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New Challenges in Central Banking: Monetary Policy Governance and Macroprudential Issues

Report on a conference jointly organised by SUERF and BAFFI CAREFIN Centre, Bocconi University

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By Ernest Gnan, SUERF and OeNB and Donato Masciandaro, SUERF and Bocconi University

Which are the new frontiers in central banking? Which things have changed in the aftermath of the financial, economic and sovereign debt crisis? These are questions raised frequently by central bankers, academics and interested observers alike. There are quite a few areas to cover in answering these questions. The aim of the workshop organized jointly between SUERF and the Baffi Carefin Centre of Bocconi University was to focus on two areas: monetary policy committees, on the one hand, and new prudential responsibilities, on the other hand.

Donato Masciandaro, President BAFFI CAREFIN Centre, Bocconi University and SUERF, and Urs W. Birchler, SUERF President and University of Zurich, opened the conference emphasising the importance of bringing together academic research and practitioners’ views, in order to gain relevant insights in the field.

The keynote speech was given by Athanasios Orphanides, MIT Sloan School of Management on the topic of “ECB monetary policy and euro area governance: collateral eligibility criteria for sovereign debt”. He started out by arguing that risk spreads and credit ratings on various countries’ sovereign bonds had little to do with debt to GDP levels and thus debt sustainability. A key feature of the euro area crisis in his view was the compromising of most euro area countries’ safe asset status. Before the euro, eligibility of government debt by the various NCBs as collateral for monetary policy operations was beyond questioning. With the start of the euro, the ECB used private credit ratings to determine collateral eligibility of a large number of private assets. After the softening of the Stability and Growth Pact by Germany and France in 2014, the ECB was criticized for differentiating insufficiently between various governments’ debt and was encouraged to exert fiscal discipline. In November 2015, the ECB communicated that eligibility of government debt was subject to a credit rating threshold. However, during a crisis, credit ratings based eligibility thresholds can become destabilizing: Fears of downgrades and potential default become self-fulfilling if investors expect that the ECB might refuse to accept government debt as collateral. Thus, reliance on credit ratings unintentionally guides markets to an adverse expectational equilibrium for sovereign with more fragile fundamentals. The resulting safe haven portfolio shift from weak to strong governments in Orphanides’ view induces an indirect fiscal transfer in the form of risk premium differentials. While the November 2015 decision initially entailed no market effects, the cliff effect resulting from it showed in spring 2010, when rating agencies downgraded Greece below the ECB threshold. The ECB suspended its collateral...
rules but only after the Greek government accepted conditions set by other member states. As a result, the ECB’s collateral framework de facto became a disciplining device against affected euro area governments. It would not be imaginable in e.g. the US or Japan that the corresponding national central bank adopts collateral rules aiming to discipline their respective governments.

Furthermore, in October 2010, France and Germany agreed that whenever a euro area member state faced difficulties, losses on private creditors would be demanded. This agreement relied crucially on the ECB’s collateral framework to be used as a threat against weak governments. As a result, sovereign debt of weak governments lost its status as a safe asset for private investors; the central bank no longer served as a backstop for governments and against adverse self-fulfilling expectational equilibriums. This in turn reduced fiscal scope for weak countries, reducing governments’ ability to cushion negative shocks. A reason often put forward in favour of using the collateral framework as a disciplinary device for governments is moral hazard, in the sense that extremely low interest rates would reduce governments’ willingness to embark on reforms. In Orphanides’ view, with such collateral policy, the ECB exceeds its mandate. The ECB should thus reconsider its collateral policy, perform its own independent debt sustainability assessment, without including unjustified default fears in its analysis. Enforcement of the EU’s fiscal rules should be left to the European Commission and the member states, in accordance with the Treaty; the ECB should in turn confine itself to its mandate.

Session I, chaired by Sylvester Eijffinger, Tilburg University, CESifo and CEPR, was devoted to monetary policy governance. The first paper by Sylvester Eijffinger and Louis Raes, Tilburg University, was entitled “Estimating the Preferences of Central Bankers: an Analysis of Four Voting Records”. The results presented were results of an ongoing research agenda covering various central banks, with this presentation focusing on the Czech National Bank. Recent research has paid attention to the influence of the design and composition (internal versus external members, appointment procedures, gender, regional representation, etc.) of central bank decision-making committees on monetary policy decisions. Using ideal point models, the authors first estimate latent preferences of the Czech National Bank’s central bank committee members and rank them according to their dovishness versus hawkiwhenes on a latent scale. Using data between 1998 and 2017, they tend to confirm earlier empirical results that women tend to be more hawkish; governors are either found to be rather neutral or very dovish. Their research on various central banks so far does not allow any generalized conclusions; every central bank needs to be treated as an individual case study.

The second paper by Alessandro Riboni, École Polytechnique, Paris, and Francisco Ruge-Murcia, McGill University, dealt with “Deliberation in Monetary Policy Committees”. The authors analyse a model of communication and voting within a monetary policy committee and checks whether the predictions made by the model match FOMC voting data. In particular, he is interested to what extent FOMC members change their view following the discussion and decision-making procedure (measured as the difference between final votes and views expressed before). He finds that deliberation in committees partially reveals individual members’ ability (or lack thereof) and private signals. Absence of mind changes of individual members’ does not necessarily signal ability, in the sense that a person sticking to her gun may appear smarter. On the contrary, low-skilled members may try to conceal a contrarian signal and take a conservative stance, while smart members may be less afraid to share a contrarian signal, putting it on the table for an open discussion; thus smart members might even appear less consistent.

