losses in financial markets and job cuts worldwide/Bank deposits are guaranteed in Germany, Denmark, UK, Australia and New Zealand / EU leader meetings in Paris, later in Brussels/Germany, France and Italy with individual plans / G7 summit in Washington / Oil price falls to $80 per barrel / "Black Friday" on financial markets / Hungarian central bank gets injection from ECB.
		US Treasury nationalizes Fannie Mae and Freddie Mac / Lehman Brothers files bankruptcy / Stock market downturn / Central banks inject billions in money markets / Merrill Lynch is acquired by Bank of America / AIG Corp is bailed-out by FED / Job losses worldwide / Partial nationalization of Fortis, Dexia and Glitnir / Morgan Stanley and Goldman Sachs turn to traditional banks.
		Commerzbank takes over Dresdner Kleinwort.
	July	Major banks report losses related to investments in mbs / Oil price peaks at $147/ barrel.
	April	Deutsche Bank reports loss of $3.9 billion in the first quarter of the year.
		Bear Stearns collapses and is acquired by JP Morgan Chase.
		Nationalization of the UK bank Northern Rock.
	January	Stock market downturn / Service Industry Index collapses to recession levels / Consumer confidence loss / FED cuts 125 bp.
2008		US banking reserves go negative.
	December	
		UBS, Citigroup and Merrill Lynch announce big losses.
	October	DJIA, S&P500 and Nasdaq records.
	July	Liquidity crisis emerges. FED cuts 50 bp. Credit rating agencies downgrade many mbs.
	April	Bear Stearns Hedge Fund collapses.
		Subprime industry collapses. Value of US subprime mortgage estimated to be $1.3 trillion.
2007	January	
2006		Growth of housing market is halted abruptly. Yield curve is flat compared to the year before.
2005		Maximum inflation of US housing bubble. Large amounts of mortgage-backed securities (mbs) are issued. US subprime mortgages increase by 292%.
2004		
2003		FED decreases interest rate to 45 year low: 1%.

systemic risk derived from the Risk Map be linked to suitable policy action, e.g. bank capital requirements. Under such a regime, capital requirements would need to rise during periods of high systemic risk and fall when threats to the system are declining. Ideally, such a rule would help to lower the so-called procyclicality of the financial system, i.e. the (unintended) tendency of banks to enhance the ups and downs of the financial cycle, which is another important issue addressed by the expert group.

High on the government's agenda, the Issing Committee made detailed proposals as to how non-banks, such as hedge funds and rating agencies, should be regulated. With regard to rating agencies, the group proposed to enhance competition between rating providers instead of regulating the rating process itself. Towards this end, rating agencies would have to register and provide data on rating migrations and rating defaults to a central oversight body. The data would then be used to assess predictive performance of rating agencies, leaving it to the investors to make best use of the information provided. Concerning hedge funds, the Issing Committee recommended a dual approach. On the one hand, hedge funds should be obliged to register with a central oversight body as part of the Risk Map project. On the other hand, hedge fund activity should be monitored indirectly through the major banks that provide credit and services to the funds, which would be possible with the risk map encompassing approach. The experts argued, that such a dual approach made it much more difficult for a fund to escape the radar of global surveillance altogether, while at the same time allowing to view the consolidated exposure of the financial system vis-à-vis hedge funds.

Current outcomes and the road ahead

What have been the results of the G20 meetings? Are we now better prepared to avoid the repetition of a crisis as severe as the current one?

Towards improvement of the global institutional framework, the Issing Committee recommended strengthening the role of the FSF and expanding its membership to a broader base. This point was taken up also by the London summit, where leaders from the Group of Twenty pledged to establish a new Financial Stability Board (FSB). The new board would be a strengthened successor to the Financial Stability Forum (FSF) including all G20 countries, FSF members, Spain, and the European Commission.

In addition, the G20 Group recommended strengthening the role of the IMF in international surveillance of systemic risk, a point also made by the Issing Committee. In particular, the IMF should have more resources and play a broader role in the world economy than in the past. The G20 also expects the IMF to ensure the "even-handed and independent surveillance of economies and their banks as well as of the impact of their policies on others and of risks facing the global economy".

While many proposals are still on the way, the next meeting of the G20 has already been scheduled. In September 2009, world leaders will meet in New York to assess whether the promises made in London have been kept. The meeting will also assess the progress made in implementing the range of financial regulatory reforms set in train at the G20 meeting in Washington. The Issing Committee, too, will continue its work on these issues.

Christian Weistroffer & Julia LeBlanc (CFS)

Roadmap to a New Financial Order

Washington Summit, 14-15 November 2008

- Consideration of the causes of the crisis.
- Agreement on common principles for reforming the financial system, e.g. improving transparency and accountability of financial markets and institutions, strengthening regulation, and reducing procyclicality of the financial system.
- Clear commitment to the principles of a free market economy.

London Summit, 2 April 2009

- Attempt to restore confidence, growth, and jobs by making available an additional $5 trillion in total fiscal stimulus packages.
- Establishment of a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF).
- Strengthening of the IMF in its role as an independent surveyor and mandate to provide early warnings of macroeconomic and financial risks.
- Pledge to extend regulation and oversight to all systemically important financial institutions, instruments and markets, including hedge funds and rating agencies.
- Pledge to take action against non-cooperative jurisdictions, including tax havens.

New York City Summit, September 2009

CFS White Papers

The Recommendations by the Issing Committee can be found on our website www.ifk-cfs.de

New Financial Order
Otmar Issing, Jörg Asmussen, Jan Pieter Krahnen, Klaus Regling, Jens Weidmann, William White

CFS Working Papers

2009/01 **Opting out of the Great Inflation: German Monetary Policy after the Break Down of Bretton Woods**
Andreas Beyer, Vítor Gaspar, Christina Gerberding, Otmar Issing

2009/02 **Stockholding: From Participation to Location and to Participation Spillovers**
Dimitris Christelis, Dimitris Georgarakos, Michael Haliassos

2009/03 **Analyzing Interest Rate Risk: Stochastic Volatility in the Term Structure of Government Bond Yields**
Nikolaus Hautsch, Yangguoyi Ou

2009/04 **Financial Advisors: A Case of Babysitters?**
Andreas Hackethal, Michael Haliassos, Tullio Jappelli

2009/05 **Venture Capital Exit Rights**
Carsten Bienz, Uwe Walz

2009/06 **The Design of Vertical R&D Collaborations**
Patrick Herbst, Uwe Walz

2009/07 **Governance und Vertragsstrukturen in der deutschen VC Industrie: Eine empirische Einschätzung**
Carsten Bienz, Julia Hirsch, Uwe Walz

2009/08 **Debt Literacy, Financial Experiences, and Overindebtedness**
Annamaria Lusardi, Peter Tufano

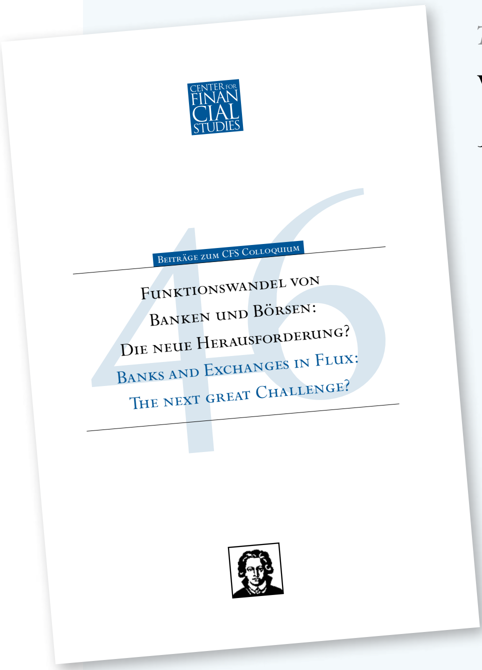
2009/09 **The Crisis of Fair Value Accounting: Making Sense of the Recent Debate**
Christian Laux, Christian Leuz

2009/10 **Algorithmic Trading Engines Versus Human Traders – Do They Behave Different in Securities Markets?**
Peter Gomber, Markus Gsell

CFS Colloquium

The 46th edition of our publication series "Beiträge zum CFS Colloquium" is now available. This volume contains contributions of the five speakers at the 2007 Colloquium Series "Banks and Exchanges in Flux: The next Great Challenge?" and is devoted to the effects of technological change on the organization of banks and on product development. All contributions are in German and have a short English summary at the end.

Funktionswandel von Banken und Börsen: Die neue Herausforderung? Banks and Exchanges in Flux: The next great Challenge?



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Central Banks, Liquidity Traps and Solvency Traps

6 May 2009

A speech by Prof. Willem H. Buiter

On 6 May 2009, Willem H. Buiter, Professor of European Political Economy at the London School of Economics and Political Science gave a presentation on "Central Banks, Liquidity Traps and Solvency Traps". His was the first speech of the new CFS Colloquium Series "Redefining accountability: Lessons from the recent financial crisis".

