

SUERF Conference on

Financial Markets, Innovation and Growth

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jointly organized with, and hosted by, the Bank of Finland
20th – 21st September 2007

Call for Papers

The Bank of Finland and SUERF are inviting submission of papers to their joint conference on “Financial Markets, Innovation and Growth”. The contribution of integrated financial markets to economic growth is high on the agenda of the European policy makers. However, research hitherto has focused less on the factors that may make finance matter for growth in the more mature economies, such as the European OECD countries. The objective of this conference is therefore to present new high-quality research on how improvements and integration in the financial markets contribute to innovations in all sectors of the economy and thereby to economic growth opportunities, with an eye to a better understanding of the nexus between finance and growth especially in advanced countries and the challenges for growth in Europe. The objective is also to provide a forum for debate on these topics among market participants, policy makers and researchers. Relevant empirical and policy-oriented studies, including clinical case studies, as well as theoretical research will be considered.

Keynote Speech:

What are the financial factors of growth in mature economies? (Speaker to be announced)

Topics:

Submission of papers in the following fields, but not restricted to them, is especially encouraged:

1. Finance and growth in developed countries

- How does finance contribute to growth in developed financial systems? What makes one developed financial system better than another for growth?
- Innovation finance as a form of financial development
- The effect of market and non-market equity finance on growth
- Political economy aspects of financing innovation and growth

2. How do financial markets finance innovation?

- The roles of various institutions (venture capitalists, private equity firms, banks, markets) in financing various stages of innovation (seeds, start-ups, ventures, exit options)
- Cross-border financing: constraints, opportunities and prospects of financial integration in financing innovation

3. Market failures? The role of private and public institutions in financing innovations.

- Are there market failures in financing innovation?
- Is public sector risk capital a complement or a substitute for private risk capital?
- The roles of the financial markets and the public sector in financing innovation (forms and stages of finance) and affecting entrepreneurial risk-taking incentives in the economy (risk-sharing, insurance, safety nets, bankruptcy laws)

4. The European Financial Market

- Does the lack of a 'European' financial market comparable to that in the United States inhibit growth?
- To what extent does finance for innovation rely on localised markets and knowledge? How important is relationship finance?

SUBMISSION of (at least 2 pages) abstract or full paper:

All proposals will be reviewed by the scientific committee comprising:
Esa Jokivuolle (Chairman), Marc-Olivier Strauss-Kahn, Wim W. Boonstra.

Proposals should be sent to
Esa Jokivuolle, Bank of Finland
 Esa.Jokivuolle@bof.fi

Deadline for receipt is 15th May, 2007

Potential contributors are welcome to discuss their ideas with Mr Jokivuolle beforehand.

Presenters and discussants from academic non-profit institutions without access to their own funding will have previously agreed travel and accommodation costs met by the Bank of Finland. There will be no charge for participating but other participants should expect to pay their own travel and accommodation costs.

All potential participants are invited to put the date of 20th and 21st September, 2007 in their diaries now. Participants should expect to stay the nights of 19th to 21st September in Helsinki, as the meeting will last all day Thursday and Friday.



SUERF Seminar

Corporate Governance in Financial Institutions

jointly organized with the Central Bank of Cyprus

Thursday, 29th March – Friday, 30th March, 2007

Venue: Hilton Hotel Cyprus, Archbishop Makarios III Avenue, CY-1516 Nicosia, Cyprus

PRELIMINARY PROGRAMME

Welcome reception on Wednesday, 28th March, 2007

Afternoon, March 29, 2007

Buffet Lunch at the Hotel

13.00 Registration

13.30 Opening of Conference:
Catherine Lubochinsky, SUERF President,
Professor of Economics and Finance,
Université Paris 2
Costa Poullis, Senior Manager, Banking
Supervision and Regulation Division,
Central Bank of Cyprus

13.45 Keynote address:
Christodoulos Christodoulou,
Governor, Central Bank of Cyprus

Session 1: Key Issues of Corporate Governance in Financial Firms

Chair and Moderation:
Franco Bruni, Professor of International
Monetary Economics, Bocconi
University, Member of the SUERF
Council of Management

14.30 **Paper 1:**
*Governing the Governors:
A Clinical Study of Central Banks*
Lars Frisell, Kasper Roszbach,
Sveriges Riksbank and
Giancarlo Spagnolo, Associate Professor,
Stockholm School of Economics, Consip
Research Unit, and CEPR

15.00 **Paper 2:**
Christian Harm, Professor, Economic
Research, University of Muenster

15.30 Discussant:
Marios Clerides, Group General
Manager, Risk Management
Hellenic Bank Public Co Ltd

15.45 General Discussion

16.15 *Coffee Break*

Session 2: Strengths and Weaknesses in Governance Arrangements

Chair and Moderation:
N. N.

16.45 **Paper 1:**
*Governance issues in not-for-profit
financial organisations*
David T. Llewellyn, Professor of Economics
and Finance, Loughborough University

17.15 **Paper 2:**
*Banking Performance and Corporate
Governance in Italy: the Case of 'Banche
Popolari' (working title)*
Giovanni Ferri, Professor of Economics
Università di Bari

17.45 Discussant:
Andreas Charitou, Professor of Accounting
and Finance, Department of Public and
Business Administration, University of Cyprus

- 18.00 General discussion
- 18.30 *End of First Day – Dinner upon invitation by the Central Bank of Cyprus*

Morning March 30, 2007

Session 3: The Market and Fund Managers Viewpoint

Chair and Moderation:

Morten Balling, Professor of Finance Emeritus, Aarhus School of Business, Chairman of the SUERF Editorial Board

- 9.00 **Paper 1:**
Bridget Gandy, Head of Accounting and Corporate Governance Research Credit Policy Group, Fitch Ratings Ltd, London
- 9.30 **Paper 2: N.N.**
- 10.00 Discussant: **N.N.**
- 10.15 General Discussion
- 10.45 *Coffee Break*
- 11.15 Keynote Address:
Hamid Mehran, Assistant Vice President, Capital Markets Function, Federal Reserve Bank New York and MIT
- 12.45 *Lunch at the hotel*

Session 4: Governance in Financial Supervisory Agencies

Chair and Moderation:

David T. Llewellyn, Professor of Economics and Finance, Loughborough University, Member of the SUERF Council of Management

- 14.00 **Paper 1:**
Governance Issues in Regulatory Bodies
Marc G. Quintyn, Chief, African Division, IMF Institute

Paper 2:

Henrik Bjerre-Nielsen, Chief Executive, Danish Financial Supervisory Agency

- 15.00 Discussant:
Morten Balling, Professor of Finance Emeritus, Aarhus School of Business, Chairman of the SUERF Editorial Board
- 15.15 General Discussion
- 15.45 *Coffee Break*

Afternoon March 30, 2006

Session 5: A Panel Discussion of Practitioners, Market Agents and Supervisors

Chair and Moderation:

Costas Tsolakkis, Manager, Bank Supervision and Regulation Department, Central Bank of Cyprus

- 16.15 Panel Discussion
Evgenios Evgeniou, Partner, PricewaterhouseCoopers Financial Services
Andreas Ittner, Director of the Section Financial Institutions and Markets, Oesterreichische Nationalbank
Per Olesen, Branch Manager and Board Member, Sydbank
Luigi Passamonti, Senior Advisor, The World Bank
David Archer, Head of Central Banking Studies, Bank for International Settlements
- 17.45 Conference conclusions
Costas Tsolakkis, Manager, Bank Supervision and Regulation, Department, Central Bank of Cyprus
Philipp Hartmann, Head Financial Research Division, European Central Bank and SUERF Vice-President
- 18.00 *End of Conference
Dinner on the invitation of the Central Bank of Cyprus*

On **Saturday, 31st March** an excursion will be offered by the Central Bank of Cyprus. A half-day guided tour including lunch will be organized for partners on Friday, 30th March.