The third paper by Donato Masciandaro, Bocconi University and SUERF, Paola Profeta, Bocconi University, and Davide Romelli, Trinity College Dublin, was entitled “Behavioural Monetary Policymaking and Gender: Theory, Institutions and Empirics”. The paper starts from the observation that women continue to be under-represented in many industries and professions, including executive positions in money and finance. They raise the question whether in monetary policy, increased gender diversity might change decision-making, e.g. because of gender-related differences in
risk aversion, loss aversion or “conservativeness”, or simply because gender diversity adds to committees’ diversity of views. The paper offers innovations in theory, metrics (first index of gender diversity in monetary policy-making for the period 2002-2015 in 37 countries) and empirics (cross-section analysis of drivers and effects of gender diversity in monetary policy committees). Based on various data sources, they first show that over time, in the sample of 37 countries, the share of women strongly increased from below 10% to 14% between 2002 and 2005, then fell back to just over 10% until 2010, and rose again to 14% by the end of the sample in 2015. In 2015, the female share was 15% for a larger sample of 112 countries. The evolution of the share of female depute governors followed a similar but more volatile pattern, rising from below 5% in 2002 to above 11% by 2015. The share of central bank boards with two or more females increased from 10% in 2002 to 30% by 2015; however, a little less than 50% of central bank boards continue to have no female member at all in 2015. The share of women over the past decade has mostly increased in those central banks, where representation was already higher. North America and Africa as well as low-income countries have the highest share of women on central bank boards. Preliminary econometric estimates indicate that gender representation on monetary policy boards is influenced by country and institutional factors, such as staff gender ratio, country gender equality and central bank independence. Female representation can affect monetary policy-making: a higher female share according to preliminary estimates seems to be associated with more hawkish monetary policy decisions.

Session II, chaired by Ernest Gnan, SUERF Secretary General and Oesterreichische Nationalbank, addressed macro-prudential policy from theoretical, institutional and empirical viewpoints. The first paper by Anil Kashyap, University of Chicago, Dimitrios Tsomocos, University of Oxford, and Alexandros Vardoulakis, Federal Reserve Board, gave a presentation on “Optimal Bank Regulation in the Presence of Credit and Run Risk”. They extend the Diamond-Dybvig (1983) model to study externalities emerging from intermediation, and how regulation can mitigate their effect. They find that all the types of regulation they investigate reduce the probability of runs, thus raising welfare for businesses and savers. The probability of a run due to bad fundamentals falls but does not vanish. Bankers are worse off because regulation does not allow them to take full advantage of limited liability. Different types of regulation (capital and leverage versus liquidity regulations) have different effects on investment and credit risk. Capital and liquidity ratios can be combined to usefully complement each other. Liquidity ratios are useful for dealing with liquidity risk but not credit risk. Capital regulations are useful for addressing credit risk but also the risk of bank runs. Net stable funding regulation is useful for addressing both liquidity and credit risks but is hard to combine with other forms of regulation. There at least three different types of margin distortions in private banking decisions. Thus, there is need for at least three separate tools to address all these externalities. But it needs to be ensured that these tools are jointly binding.

The second paper by Eugenio Cerutti, International Monetary Fund, Stijn Claessens (BIS) and Luc Laeven (ECB) provided evidence on the use and effectiveness of macro-prudential policies, based on a series of papers prepared by the authors. A first study published in 2015 covered 119 countries for the period 2000-2013 and considered 12 different macro-prudential measures: loan-to-value caps, debt-to-income ratios, time-varying loan-loss provisioning, counter-cyclical requirements, leverage ratios, capital surcharges on systemically important financial institutions, limits on interbank exposures, concentration limits, limits on foreign lending, reserve requirements, credit growth caps, and levies or taxes on financial institutions. They found that over time the use of macro-prudential measures increased markedly, less so in advanced economies than in emerging market and developing nations. Advanced economies use more borrower-based, emerging economies a broad set of macro-prudential tools. Regressions show significant and large effects of macro-prudential tools (measured by a summary index) on credit. The effect is stronger in emerging than in advanced economies, the measures are less effective in open economies, pointing to possible circumvention, which is also confirmed by a positive correlation between the use of macro-prudential tools and cross-
border activities. Furthermore, they find macro-prudential tools to have less impact on credit in countries with more developed financial systems and with flexible exchange rates. Macro-prudential tools are found to be more effective when credit growth is high. The effect of macro-prudential tools is furthermore found to be asymmetric for upswings versus downswings. A further study from 2017 covered 64 countries for the period 2000-2014, investigating usage intensity of five types of prudential instruments. The study finds that reserve requirements and loan-to-value caps are adjusted most often, while interbank exposure limits and concentration limits were not often adjusted. Capital requirements were tightened especially after the global financial crisis. Loan-to-value ratios were raised often after the financial crisis, counteracting loose monetary policies in several countries. Loan-to-value ratios and reserve requirements were used more systematically in a counter-cyclical fashion than other types of instruments. Overall, experience with macro-prudential measures is still at an early stage. More research and experience with respect to interactions with other policy areas, on side effects and costs, on political economy aspects and on rule-based versus discretionary application are needed.

The third paper by **David Martinez-Miera**, Carlos III University, Madrid and CEPR, and **Eva Schliephake** (University of Bonn and Harvard) dealt with the topic of “Bank Capital Regulation with Unregulated Competitors”. The authors analyse optimal bank regulation in a model where regulated banks are confronted with competition from unregulated institutions. They find that, contrary to common wisdom, an increase in competition from unregulated entities can result in a decrease of social welfare if the level of competition in the banking market is high enough. To limit this loss of welfare, bank regulators should reduce capital regulation. On the other hand, if the level of competition among banks is low, an increase in competition from unregulated entities leads to higher optimal capital requirements and results in higher welfare. These non-monotonic results highlight the need of a better understanding of the underlying trade-offs regarding bank capital regulation, regulatory arbitrage and social welfare.