In his introduction, Thomas Laubach (Goethe University) acknowledged Willem Buiter as one of the most qualified observers and commentators on the current crisis and especially on policy responses to the crisis. Laubach reminded the audience of Buiter's contribution to the Jackson Hole Symposium, organized last August by the Federal Reserve Bank of Kansas City. In his analysis of the responses of the Federal Reserve, the European Central Bank and the Bank of England during the first year of the crisis, Buiter controversially claimed that the Federal Reserve, and to a lesser extent the other central banks as well, had succumbed to what he called "cognitive regulatory capture". Instead of acting effectively as regulator of the financial sector, Buiter perceived the Fed's position as too close to financial markets and leading financial institutions, and too responsive to their special pleadings.

After the introductory remarks, Buiter began his talk by postulating that the zero lower bound of interest rates was merely the assumption that the short, risk-free nominal interest rate cannot be negative. In reality, he argued, there is no theoretical or practical reason for not having a negative interest rate if that was what a Taylor rule, used as a guide to official policy rate by central banks, suggested. According to Buiter, the main problem with setting (negative) nominal rates was the presence of "bearer instruments". "Bearer instruments", such as currency, are anonymous, and are transferable to another party without a requirement for countersignature.

In contrast to bearer instruments, the identity of the owner of "registered" securities, such as shares or bank accounts and reserves held by banks with the central bank, is known. As a result of this, paying interest, negative or positive, on registered instruments is trivial. In many cases today, interest payments are entries in electronic ledgers that have no technical obstacles to negative rates. Central banks, Buiter argued, could easily charge negative interest rates on deposits (reserves) held by banks with them.

Willem H. Buiter

Willem H. Buiter is Professor of European Political Economy, London School of Economics and Political Science. He received his Ph.D. from Yale in 1975. During the first 22 years of his career, he was a professor at Princeton, Bristol, the London School of Economics, Yale and Cambridge. His publication record is admirable and his range of research interests is extensive, from monetary policy and monetary institutions, pension funds and social security to public finance, for example issues of fiscal federalism.

Besides these academic credentials, Buiter also has substantial experience as policy maker. He served for three years as an external member on the Bank of England's Monetary Policy Committee. From 2000 until 2005 he served as Chief Economist and Special Counselor to the President of the European Bank for Reconstruction and Development.

Since 2005, Professor Buiter has returned to academia and has been intensely involved in the analysis and policy discussions of the financial crisis.

However, interest payments on currency (positive or negative) are more difficult because of the anonymity of the owner. The bearer instrument has to be clearly marked as 'current' on interest to determine whether interest has been settled.

Having stated the problems connected to currency, Buiter went on to describe three ways to implement negative nominal interest rates and remove the zero lower bound on short, risk-free nominal interest rates.

Abolish currency

From a technical point of view, the abolishment of currency should pose no problem, as countries can nowadays switch easily to electronic and bank-account-based means of payment and exchange. 'E-money' that can pay positive or negative interest without any additional cost is now widely available in the advanced (post-) industrial world. Given that traditional bank accounts, credit cards and debit cards can take care of most of the retail payments, currency can be made redundant as a means of payment for legitimate transactions. In Buiter's opinion, the main drawbacks of abolishing currency – loss of anonymity and of seigniorage income by central banks – do not weight against the advantage of not having a zero lower bound constraint on nominal interest rates. Besides, currency encourages tax evasion, money laundering, and criminality and large denominations pose social costs.

In his opinion, it would be enough to leave only low denominations of currency. The carry costs (safe-keeping, insurance and storage) for large amounts of cash would likely become prohibitive.

Tax currency and 'stamp' it to show it is 'current on interest due'

This proposal, originally voiced by Gesell was supported by Irving Fisher. The idea behind this proposal is that when the interest rate on currency is positive, the currency must be marked (by stamping or clipping coupons) to make sure the (anonymous) bearer does not present it repeatedly for the payment of interest. When the interest rate is negative, one could verify whether it is current on interest using inspections of the instrument. This approach however would be administratively costly and unpleasantly intrusive.

Unbundle currency from the unit of account

The third way to allow for negative nominal interest rates goes back to Eisler (1932). His solution is to decouple the numéraire from the "cash" currency.

To clarify this idea for the euro zone, Buiter invited the audience to assume that a new currency, the *"wim"* [1], would be introduced and that the euro would be kept as numéraire (i.e. for bank accounts, government contracts, bank reserves with the central bank and government debt). The government would set the exchange rate over time between the euro and

Willem H. Buiter

the *wim* instrument to ensure absence of arbitrage. Since the *wim* is the currency, there is a zero lower bound on its interest rate. However, the euro nominal interest rate could become negative.

In the following technical part of his speech, Buiter presented the decoupling of the numéraire and the currency in a dynamic, stochastic general equilibrium (DSGE) model. In the model economy, a no-arbitrage condition implies that the spot exchange rate between the euro and the *wim*, the forward exchange rate between the euro and the *wim* and the one period interest rate on safe euro securities and the one-period interest rate on safe *wim* securities are related through covered interest parity (CIP), i.e. the ratio of the interest rates is equal to the ratio of the exchange rates.

If the monetary authority followed a Taylor rule that determined both interest rates to go below zero, the *wim* interest rate would be constrained to be non-negative and therefore would equal zero. However, the euro interest rate could be set at whatever negative value the Taylor rule called for, and this without creating an arbitrage opportunity, provided that the difference in the forward price and the spot price is captured exactly by the differences in the interest rates.

Hence, the zero lower bound on euro interest rates would be removed and replaced by a zero lower bound on *wim* interest rates. By the law of one price, real interest rates (inflation corrected interest rates) would still be the same.

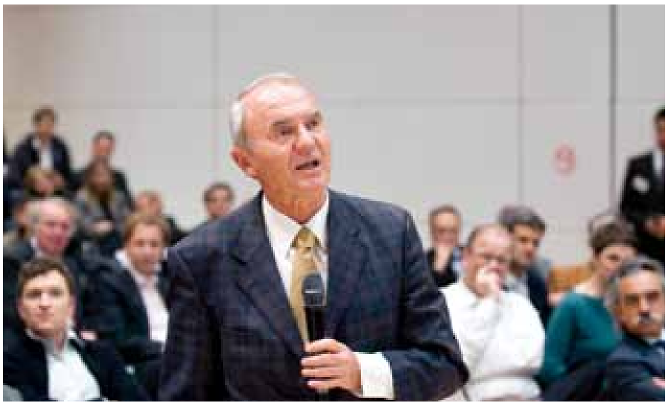
Buiter addressed potential problems in this economy if the euro would cease to be the numéraire for key private contracts (especially wage and price contracts). If the numéraire would start to follow the currency, and the *wim* price level would become the price level that matters, the economy would be back at its start, simply having renamed

[1] Name chosen in memory of *Wim* Duisenberg, the first President of the European Central Bank.

its currency. To counter these problems, Buiter claimed that authorities should strongly encourage the use of the numéraire, for example by insisting that all contracts in and with the public sector are denominated in euro or requiring that tax returns are made in euro.

Buiter summed up the advantages of this third scenario where currency and numéraire are unbundled. The abolishment of currency would no longer be necessary and removing the zero lower bound on euro interest rates would increase the effectiveness of monetary policy.

Having shown three ways to overcome the zero lower bound, Buiter pointed out that central banks continue to ignore these solutions. Instead of removing the zero lower bound, central banks engage in quantitative easing by purchasing government securities of all maturities when they are at their lower bound. This can put the central bank into a strong liquidity trap in which it can only use money-financed tax-cuts or transfer payment increases. As a result, the central bank would be either acting as a fiscal principal in its own right or as a fiscal agent for the government. Buiter claimed that this proposal could work only if increases in the monetary base are expected never to be reversed in the future. The problem of this strategy would be the default risk, especially in a currency unit like the euro zone and the absence of a 'fiscal Europe'. The lack of fiscal indemnity could pose a threat to the ECB's independence when losses incur due to defaults in monetary policy operations, liquidity enhancing and credit enhancing operations.



Otmar Issing

Another option the central bank could choose would be credit easing. In this case, Buiter asserted that central banks would also need a full fiscal indemnity for capital losses due to defaults on assets the central bank becomes exposed to through outright purchases of private securities and unsecured lending to the private sector. They would also need this indemnity when engaging in collateralized lending to the private sector when the collateral consists of private securities.

Concluding his presentation, Buiter emphasized that removing the zero lower bound on nominal interest rates would mean a valuable addition to the policy arsenal of central banks. Keeping the zero lower bound, he said, is a costly mistake.

Julia LeBlanc (CFS)

Calendar of the 2009 CFS Colloquium series Erneuerte Verantwortlichkeiten: Lehren aus der Finanzmarktkrise Redefining Accountability: Lessons from the Recent Financial Crisis

6 May 2009
Central Banks, Liquidity Traps and Solvency Traps
Prof. Willem H. Buiter
(Chair of European Political Economy, European Institute, London School of Economics and Political Science)

27 May 2009
Should Monetary Policy "Lean or Clean": That is the Question?
William R. White
(Former Economic Adviser, Head of Monetary and Economic Department, Bank for International Settlements)

9 September 2009
Management der Finanzmarktkrise aus der Sicht eines CFO
Dr. Eric Strutz (Management Board Member, Commerzbank AG)

24 November 2009
Reform der globalen Finanzstruktur
Dr. Hugo Bänziger (Management Board Member, Deutsche Bank AG)

9 December 2009
Do we need more regulation?
Prof. Eddy Wymeersch
(Chairman, Committee of European Securities Regulators)

CFS Presidential Lecture

Europe – Cultural Identity – Cultural Diversity

16 March 2009

Jean-Claude Trichet

On 16 March 2009, the Center for Financial Studies welcomed ECB President Jean-Claude Trichet to give a lecture on the topic of cultural identity and cultural diversity in Europe. This talk was part of the "CFS Presidential Lectures", a lecture series under the auspices of CFS President Otmar Issing that concentrates on European integration. After being introduced by Issing, Trichet spoke about the central concept behind Europe's cultural identity, about the diversity within Europe and about Europe's aspirations towards universality. The following paragraphs contain a brief summary of the speech.

