NEWS

CENTER FOR FINANCIAL STUDIES

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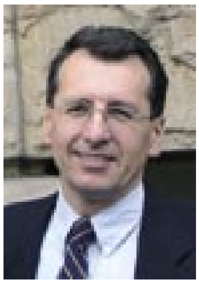
Photo: Alfred Röhrich

Editorial

In rating regulation, sometimes less can be more



by Jan Pieter Krahnen

2.5 years into the crisis, and there may still lie unpleasant surprises ahead of us. Think of some German state banks (Landesbanken), or some private banks facing a surge in borrower delinquencies, or think of the overleveraging of some European states, like Greece or Spain. Late as it may seem, we now also see the first decisive counter-moves of parliaments and governments. The long-awaited regulatory wave, likened by some to Godot, the protagonist in Beckett's famous play, is eventually arriving. This in itself is good news. But as usual, the devil is in the details. The strengths and weaknesses of each regulatory innovation have to be scrutinized, before an assessment can be made – and even then it remains preliminary, as we have to see how market participants will ⇛

adjust their behaviour in light of the new rules.

For a beginning, take the recent directive on rating agencies, issued by the European Parliament and the Council on 16 September 2009. This new piece of regulation deserves credit for a list of useful rules that rating agencies have to respect if they are active in Europe. Several rules address relevant incentive problems, for example the regulation prescribes the separation of advisory services from rating services, it requires unsolicited ratings to be explicitly marked, and it limits the possibility for rating shopping. Some other rules try to micromanage internal corporate governance rules by, for example, setting guidelines for compensation and job rotation in rating agencies; it is doubtful whether they will achieve anything meaningful, but I do not see that they cause significant harm either.

More importantly, and still on the plus side, the regulation requires agencies to deposit statistics on rating assignment default experiences in a central depository to be maintained by the new regulator, the European Securities Markets Authority (ESMA) in Paris. This is clearly an important step forward, giving the European agency access to first-hand data. However, to be able to properly compute rating performance it is essential that the agency gets access to the raw data, i.e. the ratings assigned and the defaults experienced. Only such an enhanced data sharing will allow the agency as well as investors around the world to distinguish high quality ratings (and rating agencies) from poor ones.

At the other end of the spectrum we also find significant shortcomings in the new regulation. The first relates to the key element of the directive, the disclosure of rating methodologies by agencies. The second shortcoming concerns the insufficient empowerment of a common European regulator to oversee the regulation. Let us look at both issues in turn.

First, the disclosure of rating methodologies, reasonable as it may sound at first glance, is dangerous. Most importantly, these rules invite companies and banks to come up with financial products and portfolios that escape the risk measurement rod of the agency model. It does so also because, due to disclosure and contestability of ratings, agencies will limit the amount of soft information recognized in the rating process. This is disadvantageous over the long term, because then the information value of ratings will be reduced.

The second built-in weakness is the strong role played (still played) by the national treasury and the national supervisory authorities. CESR, the forerunner of ESMA, is responsible for setting up and coordinating colleges of supervisors. It is not empowered to consolidate the supervisory process and has only limited disciplinary powers. The lack of enforcement powers on the European level opens the door widely for regulatory capture by financial institutions at the national level.

Thus, in conclusion, this major piece of new European regulation needs legal adjustment (or ‘tuning’) on issues relating to transparency (more information is not always desired) and to enforcement (proximity of regulator and agency on the national level is not always desired). Sometimes, less can be more: less methodological disclosure and less decision power retained on the national level.

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We wish Karl Otto Pöhl all the very best on the occasion of his 80th birthday!

From 1980 to 1991, Karl Otto Pöhl was President of the Deutsche Bundesbank. During that period, he played a decisive role in stabilizing the D-Mark and bringing inflation under control. He may also be considered one of the founding fathers of the euro since he was involved early on in the preparatory negotiations for the Maastricht Treaty.
From 1996 till 2006, Karl Otto Pöhl was President of CFS and Chairman of the Board of Trustees of the CFS sponsoring body (Gesellschaft für Kapitalmarktforschung e.V.).

Policy Platform

▶ Click on **www.hof.uni-frankfurt.de/policy_platform**

The first steps towards a House of Finance Policy Platform have now been accomplished. The idea is to have a single website that gives access to policy articles and related working papers written by House of Finance researchers and faculty members of the Faculty of Economics and Business Administration and the Faculty of Law of Goethe University.

The Platform is a joint project of the Center for Financial Studies (CFS), the Institute for Law and Finance (ILF), and the Institute for Monetary and Financial Stablity (IMFS). The founders of the initiative are Theodor Baums, Stefan Gerlach, Roman Inderst, and Jan Pieter Krahnen. This new project is an exciting start of a new cooperation not only between the three institutes, but also between faculty from different disciplines, namely macroeconomics, law, and finance. It is unique within the House of Finance and may be seen as a role model for future synergies and interdisciplinary scientific cooperation.

The main task of the Policy Platform is to pool policy relevant publications that are to this day widely dispersed and not easily or not at all accessible. The new Policy Platform gives access to these contributions in a well-structured manner. The site will also become the gate to policy relevant research undertaken in the House of Finance. The objective is to inform policy makers, market participants but also the general public in a non-technical way about current issues related to financial markets and their regulation, monetary economics and central banking, as well as financial law and public finance. The Policy Platform will also adopt a pro-active approach with respect to ongoing policy issues like, for instance, the reform of financial regulation.

Contributions are published either as Policy Letters or as White Papers, both are available online. White Papers comprise more comprehensive research-based contributions to current policy debates. Policy Letters are short essays or commentaries on current policy topics, usually written for publication in the press.

The Platform also aims to provide a forum for debate by organizing workshops with decision-makers.

The idea is to offer small-scale discussion rounds where decision-makers and House of Finance researchers talk in an open way about controversial themes.

This again will deliver the necessary input for future research and will also show where further expertise is needed.

In setting up the basic structure of the project, invaluable advice was received from Hermann Remsperger, a long time adjunct Professor in the Economics and Business Department of the University, and also a long time Chairman of CFS' Research Advisory Council.

More details can be found on the website:
www.hof.uni-frankfurt.de/policy_platform,
You can also contact us by email:
policy-platform@hof.uni-frankfurt.de

Systemic Risk: the Dual Challenge

by Jan Krahnen and Marcel Bluhm

Serie (Teil 14)

Nationale Souveränität in Aufsichtsfragen überdenken

Börsen-Zeitung, 21.11.2009

Eine neue Ordnung für die Finanzmärkte – Serie

Mit dem Ausbruch der Finanzkrise im Jahre 2007 sind die Begriffe „systemisches Risiko“ und „makroprudenzielle Aufsicht“ in den Mittelpunkt vieler Analysen und Lösungsansätze gerückt. Das bedeutet nicht, dass diese Konzepte neu wären. Bereits in früheren Finanzkrisen wurde ihnen zentrale Bedeutung beigemessen – jedoch ohne dass dies zu notwendigen Reformen in Regulierung und Aufsicht geführt hätte. Und obwohl diese Terminologie mittlerweile in aller Munde ist, scheint nach wie vor häufig nicht völlig klar zu sein, was mit systemischem Risiko überhaupt gemeint ist, wie man es messen kann und welche Maßnahmen geeignet sind, um angemessen darauf zu reagieren. Wir sehen hier eine doppelte Herausforderung, die sowohl die Politik als auch die Wissenschaft betrifft, einerseits die Erfassung (Messung, Interpretation) eines systemischen Risikos und andererseits dessen Verknüpfung mit konkreten Maßnahmen der Aufsicht.

Wir verstehen unter systemischem Risiko die Gefahr, dass durch Ausfälle im Finanzsystem eine ausreichende Versorgung der Märkte mit Krediten und Finanzdienstleistungen nicht mehr gewährleistet ist, sodass sich negative realwirtschaftliche Effekte ergeben. Dieses Risiko entsteht zum Beispiel dann, wenn große Teile des Finanzsystems von der Insolvenz bedroht sind. Das Finanzsystem umfasst hierbei nicht nur Banken und Versicherungen, sondern auch das sogenannte Schattenbanksystem – zum Beispiel Hedgefonds, Geldfonds, Zweckgesellschaften etc. –, das bisher nicht derselben strengen Regulierung und Aufsicht unterliegt. Die Institute eines Finanzsystems sind über ein komplexes, schwer durchschaubares Geflecht gegenseitiger Forderungen und Verbindlichkeiten, zum Beispiel über Kreditbeziehungen und deren Derivate, miteinander verbunden. Zusätzlich mögen Institute in dieselben Produktklassen investiert haben, was das System als Ganzes homogener und somit verwundbarer gegenüber einzelnen Risiken macht.

Im Verlauf der gegenwärtigen Krise war systemisches Risiko im Sinne potenzieller Schadensereignisse an manchen Tagen förmlich mit den Händen zu greifen. So etwa, als Lehman Brothers seine Finanzierungsbasis verlor und als wenig später der Versicherungskonzern AIG unter der Last vielfältig eingegangener Kreditabsicherungen in die Knie ging. Aufgrund der Undurchsichtigkeit strukturierter Finanzprodukte konnte niemand mit Sicherheit sagen, welchen Banken letztendlich Verluste drohten – es kam zu einem Vertrauensverlust, der ohne den unverzüglichen Eingriff von Zentralbank und Regierung zu einem Infarkt der weltweiten Finanzmärkte geführt hätte.

Beschreibt man das Finanzsystem als ein Netzwerk verflochtener, voneinander abhängiger Finanzinstitute, dann lassen sich die Auslöser systemischen Risikos somit genauer benennen. Systemisches Risiko ergibt sich, wenn (a) mit der Krise einzelner Institute, (b) durch von gegenseitigen Abhängigkeiten ausgelöste Insolvenzen oder (c) durch hohe Ausfälle in Produktklassen, in die ein Großteil der Finanzinstitute investiert hat, ein signifikanter Teil des Finanzsystems in den Konkurs getrieben zu werden droht. Systemisches Risiko resultiert daher ganz wesentlich aus der finanziellen Verflechtung zwischen Finanzinstitutionen. Hieraus folgt, dass sich das Ausmaß des systemischen Risikos nicht allein durch mikroprudenzielle Aufsicht – die Überwachung der Risikosituation einzelner Institute – abschätzen lässt.

Von Jan Pieter Krahnen und Marcel Bluhm

Um systemisches Risiko zu messen, bedarf es einer Karte des Finanzsystems, die die wichtigsten Institute und deren Vernetzung untereinander erfasst. Die von de0r Bundesregierung eingesetzte Issing-Kommission hat solch eine Darstellung zur Messung von systemweiten Risiken als „Risikolandkarte“ bezeichnet. Um eine derartige Risikolandkarte zu erstellen, benötigt die mit makroprudenzieller Aufsicht beauftragte Institution eine Liste aller (größeren) Forderungen und Verbindlichkeiten der einzelnen Finanzinstitute untereinander. Mithilfe dieser und weiterer Angaben lassen sich die Auswirkungen eines breiten Spektrums möglicher Stress-Szenarien untersuchen, um darauf basierend das systemische Gesamtrisiko zu messen und den Beitrag einzelner Finanzinstitute zu ermitteln.

Die zweite Herausforderung neben der Messung des systemischen Risikos betrifft das Ergreifen von Maßnahmen zur Begrenzung systemischer Risiken. Es reicht nämlich nicht aus, dass die Aufsichtsbehörde lediglich auf das ermittelte systemische Risiko hinweist. Die Stabilität des Finanzsystems ist ein öffentliches Gut, und häufig haben weder individuelle Finanzinstitute noch deren Heimatstaaten ausreichend Anreize, entsprechenden Indikationen angemessene Maßnahmen folgen zu lassen.

Um dieser Problematik Rechnung zu tragen, ist ein Verfahren zu finden, bei dem sich die beteiligten Länder vorab verpflichten („binden“), entsprechend den Meldungen der makroprudenziellen Aufsicht vorher festgelegte Maßnahmen tatsächlich zu ergreifen. Maßnahmen könnten eine Art „systemic risk charge“, eine Risikoprämie zusätzlich zu der vom Einlagensicherungsfonds verlangten Prämie, umfassen. Auch direkte Verknüpfungen der Diagnose mit den Mindestkapitalanforderungen der Banken sind vorstellbar. Gegenwärtig existiert allerdings dieses entscheidende Bindeglied von Diagnose zu Prophylaxe noch nicht. Um „verdrahtete“ („hard-wired“) Reaktion auf die Meldungen systemischen Risikos zu schaffen, wäre es beispielsweise möglich, den im September dieses Jahres beschlossenen Europäischen Ausschuss für Systemrisiken entsprechend zu ermächtigen. Dies würde weitreichende gesetzliche Anpassungen erfordern, wie sie im Rahmen der Europäisierung der Bankenaufsicht aber ebenfalls erforderlich sind.

Es ergeben sich somit zwei Schlussfolgerungen in Bezug auf eine zukünftige frühzeitige Erkennung und Eindämmung systemischer Risiken. Zum einen müssen die fachlichen, organisatorischen und gesetzlichen Voraussetzungen geschaffen werden, um die skizzierte Risikolandkarte erstellen und systemisches Risiko überhaupt erfassen zu können. Wenn darüber hinaus eine systemstabilisierende Wirkung erzielt werden soll, bedarf es des politischen Willens, von politisch unabhängiger Seite bilanzielle Anpassungen bei allen systemrelevanten Instituten anordnen und durchsetzen zu können – ein klares Abweichen von der bisher in bankaufsichtsrechtlichen Fragen verfolgten nationalen Souveränität. Während die erste Herausforderung aufgegriffen worden ist und wir erste Fortschritte erkennen können, fehlt es bei der zweiten Herausforderung noch an Konzepten und vor allem an einem entsprechenden politischen Willen.