**Session III**, chaired by **Tommaso Monacelli**, Bocconi University, studied how monetary policy and macro-prudential policies are modelled in new DSGE models. The first paper by **Margarita Rubio**, University of Nottingham, and **Fang Yao**, Reserve Bank of New Zealand, focused on macro-prudential policies in a low interest-rate environment. Post-crisis economies are characterised by very low neutral interest rates. These, on the one hand, limit the scope for conventional monetary policy to stimulate the economy while, on the other hand, raising concerns about financial imbalances and future financial instability. Using a calibrated DSGE model, the authors investigate the consequences for business and financial cycles of a steady-state interest rates falling from 4% to 2%. They find that in such a low-equilibrium interest rate environment, the zero lower bound becomes binding more frequently, leading to greater macroeconomic volatility and financial instability. In this environment, the case for macro-prudential tools becomes stronger as they may either be used to contain financial imbalances arising from ultra-low interest rates or to complement monetary policy when conventional monetary policy instruments are constrained. In a low interest environment, macro-prudential policies need to be more aggressive in responding to credit.

The second paper by **Seraffín Frache**, **Jorge Ponce**, Banco Central de Uruguay, and **Javier García-Cicco**, Banco Central de Chile, elaborated on “Monetary and Prudential Policies in a DSGE Setting”. They estimate a DSGE model of a small-open economy with a banking sector and endogenous loan default with data for Uruguay, as characterized by a dollarized banking system and by dynamic provisions since 2001. They find that counter-cyclical buffers and dynamic provisions are effective in generating buffers that may cover future losses. It is unclear whether they have counter-cyclical real-economic effects or not. The source of the shock is important, as it matters to select the optimal policy tool: dynamic provisioning seems to outperform counter-cyclical buffers in the event of external financial shocks. For dynamic provisioning, the same calibration may be excessively counter-cyclical if the shock is domestic instead of external.
The third paper by Dmitriy Sergeyev, Bocconi University, was devoted to “Countercyclical prudential tools in an estimated DSGE model”. The author solves for optimal macro-prudential and monetary policies for members of a currency union in an open economy model with nominal price rigidities, demand for safe assets, and collateral constraints. As is the case in EMU, monetary policy is conducted by a single central bank, which sets a common interest rate, while macro-prudential policies are set at a country level through the choice of reserve requirements. Two main results emerge. First, with asymmetric countries and sticky prices, the optimal macro-prudential policy has a country-specific stabilization role beyond optimal regulation of financial sectors. This result holds even if optimal fiscal transfers are allowed among the union members. Second, there is a role for global coordination of country-specific macro-prudential policies. These results call for coordinated macro-prudential policies that go beyond achieving financial stability objectives.

The final paper by Daniel Cohen, Mathilde Viennot, Paris School of Economics, and Sébastien Villemot (OFCE -SciencePo) was entitled “Schäuble versus Tsipras: a New-Keynesian DSGE model for the Eurozone Debt Crisis”. The authors calibrate a New-Keynesian DSGE model to show that consumption habit persistence (which makes adjustment after a large GDP shock painful and the shock more persistent) plays an important role in determining default probabilities and debt levels. The authors compare three frameworks: a flexible exchange rate case, a „Schäuble“ case (country leaves the monetary union if it defaults) and a „Tsipras“ case (country stays in the monetary union even if it defaults). They formulate a “Schäuble theorem”: provided habit formation is sufficiently high (i.e. adjustment is painful), if you give a country in a monetary union the choice between a) default and leaving the zone and b) default and staying in the zone, the country will always choose the latter option. From a monetary union policy maker’s point of view, one should not offer the choice and impose the first option. This result is, however, reversed in case of low habit persistence.

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As usual with SUERF’s events, the workshop managed to translate technical academic research into useful insights for practical and policy purposes. The workshops also showed that these are fields were more research and practical experience will need to be gathered in the years to come.
Modern economies need a functioning financial system. In principle, the financial system has four main functions: providing a payment system, matching borrowers and lenders, enabling people to manage their personal finances across their lifetimes and between generations, and sharing and managing risk.

Despite the implementation of a series of reforms in 2010, including enhanced capital requirements for banks, new banking resolution legislation and the centralization of derivatives markets, the question whether the current financial system is fit for the future remains unanswered. Critics claim that the financial system today is still very similar to what it was before the financial crisis started in 2007.

So is the financial system fit for the future? Will its current structure allow it to fulfill its main functions? Do we need further structural changes? If so, what kind of changes? Are tighter banking regulation, an increasing role for shadow banking and the EU’s project of establishing a capital markets union the way to go? What opportunities and potential risks do such changes involve? How will technological developments like fintech and digital money shape the future financial system?

To shed light on these issues, the OeNB joined forces with SUERF – The European Money and Finance Forum to organize its 44th Annual Economics Conference in Vienna on May 29 and 30, 2017, on the topic “The Financial System of the Future”.