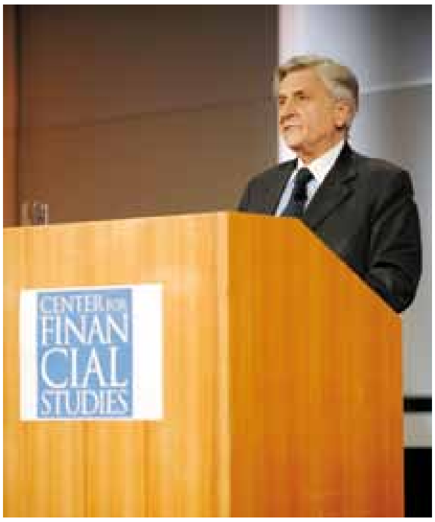
Trichet began his speech by expressing his gratitude for the invitation from his former colleague Issing, with whom he has often exchanged views on cultural issues such as literature and poetry. He said he also welcomed the opportunity to point out that the ECB values Europe's cultural diversity as a major asset and actively seeks to raise awareness for the essential contribution this diversity makes to Europe's cultural identity. Furthermore, he sees the invitation as a chance to voice his conviction that indeed money and culture have more similarities than is generally understood: poems for example, like gold coins, are meant to last and retain their integrity. They both represent a "store of value" over the long term and both belong to the people in a very deep-rooted sense.

The search for a central concept in Europe's cultural identity

One way of shedding light on the cultural identity of Europe is to search for a central concept, the 'essence' of Europe, which would simultaneously be both its source and summary. Trichet gave two references that are particularly enlightening in this respect: the vision of Paul Valéry, the poet and essayist, and that of Edmund Husserl, the philosopher.

"Partout où les noms de César, de Gaius, de Trajan et de Virgile, partout où les noms de Moïse et de St Paul, partout où les noms d'Aristote, de Platon et d'Euclide ont eu une signification et une autorité simultanées, Là est l'Europe." Paul Valéry, L'Européen, 1924

Paul Valéry emphasizing the spiritual character of Europe writes that "the people of Europe are not defined by race, nor by language or customs, but by desires and breadth of will (…)". Valéry sees the cultural identity of Europe as an expansion of the union, achieved under the Roman Empire, brought about by a confluence of Greek thought, Roman law and, the impact of the Bible.



Jean-Claude Trichet

Husserl for his part views that the origin of the spiritual idea of Europe lies in Greece, where a handful of men initiated a radical conversion of all cultural life in their own nation and among their neighbors. In a famous lecture given in 1935, he concludes with visionary perception that "Europe's crisis has its roots in a mistaken rationalism" and that "this crisis of European existence can only end, either in the ruin of a Europe alienated from its rational sense of life or in the rebirth of Europe from the spirit of philosophy."[1]

→ THE FULL TEXT OF THE SPEECH CAN BE FOUND ON THE ECB WEBSITE. A LINK IS ALSO AVAILABLE ON THE CFS WEBSITE: WWW.IFK-CFS.DE .

[1] Die Philosophie in der Krisis der europäischen Menschheit, public lecture in Vienna for the Wiener Kulturbund, May 1935

Trichet pointed out the importance of returning to the sources of the "spiritual form of Europe" in order to understand the powerful threads of Europe's cultural identity across two millennia. He likened this cultural identity to a tightly woven fabric, in which strong national cultures – each with its own identity and origin – are interwoven with transnational, reciprocal influences.

The remarkable network of transfrontier cultural admiration and influence

There are many good cases throughout history of cross-border cultural admiration and exchange between cultures and languages. Trichet illustrated this with some striking examples including that of Goethe, who expressed a strong admiration for Shakespeare in his autobiography "Dichtung und Wahrheit". Goethe also translated work from Voltaire and Diderot and contributed greatly thereby to their prominence in Germany. Goethe's own influence on other cultures is also extraordinary. He had many great admirers including even the likes of Napoléon Bonaparte.

Trichet cited Dante Alighieri, the 13th century poet and philosopher and author of "The Divine Comedy" as a further good example. His far-reaching influence is found down the ages throughout Europe, for example in the work of Proust and that of contemporary writers, such as the Albanian author Ismail Kadare. And Dante himself also drew from other European sources. His "terza rima" has its roots in an old lyric form in Provençal dialect known as "sirventès". Furthermore, the historian, Frances Yates has commented that Dante himself was influenced by the "Art of Memory" and its founder, the Greek poet Simonides of Ceos, who lived in the 5th century B.C. It is from this same Greek poet that the notion of the poem as an "indestructible monument" originally stems.

In explaining how Simonides' and Dante's work still touch Europe's cultural collection today, Trichet also provided evidence to support the argument that the "cultural fabric" of Europe extends over 25 centuries. And quoting the writer, Cees Nooteboom[2],

Trichet stressed that it is precisely this immense cultural endowment, with all its diversity, that gives Europeans their European identity. Europeans share the same basic cultural sources, regardless of the fact that they may come from vastly differing backgrounds.

The cultural activities of the European Central Bank

Trichet also spoke about the cultural activities undertaken by the ECB with a view to raising greater awareness for the cultural wealth of Europe.

Once a year, an exhibition is held in the ECB headquarters, providing insights into the contemporary art scene of a Member State of the EU. These exhibitions also give the ECB the opportunity to purchase works of art for its own collection, which currently comprises 170 works by 75 artists.

Since 2003, the ECB has also organized the "Cultural Days of the ECB", each year inviting a different Member State of the EU to organize a series of cultural events in cooperation with the national central bank. Later this year, the Romanian Cultural Days will take place in Frankfurt.

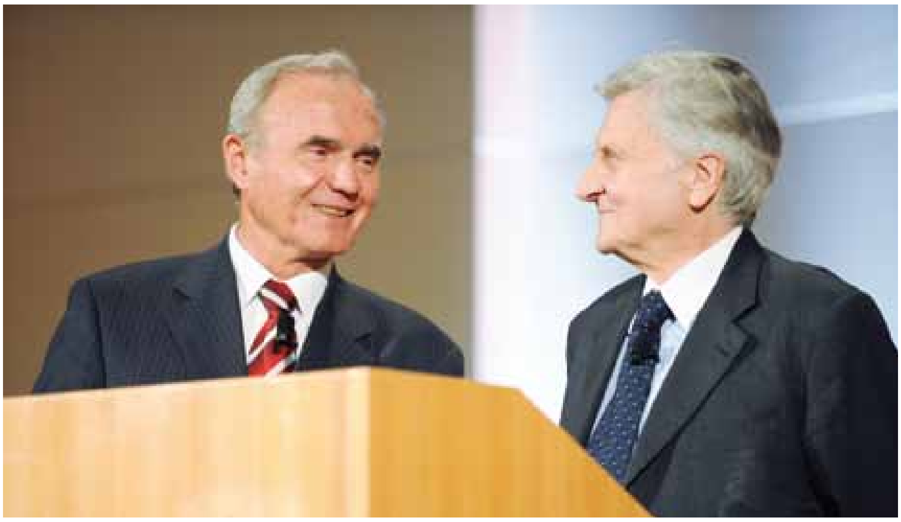
The aspiration of European culture to universality

Trichet asked whether European culture has a fundamental characteristic that makes it unique among the world's cultures.

Referring to the French philosopher, Jacques Derrida, Trichet expressed Europe's aspiration to be universal: "To feel European among other things, does it mean being more, or less, European? Both, without doubt."[3] Precisely because Europe has been gradually built on the basis of a profound recognition of its cultural diversity, does it aspire to be universal. Its cultural unity does not imply confinement, introspection or isolation inside a cultural 'fortress'. An integral part of its culture is its admiration and insatiable curiosity about the abundance of cultures beyond its shores. This deep-seated aspiration to universality is also expressed by Husserl in his Vienna lecture, when he talks about "a spirit of free criticism" and "the infinite ideals for the spreading 'synthesis' of nations".

[2] De ontvoering van Europa, "If I am European (…) this surely means that Europe's multiculturalism profoundly influences my Dutch identity".
[3] Derrida, L'autre Cap

Breuer, Weder di Mauro and Krahnen



Otmar Issing and Jean-Claude Trichet

Jan Pieter Krahnen, Jean-Claude Trichet and Otmar Issing

Trichet also looked at how this diversity and universality applies to the European Central Bank. Diversity is reflected in the fact that 27 nationalities are represented within the ECB and in the setup of the Eurosystem, which consists of the ECB and the 16 euro area national central banks. Universality is also aspired to by the ECB through its support of multilateral contact with institutions on other continents. The ECB aims to play an active role in all the international financial institutions and international informal groups to which it belongs. Last but by no means least, Trichet emphasized the importance of the ECB's role as the guardian of Europe's single currency under the Maastricht Treaty. Economic and Monetary Union form the basis of Europe's prosperity and stability and the single currency is an emblem of Europe's unity.