Jan Pieter Krahnen ist Finanzprofessor an der Goethe Universität Frankfurt und Direktor des Center for Financial Studies (CFS) im House of Finance; Marcel Bluhm ist wissenschaftlicher Mitarbeiter am CFS.

Zuletzt erschienen:
- Claudio Borio: Unkonventionelle Geldpolitik birgt Risiken (Teil 11)
- Dieter Wermuth: Hohe Bankgewinne sind ein Zeichen für Marktversagen (Teil 12)
- Hyun Song Shin: Geldpolitik und Finanzstabilität gehören zusammen (Teil 13)

In den Zusatzdiensten von boersen-zeitung.de finden Sie die bisher erschienenen Serienbeiträge in deutscher wie auch in **englischer Sprache**.

A more extensive version of the article appeared in Börsen-Zeitung on 21 November 2009 under the heading "Nationale Souveränität in Aufsichtsfragen überdenken" as part of a series on financial markets regulation entitled "Eine neue Ordnung für die Finanzmärkte".

The concepts of "systemic risk" and "macro prudential supervision" have become the focus of attention in many studies. This does not mean that these concepts are new. Already in earlier crises they were believed to be of central importance, without, however, this ever having led to the necessary reforms in regulation and supervision. And although the terminology is on everyone's lips, it still frequently appears to be unclear what systemic risk means, how it can be quantified, and which measures are suitable in order to be able to respond appropriately to it.

What we are observing here is a dual challenge that concerns policymakers, particularly those at the central banks. These challenges involve, on the one hand, determining (quantifying and interpreting) systemic risk and, on the other hand, devising applications that will lead to concrete measures for supervision.

By systemic risk we understand the danger that failures within the financial system will mean that an adequate supply of credit and financial services to the markets is no longer guaranteed, so that negative real effects will follow. This risk arises when, for example, large sectors of the financial system are threatened with insolvency. The financial system in this context is perceived as a network of interwoven, mutually dependent financial institutions – not only banks and insurances but also the so-called shadow banking system such as hedge funds, mass money funds, special purpose vehicles. If systemic risk essentially derives from the financial linkage between financial institutions, it follows from this that the extent of systemic risk cannot be determined through the supervision of individual institutions. In this context, conventional supervision, referred to as micro prudential supervision, is simply not up to the task.

The Issing commission set up by the German government coined the phrase "risk map" for measuring the system-wide risks of the financial system. Such a diagram of the financial system would capture the most important institutions and their mutual claims and liabilities in connection with other institutions within the financial sector. This and other information would enable the supervisory authority to measure the systemic total risk and to determine the role played by individual institutions. However, the necessary analysis methods required here still have to be developed. Central banks and academic research institutes have already begun to examine these issues but at present the systemically defined risk analysis remains a challenge – both intellectually as well as in the context of its legal and organizational aspects. The latter refers to the need to design a uniform approach to the collection and compilation of data under the auspices of a single responsible body such as the ESRB or the IMF. In the case of Germany, fundamental legal regulations still stand in the way. The Bundesbank, for example, is not permitted to pass institution-specific data on to a third party – not even to the ESRB.

The second challenge besides the quantification of systemic risk concerns the adopting of measures aimed at containing systemic risks. Essentially, it is not sufficient for the supervisory authority to simply point out the systemic risks it has detected. The stability of the financial system is a public good and frequently neither individual finance institutions nor their country of origin have sufficient incentives to pursue pertinent indications with appropriate measures. In order to deal with this problem, a procedure is required through which the countries involved commit themselves ex ante to implementing specific pre-agreed measures. These measures could include a kind of 'systemic risk charge', i.e. a risk premium in addition to that required by the deposit insurance funds. A direct coupling of banks' minimum capital requirements to the ESRB evaluation is also conceivable.

At the current time, however, this crucial step from diagnosis to prophylactic measures is nonexistent. And it is exactly here that we observe the second challenge mentioned above, that is the creation of a 'hard-wired' response to warnings of systemic risks. One way to achieve this would be to confer on the ESRB the necessary authority – this would require extensive legal adjustments, similar to those that will be necessary in the course of a Europeanization of banking supervision.

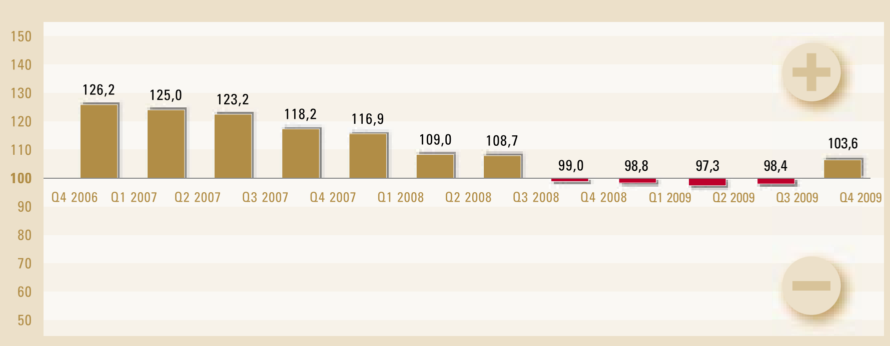
Two conclusions can be drawn with respect to a future early containment of systemic risks. On the one hand, the qualified, organizational and legal conditions must be created that would allow a risk map to be drawn up in the first place. If, in addition to this, a systemic stabilization effect is to be realized then it will require the political will to allow an independent body to enforce appropriate measures concerning systemically relevant institutions – a clear departure from the position of national sovereignty hitherto pursued in issues relating to banking supervision.

Whilst the first challenge has already been taken up and initial signs of progress can be detected, when it comes to the second challenge not only is there still a lack of feasible concepts but also and above all a lack of the corresponding political will.

CFS Financial Center Index continues upward trend

For the first time since mid 2008, the CFS Financial Center Index has shown a positive value of currently 103.6 (+5.2 points). The previous quarter had already indicated a turnaround but now there is first evidence of a recovery in the financial sector and a rise in the creation of value.

CFS FINANCIAL CENTER INDEX



SOURCE: CENTER FOR FINANCIAL STUDIES (CFS)

Consistently across all areas surveyed, the financial business climate is being viewed much more positively. While the evaluation of the performance for the third quarter of 2009 is still rather cautious, the positive effect is revealed in the fourth quarter forecast, particularly with regard to transaction volumes (+8.9 points) and profits (+6.6 points) for the whole financial sector. The business sentiment that prevails in the "supervisory and academic institutions" subgroup, which was notably negative in the last survey, has now swiftly brightened up again. Financial sector service providers, such as accountants and consultants, even assume there will be a small rise in employment and an increase in investments. As observed already in last year's survey, a majority of respondents still believe that the economic and financial crisis will continue for up to three years. "Despite the strong increase of the index value, reflecting a significant recovery of the financial sector, the sustainability of the business performance is called into question by additional uncertainties following the ongoing crisis", explained CFS Director Jan Pieter Krahnen commenting on the latest results.

Concerns about the economic costs of financial regulation

The special survey conducted this time dealt with the financial crisis and its consequences. 496 leading executives were asked about their expectations regarding the duration of the crisis, as well as their views on the regulation of securitizations, the marking-to-market of assets, and remuneration of managers.

Effectiveness of limiting executive compensations remains questionable

For an overwhelming number of respondents, the measures adopted in Pittsburgh to limit executive compensation will not help to prevent future financial crises. A small majority (51%) judges this G20 decision to be ineffective, an additional 9 % even consider it to be counterproductive for financial stability. "Although understandable from a political perspective, the regulation of management salaries is seen predominantly as an inappropriate instrument for reducing the risk of future financial crises", stated Krahnen.

CFS talks to Eugen Paravicini about Frankfurt as financial center

Eugen Paravicini is Head of the Department of Economic Systems, Financial Services and Stock Exchanges at the Hessian Ministry of Economics, Transport, Regional and Urban Development. He is also a Member of the Managing Board of the Gesellschaft für Kapitalmarktforschung (the sponsoring body of CFS)

Frankfurt is Germany's leading financial center. Many key players of the financial sector are located here. Frankfurt also plays an important role regarding the economic power and the creation and preservation of jobs in the state of Hesse. How would you rate conditions in Frankfurt as a location? And what might the federal state government do to support and improve these conditions in Frankfurt in the future?

In my view the conditions in Frankfurt as a financial center are excellent. It is not merely a coincidence that Germany's most important financial players as well as the European Central Bank and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) are all located here. This concentration of key players, developed over time, has made the location increasingly attractive to other financial services providers, and to regulatory and monetary authorities. In order to maintain this high standing in the future, however, the current infrastructure must be constantly updated to keep pace with an ever-changing environment. Financial institutions, their products and the markets are all subject to unrelenting change. In the ongoing competition between financial centers, the ability to innovate on the basis of an excellent intellectual infrastructure plays a crucial role. Continuing support for Frankfurt's financial sector is a declared goal of the federal state government. The government regards itself as both an initiator and a companion of important developments at the financial center, which in our opinion has to be greater than the sum of its individual parts. Through its regular contact with representatives of the financial sector, the federal state government advocates a common approach to supporting Frankfurt as a financial center and developing long-term strategies for its expansion. The state government within the scope of its own sphere of responsibility focuses on optimizing the intellectual infrastructure, the transportation network, and the legislative framework, which all play a vital role for the competitiveness of Frankfurt as a financial center.

In the face of international competition, Frankfurt needs to adopt a clear stance vis-à-vis its competitors. Frankfurt Main Finance is making an important contribution to marketing and coordinating initiatives aimed at promoting Frankfurt. You have been involved since the beginning. Can you tell us more about the achievements and objectives of this initiative?

The main objective of the federal state government's financial market initiatives was and is the clear positioning of the location and the pursuit of a coordinated strategy with respect, for example, to marketing and the orchestration of other activities. Frankfurt Main Finance was actually initiated by the state government. We have been successful within this set up in bringing together the most important institutes and organizations and focusing them towards common goals. The financial industry, the City of Frankfurt and the State of Hesse founded Frankfurt Main Finance in July 2008 in order to give Frankfurt's financial sector a voice with which it could make known its potential and appeal both nationally and internationally and in order to strengthen, by means of a common identity, the commitment to the location and its further development. Now that Main Finance is in its second year of existence, we can look back on a successful first round of activity. The structure of a more long-term oriented strategy is evident, and the initiative has gained acceptance and is well established. A concept for the organization of IT-based communication and information access stands ready. To be sure, much remains to be done in order to secure an even

The original German interview is available on our website or can be obtained from CFS. Please email your request to demoor@ifk-cfs.de

firmer anchorage within the financial community and to provide a sharper outline to the strategic orientation. But the necessity for cooperation between institutes and across the community's sectors has been acknowledged.
Frankfurt as a financial center finally has a common platform from which to promote and improve its profile.

In your opinion which strategies should now be adopted in order to help Frankfurt acquire greater public visibility?

The most obvious instrument for achieving this objective is undoubtedly Frankfurt Main Finance. The financial community is indeed by the nature of its services directly related to the institutes involved, moreover its presence is felt by everyone on a daily basis and is reported upon by the media. For us as a federal state it has been important to eliminate deficits in the perception of being a community and an economic cluster. In our view it has been important to give precedence in this context to introducing a single trademark, a common marketing strategy and prescribed terminology when discussing important issues regarding the financial center. And we should not stop here. Marketing requires content as well as positions. It is obvious that shared positions, given the different interests of those involved, are unrealistic at the detailed level. However, this does not preclude common ground with respect to fundamental issues being found and communicated should it be important to the future of the financial center. The current debates about the necessary consequences for regulation and supervision to be taken in the aftermath of the financial crisis provide a topical example.

The Frankfurt Main Finance initiative also promotes the academic or intellectual infrastructure here in Frankfurt. The House of Finance, for example, is a sponsoring member of the initiative. Applied research and training constitute a substantial part of the activities within the House of Finance. How do you evaluate this? And to what extent is this an asset to Frankfurt?

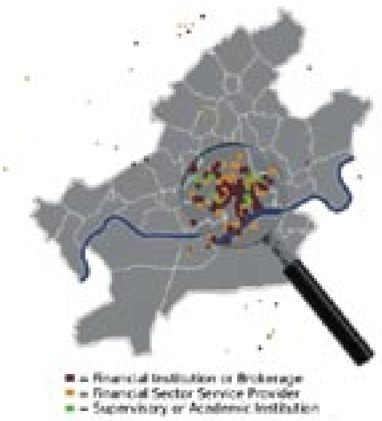
It is well known that the House of Finance was established with considerable financial support from the State of Hesse. The underlying vision was to bring together outstanding competence and recognized excellence in research and teaching in the field of finance by combining expertise in the disciplines of economics, finance and law under one roof. Individual well-established and internationally oriented institutes have come together in the House of Finance to form an institution unique even by international standards. Bearing in mind the seminal importance of its research and practice-oriented teaching for the development of a globally competitive financial services sector, the significance of such an institution cannot be emphasized enough. The Hessian state government is convinced that the interdisciplinary work at the House of Finance will, in the medium term, elevate academic research in Frankfurt once and for all to the top of the international ranks in the field of financial research.
Of course, the optimal governance and internal coordination of such a sophisticated complex will still raise many questions.
However, the planned Policy Platform will already satisfy a basic objective by ensuring the transfer of results to the arena of public debate on issues such as supervision, regulation and will in general secure the application of these results in Germany.
Through the financial support of the state government for the House of Finance as well as the support for the applied sciences universities, we have provided a considerable impetus for new developments. The financial support of the state in helping to establish the Frankfurt Institute for Risk Management and Regulation as well as a funded Chair for Insurance Management are the latest steps for promoting research and teaching in the field of finance.