In his opening remarks, OeNB Governor Ewald Nowotny welcomed the long-standing, close and excellent cooperation of the OeNB with SUERF, and on this year’s Annual Economic Conference in particular. He emphasized central banks’ commitment to long-term economic stability. This is all the more important – but also difficult – in times of fast changes. Our ability to forecast future developments and crises has proven to be quite limited. This also applies to technological innovation: we should be wary to draw deterministic conclusions on their implications for future developments. This applies both to the future path of innovation and the future sources of financial crises. It seems reasonable, though, that, whatever impact digitalization will have on the future shape of the financial sector, it is reasonable to expect job losses in the banking sector. Both globally and in Austria, downsizing is already ongoing, and this trend is going to continue. The other important change is the rise of market-based financing, also in countries like Austria, which have traditionally been dominated by bank-based finance. The EU’s capital market union will foster cross-border integration of financial markets and promote the development of new forms of finance. These
trends will, however, be shaped less by technology than by deep macroeconomic parameters, such as growth, demographics, employment, and social developments. Nonetheless, framing technological change in a way that best adapts to macroeconomic circumstances and contributes most to favorable economic development is important. Thomas Drozda, Austrian Federal Minister for Arts and Culture, Constitution and Media, thanked the organisers for bringing together policy makers and economists, bankers and academics to exchange views and learn from each other. In principle, financial systems may enhance growth and welfare, if they served their original purpose to collect savings in order to finance the creation of new productive capacity. However, if credit is used to buy existing real estate, no value added is created and the risk of housing price bubbles arises. To prevent boom-bust cycles, regulators and supervisors need to have adequate macroprudential instruments at hand. Income and wealth inequality may also be a source of financial instability by prompting the less wealthy to take out loans beyond their capacity, to maintain their standard of living. The resulting financial fragility may deepen recessions. Thus, strengthening crisis resilience requires a strengthening of the middle class and ensuring the sustainability of the welfare state. While in theory, integrated financial market facilitate international risk-sharing and the allocation of capital from surplus economies with ageing societies to catching up economies, in practice this process does not run smoothly. Excessive fiscal restraint may lead to deteriorating domestic public infrastructure.

While there is consensus that financial system stability is key, we may be trapped in a cycle of complacency as long as financial stability prevails, which leads to crises, which trigger better regulation, which in turn leads to financial stability, complacency, and so forth. To avoid this vicious cycle, those parts of the financial sector that serve a useful economic purpose should be safe in crisis situations, while the rest should be unwound. This requires a workable and credible resolution framework. The legally enacted EU framework now has to be put into practice. Recent global tendencies to roll back post-crisis regulatory reforms should be regarded critically. Policy makers in EU member states should stick to the rules they agreed to at the EU level. Regarding future means of payment, Drozda, while having some sympathy with private competing currencies, emphasized network externalities which may work in favor of existing legal tender issued by central banks. Reports on the death of cash are greatly exaggerated. The Austrian government has no intention to take away cash from citizens. To conclude, Drozda urged that we should avoid falling into the trap of „unknown knowns“: the crisis was also caused by our neglect of insights gained decades before but which had been forgotten in the run-up to the crisis. We should avoid this trap in the future, and conferences like this may also serve to uncover some forgotten important earlier insights.

Session 1 chaired by Doris Ritzberger-Grünwald, Director, Oesterreichische Nationalbank, dealt with „Digital money and digital banking“. Michael Kumhof, Senior Research Advisor, Bank of England discussed „The macroeconomics of central bank-issued digital currencies“. In his view, the emergence of distributed ledger technology (DLT) and bitcoin was a watershed in the history of e-monies. It may, for the first time in history, be technically feasible for central banks to offer universal access to their balance sheet. Kumhof suggests a scheme for central-bank digital currency (CBDC) in the form of a universally acceptable and interest-bearing central bank liability, issued against government debt and implemented through DLT, which competes with bank deposits as medium of exchange. The central bank would grant universal, electronic, continuous national-currency-denominated and interest-bearing access to its balance sheet. The majority of transaction balances would continue to be held as deposits with commercial banks. Credit would continue to be the purview of existing
financial intermediaries. While the use of DLT is not strictly required for the operation of such a CBDC system, Kumhof argues that it would be necessary in practice, to ensure system resilience.

Is such universal access economically desirable? Using a DSGE model calibrated to match the pre-crisis United States, Kumhof finds that CBDC issuance of 30% of GDP (an amount calibrated to be similar in magnitude of QE conducted by various central banks in response to the crisis), against government bonds, could permanently raise GDP by as much as 3%, due to reductions in real interest rates, distortionary taxes, and monetary transaction costs. Countercyclical CBDC price or quantity rules, as a second monetary policy instrument, could improve the central bank’s ability to stabilise the business cycle. At the same time, the speaker acknowledged that there remains concern with managing risks arising in the transition to a different monetary and financial regime.

Thomas Puschmann, Head of Swiss FinTech Innovation Lab, University of Zurich, gave a presentation on „Banking without banks? How will technology transform financial intermediation?“ He started out with the prediction that in the future we will transfer values among individuals and organizations directly without intermediaries. After the internet of information (1985-2000) and the internet of services (2000-2015), now the internet of values is the big development until 2030. DLT removes dependency on time and location. It rests on decentral (rather than central) organization, transaction validation by consensus (rather than through an intermediary), a chronological (rather than relational) data structure, the impossibility of hidden data changes, and pseudonomy (rather than transparency) of users. The blockchain enables new business models, which can be categorized by degree of complexity and coordination, and by the degree of novelty. It forms the foundation of a global peer-to-peer economy. Firms need to re-position themselves in the evolving new financial system. The development of standards and new services requires time and will not happen overnight. Nevertheless, as the first two phases of the internet have shown, early movers may benefit. Financial institutions need to act if they do not want to experience a fate similar to Kodak’s or Olivetti’s.

In Session 2, chaired by Andreas Ittner, Vice Governor, Oesterreichische Nationalbank, Sir Paul Tucker, Chair, Systemic Risk Council and Senior Fellow, John F. Kennedy School of Government, gave a keynote speech on „The political economy of central banking in the digital age“. The financial crisis has not triggered a fundamental change away from the established fractional-reserve banking system. It has, however, re-established the insight that financial system stability is integral to monetary stability because there can be no monetary stability without stability of the private part of the monetary system: banks. Monetary stability includes stability of the purchasing power of central bank money and stability of the private-banking system deposit money, in the sense that payment services by the system as whole are maintained. A „money-credit constitution“ needs to have five components: a target for inflation, a requirement for banks to hold reserves in relation to their riskiness, a liquidity-reinsurance regime for illiquid but solvent banks, a resolution regime for insolvent banks, and constraints on the central bank’s balance sheet. Typically, central banks (with some regulatory functions) manage both the state’s consolidated balance sheet (by issuing money against public and/or private debt) and constrain the banking system’s balance sheet with a view to safeguarding financial stability. This implies a lot of tasks, need for explanations and justifications, and power, raising issues of the separation between fiscal and monetary policies and about who sets the rules of the game for the financial system.