All Social Event offers are made on the invitation by the Central Bank of Cyprus. There is no cost included – advanced booking is, however, required. See the registration form.

For useful local information see the site Cyprus Programme at www.suerf.org



ÖSTERREICHISCHE BANKWISSENSCHAFTLICHE GESELLSCHAFT
AUSTRIAN SOCIETY FOR BANK-RESEARCH



ÖSTERREICHISCHE NATIONALBANK
Eurosystem

Special OeNB East Jour Fixe
**Central and Eastern Europe:
Is Economic Convergence on Track?**

and

SUERF Annual Lecture 2007
**Problems and Prospects for Enlargement
of the Eurozone**

By Professor **Paul de Grauwe**,
Katholieke Universiteit Leuven

Friday, 22nd June, 2007

Venue: Kassensaal, Oesterreichische Nationalbank, Otto-Wagner-Platz 3, A-1090 Vienna

PROGRAMME

- 12.00–13.00** *Registration and Buffet Lunch (Foyer of the Kassensaal)*
- 13.00–15:30** **Special OeNB East Jour Fixe**
Central and Eastern Europe: Is Economic Convergence on Track?
- 15.30–16.15* *Coffee Break; in parallel: SUERF General Assembly*
- 16.15–17.30** **SUERF Annual Lecture**
Problems and Prospects for Enlargement of the Eurozone

No participation fee, but prior registration is required!
For details and for the registration form please visit the SUERF website at: www.suerf.org



Report on 26th SUERF Colloquium in Lisbon

Money, Finance and Demography – the Consequences of Ageing

by Morten Balling, Frank Lierman, Ryszard Kokoszczynski and Vasco Santos

On October 12-14, 2006, SUERF in co-operation with the Universidade Nova de Lisboa and jointly organized with and sponsored by the Banco de Portugal and by Millenium bcp arranged a Colloquium *Money, Finance and Demography – the Consequences of Ageing*.

Catherine Lubochinsky (SUERF President) and **José António Ferrera Machado** (Dean, Universidade Nova de Lisboa) welcomed the participants and Catherine Lubochinsky chaired the first plenary session.

Fernando Teixeira dos Santos (Portuguese Minister of Finance) delivered a speech: *Fiscal Consolidation and Sustainability: Structural Reforms in Portugal*. According to the minister, the topic fitted particularly well with his current duties as a member of the Portuguese Government. He described the fiscal policy initiatives of the Government in strong words. In a few days, he was going to present a 2007-budget to the Parliament. Fiscal sustainability in the long run was a precondition for economic growth. It required, however, short-term sacrifices.

The proposed structural reforms implied retirement of many civil servants but the effects on the budget would only be significant in the medium term. Currently, the deficit/GDP ratio was close to 6% and it would last years to get it down to the 3% reference value in the EU Growth and Stability Pact. It was the policy of the Portuguese Government gradually to increase the minimum retirement age from 60 to 65 years and to keep wage increases to public employees low. Public employees would have to accept new mobility regulations and new laws would strengthen local government finance. Credible sanctions for non-compliance with centrally

determined guidelines would be implemented. The aim of the Government is to reduce the deficit/GDP ratio by 0.5% per year. During the process, the bureaucracy was being reduced and administrative procedures streamlined.



The next speaker was **Ignazio Visco** (Central Manager for Economic Research, Banca d'Italia). His topic was *Longevity Risk and Financial Markets*. The speaker started with quotations from the Bible, Lorenzo de' Medici and Charles Dickens. All quotations reminded the audience that human beings are mortal.

Demographic projections from the United Nations document that the world population is ageing at a very rapid rate. Old-age dependency ratios are going up with implications for the labor supply, saving, economic growth, public expenditures and asset prices. On the pension front, the expected increase in life expectancy is being generally met with higher contributions, lower replacement rates and later retirement. Longevity risk refers to accidental and systematic deviations of the number of deaths from their expected values. It is striking that the pace of mortality improvement at older ages seems to be accelerating over time. The speaker argued that it is crucial to have better and timely updated mortality tables that would allow timely changes to be introduced in pension schemes. Farsighted individual investors take longevity risk into account. Some work longer and save more. Since many people are not farsighted, mandatory public pension schemes could be

important to reduce undersaving. The trends pose challenges to the retirement savings industry and financial markets. Annuities are the classical answer to longevity risk, but not the only one. The speaker mentioned the characteristics of reverse mortgages. Finally, there were some policy recommendations: Economic growth should be supported, markets for under-supplied financial instruments should be facilitated, regulatory and supervisory frameworks should be developed and ensure better governance of private pension funds and the protection of pension beneficiaries should be improved.

As is the tradition of SUERF Colloquia, work was organized in three Commissions.

COMMISSION 1:

The Real Economy, Public Finances and Demography

The Commission was chaired by **Vasco Santos**, Professor, Universidade Nova de Lisboa, and Morten Balling, Professor Emeritus, Aarhus School of Business.

The 17 papers given can be divided into 5 categories. Papers on: (a) economic effects on the EU and individual countries; (b) theory; (c) political economy; (d) demography; (e) other topics.¹

Economic Effects on the EU and Individual Countries

Gilles Mourre (European Commission) presented a paper entitled *Looming Demographic Ageing: A Constraint to Economic Growth and Living Standards in the EU 25*. The paper presented long-term macroeconomic projections developed by the European Commission. The main conclusions are: (i) labor supply is projected to decline; (ii) low fertility rates will result in smaller age cohorts entering the labor market; (iii) the urgency of the ageing issues varies considerably across European countries; (iv) raising the employment rates of older workers and increasing the retirement age are the most frequent policy reactions.

Per Eckefeldt (European Commission) presented a paper entitled *Budgeting for Ageing*. In this paper, he discusses two measures of long-term sustainability of public finances and presents their estimates for many European countries. He concludes that numerous coun-

tries face significant or very severe challenges whereas a few may be described as being well positioned to face the future.