▶ **Frankfurt Main Finance on**
www.finanzplatz-frankfurt.de

Using the Financial Center Index, CFS carries out quarterly surveys among key players from the various financial centers in Germany regarding their assessments and expectations. The index also measures current business sentiment regarding development opportunities and the risks facing the financial center, and observes changes over time. In addition special surveys on current themes are conducted. What insights does the state government hope to gain from this project?

When in 2002/2003 a comprehensive financial center initiative of the federal state was drawn up, we had already begun at an early date to discuss with CFS and the Frankfurt School of Finance and Management the ongoing monitoring as well as the measurement and evaluation of the financial center's performance. Well-designed purpose-built indicators promised a sound database for quantifying the state of the financial services industry and the economic cluster that defines the financial center and also – and from our point of view this was very important – provided the basis on which administrative and political decisions could be made. Now that the business sentiment indicator of the CFS has been calculated for some length of time and is published in cooperation with Frankfurt Main Finance, we are pleased to witness how lively public interest in this indicator and the special surveys has become. In addition, we are also expecting valuable insights from the financial market data collection of the Frankfurt School. In future it will be possible to access this database via the internet portal of Frankfurt Main Finance.

The CFS Financial Center Index surveys Frankfurt´s financial community



The CFS Financial Center Index indicated a turnaround from July 2009 onwards. Is this a sign that Frankfurt, despite the financial crisis, has been able to maintain its high standing?

The trend of the business sentiment index has indeed brought to light and quantifiably confirmed what some pointers aside from bank balance sheets have indirectly shown or led us to believe, i.e. that Frankfurt to date has been affected to a lesser degree than other financial centers by the financial crisis. I think it is crucial that it is in fact the personal evaluation of the managers questioned when compiling the index that has led to such a clear result.

Of course it is true that the financial center as such is an extremely complex construction, especially in Frankfurt where a greater variety of institutions are to be found than elsewhere. It is also certain that the crisis has still not been completely overcome so that any concluding judgment would appear to be premature.

Even if the necessary measures, including those relating to regulation and supervision are far from being fully implemented, the trend of the index gives cause for optimism. At least the structure and profile of the German banking system have, in our opinion, generally proved themselves. Institutes with sound business models focused on safety and stability have been affected by the crisis to a lesser degree.

The Q3 2009 survey asked participants about their views on the regulation of the global financial system. Nearly three quarters of those surveyed supported the decision in favor of a European System of Financial Supervisors (ESFS), even though this would mean conceding national competences in supervision. Which (longer term) effects do you anticipate for the German financial industry?

We are currently in the process of coming to terms with the regulatory aspects of the financial crisis, and in this context we will be presenting our proposal for an appropriate form of regulation and supervision both before the Bundesrat as well as in direct discussions with the German government and the European Commission. Stability, integrity and sustainability are indispensable for restoring faith in the markets and for averting the danger of systemic crises. We cannot afford to return to business as usual. Regulatory arbitrage must be excluded by means of internationally valid standards. The European Commission has developed an ambitious concept for the European-wide supervision of financial markets together with the necessary supervisory structure and is currently working on the necessary amendments to aspects such as the regulation of coordinated bank rescue plans and an emergency winding up process that burdens the public budget to the least degree. That those surveyed by the CFS Financial Center Index are in favor of these suggestions is nothing less than a pledge to uphold the integrity and stability of the financial markets. This result reinforces the image that the financial center is focusing on the basic tenets of stability and integrity in order to provide fair and sustainable financial services. The current debate in Germany, however, also exhibits tendencies in the opposite direction. For this reason it will be important to translate into action quickly and effectively the international consensus, which is already starting to crumble, on stricter regulation for financial institutions, markets and products on a global basis. We expect that Frankfurt will gain considerable prestige as the European decisions concerning a modified archi-tecture for financial supervision are put into practice. This holds true with respect to the establishing of the European Systemic Risk Board as much as it does with respect to the location of the European insurance supervisory authority.

The setting up of the European Systemic Risk Board as an early warning system for systemic risks is an important element within the future system of supervisory structures. We believe close linkages with the ECB to be a fundamental pre-requisite for the effectiveness of the new structures. Likewise improvements in the supervision of institutions with cross-border activities will depend on the close network of financial supervisory authorities, derived by transforming the level three committees into authorities with specific duties and responsibilities. The planned system of an integrated but decentralized network of supervisory authorities, combined with specific powers endowed by the European authorities is in my view the smallest possible step that can engender a qualitative improvement. The willingness of member states to relinquish national competences should not be overstretched. Details regarding, for example, the distribution of burdens and the extent of competences of the new European authorities and the binding power of their decisions are still to be discussed at length in the course of the legislative procedure. Nevertheless, the attempt to create an effective system for monitoring institutes with cross border business operations is a step in the right direction. I assume that the proposals of the Commission in the context of the announced legislative act will be developed in such a way that questions relating to the transference of competence, the necessary national autonomy and the potential burdening of national households will be resolved in a satisfactory manner.

CFS White Paper III

Why a Common Eurozone Bond Isn't Such a Good Idea©

As the financial crisis was deepening in early 2009, the spreads of the government bonds of different EMU countries were widening and the idea of a common eurozone bond was finding more and more support. In an article that originally appeared in the Summer 2009 issue of Europe's World, Otmar Issing argues against this idea. According to Issing, a common bond would give the wrong signal by punishing the fiscally more solid countries and encouraging the "weaker" countries to continue on their wrong fiscal course. As a consequence, the credibility of the eurozone und thus the confidence of its citizens would be undermined. He concludes that "solidarity" in the true sense, meaning that all countries observe the rules of the Stability and Growth Pact, is needed. The article can be found on our website www.ifk-cfs.de and on the Europe's World website www.europesworld.org.

CFS Working Papers

The following CFS Working Papers appeared in the second half of 2009 and can be downloaded from our website www.ifk-cfs.de

2009/11 **CDOs and Systematic Risk: Why Bond Ratings are Inadequate**
Jan Pieter Krahnen, Christian Wilde

2009/12 **The American Consumer: Reforming, Or Just Resting?**
Christopher D. Carroll, Jiri Slacalek

2009/13 **Instabile Finanzmärkte**
Jan Pieter Krahnen, Günter Franke

2009/14 **A Tractable Model of Buffer Stock Saving**
Christopher D. Carroll, Patrick Toche

2009/15 **A Tractable Model of Precautionary Reserves, Net Foreign Assets, or Sovereign Wealth Funds**
Christopher D. Carroll and Olivier Jeanne

2009/16 **Precautionary Saving and the Marginal Propensity to Consume Out of Permanent Income**
Christopher D. Carroll

2009/17 **New Keynesian versus Old Keynesian Government Spending Multipliers**
John F. Cogan, Tobias Cwik, John B. Taylor, Volker Wieland

2009/18 **Modelling and Forecasting Liquidity Supply Using Semiparametric Factor Dynamics**
Wolfgang Karl Härdle, Nikolaus Hautsch, Andrija Mihoci

2009/19 **Money in Monetary Policy Design: Monetary Cross-Checking in the New-Keynesian Model**
Günter W. Beck, Volker Wieland

2009/20 **A Blocking and Regularization Approach to High Dimensional Realized Covariance Estimation**
Nikolaus Hautsch, Lada M. Kyj, Roel C.A. Oomen

2009/21 **Surprising Comparative Properties of Monetary Models: Results from a New Data Base**
John B. Taylor, Volker Wieland

2009/22 **Did Fair-Value Accounting Contribute to the Financial Crisis?**
Christian Laux, Christian Leuz

2009/23 **The Market Impact of a Limit Order**
Nikolaus Hautsch, Ruihong Huang

2009/24 **Politischer Wille oder ökonomisches Gesetz? – Einige Anmerkungen zu einem großen Thema**
Otmar Issing

2009/25 **Keynesian Government Spending Multipliers and Spillovers in the Euro Area**
Tobias Cwik; Volker Wieland

2009/26 **Fiscal Stimulus and the Promise of Future Spending Cuts: A Comment**
Volker Wieland

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CFS Colloquium Redefining Accountabilities: Lessons from the Recent Financial Crisis

Should Monetary Policy "Lean or Clean"?

27 May 2009

William White

William White, former Economic Adviser and Head of the Monetary and Economic Department of the Bank for International Settlements (BIS), gave a speech entitled "Should Monetary Policy 'Lean or Clean'?" as part of the CFS Colloquium Series. White's lecture on this new paradigm for monetary policy and his recommendation for a new macrofinancial framework are summarized in the following article.

William White, Jan Krahnen

White began his speech with a short discourse on the terminology of the lecture's subject. He explained that the notion of monetary policy "leaning against" expansionary phases of credit upturns means it becomes more restrictive than inflation forecasts indicate to prevent the build-up of asset bubbles, whereas "cleaning up" refers to a monetary approach that is satisfied with providing huge amounts of liquidity, once an economic bubble has burst. He stated that the question asked in the title of the presentation can only be answered by evaluating the relative merits of both approaches, in particular with a view to preventing a financial or economic crisis like the one currently seen.

White then analyzed the developments that had led to the current financial crisis. Since liberalized financial systems seem to be inherently procyclical, the world has witnessed many boom-bust cycles over the course of history. Furthermore, there is much evidence that the current crisis fits the same pattern as previous crises going back until the great recession of 1825. In particular, the Great Moderation, a phase that started in the mid eighties of the previous century and that was characterized by declining volatility in major economic parameters, eventually led to several excesses that collapsed around the year 2000. The following strong monetary easing and historically low short-term and long-term global interest rates led to a strong rise in borrowing through declining lending standards and cheaply available money. Growth remained relatively high until 2008, and positive supply shocks kept inflation under control. However, during this period, global imbalances started to grow ever larger, in particular with regard to savings rates and trade deficits in some countries and investment rates in others. At a certain point in time, triggered by the subprime crisis in the U.S., the imbalances began to unwind and almost resulted in a meltdown of the global financial system and an economic slump.

Having thus identified a crucial role of monetary policy in the development of the crisis, White went on to ask which role monetary policy ought to play in moderating the cost of future boom-bust cycles. In this context he outlined the main aspects of the "lean versus clean" debate. Until recently, said White, the dominant analytical paradigm for the conduct of monetary policy held "that it is impossible to lean against credit bubbles using tighter monetary policy, but that it is possible to clean up afterwards using easier monetary policy". While some central banks such as the Bank of Japan and the European Central Bank do not follow this course and tend to some extent to take explicitly into account the building up, for example, of credit excesses in their monetary policy framework, a majority of central banks – with the most obvious proponent being the Federal Reserve – conduct their monetary policy in accordance with this approach.

White then summarized the arguments supporting the view that monetary policy cannot be used to lean against expansionary phases of the credit cycle. First of all, according to these arguments, it is hard to choose an appropriate asset price to target for the process of identifying bubbles. In addition to this – even if such a unique asset price indicator were to exist – it would still be difficult to determine whether it would result in a bubble or not. Finally, targeting asset prices might clash with the goal of price stability in general.

White next outlined the arguments opposing this view, in particular that leaning against the credit cycle does not imply targeting a single asset price, but rather it means supervising "combinations of rapid increases in monetary and credit aggregates, increases in a wide range of asset prices, and deviations in spending patterns from traditional norms". Furthermore, conflicts between leaning against the credit cycle policies and inflation targets, in particular the undershooting of desired inflation, "would not seem to be a problem if the economy is still growing strongly under the influence of the credit cycle itself". He then went on to say that credible commitments by monetary policymakers might even change private investors' behavior and mitigate some of the excesses seen in the current crisis. Finally, tighter monetary policy in the upswing would lessen the extent of downswings and thus avoid hitting the zero lower bound of interest rates.

Next, White summarized the arguments, first, in favor and, second, against the view that monetary policy can be effectively used to "clean up" in contractionary phases of the credit cycle. The arguments in favor of this view consist largely of the general support for the view found in the macroeconomic Dynamic Stochastic General Equilibrium (DSGE) models that are used by most central banks. Furthermore, this policy seems to have worked well in the past and any big downturns that occurred were considered to be due to policy errors simply because the mopping up approach was not always pursued vigorously enough. Finally, proponents of the "cleaning-up-afterwards" scenario stress that monetary policy is still effective at the zero lower bound. Arguments opposing this approach, said White, consist mainly of refuting the previous arguments on the grounds that models might be seriously flawed and will therefore not adequately represent reality. In addition, it is not clear whether policy approaches that have worked in the past will necessarily work under future circumstances, and, since severe recessions occurring in the past, which were supposedly aggravated by monetary policy mistakes, can only be analyzed using model-based counterfactual analysis, these arguments rely exclusively on assumptions. In White's opinion, severe past downturns can also be explained by the unwinding of economic imbalances that had built up over time. He finally stressed that all traditional monetary policy channels do not work effectively at the zero lower bound and that unorthodox quantitative easing approaches still have to pass the test of the current crisis.