Will new technology challenge or even undermine the broad conception of central banking as it is currently done? Tucker argued that it will not, unless central banks move into providing banking services for everyone,
which would make them more like a latent state-credit bank. An important qualification to “things stay the same” is that central banks will need to re-engage with the integrity of the deep plumbing of the financial system. They must, though, be vigilant in not taking on roles that give them excessive power or which do not fit with their core purpose of maintaining monetary system stability.

An important regulatory development that will change the landscape of the banking industry in Europe is the revised directive on payment services (PSD2) which is planned to be implemented in 2018 and 2019. PSD2 is intended to improve the level of customer protection as well as to increase competition in the EU payments market by creating a level playing field for all payment service providers, including new players. It changes the amount of data that becomes portable and drives how payments are initiated and processed through various payment systems. PSD2 enforces the unbundling of banking services, i.e. services that are typically offered in a package will be broken out and offered by different service providers. This has the potential to severely affect the whole value chain of credit cards. Another effect of PSD2 is an increase in the access to information about payment behavior, specifically, the aggregation of data from banks and savings institutions that an individual or company holds accounts with. Jackson also addressed the challenges of PSD2, in particular highlighting that there is still some regulatory uncertainty associated with this directive, specifically in the areas of customer authentication and secure communication. The enhanced data that the digital revolution as well as relevant regulatory changes has made available has the potential to fundamentally change the banking industry.

“Do we have too much intermediation?” was the title of the presentation by John Kay, economist, writer and fellow of St John’s College, Oxford. Kay started with the notion that the current financial system is too complex and that there is the need for simplification and reduction to its fundamental functions. To a large extent trading activity in financial markets results in a zero sum game with limited value-added. Global trade in foreign exchange is about a hundred times the volume of underlying trade in goods and services and the volume of outstanding exposures under derivative contracts far exceeds the value of global assets. The financial sector has lost sight of its four core purposes: providing a payment system, matching borrowers and lenders, enabling people to manage their personal finances across their lifetimes and between generations, and sharing and managing risks. Over the last 50 years there has been more and more activity in secondary financial markets trading rather than in primary market operations.
intended to raise fresh capital. The insurance market shifted from a market of sharing and mutualization of risks to a market for trading risk. The latter concentrated on the transfer of risks from people with information advantages to people with little knowledge of the traded risks. The transfer of risks to less informed market participants played a crucial part in the latest financial crisis in which loans were securitized, split into tranches, repackaged, and eventually sold to people with a lack of understanding of the underlying risks.

Addressing recent developments in Europe, Kay expressed doubts about the aspiration of creating simple, transparent, and standardized securitization in Europe, arguing that from his perspective capital allocation and risk transfer are activities that are by their nature difficult to standardize. Furthermore, he disagreed with the frequent argument, as brought forward for example in the discussion about the European capital markets union, that continental Europe should follow the “Anglo-American model” of financial markets. Kay concluded that we need less intermediation in financial markets than we have today. However, despite the technological developments that we have seen in the last decades, there still is, and will be in the future, the need for financial intermediation. Lending and equity financing of new businesses requires experience, judgment, and skepticism and these are characteristics for which it is very hard to find technological replacements.

Session 4 on “The capital markets of the future” was chaired by Ernest Gnan, Secretary General, SUERF, Counsel to the Board and Head of the OeNB’s Economic Analysis Division.

The first presentation of this session was given by Nikolaus Hautsch, Professor at the University of Vienna, who elaborated on “High Frequency Trading: Costs and Benefits”. Hautsch emphasized that the discussion about the costs and benefits of high frequency trading is very controversial and his aim is to clarify the different points of view. While there is no unique definition of high frequency trading there are certainly some clear characteristics. In particular, it is automated trading that employs algorithms for order execution and routing, low-latency technology and co-location services as well as high message rates. High frequency trading is mainly carried out by proprietary firms, broker-dealer proprietary desks and hedge funds. The central characteristics of high frequency trading are very short holding periods, no significant over-night positions, very low margins per trade, as well as a focus on highly liquid instruments. In particular, high frequency trading typically avoids taking high risks, i.e. it typically avoids taking highly leveraged positions.

Hautsch then elaborated on typical high-frequency trading strategies. One is high-frequency market making in which high-frequency traders offer the best ask and bid rates and earn the bid-ask spread. Another type of strategies are order detection strategies in which traders use small test orders (“pinging”) in order to detect and exploit hidden liquidity. Further frequently employed strategies include statistical arbitrage, in which traders try to exploit inconsistencies in prices between different products or markets that typically occur only in very short periods of time, or latency arbitrage, which is based on receiving market information just a very short period of time earlier (typically a few milliseconds) than other market participants. Finally, an illegal high-frequency trading strategy is “quote stuffing”, which involves quickly placing and cancelling bids and offers in the market in order to slow down the access of other market participants to the market as well as the matching engine of the respective exchange.

Hautsch highlighted that high frequency trading is a natural part of market evolution and the consequence of both technological as well as regulatory changes, starting with the change from classical floor trading to electronic trading and the introduction of so-called electronic communication networks in the 1990s. Most research papers find that high frequency trading improves liquidity, reduces transaction costs, and improves the
informativeness of quotes. However, it is also argued that high frequency trading has the potential, especially in turbulent and crises periods, to have a destabilizing effect, increasing volatility in the market and increasing the risk of tail events. He concluded that the question whether high frequency trading overall provides social benefits is still controversial and further research is needed. The future of high frequency trading depends crucially on regulatory developments. There is currently significant regulatory uncertainty regarding high frequency trading due to recent regulatory initiatives in both the US and Europe. He warned of both insufficient as well as too rigid and misguided regulation.