Hana Genorio (Bank of Slovenia) presented a paper entitled *General Government Debt Sustainability in Slovenia*. In it, she demonstrates that the increasing proportion of elderly population in Slovenia's population will boost pension and health care expenditures by 2050. Bearing in mind that Slovenia has a public-debt-to-GDP ratio significantly below the 60% benchmark imposed by the Stability and Growth Pact and also a government deficit below 3%, Genorio computed sustainability coefficients under several scenarios for the short-, medium- and long-run. The main conclusions are that the increase of the elderly population relative to the working population gradually deteriorates long-term debt sustainability: pension and health-care expenditures will go up and GDP growth will come down.

Tarmo Valkonen (ETLA, Research Institute for the Finnish Economy) presented a paper entitled *Demographic Uncertainty and Fiscal Sustainability*. The paper provided a perspective on Finnish demographic projections and their implications for Finnish public finances. The authors apply stochastic population simulations to produce a predictive distribution of public expenditures and tax rates. Future tax increases are transformed into sustainability gaps. An interesting conclusion was that several of the more positive simulation paths implied that the level of taxation as a percentage of GDP could actually be reduced. In sum, the prospects for the Finnish economy and fiscal situation seem to be relatively favorable.

Martin Werdning (ifo Institute for Economic Research, Munich and CESifo) presented a paper entitled *Implicit Pension Debt and Fiscal Sustainability: An assessment for Germany*. In the paper, he computes the implicit liabilities faced by the German taxpayer as far as promises under the German Statutory Pension Scheme are concerned. His main conclusions are that, even though the reforms enacted in the last fifteen years have led to a significant decrease in overhanging debt, the remaining implicit debt is still quite significant.

¹ Papers are here referred to only by the name of the presenter, though some of them have more than one author.

Theory

Juha Kilponen (Bank of Finland) presented a paper entitled *Demographic Aging in a Small Open Economy: Policy Experiments Using a Lifecycle Model*. His paper extends Mark Gertler's (1999) tractable OLG model by allowing for imperfect labor markets and distortionary taxation. Moreover, he allows for stochastic demographic events. Exploiting the tractability of the model, he runs several simulations for Finland. He concludes that the importance of extending the working life is relatively limited. Fertility trends and the impact of demographic events on economic efficiency once you take into account labor supply, wages and private consumption in the modelling are more important.

Joachim Thøgersen (University of Oslo) presented a paper entitled *Funding Strategies, Unemployment and Growth: Assessing Growth Effects of Alternative Social Security Systems*. In the paper, he uses an OLG model with wage bargaining determining equilibrium unemployment which, together with pensions, induces social security expenditures. The paper tries to compare the growth induced by a PAYG system with a funded one and also with a funded system based on individual accounts. According to the analysis, growth is lowest with a PAYG system, intermediate with a funded system and highest with an individually funded system.

Debora Kusmerski Bilard, (University of Amsterdam and the Tinbergen Institute) presented a draft version of a paper entitled *Intergenerational Risk Sharing, Aggregate Saving and Optimal Social Security*. This paper is also based on an OLG model that the author will try to calibrate and use for simulation work. The paper is still in progress and not yet completed. As such, we will not yet report on its conclusions.

Markus Knell (Oesterreichische Nationalbank) presented a paper entitled *The Optimal Mix between Funded and Unfunded Pensions Systems When People Care about Relative Consumption*. His paper asks the following question: what is the optimal portfolio mix between funded and unfunded pension systems when agents care about relative consumption? Knell's main conclusion is that the optimal share of funding decreases as relative consumption becomes a more important objective.

Ross Guest (Griffith University, Australia) presented a paper entitled *Should We Smooth the Fiscal Costs of*

Population Ageing? In the paper he uses an OLG model to assess the case for smoothing the fiscal costs resulting from population ageing. His main welfare conclusions are that such smoothing, as induced by a Pension Reserve Fund (called Future Fund in New Zealand), yields quite interesting welfare gains while clearly hurting workers over 30, i.e., older workers.

Political Economy

Paola Profeta (Bocconi University) presented a paper entitled *Early Retirement and Social Security: A Long-term Perspective*. She has built a political economy model where incentives to retire are endogenous and concluded that ageing may lead to retirement postponement, as is also the case of an economic slowdown.

Vincenzo Galasso (Bocconi University and CEPR) presented a paper entitled *Postponing Retirement: The Political Push of Ageing*. The paper was selected by the SUERF Council of Management as the best contribution to the Colloquium by an author below the age of 40 and Galasso was awarded the **Marjolin Prize 2006**. In the paper, he studies the incentives of voters for voting in favour of postponing retirement respectively for increases in the social security contributions. In both cases, after calibrating the model with data for Italy, France, the UK and the US the answer is yes on both counts for France, the UK and the US. While Italians opt for increasing social security contributions, they prefer not to raise their social security contributions.

Demography

Jorgen Mortensen (CEPS) presented a paper entitled *Demographic Decline: A Problem without a Solution?* The paper reported the projections, up to 2050, of the Ageing Working Group. The paper confirms the tendency for the composition of the population to change dramatically in favour of a higher weight of the elderly population in the whole population. Its most striking conclusion is that "only by increasing the working life in line with the rise in life expectancy can disaster of the welfare schemes be avoided".

Other Topics

Anne Lavigne (LEO - University of Orléans) presented a paper entitled *Pension Reserve Funds as Solutions to Expected Financial Unsustainability of PAYG Pension Systems: An Application on French Data and Projections*. The paper discusses the evolution of the

French Pension Reserve Fund under different scenarios, reaching the optimistic conclusion that the funding of this reserve might be lower than the French Authorities have forecast.

Peter Zweifel (University of Zurich) presented a paper entitled *Life-cycle Effects of Social Security in an Open Economy: A Theoretical and Empirical Survey*. The paper discusses the expected incentive impact of several social security protection insurance schemes (such as old age insurance, health insurance, and long-term care insurance) on educational effort (negative impact), marriage (mixed impact), number of offspring (negative impact), divorce (mixed impact), retirement (anticipation) and life expectancy (positive).

Michael Moeller (Copenhagen Business School) presented a paper entitled *Taxation of Pensions in Denmark*, where he analyzes the Danish tax system and ends up concluding that the present arrangements result in an excess utilization of banking credit for funding of pension arrangements by households induced by the tax system.

Finally, **Gunnvald Grønvik** (Norwegian Central Bank) presented a paper entitled *The Pension Reform in Norway, A useful step, but more funding could be beneficial* where he proposes a reorganization of the Norwegian pension system. His main conclusion is that the oil-based wealth of which Norway benefits would allow for a more efficient tax system involving less economic inefficiency. This would result from less severe tax distortions which would yield concomitant welfare gains.

COMMISSION 2:

Monetary and Financial Stability, Supervision and Demography

The Commission was chaired by **Manuel Sebastião**, Executive Director, Banco de Portugal and **Ryszard Kokoszczyński**, Director, National Bank of Poland. There were 15 papers (with 29 authors) presented during 6 sessions of Commission 2. They can be classified into 6 groups, though a caveat is needed: this classification is somewhat subjective, and may stress only some ideas presented in the papers.