Trichet concluded his speech with a pledge to continue to offer the euro as a unique and irreplaceable anchor of stability and trust. In the present very difficult circumstances, it is more important than ever that Europe can rely on this anchor.

Issing thanked Trichet for his valuable contribution and recapitulated that "diversity is a strength and not a weakness in Europe."

A lively discussion with the audience followed. Themes such as cultural exchange, European achievements in integration, business ethics and unified challenges in Europe came up for discussion with valuable contributions from amongst others Volker Wieland (Goethe University Frankfurt and CFS) and Rolf-E. Breuer (Deutsche Bank AG and Chairman Managing Board CFS).

Lut De Moor (CFS)

More Information about the cultural days of the ECB can be found on the ECB website

CFS Presidential Lectures Upcoming Events 2009:

24 June 2009
The European Union and Economic Growth
Leszek Balcerowicz
(Chairman BRUEGEL, Professor Warsaw School of Economics)

November 2009
Jacques de Larosière
(Advisor BNP Paribas)
Bernhard Heitzer
(President, Bundeskartellamt)

Joint Lunchtime Seminar Series

Is Inflation an International Phenomenon?

Christopher Neely

According to Milton Friedman "inflation is always and everywhere a monetary phenomenon." Although this statement is widely accepted by economists when looking at the persistent changes in the price level, it does not rule out the transitory effects on inflation resulting from non-monetary factors. Christopher Neely, Assistant Vice President at the Federal Reserve Bank of St. Louis, is interested in empirical research in international finance, with an emphasis on issues of market efficiency since a number of years. In his Joint Lunchtime Lecture held on 22 April 2009, he discussed the extent to which international inflation rates move together, as well as the factors that influence regional and global co-movements.

There are a number of ways which may potentially tie together inflation rates in different countries. Countries participating in a fixed exchange rate regime such as Bretton Woods, EMU or a unilateral peg are automatically required to implement similar monetary policies. In addition, macroeconomic shocks, as well as economic and political pressures for central banks to react similarly to those shocks, may create co-movements of international inflation rates in various countries. However, "a given country's inflation rate can behave in a highly idiosyncratic manner if its central bank pursues monetary policies that substantially differ from those of the rest of the world," indicated Neely. Moreover, he finds that political, cultural, demographic and technological factors have an effect on a country's openness and hence, may determine the link of movements between domestic and foreign inflation rates.

Yet it is an empirical question to look at the extent to which countries' inflation rates are moving together. Neely deals with this issue by applying a so-called dynamic latent factor model to 65 national inflation rates between 1951 and 2006. His model ties the national inflation rates to one world, seven regional and 65 country-specific factors. "The implied variance decomposition conveniently measures the extent to which world, regional, and country-specific components explain variations in national inflation rates. The extent to which the world and regional factors explain a high proportion of inflation variability in many countries indicates the importance of international influences on national inflation rates," said Neely.

As a result, he discovered that the world and the regional components make up 34% and 16% of inflation variability on average across the countries. Specifically, international influences account for half of inflation variability. The significance of the world and regional components, then again, varies considerably across individual countries. Neely concluded that "economic and financial policy choices, as well as development measures, strongly explain the cross-section variation in the relative importance of international influences. A parsimonious model of time variation in the factor loadings shows that most countries became more sensitive to the world factor over 1951-2006 and European-specific influences became more important over time for countries participating in European economic integration."

Celia Wieland (CFS)

About the Joint Lunchtime Seminar Series:
The Joint Lunchtime Lectures have been organized by the CFS, the Deutsche Bundesbank and the ECB for nine years, and hence, have become an integral part on the CFS event calendar. Taking place on a weekly basis, the series creates a well established platform for economic experts, particularly in the area of monetary policy, to present their current research findings to a selected circle of central bankers and macroeconomists. In the first half year of 2009, the three organizing institutions have hosted the following economic professionals:

Maximilian Ulrich
(Columbia University)
James Costain
(Bank of Spain)
Jonathan Wright
(Johns Hopkins University)
Mathias Hoffmann
(Universität Zürich)
Pascal St-Amour
(University of Lausanne)
Joachim Voth
(Universitat Pompeu Fabra)
Seth Carpenter
(Federal Reserve Board)
David Thesmar
(HEC Paris)
Gerhard Illing
(Ludwig-Maximilians-Universität München)

Cédric Tille
(Graduate Institute Geneva)
Nicolas Coeurdacier
(London Business School)
Jürgen von Hagen
(Universität Bonn)
Miguel Leon-Ledesma
(University of Kent)
Christopher Neely
(Federal Reserve Bank of St. Louis)
Todd Clark
(Federal Reserve Bank of Kansas City)
Gianluca Benigno
(London School of Economics)

Michael Koetter
(University of Groningen)
Antoine Martin
(Federal Reserve Bank of New York)
Leena Rudanko
(Boston University)
Loretta Mester
(Federal Reserve Bank of Philadelphia)
Yuriy Gorodnichenko
(University of California, Berkeley)
Thijs van Rens
(Universitat Pompeu Fabra)
Gernot Müller
(Universität Bonn)

→ For further information and registration please contact Celia Wieland, email: jls@ifk-cfs.de

Lunchtime Debate

How much instability can capitalism handle?

11 May 2009

Panel discussion with Alexander Dibelius, Gerald Braunberger and Jan Pieter Krahnen

A new book entitled "Der amerikanische Virus" by Rainer Hank (Wirtschafts- und Finanzredaktion, Frankfurter Allgemeine Sonntagszeitung) appeared in February 2009. To mark the occasion, CFS organized a luncheon debate with Alexander Dibelius (Head of Goldman Sachs Germany, Austria, Russia and Central and Eastern Europe), Jan Pieter Krahnen (CFS), and Gerald Braunberger (Financial Editor, Frankfurter Allgemeine Zeitung), standing in for Rainer Hank. The views expressed by Krahnen are summarized in the editorial of this newsletter. The following paragraphs, therefore, contain a summary of the issues raised by the other speakers at the meeting.

Alexander Dibelius stated that in recent months capitalism has often been severely criticized by the press and conceded that this criticism was indeed understandable. He referred to Francis Fukuyama and Adam Smith to describe capitalism with all its strengths and weaknesses and the fundamental desire that exists within society for stability.

Jan Pieter Krahnen, Gerald Braunberger and Alexander Dibelius

Alexander Dibelius

Gerald Braunberger

However, the notion of permanent stability is unrealistic and stability can certainly not be guaranteed. Even in an improved system with more regulation, stability will not be inherent, and new crises will continue to evolve. His advice was to step away from ideology and to strive – in the words of Walter Eucken and Ludwig Erhard – for an economic policy based on experience ("erfahrungsmäßig basierte Wirtschaftspolitik"). Dibelius emphasized the importance of responsible behavior on the part of each individual. Liberalism and freedom are not synonyms for boundlessness. Neither commercial policy, nor the institutional framework can be blamed for crises since responsibility for the economic system as a whole rests in fact on all individuals. Each person is responsible for helping to ensure the correct functioning of the system. Moreover, regulation makes good economic sense only where market conditions represent a source of systemic risk. Dibelius concluded his remarks by commenting that economic success without economic output is not sustainable in the long run.

Gerald Braunberger started with the following assessment: instability is a part of capitalism and capitalism can stand up to any form of instability. However, society does not appear to be willing to endure any level of instability. Braunberger distinguished between three sources of instability in a capitalistic system. First of all, there are ups and downs caused by psychological factors. Secondly, technological progress is not a linear process but occurs in batches. Braunberger found it is surprising that technology has been barely mentioned in discussions about the current crisis. It is clear that the recent financial sector growth was only possible due to developments in information technology. Finally, he sees a destabilizing effect coming from the regulatory framework, although the contrary is perceived to be the case. Rules that are badly construed can foster instability. Furthermore, the regulators themselves also exhibit cyclical behavior.

Looking at history, capitalism has tended to result in economic growth, and phases of instability do not necessarily cause long-term economic damage. Two crises do, however, stand out: the economic crisis of the 1930s that led to a political radicalization in Europe, and the current crisis that has brought us close to a meltdown of the financial system. Only massive government intervention has been able to stabilize the system. The consequences, in terms of exploding public debt, are not yet clear.

Braunberger called for commensurate regulation that allows not only an efficient market-based financial system, but also safeguards extensively against (systemic) risks. The government cannot assume liability for losses, while gains are privatized. In his opinion, this liability issue should play a crucial role in the design of new regulation. He concluded his talk with a quote from Rainer Hank's book "Tomorrow's crises are not yet recognized by anyone today" ("Die Krisen von morgen kennt heute noch niemand").

CFS Conference

Eleventh Conference of the ECB-CFS Research Network
"The Market for Retail Financial Services: Development, Integration, and Economic Effects"

20-21 October 2008

Hosted by the Czech National Bank in Prague

The 11th conference of the ECB-CFS Research Network, hosted by the Czech National Bank in Prague, was the first event of the third phase of the Network. The topic of the conference was "The Market for Retail Financial Services: Development, Integration, and Economic Effects" and addressed one of the three new priorities set by the Steering Committee. The two-day conference combined 20 research paper presentations with two policy panels and two keynote addresses.