The second presentation of this session was given by David Yermack, Professor at NYU Stern School of Business, on “Smart contracts and corporate governance”. The basic idea behind smart contracts is that many kinds of contractual clauses (such as collateral, bonding, delineation of property rights, etc.) can be embedded in the hardware and software that is dealt with, in such a way as to make a breach of contract expensive. This provides security superior to traditional contract law and reduces transaction costs. The idea of creating a trustless system of contract law that is behind smart contracts resembles the idea of a trustless payment system upon which cryptocurrencies such as Bitcoin are based on. Smart contracts economize on contracting and enforcement costs and deter strategic behavior. Prominent examples of smart contracts include vending machines and recurring payments. Pointing to possible applications in corporate finance, Yermack explained the use of smart contracts in secured corporate debt. For example, he outlined the idea to convey collateral upon default automatically, which reduces enforcement and contracting costs as well as moral hazard problems, thereby reducing the cost of debt. Further possible applications of smart contracts in corporate governance involve self-exercising executive stock options or convertible debt that converts automatically. There are also risks of smart contracts, in particular, the risk of using excessive automated decision-making in business operations. There is the need for businesses to fully understand smart contracts and the technologies based on which they are implemented before they are introduced.

The first conference day was closed by the traditional Kamingespräch with the Austrian Federal Minister of Finance, Hans Jörg Schelling. Governor Ewald Nowotny opened the Kamingespräch by stressing the importance of the interlinkages between monetary and fiscal policy measures. In addition, he addressed the successful resolution of the Hypo Alpe Adria crisis and highlighted the successful management of this crisis by Schelling. Regarding the current economic situation in Austria, Nowotny assessed the economy as well as the banking sector in Austria to be in good shape despite today’s turbulent environment and highlighted the clear improvements that were made over the last year.

Schelling pointed out that current uncertainties are to a large part driven by political risks, referring in particular to the US, the UK, Turkey, and Russia. Looking at the European banking sector, Schelling noted that declining revenues, insufficient cost-reduction, and low interest margins led to net income falling by almost half in recent years. The gap between European banks and their US peers is currently widening as US banks continue to grow relative to their European counterparts. In particular, Schelling noted that European banks are running into a crisis of profitability with the most important challenges represented by the high number of outlets, new specialized financial services providers that pick only the most profitable banking services (“category killers”), as well as new technologies that have emerged in the course of the ongoing digitalization. In this context, Schelling also urged that, in light of the strong economic recovery in most European economies, it would be desirable to raise interest rates to non-negative levels.
Digitalization is already changing the economic landscape. It is crucial to adapt regulation accordingly. An example for the challenges associated with digitalization is the taxation of internet businesses. Discussing the situation of Austrian banks and the successful resolution of the Hypo Alpe Adria case, Schelling noted that even though the capitalization of the Austrian banking sector has improved significantly since the onset of the financial crisis, capital ratios are still below the European average and that there is potential for additional regulatory challenges ahead, for example due to Basel IV. Banks need to adapt to today’s changing regulatory, technological, and economic environment, which involves questioning their business models and making necessary adjustments.

Kurt Pribil, Executive Director of the OeNB, opened the second day with a session on “Technological change and the future of cash.”

François Velde, Senior Economist and Research Advisor at the Federal Reserve Bank of Chicago, spoke about “Money and Payments in the Digital Age: Innovations and Challenges.” The lack of information and enforcement and as a consequence the need for trust are recurring themes in monetary history. According to Velde bitcoin and the distributed ledger technology use long standing tools to solve the problem how to issue and manage online tokens without a central authority. Bitcoin is unique in monetary history because it is intrinsically worthless, dematerialized (i.e. no physical tokens exist) and neither inside nor outside money. However the need for trust is not eliminated with a distributed ledger but only displaced. Instead of having to trust a counterparty, one has to trust the protocol. When transferring this technology to applications outside the monetary and payment context, it should be kept in mind that properties of the distributed ledger technology stem from the solution to a particular problem involving decentralization and lack of trust. If this technology does come into broad use, central banks will become involved, among other things, to set standards and ensure safety or by using the new possibility to pay (negative) interest rates on digital money.

Helmut Stix, Senior Expert at the OeNB, spoke about “The surprising resilience of cash.” Using data reaching back to the 19th century, he demonstrated that – notwithstanding a downward trend because of financial innovations – currency in circulation over nominal GDP was quite resilient. Recently, demand for currency even increased in many economies including the euro area and the U.S.A. Cash allows for expenditure control and to economize on fees. The use of payment instruments is largely in line with consumers’ preferences. Regarding the drivers of the recent increase in cash demand, to some extent the increase is due to the current low interest rates. This effect becomes smaller as interest rates approach zero. There is no effect of the size of the shadow economy. In higher GDP economies the evolution of cash demand cannot be fully explained by GDP and the interest rate. It seems that there was a shift in cash demand in economies that experienced a financial crisis and that this was not the case for economies that did not experience a financial crisis.

Peter Mooslechner, Executive Director of the OeNB, chaired a panel discussion on “Fintech: opportunities and challenges for banks and regulators.” Mooslechner asked panelist whether we will see fintechs in the productivity statistics and whether technological progress will be evolutionary or revolutionary.