White next turned to analyzing whether there are other policies that can be used to clean up after a bubble has burst. One possible option would be to resort to fiscal stimulus. However, given the high levels of debt in many countries, even fiscal stimulus has "its limitations and longer term dangers". Another remedy would be to just write off all debts that cannot be serviced in an orderly way. In the context of the current financial crisis, however, this is very difficult since "literally millions of households whose debts will not be serviced under the initially agreed conditions" have been repackaged in several credit cascades through structured financial products such as mortgage-backed securities. In comparison to these remedies, simply restoring the normal functioning of the financial system, through for example recapitalization, setting up bad banks and temporary nationalizations, seems to be the better alternative. Finally, White emphasized that the crisis should also be seen as an opportunity for setting in place resource re-allocations and making markets, in particular the labor market, more flexible.

Given the unprecedented policy measures that had to be used in the current crisis and taking into account their undesirable side effects over the medium term, White stressed the need for a new macrofinancial framework to resist future procyclicality. He argued that such a macrofinancial framework should have three central characteristics: first of all, it should pay increased attention to systemic exposures, that is, take consideration of the fact that different agents have similar exposures and reactions to common shocks. A second characteristic would be a symmetric reaction of monetary policy to dealing with bubbles, that is, "pre-emptive tightening" would, to some extent, replace "pre-emptive easing". Thirdly, it would be important that "the

► The paper and the presentation are available on the CFS homepage www.ifk-cfs.de

authorities involved [are] much more mutually supportive than they appear to be at the moment" – on a national as well as on an international level.

White then concluded with three points he deemed to be of particular importance. Firstly, internationally active financial institutions need to be internationally supervised, secondly, recognition must be given to the ever growing role of international economic and financial linkages that contribute to the effects of contagion and the fostering of global imbalances, and, thirdly, much more attention needs to be paid to the effects of exchange rates on global procyclicality since fixed exchange rates play a role in supporting economic imbalances. For these reasons, said White, it is necessary to rethink the international monetary system.

Marcel Bluhm (CFS)

Management der Finanzmarktkrise aus der Sicht eines CFO

Managing the Financial Crisis from a CFO's Perspective

9 September 2009

Eric Strutz

Whereas previous speakers within the series had looked at financial institutions during the crisis from an external perspective, Eric Strutz, Chief Financial Officer of Commerzbank AG, now presented the "inside view".

Eric Strutz

In his introductory remarks, Jan Krahnen welcomed Eric Strutz and acknowledged that learning more about the "inside view" can only improve our understanding of the crisis and contribute toward preventing similar crises in the future.

Strutz first recapitulated the financial crisis that started in the first quarter of 2007. According to him, the subprime exposure of Commerzbank was not perceived as an imminent threat at the time when the first information about write downs on subprime portfolios started to filter through. A major turning point was reached on 8 August 2007, when an excessive demand for liquidity from European financial institutions became known. After that date, serious doubts about the robustness of the originate-to-distribute model arose and finally became real when certain areas of the investment banking sector were seriously disrupted and collapsed.

Analyzing the underlying causes of the crisis, Strutz pointed out that the high degree of liquidity in the market before the financial crisis had initiated a fight for assets among investors which had decreased the quality of market participants' risk assessments. Rating agencies had accelerated this process as their services had been the main assessment tool for the quality of structured products by investors. Strutz therefore questioned the view, often voiced by rating agencies, that rating agencies only give an opinion. This bears witness, he said, to a lack of commitment, in addition to the observed lack of reliability. He further pointed out that a number of market participants, in particular monolines, had exceeded their risk-bearing capacities.

Strutz then went on to identify five key assumptions of banks' business models that have come under scrutiny due to the financial crisis and that, in his view, need a thorough reconsideration. First, he said that markets had not been as efficient and liquid as originally thought by market participants. He opposed the general view that mistrust was the major reason why the interbank market had dried up. In fact it was the case that most banks had experienced a sudden and large liquidity demand from a number of special purpose vehicles. Second, Strutz argued that the existing classifications of structured products must be regarded with scepticism since a large number of products were downgraded by three or more notches within a short period of time. Third, he mentioned that the implementation of MaRisk[1] has not improved the risk management of banks automatically. Moreover, he emphasized the need for an active exchange of information between front office and risk management teams since the financial crisis has brought to light weaknesses in the coverage of market risks. Fourth, he called for caution when using statistical models for assessing financial risks. He pointed out that a number of European banks had not purchased complex financial products as their risk management systems had not been able to cope with the complexity level of these products and therefore had suffered less than their competitors. His fifth and final point was that management of the liability side, in particular debt, should have first priority as changes on the asset side are particularly costly in crisis times.

Strutz emphasized the need to anticipate major turning points in the real economy. One such turning point was the first quarter of 2009, when goods on order showed a considerable decrease across all industries. It is, however, still uncertain whether the bottom of the financial and economic crisis has been reached.

In his concluding remarks, Strutz named 10 important lessons for financial risk managers: 1) when buying financial products, careful consideration should be given to pricing differences for the same risk; 2) the possibility of illiquid markets should be taken into account; 3) risk managers should not only rely on external ratings but should also look at internal assessments; 4) a concentration of risks should be avoided and diversification encouraged; 5) banks should strictly apply their standards and guidelines across all states of the economy when assessing financial risks; 6) transparency should be enhanced by institutionalizing all reporting processes; 7) risk management should track market developments closely; 8) the information exchange between market and risk management divisions of a bank should be ensured; 9) banks should ensure that quantitative analytical methods and expert knowledge are used in a systematic and efficient manner; 10) banks should be prepared to set up a task force in case of an upcoming crisis.

David Nicolaus (CFS)

Wege zur Finanzmarktstabilität

Roads to Financial Stability

24 November 2009

Hugo Bänziger

Hugo Bänziger, Chief Risk Officer and Board Member of Deutsche Bank AG, was the next guest in the Colloquium Series on "Redefining Accountability: Lessons from the Recent Financial Crisis". As Jan Krahnen mentioned in his introduction, the keyword of this lecture series is accountability, which is demanded from all market players. Bänziger took up this issue and acknowledged the importance of a bank's accountability. Based on his own experience, he said that banks and managers are indeed being held accountable for the consequences of the crisis.

Hugo Bänziger

Bänziger said that major shifts are taking place and there is plenty of new information and new proposals being put forward in rapid succession. Banks have lost a lot of equity capital and the old standards were shown to have clearly been insufficient as a buffer. Bänziger said that for this reason he considered the supervisors' call for more capital both understandable and justified. Deutsche Bank, for example, managed the events during the last quarter of 2008 relatively well thanks to a capital ratio that was substantially above the minimum requirements. The main question, however, is how much capital does our system need? Bänziger emphasized that there is a trade-off. Equity capital is an expensive refinancing tool, the costs of which are borne by the firms and private clients on the asset side of the balance sheet. He, therefore, emphasized the importance of thinking the whole matter through very carefully. To determine an appropriate level of capital is not a straightforward matter. UBS, for example, had

[1] Mindestanforderungen an das Risikomanagement

a high core capital ratio but it was still not sufficient during the crisis. For this reason, Bänziger said the focus should not be solely on the absolute levels of capital. He went on to analyze the sequence of events that had happened during 2008. After a rather slow start to the crisis, a chain reaction was set in motion that eventually spread to the whole financial sector. Recently, a lot is being said about systemic risk, but no clear definition is at hand. Here, Bänziger made the comparison with a viral infection. It is essential to understand the transmission mechanisms that cause the contamination.

Bänziger then identified possible causes of the chain reaction and analyzed five potential areas for improvement. First, inter-bank markets need tighter regulation. From the crisis it became clear that due to the lack of credit rules and limits, many institutions overstretched their commitments. He used the example of Hypo Real Estate to show the far-reaching impact of this deficiency. Second, the payment systems had been neglected and were inadequate for the transmission requirements of banks. Clear mechanisms for well-functioning payment and settlement channels are thus vital. Third, we need to unravel and simplify some of the complexities within the derivatives markets. Solutions, such as moving the clearing of OTC derivatives to central clearing counterparties, are already being pushed through. Fourth, deposit-guarantee schemes in Europe are archaic and flawed as a result of national sovereignty claims and political resistance. Bänziger made a comparison with the U.S. and claimed that there is much room for a Europe-wide improvement. Fifth, the insolvency laws need to be improved in order to be able to handle bank bankruptcies in a timely and effective manner. Bank defaults at the moment have a very negative impact on the real economy. There are many conceivable solutions for making solvency law for banks more effective.

In his closing remarks, Bänziger emphasized the importance of a strong financial infrastructure that is able to prevent shockwaves. He pointed out that company failures are an intrinsic part of our market system. This is exactly why our society has insolvency laws. However, for banks, there is a policy conflict at the highest level. This makes a transparent system with clear rules all the more important.

After the lecture, there was a lively discussion on many issues such as European regulation, the concept of a "bank hospital", accounting standards and guarantee schemes. Bänziger said the answer lies in preventive action and proper regulation, and a crisis fund for banks must be a last resort or emergency solution. In particular, the complex interconnectedness of market players should be brought under control. All markets need proper regulation in order to warrant the mutual trust of its participants. When asked about the issue of a systemic risk charge, Bänziger replied that he considered such intervention and the role played by the Financial Stability Board to be justified. He added, however, that the instruments of financial surveillance should be fine-tuned. *Lut De Moor (CFS)*

Do we need more regulation?

10 December 2009

Eddy Wymeersch

The last event in this year's colloquium series took place on 10 December with a lecture by Eddy Wymeersch, Chairman of the Committee on European Securities Regulators (CESR).

His introductory remark was that the question in the title of his speech "Do we need more regulation?" has become obsolete over the last year because more regulation is now effectively in place or is being prepared. As a consequence of the crisis, parts of the markets are being reregulated. He listed the topics on the agenda for markets and securities regulation. Looking at the different areas in more detail, he made the distinction between regulation as "rule making" and regulatory supervision.

The first issue on the agenda is the regulation of credit rating agencies. According to Wymeersch, they have not performed well before and during the crisis. The fees that were received by credit agencies had risen dramatically in the period 2005-2008, mainly due to their activities in the market of structured products. One of the big weaknesses of the system was that the agencies were not only rating the products but also advising the issuers, leading to a clear conflict of interest. In addition, their evaluation method for structured products was flawed as they only used statistical methods to look at the behavior of products and never took a profound look at the substance of the products. In the future, the new regulation for credit rating agencies will introduce obligations for registration, rules on conflicts of interest and on procedures and more transparency through disclosure. Wymeersch said that there should be no room for "second guessing" on ratings and that international coordination is of great importance. The supervision and rulemaking will be directly exercised by the new European Securities and Markets Authority (ESMA).

The second issue on the agenda is the regulation of hedge funds. The proposed directive that is currently under discussion is very controversial. To Wymeersch, the initial proposal by the commission was not very balanced. Important is to define first why hedge funds need to be regulated. In his view, it is not obvious that hedge funds have contributed to the crisis. The issues at stake are the systemic risk they can pose, and the possibility of market abuse due to insider trading. In addition there is a need for investor protection if hedge funds are distributing their products to the public at large. One of the points that is also addressed in the proposal is remuneration. The debate is still ongoing and an outcome might be expected in the next half year.

The third issue is the regulation of secondary markets. Today, a large part of equity trading – by some estimated to be around 40% - has moved away from the traditional stock exchanges. CESR is currently investigating the different types of trading and their volumes in order to get a clear picture of the size of this new trend. According to Wymeersch, the problems caused by this evolution are twofold: the lack of reliable and transparent prices is detrimental for investor confidence and makes the evaluation basis of investment funds (based on stock exchange prices) unreliable. In order to adjust to the new situation Wymeersch sees a need for more post-trade transparency and possibly pre-trade transparency.

The fourth issue concerns the regulation of Packaged Retail Investment Products (PRIPs), which are financially equivalent to regulated products but with a lower level of investor protection requirements. A proposal for regulation by CESR is being discussed. It would introduce an equivalent regime regarding disclosure in the form of a short prospectus (KID) and regarding rules of conduct for these products.

The next issue concerns the systemic risk posed by considerable accumulation of exposure in the derivatives markets. Under pressure from the central banks, transactions are now centralized and cleared through Central Counterparties. For this purpose, contracts need to be standardized which is not self-evident, especially not in the market of Credit Default Swaps (CDS).

Eddy Wymeersch

As final point on the agenda, Wymeersch spoke about short selling rules. The proposals that have been discussed so far were rather chaotic. CESR has now put a proposal on the table for rules of disclosure and possibly on the time till settlement.

Wymeersch then continued with an overview of the new supervisory architecture. He said that the limits of what can be reached with the current system – which is based on self-regulation, cooperation and voluntary regulation - have been reached. The new system will be much stronger in its demands for coordination. At the ECOFIN meeting on 2 December, a regulation for the banking, insurance and securities sectors was set up. The European Parliament will now propose amendments and the legislative process is expected to be finalized in the first half of 2010. The new authorities, which are built on the existing structures, will then hopefully become operational in 2011, which is a very fast procedure.