In 2002, the European Central Bank (ECB) and the Center for Financial Studies (CFS) launched a research network to promote research on "Capital Markets and Financial Integration in Europe". The ECB-CFS Research Network was initially set up for a period of two years, which ended in May 2004 with a symposium organized around its five initial priority areas. Following the successful conclusion of this first phase, the ECB and the CFS decided to extend the activities of the Network for a further three years, until 2007. The scope of the Network during this second phase was also extended to include the new EU Member States and was concluded with a second symposium of the ECB-CFS Research Network, hosted by the European Central Bank in Frankfurt on 13-14 February 2008 *(see also Newsletter 1/08)*.

On 12 July 2006, the Steering Committee (SC) proposed a further extension of the Network for three more years after the completion of the second phase. For this third phase, three new priorities were selected, replacing the 8 priorities that were active until 2007.

At its meeting during the second symposium, the SC called for the research priorities previously agreed upon in July 2006 to be adapted in order to take account of recent developments. In particular, the SC decided that Network research should pay greater attention to implications for financial stability and monetary policy under the existing three priorities. It was agreed that during the third phase of the Network particular attention in both the conferences and the Lamfalussy Fellowships should be given to the following three topics:

1) financial systems as risk managers, risk distributors and risk creators;
2) the integration and development of retail financial services and the promotion of innovative firms;
3) financial modernization, governance and the integration of the European financial system in global capital markets.

Priority 2 was addressed by the first conference of the Third Phase – in effect the 11th conference of the Network hosted by the Czech National Bank in Prague – under the topic: "The Market for Retail Financial Services: Development, Integration, and Economic Effects". Priority 3 concerns the international financial architecture and will be the topic of the first Network event in 2009.

The SC of the ECB-CFS Research Network is composed of representatives from the two organizing institutions:

Chair: Gertrude Tumpel-Gugerell (European Central Bank)
Michael Binder (CFS and Goethe University Frankfurt)
Philipp Hartmann (European Central Bank)
Jan Pieter Krahnen (CFS and Goethe University Frankfurt)
Philippe Moutot (European Central Bank)

Zdeněk Tůma

The opening remarks were delivered by the Governor of the Czech National Bank **Zdeněk Tůma**. He started by pointing out that the topic of the conference could not have been more relevant given the current situation in global financial markets. In his opinion, European financial integration has made rapid progress, albeit to a lesser degree for the retail finance market. He raised three questions, which he hoped the conference would address. First, what are – if any – the limits to integration in retail finance? Second, what are the implications of the integration of retail banking on growth? And finally, can regulation be designed such that financial stability is guaranteed while competition is promoted?

The first session on "Retail Banks: Competition, M&As and Cross-Border Issues" brought important findings by **Ben Craig** (Federal Reserve Bank of Cleveland), who addressed the effect of bank mergers on the dynamics of deposit rates. The second paper in this session was presented by **Adrian van Rixtel** (Banco de España) and focused on a similar topic, namely, the effect of loan market competition on the interest rates applied by euro area banks on loans and deposits.

The session on "Payment Systems" was chaired by **Cornelia Holthausen** (European Central Bank). She pointed out that the two papers in the session – "Consumer choice and merchant acceptance of payment media" presented by **Sujit Chakravorti** (Federal Reserve Bank Chicago) and "Integrating European retail payment systems: some economics of SEPA" presented by **Kari Kemppainen** – had the same general goal, namely, measuring the efficiency effects of payment systems' integration, which is a particularly relevant, but hitherto not extensively researched, topic in modern economics. The discussant of this session was **Henri Pages** (Banque de France).

A parallel session on "Retail Banking Integration and Access to Credit" was chaired by **Jan Frait** (Czech National Bank). The first paper, "A quantitative theory of information and unsecured credit", presented by **Kartik Athreya** (Federal Reserve Bank of Richmond) aims at providing an explanation for five big trends in unsecured credit markets – rising debt, rising default, rising discharge, increasing dispersion of interest rates, and increasing good borrower discounts. The second paper, "Integration in the European retail banking sector: evidence from savings and lending rates", presented by **Aarti Rughoo** (London Metropolitan University), investigates the degree of integration in the retail banking sector for 15 European Union member states in the period 1991-2008.

Gertrude Tumpel-Gugerell

In her keynote address, **Gertrude Tumpel-Gugerell** (Member of the Executive Board, European Central Bank) reviewed the change in the banks' business model in recent years. With more funding via market sources rather than from deposits, and diversification in the sources of revenues via non-interest income, the profits of the banks have become more volatile. She also addressed the implementation of SEPA and its importance for retail banks. In view of the strong growth world wide in non-cash transactions, Europe has shown a more moderate growth rate in non-cash payments. In her opinion, this development is crucial for the real sector since retail payment activity spurs economic growth by reducing transaction costs and creating new business opportunities. She also spoke about the "final hurdles" involved in implementing SEPA and its timeframe before the end of 2009.

The following session on "Recent Developments in Retail Finance" was chaired by **Jan Pieter Krahnen** (CFS). **Carole Bernard** (University of Waterloo) focused on specific structured investment products, and endeavored to explain why retail investors buy these complex contracts. The economic role of the insurance sector was the topic of the next presentation by **Kjell Suemegi** (Vienna University of Economics and Business Administration). He analyzed by looking at different channels of influence such as risk transfer and investment how the insurance sector influences economic growth. The third presentation by **Jos van Bommel** (University of Oxford) focused on an innovative and increasingly popular structured product – the endless leverage certificate (ELC) – and looked at its pricing and secondary market liquidity.

The parallel session was on "Retail Finance in the New EU Member States". The first paper, presented by **Anita Taci** (EBRD), examines how bank characteristics and the institutional environment influence the composition of banks' loan portfolios and shows that bank ownership and size are the main determinants of bank customer focus. The second paper, presented by **Petr Zemčík** (CERGE-EI) is an empirical investigation of the effects of changes in mortgage payments, housing prices, and rents on household consumption in the Czech Republic.

The first panel discussion about the integration of banking supervision was chaired by **Ignazio Angeloni** (European Central Bank). He opened the debate by stating that the current crisis had led to new insights on the importance of supervision. He pointed out that the main difference between the U.S. and Europe in this respect is that Europe has a more formal regulatory process. In his opinion, the Lamfalussy framework has so far been very successful at the legislation level, but progress with national implementation has been less satisfactory. Currently, there is cooperation at a global level through the Financial Stability Forum, which in his opinion, is a very successful initiative. **Miroslav Singer** (Czech National Bank) first spoke about the experiences of the Czech Republic during the current financial turmoil. With regard to regulation, he argued that none of the disturbing events over the past months could have been prevented by a unified European supervision. In his opinion, even though there were obvious problems with information asymmetries, the current crisis was not caused by a lack of unified supervision and could hardly have been prevented by the existence of it. He concluded that Europe should proceed with utmost caution towards cross-border supervision and stressed the importance of supervision at home. The next panelist, **Kari Kemppainen** (Bank of Finland) recalled for the audience Finland's severe banking crisis in the early 90s. At that time, banking crises were national, but this is obviously no longer the case. In his opinion, a pan-European College of Supervisors, analogous to the ESCB (European System of Central Banks), was a feasible concept for dealing with an international crisis. **Vitor Gaspar** (Bureau of European Policy Advisors) pointed out that there are different levels of governance – national, international (e.g. the euro zone), and global. In the run-up to the crisis, countries have shown an impressive ability to cooperate across borders. However, this fast and coordinated action was mainly driven by the obvious spillover effects. He argued that Europe needs a flexible way of reconciling efficiency and stability.

The second day of the conference started with a presentation by **Santiago Carbo-Valverde** (University of Granada and Federal Reserve Bank Chicago) on the sensitivity of SME investments to bank loans and trade credit. He concluded that his results confirm that constrained firms do indeed rely more on trade credit and unconstrained firms more on bank loans. **Hannah Hempell** (Deutsche Bundesbank) presented the second paper, which investigates empirically whether competition has an effect on rate dispersion. Her conclusion is that local competition still matters for access to credit, and therefore European policies to promote competition should also take this fact into consideration. The third paper presented by **Klaus Schaeck** (University of Wales) investigates banking relationships and the use of venture capital for SMEs. The paper finds that younger and larger firms tend to rely more on VC whereas firms with multiple banking relationships tend to make less use of VC. He concludes that the availability of VC dramatically enhances the performance of SMEs.

The parallel session looked at retail finance from a practical angle with presentations by **Dubravko Mihaljek** (Bank for International Settlements), who looked at recent trends in capital flows to and from emerging market economies, **Markus Eller** (Oesterreichische Nationalbank) with a paper analyzing the equilibrium level of private credit to GDP in Central and Eastern European countries, and **Nicole Jonker** (De Nederlandsche Bank), who analyzed differences in payment behavior at home and abroad and between countries.

Hans-Helmut Kotz (Deutsche Bundesbank) opened the second panel discussion with **Radek Urban** (Ceska Sporitelna), **Costa Vayenas** (UBS AG), and **Jim Strang** (Dunedin Capital Partners) giving a market participant's view on the current financial turmoil. His conclusions after hearing the panelists were twofold: do not try to beat the market, and be sure to diversify. Also, he said that policy makers should work on educating investors on what returns to expect, in the sense that most investors surveyed expect average annual returns that are much higher than the actual returns.