Demographic Trends, Macroeconomics and Banking

The first paper in this group by **Jan Kuné** (APB Pension Fund, Netherlands), tried to comprehensively answer its

title question *Global Aging: Can We Grow Older Comfortably?* Kuné identified the major reasons for global ageing as the increase in longevity and decline in fertility rate. They may cause problems in labour markets, public finance and in labour-capital balance (increasing wages and pushing down rates of return), though there is still a possibility to adjust to the ageing process via reforms in pension schemes, labour force participation and fiscal policy. Migration can be only of a limited assistance, and it would have to be a very selective process to improve things substantially. In a nutshell, Kuné is saying that there is a lot to be done to grow older comfortably, but we could manage to do what is needed. However, there is one important change in more general public attitudes that cannot be simply introduced as a policy change, e.g. a new form of inter-generational solidarity and a social cohesion.

The next paper, by **Angela Maddaloni** (European Central Bank), presented *Macroeconomic Implications of Demographic Developments in the Euro Area*. Here again, there was a wide coverage of issues presented with a message similar to the previous one. There are changes ahead, and if we do not adjust they would bring an increasing burden for the public finances, mostly for pension schemes and healthcare systems. Another important feature addressed by this paper is the problem of uncertainty of demographic projections.

Two other papers in this group limited themselves to more specific, though still relatively wide issues. **Leopold von Thadden** (ECB) analysed broadly *Monetary Policy Aspects of Demographic Changes* and **Geoffrey Wood** (City University, London) showed us *The Implications of an Ageing Population for the Banking Sector*. Von Thadden suggests that demographic changes are slow enough for the monetary policymaker not to be in a pressing need to change the current monetary policy framework, though a decline in an equilibrium interest rate is something that has to be closely monitored. Wood surveys comprehensively changes in the bank product structure and their balance sheets, risk profile of banks' customers and resulting changes for bank regulators. He also strongly signals the importance of deep social cohesion for stability of the banking system.

These 4 papers were nicely complemented by **Ismail Seyrek**'s (Gazi University, Turkey) empirically based *Comparison of Financial Effect of Aging among*

Countries: A Panel Data Analysis. Seyrek's sample includes roughly 75 countries and 25 years of data and he tries to show the age structure impact on savings and capital formation. Simple statistical measures seem to confirm expected results, but more sophisticated regression analysis brings alas inconclusive results.

Other papers presented in Commission 2 were devoted to more specific issues and can be classified in 5 more groups.

Public Finance Sustainability

António Afonso (ECB) studied *Ricardian Fiscal Regimes in the EU*. He checked the reaction of the primary budget surplus of the EU-15 to changes in government debt. As his sample included various institutional changes (Maastricht Treaty, Stability and Growth Pact) he estimates his regression for various subsamples getting relatively robust results: governments behaved rather reasonably in the period 1970-1003, with the exception of periods preceding directly national elections.

Virginia Maria Costa e Sousa (University of Aveiro, Portugal) proposed using ESA95 – *A System for Financial Stability in the Ageing Time* for assessing the sustainability of the public finances as ESA95 allows for calculation of government net worth.

International Dimensions of Ageing

Wim W. Boonstra (Rabobank Netherlands) in his paper on *Ageing, Saving, and the International Investment Position: The Experience of the Netherlands* showed that the substantial national savings surplus did not guarantee the comfortable net foreign assets position. Relative performance of capital markets and exchange rate changes may become a source of significant losses, so for a single country more savings is not enough to weather easily the consequences of ageing population.

Roberto de Santis (ECB) in a paper *On the Determinants of External Imbalances and Net International Portfolio Flows: The Role of Ageing* showed – controlling plausibly for many other factors – how important demographic factors are for international flows correcting various imbalances.

Uncertainties of Demographic Projections

Casper van Ewijk (Dutch Central Planning Bureau) presented a paper on *Demographic Uncertainty and Sustainability of Government Finances* where he

showed, applying a dynamic general equilibrium model, that accounting explicitly for uncertainty might change widely accepted features of optimal policy, like the need for intertemporal tax smoothing. Uncertainty played also an important role in a paper presented by **Tarmo Valkonen** (ETLA Research Institute for the Finnish Economy) on *Longevity Adjustment as a Pension Policy Instrument*. He showed advantages of using this instrument on the Finnish example, also for decreasing the uncertainty tied to the various pension schemes.

Household Wealth

Willem Heeringa (De Nederlandsche Bank) presented a paper on *Optimal Life Cycle Investment with Pay-as-you-go Pension Schemes: A Portfolio Approach* where he showed the impact of human wealth (coming from net wages) and pension wealth (from the PAYG scheme), both uncertain, on the optimal allocation of financial wealth. Without accounting for these two components investment portfolio becomes suboptimal.

David Love (Williams College, United States) asked *How many Calories in a Nest Egg? Measuring the Adequacy of Household Retirement Wealth*. He used a survey of US households to make a detailed analysis of their wealth, including financial assets, real estate, cars, social security benefits etc. He calculated an annuitized value of this wealth and compared it with the level of poverty line. The situation of an average household seems to be quite comfortable, but some of them in the left tail of the distribution may have an (annualized) value of wealth below 5 000 USD which put them in the very poor position.

Country Papers

Nuran Topal Asilbay from Turkey analysed *The Nature of Turkish Pension Problems: Should Turkey Reform its Pension System?* She asked specifically whether the move from the PAYG scheme into the funded pension system could improve the inequality and after some simulations got a rather negative answer to her question.

Maria Teresa Medeiros Garcia (Technical University of Lisbon) presented a paper *Pensions – State or Private Managed Capitalisation?* where she compared the performance of publicly and privately managed pension funds in Portugal. Her sample was too short to generalize easily, nevertheless her conclusions seemed to suggest that combining participation in both types of schemes may be beneficial.



COMMISSION 3:

Financial Institutions, Markets and Demography

The Commission was chaired by **Frank Lierman**, Chief Economist, Dexia Bank Belgium. 15 papers were presented and there was a panel discussion with 4 participants from 4 different countries (Ireland, Germany, Spain and Europe (EFAMA)).

The 15 papers can be grouped into 5 themes:

Savings; new products; country case studies; link with financial markets; shift of risk to households.

Savings

Traditionally it is said that people have to save more in order to build up a complementary pension. According to a paper by **Etienne de Callataÿ** (Bank Degroof) *Sensible Individual Behaviour, Wrong Collective Policies – Why Promoting Private Saving is Only Part of the Ageing Public Strategy*, if everybody saves more, consumption is in danger and also economic growth. So it is important to stress that household savings are only a complement to an appropriate budget and debt policy of the government. Fiscal orthodoxy and structural reforms are needed.

Gunter Wuyts (KU Leuven) and his three co-authors in the paper *The Determinants of Private Saving for Retirement in an Aging Society*, analysed the determinants of private saving in the third pillar. The dataset was composed of tax declarations. Self employed and high income households are the most active participants, which is no surprise. They do have the money and feel the necessity. The correlation between pension saving and age is quite evident. Life insurance and pension saving are complementary; both are fiscally stimulated. In a paper *Fiscal Incentives to Retirement Saving and Saving Rates: Evidence from Consumption Data*,

Ernesto Villaneuva (Banco de España) and his two co-authors tried to answer the question if tax incentives do have a positive effect on retirement savings. They have found that too much saving is negative for consumption, income and wealth. The higher the revenues, the higher the readiness to participate in tax stimulated savings.