The de Larosière report stated that supervision cannot be centralized too much if progress is to be made at the European level. Day-to-day supervision of banks, investment funds, etc. should remain at the local level. What needs to be centralized is rulemaking, so that rules are the same and are applied in the same manner throughout Europe, said Wymeersch. The three agencies (ESAs) will operate very independently from the Commission and will have a number of "hard powers" in rule making, in the consistent application of the rules, in emergency matters and in mediating and settling disagreements. Some areas of power are still controversial, such as the power to act directly against individual firms and the power to declare an emergency.

He concluded that the current transition to a new architecture is crucial as it means that more regulation is put at the level of central decision making. It is now up to the authorities to implement the new mandate they got from the European Institutions.

Lut De Moor (CFS)

CFS Presidential Lecture

European Proposals for Better Regulation and Supervision in a Global Financial System

17 November 2009

Jacques de Larosière

CFS President Otmar Issing welcomed another prominent guest in Frankfurt for the CFS Presidential Lecture Series on European Integration. Jacques de Larosière, former Managing Director of the International Monetary Fund and former President of the European Bank for Reconstruction and Development and of course widely known for his recent work as Chairman of the High Level Group on Financial Supervision in the EU – also referred to as the de Larosière Group – spoke before a full audience about the European proposals for better financial regulation and supervision.

He started his lecture by reflecting on the causes of the financial crisis that erupted in 2007 in a manner that has so far been beyond comparison to any other upheaval in the recent past. In his opinion, an expansionary monetary policy, together with massive liquidity and an erosion of risk awareness were the factors that contributed in a cohesive and synchronized manner to the crisis. In addition to this, financial innovation was used as an excuse to turn a blind eye to common sense. After its break-out in the U.S., the crisis spread almost instantaneously to all countries and exacted a high price in terms of employment and growth. In the first part of his lecture, de Larosière spoke about the global economic imbalances that led to the crisis and how these issues should be addressed. In the second part, he talked about Europe's role in a global solution.

Jacques de Larosière, Otmar Issing

Addressing global imbalances

Before the 2007 crisis, comments such as "global imbalances are unsustainable but fortunately we have a resilient financial system" were not unusual. For years, we faced global macroeconomic imbalances that also led in 2004 to a phenomenon in the U.S. of persistently declining long-term interest rates at a time of rising short-term interest rates. The explanation for what was referred to as "Greenspan's conundrum" lay in the excess capital inflows from large parts of the world that were driving down yields. For a decade, ever higher U.S. consumption financed by an ever increasing indebtedness kept the situation together. At the same time, the general awareness that the existing global imbalances could not last forever was rising.

The response today to these macroeconomic imbalances needs to be adequate and well-coordinated, said de Larosière. The G-20 Group has in fact launched a new framework for sustainable and balanced growth and their last meeting in Pittsburgh paved the way for action. De Larosière, however, expressed his doubts by saying "if the past is a guide for the future, we have reason to be sceptical". He stressed that the "pitfall of wishful thinking" should be avoided and warned against a relapse into purely intellectual reflections.

He continued his lecture with his views on the new supervisory framework for Europe and the recommendations that were made by the High Level Group on Financial Supervision. The first part of the new framework concerns the monitoring and assessing of macro-economic trends (macro-prudential supervision) by the ESRB. This body will have no mandatory powers but can issue warnings and give recommendations to governments and regulators. In his opinion, central banks are well equipped for this challenge because of their independency and their close relation with regulators. The second part of the framework is the regulatory reform aimed at strengthening financial institutions. De Larosière identified some major flaws in the pre-crisis system. He said that the weakness of the financial institutions did not lie in an undercapitalization, but rather in the fact that in the face of market disruptions many institutions were less liquid than they thought. The problem was compounded by rising securitization. In addition, the existing Basel rules relied too much on rating agencies and internal risk models. These weaknesses must be met by a number of counter initiatives, such as increased capital requirements (albeit to a lesser extent for commercial lending), anticyclical provisioning, tighter liquidity control, stress tests, and transparent accounting rules. De Larosière expressed his hope that a harmonized set of rules will be established and applied in all countries.

Role of Europe

He stressed that these European proposals are essential, not only because they strengthen the regulation and supervision in Europe but also because they consolidate Europe's influence in international negotiations. If Europe comes forward with a well-designed proposal that has the right balance between prudential rules and intermediation, it will potentially have more influence on the debate.

Helmut Schlesinger

The report presented by the de Larosière Group earlier this year entailed 31 recommendations. De Larosière highlighted some of the report's essential elements in his speech. Firstly, the highly fragmented national regulations should be harmonized because the current regulatory patchwork hinders cross border activities. Secondly, the proposed European System of Financial Supervisors (ESFS) should not aim at replacing the national supervisors with a kind of supranational body. As bank bail-outs and rescues remain a national task, it is self-evident that the day-to-day supervision should remain at that level. The ESFS should exercise a mediating and coordinating role through three authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities Authority (ESA). Thirdly, macroeconomic surveillance should be part of the new architecture.

The U.S. currently has a very fragmented supervisory system. De Larosière expressed surprise that, given the immensity of the crisis, no real proposal for a harmonization of the U.S. system exists. Europe should set its stamp on suggestions for a global solution and try to exercise influence in the following areas: 1) in the field of systemic risk oversight, Europe's proposal of macro-prudential supervision can serve as a model solution; 2) putting in heavy layers of capital requirements should be avoided. Given that Europe has a higher degree of financing through bank intermediation, any additional requirement would have a relatively heavier impact on growth in Europe; 3) in the accounting debate Europe should place emphasis on the observance of the quality of the standards; and 4) Europe should stress the importance of a uniformed enforcement of the rules, which is as important as the definition of the rule itself.

The speech is available on the CFS homepage www.ifk-cfs.de

How could such rules be imposed and what possible procedures of appeal exist? According to de Larosière, the IMF could play a more operational role in this respect, given its capacity to send missions to countries to observe.

De Larosière concluded his speech by accentuating the importance of a global reform. In this reform, Europe should face up to its responsibilities and since the European system has proven to be resilient, demonstrate confidence in exerting authority to influence the discussion.

Lut De Moor (CFS)

CFS Presidential Lectures –
Upcoming Event:
23 Juni 2010
Prof. Dr. Roman Herzog
Bundespräsident a.D.

CFS Lectures

Economic Recovery and the Future of Banking

8 October 2009

Vikram Pandit

Lecture jointly organized by GSEFM and CFS

Vikram Pandit, Chief Executive Officer of Citigroup, was the keynote speaker at a lecture jointly organized by the Graduate School of Economics, Finance, and Management (GSEFM[1]) and CFS. His presentation entitled "Economic Recovery and the Future of Banking" was addressed to the students of the Graduate School of Economics, Finance, and Management and attracted much attention from a wider public.

After introductory remarks by Vice President Rainer Klump (Goethe University), the Dean of GSEFM, Michael Binder (Goethe University and CFS), opened with a reminder that in light of the painful economic and financial imbalances of the recent past, it is imperative that initiatives be undertaken to further develop proper governance structures for global economic and financial markets. He noted, however, that for economic growth it is essential that financial development and international financial integration continue to flourish within the proper institutional structures. In this context, he welcomed Vikram Pandit as an ambassador of globally oriented innovations for financial market development.

Vikram Pandit began his speech on a positive note, pointing out that a degree of normality is now returning to the markets. The world economy seems to be heading towards recovery, and the financial markets show positive signs and pockets of strength. He cautioned, however, that focusing on a positive future also requires a proper understanding of the past and the reasons why the crisis occurred.

The great imbalances in the world, and especially in the U.S., were key factors in the crisis. To name just a few, the world is facing imbalances in the housing market, in terms of trade deficits and budget deficits, and in the form of unemployment. We are now in the middle of the largest rebalancing act within the last 100 years, and we can expect this rebalancing cycle to go on for a long time. One of the biggest tasks is the rebalancing of growth. For a long period in the past, there were two major drivers of growth: U.S. consumption and credit creation. It is, however, very unlikely that either of these will be able to take on this role in the future. New sources of growth are to be found, such as the consumption in emerging market economies. This will lead

[1] This lecture was also GSEFM's inaugural 'Global Economic and Financial Policy Series' lecture

to a new economic reality, reflected in a stronger reliance on emerging market growth, lower growth rates in the western developed countries, readjustments in the exchange rates and also in the economic power of individual countries.

Vikram Pandit

As a second issue, Pandit addressed the reshaping of the financial architecture. "We have been riding on a high-speed train...but on rails laid more than sixty years ago", he said, referring to the lack of a genuine global architecture. In the past, we saw the creation of a shadow banking system

Vikram Pandit, Rainer Klump, Michael Binder

with little or no regulation and no deposit base for its lending activities. This sector could thrive on the arbitrage of regulation, and was responsible for half the credit creation in the U.S. Its collapse, however, has spurred two changes: a regulatory change and a change in the funding markets. Pandit emphasized that regulatory changes are an advantage as they create a "level playing field". He specified several steps towards a new form of regulation, such as regulating transparency and introducing a more clear-cut system with systemic regulators who aggregate information and raise transparency. Changes in the funding market will lead to a greater reliance on deposits for credit growth and this in turn will lead to a restructuring of the financial industry and financial institutions.

Finally, Pandit spoke about a new level of global cooperation. He attached great importance to the need for open trade

and capital, with a sound underlying regulatory base. "This is not the time to put up barriers", he said. As the current imbalances will continue for a while, it is more than necessary to be able to rely on each other.

After the lecture, Pandit answered student questions. When asked about the role of the government and regulation, he spoke about the experience of Citigroup with the capital support from the government. Pandit explained that the bank has a constructive relationship with its regulators and that the U.S. government does not intend to operate the bank or participate in its strategy. The objective is to lend a "helping hand to the invisible hand", said Pandit.

The lecture was followed by the scholarship awards of the "Citi Foundation Frankfurt Scholars in Economics and Finance" bestowed upon a selected group of graduate students with a migrant and economically disadvantaged background, as well as the requisite strong quantitative and analytical skills.

The Graduate School of Economics, Finance, and Management (GSEFM) – based in the House of Finance – constitutes an alliance between Goethe University Frankfurt, Johannes Gutenberg University Mainz, and Technical University Darmstadt. Operating in continental Europe's primary center for financial markets and central banking, GSEFM aims to realize the three universities' joint vision to establish a premier European center for quantitative and research-oriented graduate-level education in economics, finance, and management. www.gsefm.eu

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GRADUATE SCHOOL OF ECONOMICS, FINANCE, AND MANAGEMENT

A Solution for Europe's Banking Problem

15 July 2009

Nicolas Véron

During the summer, CFS organized a lunchtime seminar with Nicolas Véron (Research Fellow at Bruegel), who spoke about solutions for continental Europe's banking system. Véron's lecture was based on a joint article with Adam Posen, entitled "A Solution for Europe's Banking Problem", which appeared in the Bruegel Policy Brief Series.

In this article, Véron states that Europe is very reliant on bank credit and bank intermediation of savings. The state of continental Europe's banking industry remains very fragile. Many European banks cannot be considered any more robust now than they were in late 2008. Moreover, healing the banking system has become vital to securing a sustained recovery of the economy.

Nicolas Véron

In order to counter a potentially rising number of insolvent banks, Véron sees a need for a joint European approach to the problem. According to Véron, systemic bank crises are not self-solving but policymakers are reluctant to take tough measures. In order to differentiate among banks, he proposes implementing a centralized "triage" process that would assess the solidity and long-term viability of key banks on a comparative basis. He refers to other major banking crises in developed economies in which a form of triage had eventually been used to overcome the banks' problems.

Because banking supervision is primarily national, Véron acknowledges that there would be opposition to a centralized Europe-wide system of stress testing. He gives two reasons why tackling the problem cross-nationally is the best way to proceed. First, only by introducing a conform and harmonized assessment can trust be restored. National authorities would otherwise tend to be too lenient towards "their" banks, and a supervisory race to the bottom could ensue. Second, the risk landscape has changed profoundly due to financial and banking integration. Therefore, the increased risk of cross-border bank insolvencies requires a supranational approach.

▶ The Policy Brief can be found on www.bruegel.org

Véron proposes the creation of a temporary supranational agency, a European banking "Treuhand" with three well-defined tasks: 1) steering the triage process through an evaluation of the capital adequacy of major banks and publishing its outcome, 2) catalyzing the recapitalization and brokering negotiations among member states to share the burden of recapitalization, 3) managing assets that fall into public ownership as a result of restructurings. This approach is of a short-term nature but it would buy time for a broader reform of the supervisory architecture and would keep cross-border banking sustainable in the EU.