Roman Inderst

In his keynote speech, **Roman Inderst** (IMFS, Goethe University Frankfurt) addressed current problems with regulatory policies from three angles: the missing supply side, innovation and regulation, and a discussion of optimal policies. He stated that the supply of funds had played an important role in the last decade, but had remained surprisingly neglected. Next, he questioned comments, so often raised in recent months, about there being "too much innovation". In his opinion, the U.S. experience showed that financial innovation had made credit markets more complete. He disagreed that there was a trade-off between innovation and competition. Instead, he said, there is a need for a regulatory framework that promotes both innovation and competition. Finally, Inderst worried that the principles of competition were being severely undermined. He said that, by sacrificing competition for stability, policy-makers were being too shortsighted, and that policies to restore competition would be needed very soon.

In the last session **Christian Beer** (Vienna University) presented a paper on the causes and effects of carry trades by Austrian households. Another paper presented by **Deniz Igan** (International Monetary Fund) links the subprime mortgage crisis to a decline in lending standards associated with the rapid expansion of this market. The authors find that lending standards tend to decline more in areas with larger credit booms and house price increases as well as in areas with higher mortgage securitization rates. The third paper presented by **Angela Maddaloni** (European Central Bank) analyzes the impact of monetary policy on bank lending standards. The main findings are that lower overnight rates soften bank credit standards, whilst securitization makes the impact stronger.

In his closing remarks, **Philipp Hartmann** (European Central Bank) reviewed five distinct topics that the conference had focused on: competition, regulation, financial stability, integration of payment systems and retail finance in the new EU member states. Hartmann also thanked the organizers for an excellent conference.

The text is based on the Conference Summary and is also available on the network's website.

→ The conference program as well as papers and presentations with references to all co-authors not mentioned in this article can be found on the network's website under http://www.eu-financial-system.org

4th CFS-DAI Seminar on Risk Management and Value Creation

"Organizational and Structural Challenges of Risk Management"

26 March 2009

Frankfurt am Main

The current financial crisis has raised several questions about the role of risk management. For example, observers ask *'why the sophisticated models did not properly capture the risks of securitized financial products' and 'why state of the art RM systems failed to prevent the financial crisis'.* While it would be dangerous to jump to conclusions, it is safe to say that risk management faces several organizational and structural challenges. These challenges involve implementing a complex system that is easy to understand as well as improving communication, designing interfaces between qualitative models and quantitative assessments, and obtaining senior management commitment. Choosing the right models for the right questions and communicating the results determines the effectiveness of risk management. To promote the discussion of these issues, CFS together with the Deutsche Aktieninstitut e.V. chose the topic "Organizational and Structural Challenges of Risk Management" for their 4th joint seminar, which was held at the Goethe University Frankfurt on 26 March 2009. The seminar was part of the CFS program "Insurance and Risk Transfer" and was organized by **Walther Kiep** (Managing Director of Kiep Consulting GmbH) and **Christian Laux** (Goethe University and Program Director at CFS).

Rüdiger von Rosen

With many distinguished speakers and about 60 participants, the program's topics provided valuable insights into numerous aspects of the organization and effectiveness of risk management. In his welcoming address, **Rüdiger von Rosen** (Managing Director, Deutsches Aktieninstitut e.V.) stressed that the current financial crisis is also perceived to be a crisis of risk management. In his view, it is particularly the systemic risk that has been underestimated. On the other hand, it is not clear if the crisis would not have been worse without risk management. By way of a solution, he called for companies to have higher levels of risk capital in order to create a buffer against adverse events in the future. Moreover, he emphasized that the willingness of investors to provide equity capital depends on the institutional setting, especially with respect to taxes.

Christian Laux

In his introduction, **Christian Laux** asked about the lessons to be learned from the financial crisis. One key problem seems to be that too much faith has been placed in the output of complex models, creating a dangerous feeling of safety. Moreover, there has been a clear tendency to underestimate the incentive and feedback effects of credit risk transfers. Risk management has allowed more risks to be taken and incentives have been given to do so. However, initially uncorrelated risks suddenly affected all market participants. A sound integrated risk management needs to account for questions that quantitative models will not answer. It needs to consider not only correlation but also economic interdependencies, which often arise endogenously rather than exogenously. Moreover, risk management per se will not reduce management's appetite for risk. However, at the same time, management cannot make sound decisions without an effective risk management system in place.

Frank Romeike

Frank Romeike (Board, Risk Management Association (RMA) e.V., and Managing Partner, RiskNET GmbH) presented a variety of potential pitfalls in quantitative risk management approaches. First, models often lack data and proper specifications. Moreover, most of the distributions used in quantitative assessments underestimate "fat-tails" and tend instead to exploit normal densities' easily manageable characteristics. Models thereby fail to recognize *black swans*. For the remainder of his presentation, Romeike focused on how to overcome these flaws. One important aspect is to constantly run sanity checks on model in- and outputs, involving senior level management. A necessary requirement for a responsible treatment of risks is that risk owners have clear responsibilities and well-understood risk management processes are in place.

Dieter Schmitt (Managing Director, adidas Versicherungs-Vermittlungs GmbH) outlined how insurance management at adidas has evolved to eventually become risk management. He stressed the difficulty in measuring risk management's value added, especially when taking into account that it is driven strongly by regulation and EU directives. A crucial success factor for implementing risk management at adidas has been the consistent reporting and documentation framework throughout the organization. This has enabled the implementation of the necessary risk culture. Meanwhile, adidas has established an internal risk market, which enables functions within the organization to "manage" their own risks either via insurance, retention or capital market transfer.

Jens Schmidt-Bürgel

Jens Schmidt-Bürgel (Managing Director, Fitch Deutschland GmbH) began his presentation by stressing that credit ratings are often misunderstood. They provide information about default probabilities, and only very few exceptions include loss given default figures. In particular, ratings also do not incorporate information on liquidity or market risk factors. Schmidt-Bürgel predicts that the importance of ratings will grow in the future and argued that early warning signs related to the capital market crisis were available, but ignored. Even though the worst is over, a large fraction of leveraged instruments are still outstanding so that a second round of defaults may not be unlikely. Schmidt-Bürgel predicts a slow economic turnaround in 2010.

Reiner Hoffmann (Head of Corporate Solutions, Allianz Global Corporate & Speciality AG) pointed out the difficulties of benchmarking when the performance measure is merely one realization of a distribution. But at the same time, when data is highly aggregated, many valuable details are lost. Moreover, different addressees have different interpretations of the figures and an unambiguous measure is impossible. Hoffmann sketched the risk balance sheet as a possible solution, but cautioned that communicating risk metrics may be equally as problematic as communicating performance measures. He argued that an important step to overcoming the problems is to price the risk. For example, by transferring the risk to an insurer, it is priced and noise in performance measures is reduced. The reduction of the variance may, ceteris paribus, enable performance measures to convey better information.

Johannes Wedding

Johannes Wedding (Managing Director and Partner, Wedding & Partner) focused on the legal requirements for external auditors. Specifically, the auditor's task is to certify the correctness of the risk management system and not the decisions made subject to its output. Moreover, Wedding showed how the definition of insurance differs according to the underlying accounting principles involved, i.e. IAS / IFRS, German GAAP, US GAAP, or the International Association of Insurance Supervisors (IAIS). Important issues in the definition of insurance include the distinction between timing risk and underwriting risk as well as the significance of the involved risk transfer.

Walther Kiep

Walther Kiep hosted a panel with leading experts to discuss the challenges of corporate risk management. Participants on the panel were Thomas Berger (Project Manager, Future Value Group AG), Tore Ellingsen (Managing Director, The Royal Bank of Scotland plc), Wolfgang Henle (VP Opportunity and Risk Management, Austrian Airlines AG), Jutta Hennecke (Senior Manager, PricewaterhouseCoopers AG), and Michael Lomitschka (Director Group-Risk Controlling, MVV Energie AG). In the opening discussion, it was mentioned that the selective reporting of business risks in annual reports leads to a biased perception by investors regarding the risk management activities of companies. However, innovative solutions such as Insurance Linked Securities are continuing to gain ground, thus facilitating capital efficiency management. The panelists agreed that the hardest task is to justify risk management strategies after adverse events occur. This is an especially delicate situation because some events are deliberately not insured or transferred as premiums may be too high and self-insurance is the cheaper alternative – in particular, when taking into account the need to provide managers with incentives to react to changes. Moreover, inconsistent or missing data still complicate a consistent quantitative approach. It is risk management's task to complete these data so as to minimize "model risk". Senior management will thereby be encouraged to make sustainable decisions based on better facts. In the closing discussion, it became apparent that companies' business risks remained uninsurable. It should in fact be in the companies' own interest to retain these risks because after all they represent their core competency.

THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS

2009

Robert J. Shiller

The Deutsche Bank Prize in Financial Economics 2009 is awarded to the U.S. economist Robert J. Shiller. The Jury has chosen Professor Shiller for his pioneering research in the field of financial economics, relating to the dynamics of asset prices, such as fixed income, equities, and real estate, and their metrics. His work has been influential in the development of the theory as well as its implications for practice and policy-making. His contributions on risk sharing, financial market volatility, bubbles and crises, have received widespread attention among academics, practitioners and policy makers alike.