New Products

Pablo Antolin (OECD) presented a paper entitled *Governments and the Market for Longevity Index Bonds (LIBs)*. It contained the results of an OECD simulation concerning longevity risk of pension funds and annuity providers. It is striking that the market fails to create sufficient demand for the only longevity index bond issued by a private institution. This was not due to overpricing. Longevity risk is completely different from risks regarding interest and inflation. It is a long term risk with low volatility. Governments already are exposed to significant long risks. There is a proposal to launch a longevity index as benchmark.

Mark Weth (Deutsche Bundesbank) in the paper *Pension-Related Demand for High-Quality Bonds – What Demographics May Imply*, analysed the demand by pension institutions for high quality bonds. The results of the simulation exercise signal the possibility that demand could exceed the supply in the coming three decades.

Sonja Püntener and **Sigrid Röhrs** (University of St. Gallen) in their paper *Sleeping Capital in the Hands of Aged People and How Reverse Mortgage Can Help*, presented the “reverse mortgage” products as a solution to activation of sleeping capital. This product was initially launched in the US, but quickly copied by other Anglo-Saxon and Northern European countries. The market is small but promising. There has been a very lively discussion between pro’s and con’s.

Country Case Studies

Theo Peeters (KU Leuven) described in the paper *Financial Threats of Ageing: The Case of Belgium*, the initiatives taken by the Belgian government over the last 5 years such as measures to stimulate employment, the launch of a “Silver Fund” for future pension liabilities in the first pillar, the so-called generation pact. Progress is made but there is still a long way to go. The Silver Fund invests in government bonds.

Stefan Schmitz (Oesterreichische Nationalbank) presented a paper *The Impact of Projected Demographic Developments on Funded Pension Provision in Austria*. The key results of his simulations, which are no forecasts, are twofold. The households' net supply of savings and the demand of capital by the corporate sector need to be integrated. Long term real interest rates and future pension income decrease due to declining birth rates and increasing longevity. Decreasing future savings relative to investment partly compensate for the decline of the long term real interest rate. The negative impact of demographic change on funded pension provision is non-negligible.

Nils Martin Stølen (Statistics Department of Norway), analysed in the paper *How to Prevent Increased Pension Expenditures in a Defined Benefit System When Life Expectancy Improves*, the defined benefit system in Norway. A DB system can survive if in advance a rule is fixed concerning how pension benefits may be reduced if life expectancy improves. Yearly benefits become lower the earlier the actual person chooses to retire. Difficult political choices are needed: lower replacement rates in the public pension system or higher contribution rates for the working population. An increase of the retirement age is a possibility.

Link with Financial Markets

In the paper *Ownership, Efficiency and Policyholder Concerns: Evidence from the Trichotomy in the German Life Insurance Market*, **Franz Diboky** (University of Vienna) and his co-author gave an in depth analysis of the German life-insurance market. Ownership (stock versus mutual or public versus private) is not neutral for the efficiency analysis. Stock insurers dominate mutual and public life companies in technical and cost frontiers.

Koen De Leus, (KBC Securities), presented the paper *Asset Meltdown in Europe: A Probability Assessment*. He referred to the many studies made for the US. The immaturity of European pension funds will more than counter an eventual dissaving by the baby boomers in the coming 3 to 4 decades. Contributions minus payments will turn negative very soon but return on the total assets is sufficient for a further pension wealth increase until 2030. Real estate values will also go up due to some 15 year delay between the lower number of households and the decreasing population. Smaller households tend to have a higher floor area per person.

Rising life expectancy and more prosperous young birth cohorts will lift demand for living space.

Yu-Wei Hu (Brunel Business School) explored in the paper *Pension Funds, Institutions and Financial Markets*, the impact of pension fund assets on market volatility, equity prices, government finances and corporate bond yields. There is a significant positive relationship between market volatility and pension assets. Equity prices are found to correlate positively with the investments of pension funds. But there is a negative link between pension fund assets and both corporate and government bond yields due to the sizeable buying effects of pension funds, used by governments to finance implicit pension debts when the traditional pay-as-you-go-systems shift to funded systems.

Shift of Risk to Households

Siegfried Utzig (German Bankers Association) in the paper *Increasing Financial Risk in the Household Sector*, stressed the transfer of risk to households on the financial markets. Households are the ultimate bearers of risk, but are they the best risk managers? Two solutions have been explored: increasing risk management skills by improving the financial literacy, and reducing the complexity of financial decisions associated with providing for retirement. Households must build up savings to have an adequate income in retirement. The state will continue to have a key role to play: providing financial education, reducing complexity of the decisions, taking responsibility in cases where the market fails. The final goal is the strengthening of the stability of the financial system.

Johan Van Gompel (KBC Asset Management) presented the paper *How Socio-demographic Factors Shape European Investors' Risk Profile*. He analysed the risk profiles of Belgian and European investors. An increased exposure of portfolios to stock market volatility goes hand in hand with the observed shift of investors towards a more dynamic risk profile due to age structure, family size, wealth accumulation, educational level.

Marianna Brunetti (University of Bergamo), in the paper *The Population Ageing in Italy: Facts and Impact on Households' Portfolios*, focused on the households portfolios in Italy and on financial markets. Italy turns out to be one of the countries most affected by ageing; financial choices are therefore strongly affected by age.

A substantial shift from risky assets such as stocks and corporate bonds towards safer ones, managed investments, government bonds and deposits will take place. This is perhaps not a surprising conclusion but it could have a serious impact on the product basket of the financial institutions and perhaps also on the evolution of the financial markets.

The main messages of the **Panel Discussion** can be summarised as follows.

Joaquín Vial (BBVA) presented an overall overview of the ageing problem but introduced some emerging markets where the situation is even worse than in the European Union. Of course pension expenditure will rise as the dependency ratio rises. Not-reformed PAYG pension systems accumulate commitments between one and two times the current GDP level. The example of Chile illustrates that large fiscal savings are necessary despite persistent transition costs. But even countries which have moved to DC systems will face significant fiscal commitments. They have to reinforce the solidarity component. He mentioned also public health-care expenditures which will increase. An asset meltdown is not expected. The biggest world savers of today are the same countries facing the biggest challenge for ageing: Japan and China. The GDP growth will suffer from ageing even with the actual productivity growth, participation rates and unemployment constant.

Pat McArdle (Ulster Bank, Northern Ireland) focused on the Irish situation where population increase is higher than the increase in productivity. Population increase is due to high migration and fertility. GDP growth which has been huge in recent years cannot continue at that speed even with a continued increase of employment sustained by greater female participation. Ireland is lucky because the ageing process is lagging. Meanwhile government expenditures are rising rapidly. Nevertheless Ireland is better prepared thanks to a well established 3 pillar system, tax incentives for pension contributions and the existence of a national pension reserve fund (1 % of GDP par annum is contributed). The investments: 79 % equities, 12 % government bonds, 7 % cash.