Lut De Moor (CFS)

Joint Lunchtime Seminars

The Joint Lunchtime Seminars are weekly research lectures jointly organized by the CFS, the Deutsche Bundesbank and the ECB. The speakers, particularly economic experts in the area of monetary policy, present their current research findings to a selected circle of central bankers and macroeconomists. In the second half year of 2009, the organizing institutions have hosted the following economic professionals:

1 Jul 2009 **Tax Smoothing in Frictional Labor Markets**
Sanjay Chugh (University of Maryland)

8 Jul 2009 **A Market for Interbank Lemons**
Tommaso Mancini Griffoli (Swiss National Bank)

15 Jul 2009 **The Quality of Political Institutions and the Curse of Natural Resources**
Ester Hauck (Institut d'Anàlisi Econòmica)

22 Jul 2009 **Potential and Natural Output**
Giorgio Primiceri (Northwestern University)

12 Aug 2009 **Explaining Cross-Country Labor Market Cyclicality: U.S. vs. Germany**
Moritz Kuhn (University of Mannheim)

19 Aug 2009 **Contagion and Regulatory Forbearance**
Lucy White (Harvard Business School)

26 Aug 2009 **Securitization Without Risk Transfer**
Philipp Schnabl (New York University)

2 Sep 2009 **News – Good or Bad – and Its Impact on Volatility Predictions Over Multiple Horizons**
Eric Ghysels (University of North Carolina)

9 Sep 2009 **Inattentive Professional Forecasters**
Philippe Andrade (Banque de France)

16 Sep 2009 **Persistent Liquidity Effect and Long run Money Demand**
Francesco Lippi (Università degli Studi di Sassari)

23 Sep 2009 **Asset Price Fluctuations, Financial Crises and the Stabilizing Effects of a General Transaction Tax**
Stephan Schulmeister (Austrian Institute of Economic Research)

30 Sep 2009 **Sector-Specific Technical Change**
John Fernald (Federal Reserve Bank of San Francisco)

7 Oct 2009 **Information, Heterogeneity and Market Incompleteness**
Liam Graham (University College London)

14 Oct 2009 **Equilibrium in a Production Model with Limited Commitment**
Tom Krebs (Universität Mannheim)

21 Oct 2009 **Wage Rigidity and Job Creation**
Christian Haefke (Institute for Advanced Studies)

28 Oct 2009 **Capital Misallocation and Aggregate Factor Productivity**
Costas Azariadis (Washington Universityn in St. Louis)

4 Nov 2009 **Household Decisions, Credit Markets and the Macroeconomy: Implications for the Design of Central Bank Models**
John Muellbauer (Nuffield College, Oxford University)

11 Nov 2009 **Corporate Bond Liquidity Before and After the Onset of the Subprime Crisis**
David Lando (Copenhagen Business School)

18 Nov 2009 **Evidence of Regulatory Arbitrage in Cross-Border Mergers of Banks in the EU**
Santiago Carbó Valverde (Universidad de Granada)

25 Nov 2009 **Global Liquidity Trap**
Ippei Fujiwara (Bank of Japan)

2 Dec 2009 **Modelling International Linkages for Large Open Economics: US and Euro Area**
Mardi Dungey (University of Tasmania)

9 Dec 2009 **Quantifying the Distortionary Fiscal Cost of, The Bailout**
Alex Michaelides (LSE)

16 Dec 2009 **Financial Globalization, Financial Crises and Contagion**
Enrique Mendoza (University of Maryland)

► **For further information and registration please contact Celia Wieland, email: JLS@ifk-cfs.de**

CFS Conferences

The ECB and Its Watchers XI

4 September 2009

Frankfurt am Main

When ECB officials and watchers met at the conference in September 2007, President Trichet reported that liquidity-starved banks had been rushing into the "ECB's emergency room" to receive immediate aid. One year later the ECB had surfaced as one of the most effective central banks in treating its liquidity-hurt patients during thirteen months of financial instability. Many ECB watchers, however, attributed its success as much to the luck of inheritance of a much broader set of instruments for liquidity-provision as to the competence of the "ECB physicians".

At the ten-year anniversary in 2008, ECB watchers discussed whether the euro area possessed an appropriate framework for dealing with the threat of an immediate failure of a large, global and financial player. A number of commentators were highly skeptical. Names such as Fortis came up. Soon thereafter, these names made headlines. Yet necessary rescues were handled surprisingly quickly, apparently helped along by ECB diplomacy.

The second year of the financial crisis brought on the worst recession since World War II. The ECB was forced to make use of conventional and unconventional tools. This time, it did not enjoy the luck of inheritance, but faced particular challenges in drafting appropriate quantitative and credit easing instruments.

At this year's conference participants discussed the ECB's performance under the threats of a deflationary spiral or rebounding inflation and reviewed its exit strategy from unconventional policies. They also debated whether the ECB has appropriate instruments for ensuring monetary and financial stability, and explored if euro area governments should help bail out each other to ensure fiscal sustainability.






Since the economy showed signs of stabilizing, commentators have increasingly asked about "the ECB's exit strategy". President **Jean-Claude Trichet**'s (ECB) address on this particular topic was therefore much anticipated. First, Trichet repeated that exceptional times demanded exceptional actions. In the face of the financial crisis, the ECB introduced a set of non-standard measures, which they called "enhanced credit support". These measures were meant to help avoid drastic losses of liquidity in the financial system and maintain the flow of credit to firms and households beyond the effect of standard policy rate cuts. Yet given the fact that these measures are exceptional, Trichet stressed that they need to be undone once conditions are restored back to normal. In this context, he emphasized that the term 'exit strategy' should be understood as the framework and set of principles guiding the ECB's approach to unwinding the various non-standard measures. It does not include considerations about interest policy. Moreover, he said that "it would be premature to declare the crisis over. Now is not the time to exit. But I would like to make it clear that the ECB has an exit strategy, and we stand ready to put it into action when the appropriate time comes."

Jean-Claude Trichet

The strategy for scaling back non-standard monetary policy measures relies on the ECB's reputation for quick and crucial action when it is required, its technical and institutional ability to act, the forward-looking initial design of these measures, and the link to the ECB's monetary policy strategy. Ultimately, it is bound by the main objective of securing price stability in the euro area over the medium and longer term. According to Trichet, "the exit strategy, in the end, will need to be invoked at the precise time in which the traditional link between broad money and our provision of liquidity to the banking system will re-establish itself."

Monetary policy in the financial crisis: How to deal with the threats of a deflationary spiral or rebounding inflation?

Jürgen Stark (ECB) started by jesting that President Trichet had left him with the "easy" topic concerning the exit strategy, namely that of "timing". Indeed his presentation elaborated on Trichet's remarks by considering how the ECB's monetary policy framework would complement the appropriate timing of the exit. With respect to the current outlook, Stark signaled that there are no deflationary risks. Both pillars in the ECB's analytical framework indicate low inflationary pressures. "This is why the Governing Council assesses that current rates are appropriate and why the policy rates were left unchanged on September 3." However, this also implies that the time to withdraw the exceptional measures has not yet arrived.

Jürgen Stark

When it comes to the how and when of phasing out non-standard measures, Stark considered two possibilities. Firstly, the problems in the money markets could disappear before price stability weakens, which would entail that the enhanced credit support would need to be removed before interest rates are raised and the removal of the enhanced credit support would not have much effect. Alternatively, if the risks to price stability become apparent while the problems in the money markets continue, the ECB will have to uphold components of the non-standard measures, while interest rates would be increased to counteract upside swings in prices. Stark acknowledged that the time for exit had not yet come, but concluded "I assure you that we will continue to monitor very closely all developments in the period ahead, in order to continue to deliver on our task of maintaining price stability over the medium term."

Vincent Reinhart (American Enterprise Institute) started by weighing the threats of a deflationary spiral versus rebounding inflation. In such a "balancing act", central bankers have to weigh the costs to the economy of making a mistake in either direction. In other words, they have to take into account the economic outlook as well as structural features of the economy concerning the determination of inflation, the extent of nominal rigidities and the anchoring of expectations regarding inflation and permanent income. Costs are also related to the "therapy" required by either mistake, in particular whether the monetary tools are effective and how long it would take to achieve a correction. The consequence of a mistake may be that the public would start to doubt the central bank's competence, investors would become skeptical and politicians would raise questions about the central bank's independence.

In conclusion, Reinhart questioned prevailing assessments regarding the appropriate balancing of deflationary and inflationary risks. Although market economies are resilient and a rebound is visible in the U.S. economy, key financial institutions remain burdened by unrecognized losses on legacy assets. Concerning the Fed, he noted that premature investor concerns about its exit strategy might force an early exit, while the ECB would still need to convince the public that it views its inflation goal symmetrically.

As the third speaker in this debate, **Erik Nielsen** (Goldman Sachs) complimented the ECB on its recent performance, but strongly disagreed with Jürgen Stark who had stressed the absence of a risk of deflation. He noted that "if the ECB's inflation target is symmetric, its actions and words could suggest otherwise." There appears to

Erik Nielsen

be less concern when inflation undershoots as suggested by Jean-Claude Trichet's comment in August 2009 that "inflation rates are projected to remain temporarily in negative territory... however such short-term movements are not relevant... looking further ahead, inflation is expected to remain in positive territory." At the same time, the number of forecasters expecting consumer prices to stay flat or fall has risen in 2009, meaning the deflation risk is worrisome.

Regarding the exit strategy, he noted that in a basic scenario, exit from credit support might come spontaneously as well as gradually over the next two to three years. One reason being that the Taylor rule suggests no need to exit anytime soon. Moreover, the output gap, assuming 1.5% trend growth since 2007, would point to a precipitous fall in core inflation. If a masterminded exit would be needed, he suggested, gradual restrictions on allotment would be the way back to competitive auctions.

Macro-prudential supervision: Does the ECB have the appropriate instruments? Is there a trade-off between monetary and financial stability?

Starting the debate Vice-President **Lucas Papademos** (ECB) emphasized that the crisis had shown the importance of protecting financial stability and the significance of a macro-prudential approach to regulation and supervision. The European Commission proposal of a set of bold reforms including the design of a new "European Systemic Risk Board" (ESRB) is supported by the ECB. The formation of such a new framework in the EU, has called attention to a number of essential issues with respect to its objectives, powers and tools. According to Papademos, there exist "important questions on how the conduct of macro-prudential supervision relates to, and complements, the performance of other central banking tasks that can also contribute to financial stability."

Lucas Papademos

As to safeguarding financial stability, he stressed that the "ECB's monetary policy strategy is very well suited for the potential use of the interest rate instrument in order to 'lean against the wind' of financial market excesses, in a manner consistent with the preservation of price stability over the medium and long term." Establishing the ESRB and attributing macro-prudential tasks to the ECB, will reinforce the ECB's power and means to contribute to financial stability, but without endangering its monetary policy tasks. Furthermore, such a macro-prudential supervisory body must be independent in carrying out its mission. Papademos closed by emphasizing that "the ECB is actively preparing, in collaboration with the national and central banks, in order to provide the appropriate analytical statistical and administrative support to the ESRB."

Markus Brunnermeier

Markus Brunnermeier (Princeton University) highlighted some problems with current regulation. The risk of each bank is treated in isolation. Capital requirements are pro-cyclical and the regulation focuses on the asset side of the balance sheet. Instead, the focus should be on the externalities that contribute to systemic risk. Brunnermeier proposed particular measures of this contribution and drew an analogy to the fire-code that requires fire-protection walls for "neighbors". When banks are forced into fire-sales they also depress prices for other banks. Other externalities arise when banks hoard funds or hide their own commitments, thereby creating uncertainty for counterparties.

According to Brunnermeier regulation should be countercyclical, that is "it should be strict, when the market is not strict, but less strict when the market is strict." Macro-prudential regulation would imply leaning against "credit bubbles" and imposing capital requirements and other tax or insurance schemes. Brunnermeier emphasized that such macro-prudential instruments must be independent of political pressure. He pointed to potential tradeoffs between financial and monetary stability during the build-up of credit bubbles and suggested that this tradeoff provides a new rationale for monetary aggregates in the policy strategy.

Michael Dooley (University of California, Santa Cruz) disagreed with much of what had been said by the preceding speakers. In his assessment, the ideas behind macro-prudential supervision lead down the wrong path in reacting to the crisis. Dooley questioned previously-alleged impulses from the crisis. For example, he noted that easy monetary policy cannot depress the real interest rate for years and "does not have an imaginary twin called liquidity." Instead,

Michael Dooley

he emphasized that leverage is profitable at any level of interest rates. International imbalances had been mentioned as the source of a flood of liquidity. Dooley acknowledged that they could account for low real interest rates and expectations of future low rates, resulting in equilibrium "high" asset values. However, the crisis would require a stop in capital flows, a spike in real interest rates and a collapse of the dollar. None of that had been observed. If easy monetary policy and international imbalances were not causes of the crisis, they should not determine the reaction to the crisis.

Dooley argued that the source of the crisis was a breakdown of the philosophy of supervision. While regulation had been improved and new rules imposed, the political economy of supervision had not changed. According to Dooley, supervision slipped away, because of the view that the market would supervise itself. No set of regulations can deal with this crisis unless they push the system far from the efficient frontier. The proposed regulatory reforms are partial descriptions of what any sensible and motivated supervisor should do as a matter of course. The profit motive will continue to drive banks and other financial intermediaries to circumvent regulations. Dooley concluded, "The problem is that ex ante we cannot imagine how they will do it or what form of political protections and public interest they will invoke to get away with it."

Government bail-outs in the euro area: Much-needed rescue from fiscal collapse or deadly threat to long-run stability of EMU?

José Manuel González-Páramo

Addressing the fiscal consequences of the financial crisis, **José Manuel González-Páramo** (ECB) called for an effective exit strategy for fiscal policy. He reviewed fiscal measures taken to safeguard the financial system, such as the U.S. Treasury's plan to buy 700 billion US$ of illiquid mortgage-based assets, and government interventions in the EU to rescue financial institutions and stabilize the system. Even though the governments intervened, economic activity has contracted more sharply than at any time since World War II. But the financial crisis would have been even more intense and the recession deeper, if governments had not acted.