The award will be presented to Robert Shiller by Josef Ackermann (Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG) in a ceremony to be held in Frankfurt on 30 September 2009.

Prior to the award ceremony, the international academic symposium "Financial Innovation and Economic Crisis", a scientific discussion on themes highlighted in Shiller's work, will take place at Campus Westend. We are delighted to announce that Robert C. Merton, the John and Natty McArthur University Professor at Harvard Business School and Nobel Laureate in Economics, has already confirmed his participation as plenary speaker in this event.

Josef Ackermann

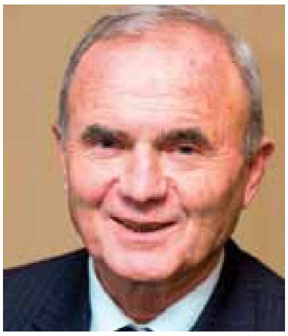
"There could probably not be a more appropriate time to honor Professor Robert J. Shiller with the Deutsche Bank Prize in Financial Economics for his outstanding research work on the volatility of asset prices and the related macroeconomic risks. Professor Shiller has not only developed financial instruments and databases to gauge the extent of over-exuberance on capital and property markets. He has also used these instruments to give timely warnings on the risks of such over-exuberance. However, his research has not been confined to problem analysis; he has also published numerous studies aimed at solving the problems. For this reason, his research findings have spread far beyond the academic community and are relevant for policymakers and financial market players alike."

→ CFS Symposium "Financial Innovation and Economic Crisis"
Date: 30 September 2009 12:00 – 17:00
Venue: Campus Westend, Goethe University, new lecture hall (Hörsaal 2)
Please register for this event online on www.db-prize-financialeconomics.org.
-- The number of participants is limited --

Jury members

A Jury of international financial experts decides on the recipient of the Deutsche Bank Prize in Financial Economics. The members of this year's Jury are: **Michael Binder** (Goethe University and CFS), **Otmar Issing** (CFS President), **Takatoshi Ito** (University of Tokyo), **Jan Pieter Krahnen** (Goethe University and CFS), **Reinhard H. Schmidt** (Goethe University), **Klaus Schmidt-Hebbel** (OECD), **Marti Subrahmanyam** (Stern School, New York University), **Maria Vassalou** (SAC Capital Advisors LLC and EFA), **Norbert Walter** (Deutsche Bank Group), and **Volker Wieland** (Goethe University and CFS). Chairman of the Jury is CFS Director Jan Pieter Krahnen. *More than 3600 university teachers and researchers from more than 55 countries had the opportunity to submit a suggestion for the nomination. At this occasion, the Jury would like to thank the nominators for their immense support during the nomination procedure.*

Statements by the Jury members



Otmar Issing

"There is one name that has been at the centre of the debate around the identification of "bubbles" in asset prices: Professor Robert Shiller. His warnings against excessive share and real estate prices are based on pioneering studies which have brought significant theoretical and empirical impulses to economic research. The combination of his top-class academic research and his contributions to objectifying the public debate make him the ideal candidate to receive the Deutsche Bank Prize in Financial Economics 2009."

Jan Pieter Krahnen

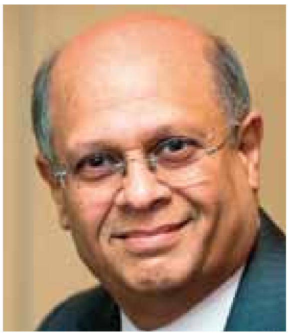
"Through his innovative work exploring the dynamics of asset prices, Robert Shiller has become a pioneer in the field of financial economics. His findings on the volatility of share prices, the occurrence of price bubbles and resultant crises, as well as on the distribution of macroeconomic risks are not only of great academic importance, they have also broken new ground in economic practice."

Takatoshi Ito

"Professor Shiller is a very versatile scholar. He first became well-known among macro-finance professors because of his excellent work on asset price volatility and on an asset price bubble (sustained deviation of a market price from fundamental value).Then, he has started to write more policy relevant articles and books, warning about tech bubble and housing bubble. He also transformed his research on housing prices into a commercial venture to calculate and publish a housing price index. Now, the Case-Shiller index is a standard, reliable housing price index everyone uses, and there is securities trading based on this index. Housing prices are notorious in non-comparability due to each housing unit being unique in its location, floor space, years since built, and other characteristics. The Case-Shiller index is calculated using repeated sales units so that many of the characteristics can be regarded the same. His ability to transform research from basic to policy-relevant, and from basic to commercially useful should be highly regarded, and the award is timely and well-deserved."

Klaus Schmidt-Hebbel

"The Deutsche Bank Prize is awarded to an outstanding economist who has made path-breaking contributions to theory, empirics and /or policy in the fields of finance, money or macroeconomics. Nobody fulfills these conditions better than Robert Shiller. His analytical and empirical work on asset price dynamics, equity price volatility, asset and housing price bubbles, financial crises, and risk diversification has extended significantly the frontier of financial economics. His prescient work and warnings on the development of the 1990s-early 2000s stock market boom and bust and the 2000s housing and stock market bubble that led to the ongoing global financial crisis and recession are proof of Shiller's rare combination of analytical strength and empirical insightfulness. There is no better recipient of the 2009 Deutsche Bank Prize in Financial Economics than Professor Shiller."



Marti Subrahmanyam

"Professor Robert Shiller is one of the world's foremost researchers on financial markets and has been working in the intersection of macroeconomics and financial markets for almost four decades. His work spans a broad spectrum of issues that are both academically challenging and practically relevant. Noteworthy examples of his extensive research on the limits of market efficiency include his papers on "excess volatility", predictability of asset returns, behavioral macroeconomics, and real estate economics. His work on pricing metrics, particularly in the area of real estate, has had a major impact on practice and policy making. Given the breadth of his research, Professor Shiller is uniquely qualified to address the important issues relating to the current global financial crisis."

Maria Vassalou

"Shiller's important work on the excess volatility puzzle has far-reaching implications for economic models of price fluctuations. His contribution has greatly shaped the evolution of both academic and practitioners' thinking on the pricing of assets in speculative markets."

ROBERT J. SHILLER – THE PRIZEWINNER 2009

Robert Shiller is the Arthur M. Okun Professor of Economics at the Cowles Foundation for Research in Economics, Yale University, and Professor of Finance at the International Center for Finance, Yale School of Management. He received his Ph.D. in Economics from the Massachusetts Institute of Technology (MIT) in 1972. Robert Shiller has been a Research Associate at the National Bureau of Economic Research since 1980. In 2005, he also served as Vice President of the American Economic Association. He regularly writes the column "Economic View" for the New York Times. In 1996, he received the Paul A. Samuelson award for his book Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks.

By combining theoretical and empirical analysis on the volatility of asset prices, in particular stocks, bonds and real estate, Robert Shiller has made a decisive contribution to the understanding of price fluctuations in these markets. His research has led to the development of financial instruments to hedge against macroeconomic risks. Amongst other things, Robert Shiller has been jointly responsible for developing the Standard & Poor's/Case-Shiller Home Price Index for the most important metropolitan regions in the U.S., which is widely used in academic research and investment management. He is also the co-founder and Chief Economist of MacroMarkets LLC, which designs innovative financing instruments in order to complete financial markets.

Based on his analyses Robert Shiller has been very influential for the tone of research in this field and delivers valuable insights for the world of practice. He predicted the peak of the new-economy euphoria and the collapse of the market and published the best-selling book Irrational Exuberance in the year 2000. In 2005, he was one of the first to identify a real estate bubble in the U.S., and predicted that it would burst and trigger a financial crisis. In his new book Animal Spirits, co-written with Nobel Prize winner George Akerlof, Robert Shiller makes the case for a more active state role in financial markets owing to the existence of the "human factor".

Selected Books

Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism, Princeton University Press, March 2009, with George Akerlof, translated into 7 languages.

Subprime Solution: How Today's Global Financial Crisis Happened and What to Do about It, Princeton University Press, September 2008, translated into 6 languages.

The New Financial Order: Risk in the 21st Century, Princeton University Press, April 2003, translated into 7 languages

Irrational Exuberance, Princeton University Press, 2000 & 2005 Republished, Broadway Books, April 2001, translated into 15 languages, winner of the Commonfund Prize.

Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks, Oxford University Press, 1993, winner of the Paul A. Samuelson Award from TIAA-CREF.

Market Volatility, MIT Press, Cambridge MA, 1989.

THE AWARD WINNERS IN 2005 AND 2007

The Deutsche Bank Prize in Financial Economics is awarded biannually and carries an endowment of € 50,000 which is donated by the Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft. The award honors internationally renowned economic researchers whose work has significantly influenced research in financial economics and macroeconomics, and has led to fundamental advances in economic theory and practice.

The prize was awarded for the first time in 2005 to Eugene F. Fama, Professor of Finance at the University of Chicago, for developing and researching the concept of market efficiency. An international scientific symposium on "Market Efficiency Today" was organized on the occasion of the award ceremony.