Bernard Delbecque (EFAMA) stressed that saving better should become a policy objective. Higher efficiency in the European pensions markets is needed. How to

do it? There are a lot of handicaps: fragmentation, too limited access, too high costs, too weak innovation... Regulation must be modernised. But there are also other ways: Better access via revision of the Occupational Pension Retirement Directive. A level playing field in both 2nd and 3rd pillar markets is needed. Greater integration via pan-European pension products. Actual regulation focuses only on pension institutions. Once more EU-wide prudential rules must be adapted. Greater transparency via a disclosure of costs, risks and returns. Tax incentives tend to hide costs, hinder transparency and distort competition. Better allocation via diversified assets. Annuities are not the sole solution. We have to look seriously also to drawdown arrangements, reverse mortgages e.a.; If we succeed in doing this, competition will increase, product choice will become greater, cost will come down and pensions will be higher.

Sven Lautenschläger (L-Bank Baden Württemberg) started from the demographic situation in Baden Württemberg and its impact on housing demand, gross yield on productive capital and shares and rate of return on money. He presented some innovation products such as mortality bonds, aging bonds, fertility bonds, productivity linked structures, country GDP swaps, private equity and SME funds. A lot of them are experimental up to now, but they could become a real part of the necessary offer of new products for institutional investors.

On the Friday morning, **Pedro Duarte Neves** (Deputy Governor of Banco de Portugal) delivered a keynote speech *Ageing and Financial Stability*. The speaker presented exhibits that illuminated population projections and expected age pyramids in 2050. Rise in life expectancy and low fertility implied that total employment is expected to fall. Potential GDP growth will decline. In the banking sector, lower growth will reduce the demand for some bank products and increase the demand for others such as reversal mortgage loans. In pension fund portfolios a shift from shares to long-term bonds can be expected. Among the policy options, the Deputy Governor mentioned an increase of the minimum retirement age, better incentives to private pension savings and an increase in old-age labour market participation.

On Saturday morning, Professor **Barry Eichengreen** University of California, Berkeley gave the **2006 Marjolin Lecture** *Global Imbalances: What Does Population Ageing Imply for their Evolution?* The speaker started by referring to the large and persistent deficit on the United States balance of payments current account and the surplus on the Chinese current account. The under-developed capital market in China implies that most Chinese consumers are unable to borrow on their future income prospects as Americans do. The Chinese savings rate is therefore very high. Currently, China has a low old-age dependency ratio but the prospects for the age distribution should give lower savings rates in the future. Some forecasts predict a Chinese current account deficit within few years. Professor Eichengreen was sceptical regarding economic models aimed at explaining savings behaviour and balance of payments development by means of demographic trends. The Lisbon Colloquium dealt with the economic consequences of ageing in Europe, but can we be sure that this ageing in the future will move Europe's current account into deficit? There is clearly a limit to how far demographic explanations can take us. Other factors may be more important. China's exchange rate policy aimed at keeping the Remimbi low towards the US Dollar has boosted enterprise development in China and stimulated Chinese exports. Until now, the Chinese authorities and institutions have invested heavily in US Government bonds and accepted a relatively low yield but it is possible that Chinese investors to an increasing

extent will invest their surpluses in US companies. That will raise the issue of political sustainability. Will it for instance be acceptable to members of the US Congress if Chinese investors acquire control of American oil companies?

Most of the discussion following the Marjolin Lecture dealt with exchange rate policies and the international monetary system. In one of his answers to questions, professor Eichengreen argued that the huge current global imbalances would be reduced in the years to come. The United States cannot continue to live beyond its means. At some stage, real exchange rates will have to adjust.

After the discussion, professor Eichengreen announced that the Marjolin Prize 2006 for the best contribution to the Colloquium by an author below the age of 40 had been awarded by the SUERF Council of Management to **Vincenzo Galasso**, Universita Bocconi and CEPR.

Catherine Lubochinsky, President of SUERF concluded the Colloquium by thanking Universidade Nova de Lisboa, Banco de Portugal and Millenium bcp for excellent cooperation and authors, speakers and other participants for their contributions to the event.



Marjolin Winner 26th SUERF Colloquium



After the Marjolin Lecture, Professor Eichengreen announced to the audience the winner of the Marjolin Prize 2006. There were several excellent contributions given at the Colloquium written by authors below the age of 40. After a careful evaluation process, the SUERF Council of Management had decided to award **Vincenzo Galasso** for his paper *Postponing Retirement: The Political Push of Ageing*. Mr Galasso holds a PhD in Economics from UCLA. He is Associate Professor of Economics at Bocconi University, Milan. He is Research Affiliate at the Center for Economic Policy Research, London, Research Fellow at IGER, Milan, and Associate Editor of the European Journal of Political Economy. Readers may be interested that he has recently also published a book entitled *The Political Future of Social Security in Aging Societies*, The MIT Press.

News from the Council of Management

The **SUERF General Assembly 2006** was held at the 26th SUERF Colloquium in Lisbon on 13th October 2006. The meeting was chaired by new SUERF President **Catherine Lubochinsky**, Professor in Economics and Finance at the University Paris 2. The following Members of the SUERF Council of Management were re-elected for another three years term: **Franco Bruni**, **John P. Calverley**, **Richard Kokoszczyński**, **David T. Llewellyn**. The General Assembly also agreed on the suggested changes of the Articles. The President informed about the past and forthcoming activities of the association and the Treasurer **Eric Pollefliet** gave a report on the healthy financial situation of SUERF. Members will receive the detailed Minutes.

The Council of Management was pleased to introduce the new Observer **Jan Marc Berk**, Head of the Financial Research Department at De Nederlandsche Bank. Mr Berk will be put forward for election to the General Assembly in the Spring 2007.

The SUERF President informed that the former Secretary General (**Eduard Hochreiter**) retired from the Oesterreichische Nationalbank (OeNB) and therefore also from SUERF. The OeNB expressed its willingness to continue to host and support the SUERF Secretariat and nominated Mr **Ernest Gnan**, Senior Advisor and Head Economic Analysis Division, OeNB, as Mr Hochreiter's successor. Mr Gnan became an Observer and Acting Secretary General with effect from 13th October, 2006. He will be put forward for election as a Member of the Council of Management by the General Assembly on 22nd June, 2007 in Vienna.

Claudio Borio who has served the SUERF Council of Management for the last 9 years has informed that he can no longer serve on the Council of Management and that he will stand down as Member of the Council of Management when his mandate expires at the end of 2006. The Council of Management was pleased to learn that **Már Gudmundsson** would be interested to succeed Mr Borio.