Reinhold Bierbaumer, managing partner of MEP Mobile Equity Partners, sees the key opportunities for fintechs in B2B platforms. The reason why there are less interesting start-ups in Vienna then in e.g. Berlin or London is attributed by Bierbaumer among other things to a lack of cooperative attitude. Klaus Kumpfmüller, Executive Director of Austria’s Financial Market Authority, stated that regulators support innovations as long as they comply with the law. The regulator applies
both technological neutrality and neutrality between newcomers and incumbents. The Financial Market Authority has established a Fintech contact point. Kumpfmüller invited market participants to make regulators aware if legislation hinders innovation. Marc Niederkorn, Senior Partner at McKinsey & Company, confirmed that enormous investment in fintechs has taken place. The larger part of these investments focuses on retail banking especially payment systems. Fintechs and banks are increasingly moving towards working together. Customer disintermediation targets origination and sales, which is the most profitable activity in banking. Furthermore, fee based businesses are likely to experience the largest margin reduction. Thomas Schaufler, Member of the Management Board of Erste Bank, described the approach of Erste Bank as having established a fintech inside the bank. Clients are asked to participate in the development of applications. Schaufler thinks that advice will remain important for clients and therefore bank branches will still play a role in the future. Valentin Stalf, Founder and CEO of N26 Bank, expects a massive shift in user behavior and sees the bank of the future on the mobile phone. For banks to be successful, customer relationship, technology and design are important. He claims that successful start-ups need an ecosystem. Such an ecosystem exists in Berlin or London but only to a smaller degree in Vienna. According to the panelists there will be an impact of the technological developments on employment in the banking sector. In the future qualification profiles will change.

In the final session, chaired by Urs Birchler, president of SUERF, Erkki Liikanen, the Governor of Suomen Pankki – Finlands Bank, delivered the SUERF annual lecture entitled “Is the post-crisis financial system more resilient?”. According to Liikanen, the financial crisis was caused among other things by underlying macroeconomic factors (e.g. current account imbalances between the US and China, a false sense of security as a result of the great moderation), deficient monetary and macroprudential policies, and imbalances in financial market developments (e.g. liberalization of the global financial markets and deregulation, too-big-to-fail financial institutions). In response to the crisis, banks’ loss absorption capacity and banks’ ability to withstand a liquidity crisis were strengthened. Furthermore, no bank can be regarded as too-big-to-fail anymore, as authorities have been granted new powers to resolve banks efficiently. Supervisors were also given a stronger mandate to ensure stability of the financial system as a whole. It is essential that the profitability of banks is no longer based on banks’ funding being supported by public safety nets. The new rules regarding bank recovery and resolution allow for a genuine transfer of risks to bank owners and investors. A key remaining task for Europe is finalizing the banking union, i.e. establishing the single deposit protection. Furthermore, the banking union should be complemented by the implementation of the capital markets union. The links between banks and the shadow banking sector are now regulated more effectively which helps to transform shadow banking into resilient market-based finance that will not transmit excessive risks to the banking sector. Governor Liikanen concluded by warning that regulatory fatigue should not bring financial regulation and market infrastructure reform to a premature end.

Conference presentations are available at:

www.suerf.org/vienna2017
Motivation - Protectionism is major theme in the political debate. Flows across borders, be it immigration, trade or capital, are under scrutiny. Financial and economic integration is being challenged. The theme played an important role in the Brexit, the 2016 US Presidential election and is visibly present in the electoral calendar in Europe. In the emerging world, the dynamics of capital flows, including China’s policies to stem outflows and insulate its overleveraged financial system, continue to be central.

Bringing together leading policymakers, experts and practitioners from both sides of the Atlantic, the second SUERF conference held in the United States, organised in cooperation with Columbia University | SIPA, the European Investment Bank and Société Générale, offers the opportunity to debate globalisation and the international economic order from a transatlantic perspective. The conference will address the following key questions: Are euro area institutions robust enough to tackle a new crisis and weather changing globalisation patterns? Is the slowdown in global trade cyclical, structural and/or political? What are the implications of shifts in the global savings glut for financial stability? What role have central bank balance sheets played, and what will normalisation bring? What shape will Europe take post-Brexit and post the 2017 elections?

Iain Begg, Professorial Research, Fellow at the European Institute, London School of Economics
Jesper Berg, Director General, Danish FSA
Willem Buiter, Chief Economist, Citigroup
Marco Buti, Director General for Economic and Financial Affairs, EU Commission
Alessandra Casella, Professor of Economics and Political Science, Columbia University
Henrik Enderlein, Professor of Political Economy, Jacques Delors Institute, Berlin
Olivier Garnier, Group Chief Economist, Société Générale
Ernest Gnan, SUERF Secretary General, Counsel to the Board, Head of Economics Analysis, Central Bank of Austria
Dan Hamilton, Director of the Centre for Transatlantic Relations (SAIS), Johns Hopkins University
Werner Hoyer, President, European Investment Bank
Merit Janow, Dean, Columbia | SIPA
Jack Lew, Visiting Professor of International and Public Affairs, Columbia University
Michala Marcussen, SUERF Vice President, Global Head of Economics, Société Générale CIB
Andrew McDowell, Vice-President, European Investment Bank
Patricia Mosser, Senior Research Scholar, Founding Director of the Initiative on Central Banking, Columbia | SIPA
Athanasios Orphanides, Professor of the Practice of Global economics and Management, MIT Sloan School of Management
Simon Potter, Executive Vice President, Head of Markets Group, SOMA Manager, Federal Reserve Bank of New York
Peter Praet, Executive Board Member, European Central Bank
Debora Revoltella, SUERF Council Member, Director of Economics Department, European Investment Bank
Lorenzo Bini Smaghi, Chairman, Société Générale
Hyun-Song Shin, Economic Advisor and Head of Research, Bank of International Settlements
Marc Olivier Strauss-Kahn, Director General of Economics and International Relations, Banque de France
Jan Svejnar, Director of CSEG, Professor of Political Economy, Columbia | SIPA
Natacha Valla, SUERF Chair of the Editorial Board, Head of Policy and Strategy Division, European Investment Bank
Jeromin Zettelmeyer, Senior Fellow, Peterson Institute for International Economics