In 2007, Michael Woodford, Professor of Political Economy at Columbia University in New York, received the prize in recognition of his fundamental contributions to the theory and practical analysis of monetary policy. The academic CFS Symposium "The Theory and Practice of Monetary Policy Today", held in honor of Professor Woodford's work, took place prior to the presentation of the award.

Sabine Neumann and Daniela Dimitrova (CFS)

Professor Shiller wrote the following article as guest writer for the Financial Times

A failure to control the animal spirits

By Robert Shiller

Published: Financial Times – 9 March 2009

Lydia Lopokova, wife of the economist John Maynard Keynes, was a famous ballerina. She was also a Russian émigré. Thus Keynes knew from the experience of his in-laws the horrors of living in the worst of socialist economies. But he also knew first-hand the great difficulties that come from unregulated, unfettered capitalism. He lived through the British depression of the 1920s and 1930s. Thus Keynes was inspired to find a middle way for modern economies.

We are seeing, in this financial crisis, a rebirth of Keynesian economics. We are talking again of his 1936 book The General Theory of Employment, Interest and Money, which was written during the Great Depression. This era, like the present, saw many calls to end capitalism as we know it. The 1930s have been called the heyday of communism in western countries. Keynes's middle way would avoid the unemployment and the panics and manias of capitalism. But it would also avoid the economic and political controls of communism. The General Theory became the most important economics book of the 20th century because of its sensible balanced message.

In times of high unemployment, creditworthy governments should expand demand by deficit spending. Then, in times of low unemployment, governments should pay down the resultant debt. With that seemingly minor change in procedures, a capitalist system can be stable. There is no need for radical surgery on capitalism.

Adherents to Keynes's message were so eager to get this simple policy implemented, on both sides of the Atlantic, that they failed to notice – or perhaps they intentionally disregarded – that the General Theory also had a deeper, more fundamental message about how capitalism worked, if only briefly spelled out. It explained why capitalist economies, left to their own devices, without the balancing of governments, were essentially unstable. And it explained why, for capitalist economies to work well, the government should serve as a counterbalance.

The key to this insight was the role Keynes gave to people's psychological motivations. These are usually ignored by macroeconomists. Keynes called them animal spirits, and he thought they were especially important in determining people's willingness to take risks. Businessmen's calculations, he said, were precarious: "Our basis of knowledge for estimating the yield 10 years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing." Despite this, people somehow make decisions and act. This "can only be taken as a result of animal spirits". There is "a spontaneous urge to action".

There are times when people are especially adventuresome – indeed, too much so. Their adventures are supported in these times by a blithe faith in the future, and trust in economic institutions. These are the upswing of the business cycle. But then the animal spirits also veer in the other direction, and then people are too wary.

George Akerlof and I, in our book Animal Spirits (Princeton 2009), expand on Keynes's concept and tie it in to modern literature on behavioural economics and psychology. Much more clarity about the psychological underpinnings of animal spirits is possible today.

For example, social psychologists, notably Roger Schank and Robert Abelson, have shown how much stories and storytelling, especially human-interest stories, motivate much of human behaviour. These stories can count for much more than abstract calculation. People's economic moods are largely based on the stories that people tell themselves and tell each other that are related to the economy.

We have seen these stories come and go in rapid succession in recent years. We first had the dotcom bubble and the envy-producing stories of young millionaires. It burst in 2000, but was soon replaced with another bubble, involving smart "flippers" of properties.

This mania was the product not only of a story about people but also a story about how the economy worked. It was part of a story that all investments in securitised mortgages were safe because those smart people were buying them. Those enviable people who are buying these assets must be checking on them, therefore we do not need to. We need only run alongside them.

What allowed this mania and these stories to persist as long as they did? To a remarkable extent we have got into the current economic and financial crisis because of a wrong economic theory – an economic theory that itself denied the role of the animal spirits in getting us into manias and panics.

According to the standard "classical" theory, which goes back to Adam Smith with his Wealth of Nations in 1776, the economy is essentially stable. If people rationally pursue their own economic interests in free markets they will exhaust all mutually beneficial opportunities to produce goods and exchange with one another. Such exhaustion of opportunities for mutually beneficial trade results in full employment. By this theory it could not be otherwise.

Of course, some workers will be unemployed. But they will be unable to find work only because they are in a temporary search for a job or because they insist on pay that is unreasonably high. Such unemployment is viewed as voluntary, and evokes no sympathy.

Classical theory also tells us that financial markets will also be stable. People will only make trades that they consider to benefit themselves. When entering financial markets – buying stocks or bonds or taking out a mortgage or even very complex securities – they will do due diligence in seeing that what they are buying is worth what they are paying, or what they are selling.

What this theory neglects is that there are times when people are too trusting. And it also fails to take into account that if it can do so profitably, capitalism will produce not only what people really want, but also what they think they want. It can produce the medicine people want to cure their ills. That is what people really want. But if it can do so profitably, it will also produce what people mistakenly want.

It will produce snake oil. Not only that: it may also produce the want for the snake oil itself. That is a downside to capitalism. Standard economic theory failed to take into account that buyers and sellers of assets might not be taking due diligence, and the marketplace was not selling them insurance against risk in the complex securities that they were buying, but was, instead, selling them the financial equivalent of snake oil.

There is a broader moral to all this – about the nature of capitalism. On the one hand, we want to take advantage of the wisdom of Adam Smith. For the most part, the products produced by capitalism are what we really want, produced at a price that we are willing and able to pay. On the other hand, when confidence is high, and since financial assets are hard to evaluate by those who are buying them, people will and do buy snake oil. And when that is discovered, as it invariably must be, the confidence disappears and the economy goes sour.

It is the role of the government at two levels to see that these events do not occur. First, it has a duty to regulate asset markets so that people are not falsely lured into buying snake-oil assets. Such standards for our financial assets make as much common sense as the standards for the food we eat, or the purchase medicine we get from the pharmacy. But we do not want to throw out the good parts of capitalism with the bad. To take advantage of the good parts of capitalism, when fluctuations occur it is the role of the government to see that those who can and want to produce what others want to buy can do so. It is the role of the government, through its counterbalancing fiscal and monetary policy, to maintain full employment.

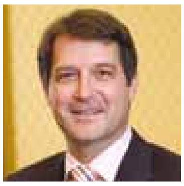
The principles behind such an economy are not the principles behind a socialist economy. The government insofar as possible is only creating the macroeconomic conditions that will allow the economy to function well.

That is the role of government. Its role is to ensure a "wise laisser faire". This is not the free-for-all capitalism that has been recommended by the current economic theory, and seems to have been accepted as gospel by economic planners, and also many economists, since the Thatcher and Reagan governments. But it also is a significant middle way between those who see the economic disasters and unemployment of unfettered capitalism, on the one hand, and those who believe that the government should play no role at all.

The idea that unfettered, unregulated capitalism would invariably produce the good outcomes was a wrong economic theory regarding how capitalist societies behave and what causes their crises. That wrong economic theory fails to take account of how the animal spirits affect economic behaviour. It fails to take into account the roles of confidence, stories and snake oil in economic fluctuation.

The article can be found online on www.ft.com

Change in Directorship



After six successful years at the management board of the Gesellschaft für Kapitalmarktforschung, Volker Wieland has stepped down as a director of CFS. However, he will remain an active partner within CFS, serving as the program director of the area "Central Banking and Monetary Economics". He will also continue to organize the ECB Watchers conference.

A director since 2003, Volker has greatly enhanced the Monetary and Macro Group, and has contributed enormously to the strong stand of CFS in both academic and policy circles. Volker Wieland has been responsible for CFS' flag ship event, the annual conference "The ECB and Its Watchers", the 10th of which was held in the fall of 2008. Volker's work on monetary policy has been discussed and his publication record has been outstanding. As a director, he was also an organizer of the International Research Forum on Monetary Policy, an annual conference involving the Federal Reserve Board and Georgetown University in Washington, as well as the European Central Bank and CFS in Frankfurt. Furthermore, over the past year, Wieland was working as a Duisenberg Fellow at the ECB.

"It was a great pleasure to work together with Volker, and we are very grateful for his important and lasting contributions to CFS management, and its academic profile. We welcome Volker in his old and new role as CFS Program Director in the area of Central Banking and Monetary Economics", said Jan Krahnen. Appointment of the new CFS management team is under way.

CFS Executive Education

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17-18 Sep 2009 — **Zinsprodukte: Analyse und Bewertung (Teil I)**
Wolfgang Bühler (University Mannheim)

01-02 Oct 2009 — **Kreditderivate und deren Bewertung. Ein Werkstattseminar zum Mitmachen**
Prof. Dr. Stefan Reitz (Hochschule für Technik Stuttgart)

08-09 Oct 2009 — **Zinsprodukte: Analyse und Bewertung (Teil II)**
Prof. Dr. Wolfgang M. Schmidt (Frankfurt School of Finance & Management)

29-30 Oct 2009 — **Zukunftsgestaltung. Die Finanzbranche von morgen denken**
Stephan Meyer (denkstelle) and Axel Liebetrau (PortaFinancia)

12-13 Nov 2009 — **Behavioral Finance und der Einfluss von Stimmungen auf die Finanzmärkte**
Dr. Conrad Mattern (Conquest Investment Advisory AG)

For further information and registration please contact Anca Becheanu: hof-trainings@ifk-cfs.de

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