Born in 1964 in Vienna, **Ernest Gnan** received his PhD in economics at the University of Economics and Business Administration, Vienna, in 1989. He started his professional career as an investment fund manager in 1987 and joined the

Oesterreichische Nationalbank as an economist in 1988. In 1992, he moved to the European Commission in Brussels and in 1994 to the European Monetary Institute in Frankfurt. In 1998, he became Deputy Head of the Oesterreichische Nationalbank's Foreign

Research Division; and since 1999, he has been Head of the Bank's Economic Analysis Division. He is a member of the European Central Bank's Monetary Policy Committee and a member of the Austrian Government Debt Committee. He has been giving numerous lectures on issues related to macroeconomics, monetary union and European integration; since 1999, he has been adjunct professor at Webster University Vienna, and since 2005 lecturer at the University of Vienna. His publications cover macroeconomics; economic growth; monetary policy; economic, institutional and legal aspects of European Monetary Union; exchange rate policy, the European Monetary System, the ERM2 and the international monetary system; the institutional status of central banks; and the Austrian capital market.



Már Gudmundsson has been the Deputy Head of the Monetary and Economic Department at the Bank for International Settlements since June 2004. Mr Gudmundsson was the Chief Economist and Director of the Economics Department

at the Central Bank of Iceland from 1994-2004. He became an economist in that department in 1980, where he later held the position of Head of Research and Manager. From 1988 to 1991 he was economic adviser to the Minister of Finance in Iceland.

He holds a BA honours degree in Economics from the University of Essex and an MPhil in Economics from

Cambridge University, England. His main research interests are in the fields of inflation, exchange rates, monetary policy, financial stability, pensions and energy. He has published several articles in books and economic journals and has been on the editorial boards of economic journals, both in Iceland and in the UK.

Mr Gudmundsson has also been a member of various governmental committees in Iceland, among others on central bank legislation; pension reform; and energy. He was the Chairman of the board of one of the biggest pension funds in Iceland from 1989-1992 and a board member of a ferro-silicon company during 2000-2003. During 1998-1999 he served as an IMF adviser to the Central Bank of Trinidad and Tobago.

Born in Iceland in 1954, Mr Gudmundsson is married and has three children.

Readers may be interested to see the biographies of all members of the Council of Management on our website www.suerf.org.

Thanks to leaving colleagues:



It is with great regret that we have had to announce the departure of **Edi Hochreiter** as Secretary General of SUERF and as a member of the Council of Management. After three decades of service at the Oesterreichische Nationalbank (which houses the

SUERF Secretariat), he left to become Director of the Joint Vienna Institute, a Vienna-based training organisation for officials from transitional countries. Without doubt, his and SUERF's paths will continue to cross, not least as he remains a Personal Member of SUERF.

Edi became Secretary General in 2000 as the secretariat was relocated from Amsterdam. and it was his initiative to negotiate with the OeNB that it might house the Secretariat, and to subsequently organise the logistics of the move to Vienna, appointing Beatrix Krones as

Executive Secretary and subsequently Michael Bailey as the Executive Assistant. The move went very smoothly due to the efficiency of the new Secretary General, and his dedication and enthusiasm for his new role.

During Edi's six year tenure as Secretary General, a great deal has been achieved - along with the reorganisation of the Secretariat, putting the finances on a firmer basis and revising the Articles of Association, the programme of events and publications that SUERF offers has also been substantially enhanced. That SUERF is now a very different organisation to the one that it was in 2000 is due in no small part to the role of Edi as Secretary General.

I am sure I speak on behalf of all current and former members of Council, and of the membership generally, in saying that in all respects Edi was an exemplary Secretary General, Presidency and Council member. His enormous network of contacts in the central banking community and in academia enabled SUERF to develop

in a dynamic way and to broaden both the quantity and quality of its programme. In this sense and in many other ways, he acted as a superb ambassador for the Association, universally liked and respected by everyone who had any dealings with SUERF. We must also recognise that all this was achieved whilst at the same time he continued to be a widely respected central bank economist (and Head of Economic Studies at the OeNB) and latterly also as Associate Professor of Economic Theory and Policy at Vienna University of Economics and Business Administration.

It so happens that, by chance, his tenure as Secretary General and my own as President almost precisely coincided. I would like to pay a particular personal tribute to him. It was a very real personal pleasure to work closely with him and, perhaps more than most, I was conscious of how much dedication and enthusiasm he gave to his role and the enormous efforts he made on behalf of SUERF and what he achieved on our behalf.

In very many ways Edi will be sorely missed as Secretary General. However, he would also wish us to look to the future and to build on the strengths that he contributed to. In this regard, we are very pleased that the OeNB will continue to house the secretariat (for which we are extremely grateful) and that another senior and respected economist at the bank – Ernest Gnan – has replaced him as the new Secretary General of SUERF. We are delighted to welcome Ernest as Secretary General and are confident he will continue the excellent work of his predecessor. He can be assured of the enthusiastic support of the Council and we all look forward to working with him in the future development of SUERF.

We wish Edi every success and happiness for the future. Whilst we congratulate him on his new appointment at the Joint Vienna Institute, we are selfishly truly sorry that he has stepped down as Secretary General. Their gain is our loss.

David T Llewellyn



It is with very real regret that we have to announce that one of Council's longest standing members has reluctantly decided that, due to pressure of other professional commitments, he has to step down after many years of excellent service to Council and

SUERF generally. **Claudio Borio** (a very distinguished economist at the BIS) has been a steadfast and unwavering supporter of SUERF and an invaluable member of Council for a long time. He served Council and SUERF with distinction. He has always been dedicated to the ideals of the Association and a strong supporter of its work. He has contributed a great deal to all aspects of SUERF's activities. Claudio could always be relied upon to give wise advice and he had clear ideas about what SUERF could and should do in the interests of all its members.

Claudio, and his invariably wise counsel, will be greatly missed as a member of Council. Perhaps above all, we will miss his friendly manner which has brought him many friends within SUERF and beyond. I am sure that I speak on behalf of all members of Council in saying that it has been a very real pleasure to work with him.

Claudio is a distinguished economist and a prolific writer of highly-regarded papers most especially in the area of financial stability. I am sure many of us will have the pleasure of maintaining regular contact with him both through his writing and at international conferences where he is a frequent and highly respected contributor.

We all very much hope, and confidently anticipate, that he will continue to support SUERF and its ideals and we very much look forward to seeing him at future SUERF events. We wish him every continued success in his future career.

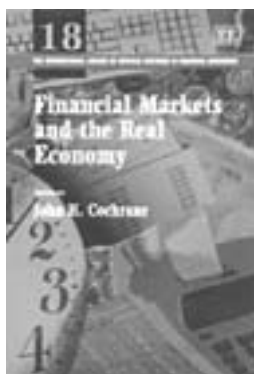
While it is sad that we will lose Claudio, we are nevertheless very pleased that he will be succeeded on Council by his colleague at the BIS – Már Gudmundsson who is Deputy Head of the Monetary and Economics Department. Már is well acquainted with SUERF and its activities and we are sure that we can count on his dedicated support.