The fiscal costs of the economic and financial crisis are expected to be substantial. In the Spring 2009 forecast, the European Commission projected that government borrowing in the euro area would rise to 5.3% of GDP this year and 6.5% next year. In addition, 13 out of 16 euro countries are projected to breach the 3% of GDP deficit outlined in the Maastricht Treaty. Given the size of deficits and the uncertainty regarding the final costs of bank rescue packages, González-Páramo emphasized the priority for fiscal policy to set out a clear and credible plan for restoring order to the public finances over the medium term. In light also of the fiscal burden associated with population ageing, he warned, "if confidence in future stability is to be ensured, now is the time to set out an effective fiscal exit strategy."

Referring to the question posed to the speakers, **Paul De Grauwe** (Katholieke Universiteit Leuven) asked if government bailouts of financial institutions had been necessary or dangerous. In the period prior to the crisis, the problem was excessive and fast increasing private debt, instead of public debt. Yet the euro zone had set up an elaborate mechanism watching and controlling public debt and deficits. No such mechanism existed to contain private debt, despite the fact that governments were implicitly guaranteeing significant parts of private debt, especially debt of

Paul De Grauwe

financial institutions. Thus, the bailouts were necessary to avoid banking collapse, while the deadly threat came from the explosion of private debt. Are the euro area government deficits noted by González-Páramo sustainable? According to De Grauwe these deficits are not sustainable if maintained indefinitely, and if the nominal growth rate remains low. However, they are necessary now and will be easier to deal with when nominal growth increases, and modern democracies are sufficiently mature to deal with this problem by adjusting the primary surplus.

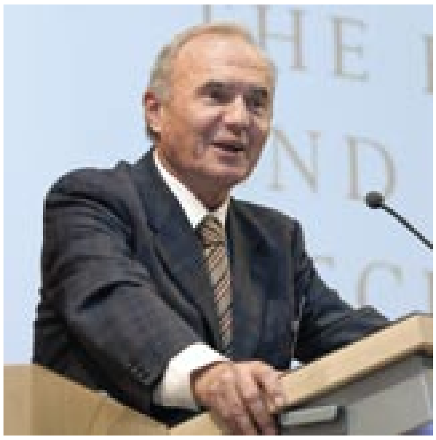
As to the ECB's role during the boom years, De Grauwe suggested its two-pillar strategy should have warned about excessive growth of bank credit and liabilities, but did not. While the ECB was successful in keeping inflation low, its two-pillar strategy failed to detect the credit boom.

Michael Burda (Humboldt University Berlin)reminded the audience that fiscal discipline is essential in a monetary union. On the national level, governments are exposed to "too big to fail" financial institutions. At the same time there is no political will in Europe to bail out governments. A program similar to the bailout of U.S. states to the tune of US$ 180 billion is not an option in the EU. In fact, "an Italian or Greek 'California' would quickly lead to scrip issue and dissolution of the monetary union," said Burda. 'Doing nothing' in vulnerable countries such as Italy, would be dangerous for they can neither devalue nor inflate.

On the positive side, internal migration and capital mobility within the euro area have increased sharply and provide a stabilizing effect. However, a negative side effect of EMU is that the low real interest rates tend to lull governments into complacency. Real interest rates could rise again, possibly sharply in the next three to five years. Exploding debt with anemic growth could lead to massive speculation against government paper from high debt EMU countries. It is very important to keep an eye on fiscal sustainability and maintain the euro's credibility. Burda recommended greater fiscal discipline and abstaining from admitting new member countries.

As the last speaker of the day, **Otmar Issing** (CFS) drew some lessons from the financial market crisis. Abundant liquidity and low interest rates created a situation in which excessive risk taking and asset price bubbles took place, fostered by sophisticated financial innovations. In the past, the "Jackson Hole" consensus was that central banks (i) should not target asset prices, (ii) should not try to prick a bubble, and (iii) should follow a "mop up strategy" after the burst of a bubble injecting enough liquidity to avoid a macroeconomic meltdown. Issing said, "the big question is whether this should be the full story. Restricting central banks to these three commandments implies a totally asymmetric approach." When asset prices go up monetary policy does not react. Yet, when a bubble bursts, central banks must come to the rescue. Implicitly or explicitly pre-announcing this commitment as "savior" induces moral hazard for the actors driving the development of asset prices. Applying this approach over a longer period of time induces a sequence of ever bigger bubbles followed by asset price collapses.

Issing emphasized the advantage of the ECB's monetary policy strategy. Its monetary analysis ensures a more symmetric reaction to bubbles and avoids the need to be specific about mispricings of assets. It works symmetrically, leaning against "headwind" (asset price declines) as well as against "tail wind" (increases).



Otmar Issing

The biggest risk for central banks in this context, according to Issing, is going outside their narrow mandate to satisfy political interest. There is a tendency to overburden central banks with additional responsibilities. While the de *Larosière Group*, of which Issing was a member, recommended to give the ECB responsibility for macro-prudential supervision and the leadership of the European Systemic Risk Council, it argued against giving it responsibility for micro-prudential supervision.

Celia Wieland (CFS & wieland EconConsult)

THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS

2009

The Deutsche Bank Prize 2009 was given to Robert J. Shiller for his contributions to financial economics. 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 was chosen by an international Jury of experts for his path breaking research related to the dynamics of asset prices, such as fixed income, equities, and real estate and their metrics. His work has been significant not only in the development of theory, but also in the implications for practice and policymaking. His contributions to risk sharing, financial market volatility, bubbles and crises, have received wide-spread recognition among academics, practitioners and policy makers around the globe.

CFS Symposium: "Financial Innovation and Economic Crisis" In honor of Robert J. Shiller

30 September 2009

Frankfurt am Main

The scientific symposium "Financial Innovation and Economic Crisis" in honor of Robert Shiller aimed to encourage discussion on the sources of economic crises, the development of instruments to manage a variety of risks and the prevention of future crises. It was organized by Michael Haliassos (CFS and Goethe University). Along with a list of prominent speakers, such as Nobel Prize laureate Robert C. Merton of Harvard Business School, some 600 participants from politics, academia, press, business and the financial sector took part in the event.






Jan Pieter Krahnen, Chairman of the prize Jury, opened the symposium by congratulating the winner, whose work "has been highly influential both with respect to academic research and to its macroeconomic implications." He also thanked the Deutsche Bank for supporting the prize and in doing so, setting a valuable example of corporate citizenship. Reviewing the nomination process, he noted that nominators from 55 countries proposed a group of more than 370 nominees, from whom the prize winner was selected by an independent Jury. The Jury itself consisted of leading international experts thereby ensuring exceptional academic standards are maintained and enhancing the credibility and reputation of the prize.

Josef Ackermann

In his welcome address, **Josef Ackermann**, Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG, praised Robert Shiller as a noteworthy prize winner. If the financial world would have spent more time on understanding the dynamics of asset markets, the psychological underpinnings of asset bubbles and the risks involved in buying a home in Florida versus Arizona in the middle of the decade, then the crisis would have at least been attenuated.

"An easy way of achieving that task would have been to read the contributions of Robert Shiller, looking at some of the indices he and his colleagues invented," said Ackermann. There would have been greater awareness of the potential

The Deutsche Bank Prize in Financial Economics is a highly endowed international award given for outstanding academic achievements in the fields of money and finance with a practice and policy relevant orientation. It was established in 2005 by the Center for Financial Studies, in cooperation with Goethe University Frankfurt. The prize is sponsored by the Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft* and carries a € 50,000 cash award. It is awarded every two years and presented by Josef Ackermann (Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG). Previous winners were Eugene F. Fama (University of Chicago) in 2005 and Michael Woodford (Columbia University) in 2007.

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

for unforeseen interactions in asset and money markets, something most existing risk models failed to capture. The costs of this failure have been immense. A number of large financial institutions failed and government interventions were needed to rescue others. "Both principled improvements based on sound academic research as well as practical improvements based on better-grounded risk management techniques are required," according to Ackermann.

Keynote Lecture: On the Science of Finance in the Practice of Finance: Challenges from the Financial Crisis and Opportunities from Financial Innovation

The keynote lecture was delivered by **Robert C. Merton**, Professor at Harvard Business School and Nobel Laureate in Economics. Merton noted that for nearly four decades financial innovation had been a central force driving the global financial system towards greater efficiency with considerable economic benefit accruing from these changes. The scientific breakthroughs in finance during this period both shaped and were shaped by the extraordinary innovations in finance practice that expanded opportunities for risk sharing, lowering transactions costs and reducing information and agency costs. Yet today, we are in a global financial crisis which many commentators attribute to the changes in the financial system brought about by financial innovation, derivatives and mathematical models. Merton's remarks mirrored these seemingly contradictory characterizations of finance.

First, he considered the structure of credit risk propagation and explained

Robert C. Merton

how large risks can build up without being recognized and then appear to explode. In the crisis, guarantees of debt in various forms played an important role. For example, so-called credit default swaps (CDS) are guarantees of debt. If a guarantee is used to render a risky debt risk-free, then the risky debt itself must be equal to the risk-free debt minus the guarantee. In default, this implies that the holder of the guarantee receives the difference between what was promised and what has been liquidated. The value of this guarantee can be very sensitive to small movements in the underlying asset's value. If the asset loses value, the value of the guarantee goes up and so does the risk involved. Thus, in a short time the risk associated with a particular portfolio may increase a lot. Macro risks can then build up in a nonlinear fashion, in particular if the asset and guarantees change hands without full consideration of the changes in value and risk. Additional destructive feedback loops arise with guarantors writing a guarantee even though their assets will not be adequate to meet obligations precisely in those states of the world in which it will be called on to pay. Examples would be a corporation writing a CDS contract on its own debt, or the Pension Benefit Corporation investing in the equities of the companies whose pensions it guarantees. Indeed, governments act as guarantors of banks liabilities, for example via deposit insurance. So "the governments are effectively writing a guarantee on a guarantee," stressed Merton. A government can be going with very little exposure on its guarantees, but should assets fall in value as they have, then the risks from those assets to the governments can rise very dramatically.

Plenary Lectures

The next speaker, **Nicholas Barberis**, Professor of Finance at the Yale School of Management, discussed the relationship between "Psychology and the Financial Crisis". He quickly summarized two alternative widely expressed views on the causes of the crisis. One of them is the "bad incentives" view, which states that banks knew that subprime loans had a significant risk of default, but their incentives led them to keep originating and packaging. According to Barberis, this explanation only works if decision makers have very short-term incentives. The other one is the "bad models" view. In this case, banks simply failed to forecast the likelihood and severity of a collapse. Barberis questioned how such smart and well-trained people could be comfortable with such deficient models.

Then he proposed a different perspective on the crisis based on the concepts used in behavioral finance. This explanation involves less than fully rational thinking by the actors in financial markets and institutions. Though to some level banks may have been aware of problems associated with their business models, a variety of psychological forces may have driven decision makers to delude themselves into thinking that everything was fine. Reasons for such delusion are found in cognitive dissonance, conformity, groupthink and excessive

Nicholas Barberis

obedience. Cognitive dissonance refers to discomfort with beliefs that question one's self-image. Thus, bankers may have manipulated their own beliefs and convinced themselves that everything was fine. Even if some bankers or traders acknowledged the possibility of problems to themselves, they may have kept quiet for the sake of conformity.

Furthermore, Barberis accentuated the role of psychological factors in amplifying the crisis. Absence of trading in some debt markets may have to do with lack of trust and ambiguity aversion. Moreover, the firm belief that house prices would keep on rising may have reflected people's tendency to see patterns where there are none, a behavior called representativeness, or their overconfidence. The same psychological factors may have led people to believe that they could forecast future house price movements more accurately than they could, in addition to underestimating the risks of taking on a large mortgage.

Luis M. Viceira, Professor at Harvard Business School, spoke on "Understanding Inflation-Indexed Bond Markets". He shared with the audience that he first learned about inflation-indexed bonds from Robert Shiller, who was studying them in 1996 to 1997 when the U.S. Treasury was thinking about launching these bonds. Essentially, inflation-indexed bonds are bonds whose principal and coupons adjust with inflation. In other words, they preserve the purchasing power of the coupon and principal, which is not the case for a standard nominal bond. In the United Kingdom inflation-indexed government bonds were already issued in the 1980s, whereas the United States followed in 1997. In both countries, these bonds are growing in share of total public debt and also as a share of GDP. If one thinks about the interest rate or yield paid on these bonds, they actually reflect market prices or market values unobserved until these bonds were invented and issued. This price is the real interest rate as assessed by the markets.

Luis Viceira

Viceira reviewed the decline of real interest rates from 4% in the 1980s and '90s to 2% in the 2000s, leveling off at around 1% in early 2008. The market turmoil in the fall of 2008 sent the yield of these bonds up to 3% while the yield on their nominal counterparts declined massively. However, inflation-indexed bonds gained in popularity among investors over the years, in spite of the short-run volatility they exhibit. The reason is that inflation-indexed bonds provide investors with a stream of coupons and principal payment at maturity that is constant in real terms. These are not "exotic" or "alternative" instruments. "They are a riskless asset for long-term investors and should be at the very core of conservative portfolios," according to Viceira. Inflation-indexed bonds can do what conventional nominal government bonds and cash instruments cannot. Cash is safe only in the short-term, if short run inflation uncertainty is small, and exposed to reinvestment risk in the longer run, because real interest rates fluctuate. The coupon and principal of long-term nominal government bonds may be eroded by unexpected inflation.

Keynote Lecture: Inventors in Finance: An Impressionistic History of the People Who Have Made Risk Management Work

Deutsche Bank Prize winner **Robert J. Shiller** began his speech in German to declare how honored he felt to receive this prize and thanked Deutsche Bank and CFS. He quoted Isaac Newton, "If I have seen further, it is by standing on the shoulders of giants." Shiller then focused on the history of innovations and the giants who have founded the financial system.

According to Shiller, the basic mission of finance is risk management and incentivization to further economic growth. In order to achieve that, it is necessary to be inventive. "What we need is innovation and economic progress, not bailouts," he stressed. Although bailouts might be necessary in the short run, they need to be done in the context of progress. Economic or financial inventions drive the economy forward. Yet inventions in finance are driven by certain intellectual processes. Shiller pointed to behavioral economics and the revolution which occurred in the last 30 years in bringing psychology into the fields of economics and finance. To Shiller, it is essential that the knowledge of human psychology is incorporated in finance if there is to be progress and financial innovation.

Robert Shiller

In response to the financial crisis, Shiller called for a commitment towards the democratization of finance making it work better for the people. Not long ago, financial innovations were used narrowly. Only wealthy or well-connected people would take advantage of them. Democratization of finance implies setting up a risk management and incentivization system that works well for the society at large. In many ways the current financial crisis is due to a failure to manage certain kinds of risks. "We have not democratized finance well enough because we did not put risk management institutions in place that could have been there in the crisis," said Shiller.

The process of invention and advancement of the financial system has to involve experimentation and many minds. Shiller surveyed historical examples of key inventions touching on the founding of the Dutch East India Company in 1602, the Bank of England in 1894, the first indexed bond in Massachusetts in 1780, and the introduction of limited liability in New York State corporate law in 1811. What emerged out of these wild ideas, were great innovations. He concluded that changes to the financial structure are needed but will require some time to be accomplished.

Expert Panel: Providing perspectives on the financial crisis and the role of financial innovation from different angles

The symposium ended with a panel discussion, moderated by Michalis Haliassos. Panelists included Otmar Issing, President of the Center for Financial Studies, Klaus Schmidt-Hebbel, Professor at Catholic University of Chile, Frank Smets, Director General for Research at the ECB, Susan Smith, Director of the Institute of Advanced Study at Durham University and Mistress of Girton College, Cambridge, and Maria Vassalou, President of the European Finance Association and Global Macro Portfolio Manager at SAC Capital Advisors, LP.

Michael Haliassos pointed to an important challenge brought out by the symposium: how to create a new financial market environment that fosters socially useful financial innovation while at the same time avoiding the excesses of the past. He cautioned that the answer is unlikely to involve a severely constrained financial industry unable to experiment with new products; or one allowed to offer only very simple products. He introduced the panel as adding to the discussion differences in vantage points: those of the government and regulators; of the monetary policy maker; of the international organization; of the academic in social sciences; and of the professional investor.

Michael Haliassos

Otmar Issing reminded the audience of the surge of criticism of economics in the aftermath of the financial crisis. He emphasized that financial science is in flux, perhaps best illustrated by the same prize being given for opposing views on the efficiency of financial markets. Turning to the financial crisis, Issing focused on an aspect that is fundamental to the reform of the system. He saw a great risk in that government interventions have created the impression that in the future no major financial institution will be allowed to fail and that savers as well as bond holders will be largely bailed out. This would be a fatal deviation from the principles of a free markets system in which risk and uncertainty are unavoidable. Issing advised stricter capital and liquidity restrictions on systemically relevant financial institutions. Also, it should

M. Vassalou, S. Smith, F. Smets, K. Schmidt-Hebbel, O. Issing

be made easier to resolve financial institutions. The required solution combines an unconditional government guarantee for the bank's new business after the resolution date with an orderly run-down of its business contracted before the resolution.

Klaus Schmidt-Hebbel drew on his experience as former Director of the OECD Economics Department, to discuss the crisis from the viewpoint of international organizations. He acknowledged that just like most other observers they underestimated the build-up of risks in the world economy and missed the problems in financial regulation and supervision. They should have given more weight to the work of Professors Shiller and Case on the housing market and reacted to their warnings. Nevertheless, they did identify some problems early on, for example, the international imbalances implied by excess savings in China and dissaving in the United States. Also, the OECD had questioned the role of the semi-governmental agencies Fannie Mae and Freddie Mac in the U.S. housing market. International institutions responded quickly to the crisis. The OECD and IMF advised governments and helped induce cross-country collaborations, analysis and policy recommendations.

Frank Smets addressed the pro-cyclicality of the financial system and the various policy responses that are being pursued to alleviate it. Many of the booms and busts in credit and asset prices in the past start from a good fundamentals story underlying them. Yet, time and again there are episodes when these good fundamentals mutate into excessive credit expansion and risk taking. There are many feedback mechanisms that lead to procyclical behavior, but fiscal and monetary policies also often contribute to it. Initiatives on

Frank Smets

the reform agenda also include measures dealing with regulation strengthening the market infrastructure and increasing transparency. Furthermore, there is a growing consensus that a new macro prudential policy framework is needed. The European Council has agreed to establish a new framework for both micro and macro prudential supervision. On the macro side this includes the establishment of a systemic risk board, which will assess the stability of the financial system in the EU, issue risk warnings and make policy recommendations.

The effect of innovations in the housing economy and interactions with the financial crisis formed the focus of **Susan Smith**'s presentation. She reviewed housing, mortgage and financial markets. Their uneven integration is certainly related to the causes of the crisis but may also carry seeds of its resolution. She looked at equity borrowing in the United Kingdom and Australia, finding that (i) equity borrowing is widespread, frequent and not trivial, (ii) housing wealth operates via equity borrowing as a store for precautionary savings, and (iii) equity borrowing is risky. Finally, she indicated barriers to innovation on the side of industry and housing demand.

In conclusion, **Maria Vassalou** compared market efficiency theory as developed by Eugene Fama, the Deutsche Bank Prize winner in 2005, and the new behavioral finance. She noted that market efficiency, that is whether prices incorporate all available information, can only be tested along with an asset pricing model. Thus, it is joint hypothesis of market efficiency and the particular model to test it. Some of the "bad press" that market efficiency had gotten is related to the particular capital asset pricing model used in testing it. Some of the "anomalies" that were studied by behavioral economists were defined relative to mis-specified asset pricing models. Instead of signaling irrationality of investors, these anomalies are better explained by asset pricing models that link important macroeconomic variables to asset prices. She was skeptical of behavioral finance stating she "has seen no convincing evidence...that markets are persistently inefficient and investors act irrationally in a way that has a material impact on prices for a prolonged period of time."

Maria Vassalou

Nevertheless, she praised Shiller for his influential research on asset pricing and on financial innovations such as the "MacroMarkets" he proposed to hedge economic risk factors.

Celia Wieland (CFS & wieland EconConsult)

The Award Ceremony






The symposium was followed by an exclusive award presentation ceremony where Josef Ackermann presented the award to Robert Shiller. The laudatio was given by Karl Case, the Coman and Barton Hepburn Professor of Economics at Wellesley College and co-founder of the widely known Case-Shiller Home Price Index for the United States


Karl Case

▶ Project Manager: Sabine Neumann, Email: db-prize@ifk-cfs.de, www.db-prize-financialeconomics.org

Executive Education

New Compact Seminars

Continuing to expand and improve your professional knowledge is vitally important. However, lack of time can be a serious hindrance to attending training courses. For this reason we have developed a new series of compact seminars that can be attended after work, right here in Frankfurt.

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All our compact seminars will focus on highly topical issues and will start at 16:00, finish by 20:00, and be followed by a get-together, thus allowing the participants and the instructor to continue their discussion in a more informal atmosphere.

All Seminars will be held in German.

▶ More information on the CFS Seminars is available on the CFS website www. ifk-cfs.de under "Executive Education".

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- Fallen und Haftungsrisiken in der Kundenberatung
- Spieltheorie: strategisch denken in der Finanzbranche
- Projektfinanzierung und Public Private Partnership
- Gründung von Finanzdienstleistungsunternehmen

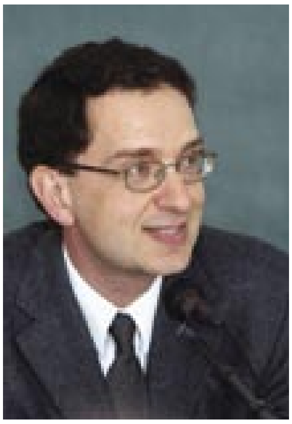
More topics are planned for 2010. If you are interested, please contact Christian Rieck (Head of CFS Executive Education) Email: rieck@ifk-cfs.de

Regular 2-day Seminars:

- Zukunftsseminar
- Kreditderivate
- Zinsprodukte I und II
- Behavioral Finance

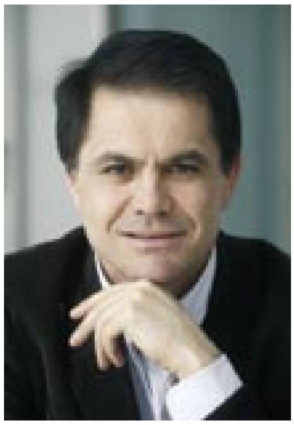
New Team of Directors at CFS

We are delighted to announce the appointment of two new CFS Directors. Michael Haliassos and Uwe Walz together with Jan Krahnen will form the new CFS management team. Both Haliassos and Walz currently hold a chair at the Goethe University and are already associated with CFS. With these appointments we aim to reinforce our research activities and to continue our mission in a successful way.



Michael Haliassos holds the Chair in Macroeconomics and Finance and is Director of the CFS Program on Household Wealth Management. Haliassos is also a CEPR Research Fellow, Research Professor at the Mannheim Research Institute on the Economics of Aging (MEA), and International Research Fellow of NETSPAR. He received a B.A. in Economics from Cambridge University and a Ph.D. in Economics from Yale University. Prior to joining the Goethe University, he was a faculty member at the University of Maryland, and at the University of Cyprus. He has held visiting appointments inter alia at the European University Institute, and at the Center of Studies in Economics and Finance (CSEF).

His research interests lie in Macroeconomics and Finance with emphasis on household finance. He has studied household portfolio choice under labor income risk, stockholding behavior, consumer debt, portfolios of aging households internationally, the distribution of wealth, the impact of credit market imperfections, and the role of financial advice. Haliassos has coordinated a number of international research projects, such as a project on "Household Portfolios", resulting in a volume published by MIT Press that currently serves as a standard reference in household finance, and one on "Stockholding: A European comparison" with results published by Palgrave Macmillan Publishers. His papers have appeared in international journals, including the International Economic Review, the Economic Journal, the Journal of Money, Credit and Banking, the Journal of Economic Dynamics and Control, the Review of Finance, and Economic Policy; and in edited volumes, including the Handbook of Monetary Economics and the New Palgrave Dictionary of Economics and Finance. Haliassos has recently served as advisor to the European Central Bank on the construction of a major Eurozone Survey of Household Finances and Consumption.



Uwe Walz holds the Chair of Industrial Organization at the Goethe University and is Program Director of the CFS Program on Entrepreneurial Finance. He is also a research pro-fessor at the Centre for European Research (ZEW) and an Associate Dean of the Goethe Business School. He obtained his doctoral degree from the University of Tübingen and finished his habilitation at the University of Mannheim. Before joining the Goethe University, he was a visiting research fellow at the London School of Economics and the University of California at Berkeley and was associate professor at the University of Bochum and the University of Tübingen.

His research focuses on venture capital, private equity, entrepreneurial finance, and contract theory as well as on the economics of network industries. Current research projects are on the impact of monetary incentive schemes, risk taking and leveraged finance in the private equity industry as well as on the interrelationship between competition and vertical integration in the financial exchange industry.

Uwe Walz has published in various leading international journals such as the European Economic Review, Economica, Journal of Urban Economics, Journal of International Economics, Journal of International Business Studies, Journal of Public Economics, Journal of Corporate Finance, Journal of Financial Intermediation, Journal of Business Venturing, Regional Science and Urban Economics, and the Review of Finance.

Recently Walz has been actively involved in network research on "Risk Capital and the Financing (2003-2008) of European Innovative Firms" in the European Union RTN research network RICAFE I and II.

Program Director **Michael Binder** has successfully established a new alliance between Goethe University Frankfurt, Johannes Gutenberg University Mainz, and Technical University Darmstadt. Together with Isabel Schnabel from the University Mainz, he launched the new Graduate School of Economics, Finance, and Management (GSEFM) which offers quantitative and research-oriented graduate-level education in economics, finance, and management. More can be found on page 18-19.

The **Macro Model Data Base** project headed by Program Director **Volker Wieland** has a new website: www.macromodelbase.com. This website contains a model archive that includes many well-known empirically estimated macroeconomic models based on a common computational platform. It enables individual researchers to conduct model comparisons easily, frequently, at low cost and on a large scale.

The **Eurozone Survey** on Household Finances and Consumption has now been launched. The Household Finances and Consumption Network (HFCN) will collect internationally comparable data on household wealth, assets, and debts in all Eurozone countries. CFS Director and Program Director **Michael Haliassos**, together with **Luigi Guiso** (EUI) and **Arthur Kennickell** (Federal Reserve Board) served as advisors to the network.

In September 2009 Program Director **Erik Theissen** moved from the University of Bonn to the University of Mannheim. He accepted a position as Professor of Finance at the Department of Business Administration.

CFS Director **Jan Krahnen** is Program Chair of the 37th Annual Meeting of the **European Finance Association**. The event is being organized by the Finance Department of Goethe University and the House of Finance.

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