David T Llewellyn

Book Review • Book Review • Book Review

Financial Markets and the Real Economy

Edited by John H. Cochrane, Myron S. Scholes Professor of Finance,
University of Chicago Graduate School of Business, US



This insightful collection examines the intersection between macroeconomics and finance. The key challenge in this area is to find the right measure of “bad times” (the marginal value of wealth) to explain some assets’ high average returns or low prices as compensation for those assets’ tendency to pay off poorly in bad times. The volume includes a carefully chosen selection of articles that survey the various approaches to this question – including the equity premium, consumption based models, general equilibrium models and labour income/idiosyncratic risk approaches. The editor also provides a comprehensive introduction which sets these papers in context and surveys the broader literature. 21 articles, dating from 1982 to 2004; Contributors include: J.Y. Campbell, G. Constantinides, E.F. Fama, K.R. French, L.P. Hansen, M. Lettau, S. Ludvigson, R. Mehra, E. Prescott, K. Singleton. 2006, 720pp Hardback, ISBN 1 84376 192 0, £170.00, The International Library of Critical Writings in Financial Economics

This volume brings together twenty one important academic articles on the links between investment risks and returns and the real economy. It provides fascinating reading for all those interested in understanding the markets, whether their primary field is finance or economics. Not least because, from the introduction onwards, it is clear that, despite the major work in this field over the last half century, theoreticians are still struggling to tie financial economics and macroeconomics together in a satisfactory way.

Most of the contributions date from the last ten years and include key articles by Eugene Fama, Kenneth French, Rajnish Mehra, Edward Prescott, Lars Peter Hansen, George Constantinides and John Campbell among others. The *Journal of Political Economy* originally published seven of the contributions, with the *Journal of Financial Economics*, the *Journal of Finance*, the *Journal of Monetary Economics* and the *American Economic Review* responsible for most of the rest. The editor notes that he has chosen the most illuminating pieces, not necessarily the earliest publication where the author may still be groping for the idea, a good policy in my view.

The book leads with an extremely useful introduction by the editor, John Cochrane, himself a key contributor in this field, which makes a passionate case for the importance of these studies both to finance specialists and economists. He argues that macro-economists cannot

simply dismiss the volatility in the stock market as caused by fads and fashions, but then assume that macro-economic resource utilisation is working well, since asset markets are a vital part of the signalling for a well functioning economy.

Equally he argues that investors who simply search the data for a market strategy that has worked in the past, without considering why it works in theory, are fishing without a licence. It will always be possible to find patterns in past data, but in the absence of a reason for them, based in well-grounded theory, the pattern is liable to evaporate in the future. Cochrane argues forcefully that returns must ultimately be linked to the concept of the “marginal value of wealth”.

How much happier would you be if you found a euro on the street? If you were a penniless orphan you would probably rush to pick it up. If you were a well-off corporate member of SUERF, it might still be welcome but would not much change your day! This is the concept underlying the “marginal value of wealth”. Ultimately this is the concept we need to bring economics and finance theory together.

Take the issue of the equity risk premium, the key investment question underlying this volume. Why do equities outperform bonds over time? Using the marginal value of wealth concept we realise that equities need to offer a

higher average return than other assets because they tend to do badly when you need them most. For example in recessions, when incomes are under pressure and jobs are scarce, the value of your investment portfolio becomes more important. But, in a recession, equities usually fall in value. Government bonds, in contrast, at least hold their value and usually rise. Hence government bonds are a “better asset”, but for that you have to accept that they will generally under-perform over time. This will not be news to private investors who lost their jobs during the 2001 recession just as their technology stocks crashed, or to companies at that time struggling with simultaneously weak profits and debilitated pension schemes. That period saw equities go through the worst bear market since at least the 1970s while, of course, bonds provided strong returns.

Modern finance theory sometimes gives the impression that assets which tend to provide high returns, do so purely because they have higher volatility, as measured by monthly or other short-period fluctuations. But, if that were the reason, long term investors could earn a free lunch simply by riding out the fluctuations. This volume is an important reminder that these assets generate high returns, not only because of the volatility and not only because sometimes they can perform badly for very long periods but also because they tend to perform badly just when you need the money most!

This reviewer wonders if the point has been forgotten in the rush to add real estate to investment portfolios. Real estate often appears to be of low volatility, largely because valuations are not performed on a daily basis and, even when performed on a periodic basis, valuations are often effectively smoothed, but there is no doubt that values are closely correlated to the economy and will suffer grievously if, or perhaps rather when, we have another recession.

Understanding, elaborating and trying to prove the key role of the marginal value of wealth is the key theme running through this volume. However, it has been clear for some time that the historical equity risk premium seems too large. A premium of 6–7% p.a. is not consistent with a plausible number for the marginal value of wealth. There have been a number of attempts to explain this, many of them represented in this book. So far, no one theory has gained general acceptance, leaving most practitioners to nervously conclude that we should expect a lower risk premium going forward. Meanwhile the theoreticians have plenty left to do.

Reviewed by John P. Calverley
Chief Economist & Strategist, American Express
Member of the SUERF Council of Management

New SUERF Studies

2006/2 Visions about the Future of Banking. By Hans J. Blommestein, Vienna, August 2006, ISBN13 978-3-902109-32-7

2006/3 Cost Efficiency in the European Securities, Settlement and Safekeeping Industry. By Patrick van Cayseele and Christophe Wuyts, Vienna, October 2006, ISBN13, 978-3-902109-33-5

2006/4 Macroeconomic Adjustment in the New EU Member States. By Iulia Traistaru-Siedschlag and Jürgen von Hagen. A joint publication with the Central Bank of Malta. November 2006, ISBN13, 978-3-902109-34-3

2006/5 The Adoption of the Euro, Choice of Currency Regime and Integration of Payment Systems. Three papers by Michael C. Bonello, George M. von Furstenberg and Kari Kemppainen and Sinikka Salo. Introduction by Morten Balling. A joint publication with the Central Bank of Malta. December 2006, ISBN13, 978-3-902109-35-1

Future SUERF Events

The Council of Management has decided on the following forthcoming events for 2007. Other events will follow during the year and will become available on the website and in the Newsletters in due course. You are therefore invited to visit the website regularly – www.suerf.org – to receive the most up-to-date information.

The Council of Management is always pleased to consider suggestions for joint events from members.

29/30 March 2007 Nicosia, Cyprus	SUERF Seminar <i>Governance Issues in Financial Institutions</i> jointly organized with the Central Bank of Cyprus.
22 June 2007 Vienna, Austria Afternoon	Special OeNB East Jour Fixe <i>Central and Eastern Europe: Is Economic Convergence on Track?</i> and SUERF Annual Lecture 2007 , Professor Paul De Grauwe, Katholieke Universiteit Leuven, <i>Problems and Prospects for Enlargement of the Eurozone</i> with the Oesterreichische Nationalbank and the Austrian Society for Bank Research. SUERF General Assembly 2007.
20/21 September 2007 Helsinki	SUERF Conference <i>Financial Markets, Innovation and Growth</i> , jointly organized and hosted by the Bank of Finland – see Call for Papers in this Newsletter.

**For more details and latest news on SUERF Events
and for Registration Forms, please visit**

www.suerf.org

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