To register, please contact us at suerf@oenb.at

www.suerf.org/ny2017
EIB Annual Economics Conference in co-operation with SUERF:  
*Investment and Investment Finance*

Thursday, 23 November 2017  
98-100, Boulevard Konrad Adenauer  
L-2950 Luxembourg

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**Preliminary Programme**

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<tr>
<th>Time</th>
<th>Activity</th>
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<tr>
<td>08:30</td>
<td>Registration and Welcome Coffee</td>
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<tr>
<td>09:00</td>
<td><strong>Opening Remarks</strong></td>
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<tr>
<td>09:00</td>
<td>Werner Hoyer, President, European Investment Bank</td>
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<td>09:20</td>
<td><strong>Panel Session I</strong></td>
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<td>Investment and investment finance in Europe: a policy perspective</td>
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<td>The European economy is in a phase of recovery, but heated debate persists on fiscal policy, monetary policy, regulatory frameworks and the long-term outlook for growth. Many questions remain on the macro-financial environment influencing investment. Can we now stop worrying about secular stagnation? What stimulus is being provided by monetary policy? Have European corporates deleveraged enough? Can they now support a possible normalisation? How can we better exploit synergies between fiscal and monetary policy? How can we make public investment less procyclical in Europe? How can we strengthen the financial regulatory framework yet also foster risk-sharing and further capital markets development? Reviewing the evidence on recent investment activity in Europe, the panel will discuss what is driving investment trends, whether there is a need for further policy support, and the role that government investment should play. How should policy makers respond to the trend of slow aggregate productivity growth?</td>
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<td>11:30</td>
<td>Coffee</td>
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<td>11:45</td>
<td><strong>Panel Session II</strong></td>
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<td>The role of innovation and skills in boosting investment activity</td>
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<td>Innovation and technological progress are the most important drivers of economic growth over the longer term. While only a fraction of firms are active at the technological frontier, the spread of innovations throughout the economy is also vital, as is adjustment to changing demands for skills. Indeed, EIBIS results reveal that persistent skills mismatches are seen as major impediments to investment, innovation diffusion and growth in Europe today. The panel will debate the nature of the skills mismatch in Europe, its impacts, and how we need to respond. Does uncertainty affect investment in innovation and skills differently than other types of investment? What policies can address gaps in the availability of skills to support the process of convergence and European integration? How can investment in capacity for training along the entire work-life cycle serve to accompany technological change and reduce the skills mismatch? What role can the EIB play in implementing these policies?</td>
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Chair: Natacha Valla, Head of Policy and Strategy, Economics Department, European Investment Bank
Eric Bartelsman, Professor, Vrije Universiteit
Yuriy Gorodnichenko, Professor, University of California Berkeley
Sergei Guriev, Chief Economist, European Bank for Reconstruction and Development
Jan Svejnar, Professor, Columbia University

13:30 Lunch
14:30 Panel Session III

European financial landscape and access to finance
The recent financial crisis was arguably longer and deeper in Europe than in the rest of the developed world, partly owing to Europe’s strong reliance on banks in its financial system. Even today, EIBIS results suggest that pockets of tight access to external finance remain in several European jurisdictions. This panel will discuss the weakness and strengths of the European banking sector and how it differs from financial systems elsewhere. It will also touch upon the capital market union, its expected design and the current gaps. Turning to policy, it will discuss how we can increase the financial resilience of corporates, diversify their sources of finance, and facilitate the development of young and small corporates that were disproportionately affected by the crisis. Is non-bank financing on the rise in Europe? Should its share in financing increase further and is there a role for policy makers to enhance this process?

Chair: Barbara Marchitto, Head of Country and Financial Sector Analysis, Economics Department, European Investment Bank
Sebnem Kalemli-Özcan, Neil Moskowitz Endowed Professor of Economics, University of Maryland
Jean-Pierre Mustier, Chief Executive Officer, UniCredit Group (tbc)
Christian Thimann, Group Head of Regulation, AXA
Reinhilde Veugelers, Professor, University of Leuven and Bruegel

16:30 Closing Remarks
Andrew McDowell, Vice President, European Investment Bank

17:00 End of Conference
5th SUERF/UniCredit & Universities Foundation Research Prize

Current and future topics in sovereign debt markets

Call For Papers

Deadline for Submissions: 15 October 2017

Motivation:

Sovereign debt markets have undergone fundamental changes since the financial, economic and Euro Area sovereign debt crises. Sovereign debt to GDP ratios have soared as a result of massive government spending in support of financial systems and the real economy, and so far in most countries no substantial return to lower ratios is visible. Sovereign bonds have lost their previous – alleged - status as risk-free assets. The bail-in of private holders of Greek debt marked a watershed. Contagion among sovereigns became very visible during the crisis. Default by several European sovereigns was averted only by massive involvement of the Eurosystem. Central banks worldwide have become dominant players on the demand side in the context of QE, affecting both the level and slope of risk-free sovereign yield curves as well as risk premiums. The composition of private holders of sovereign debt has as a result changed markedly. The effects from eventual tapering of central bank QE on sovereign yields are uncertain. Resulting risks to, and precautionary measures to ensure, sovereign debt sustainability in some countries are so far open issues. Will public debt to GDP ratios be eventually brought back to pre-crisis levels, and how? Will highly indebted governments be able/willing to pay back outstanding debt? Is debt repudiation unavoidable in some cases? Which form might it take? The preferential treatment of sovereign debt in bank and other regulatory frameworks is under discussion. In the Euro Area, alternative schemes to pool some parts of sovereign debt in one or the other way are being discussed. Ultra-low nominal yield and the risk of future valuation losses may have changed the role and assessment of sovereign issues in institutional investors’ portfolios. Ageing and its consequences for state and individual finances may affect both the supply and the demand for sovereign debt.

Content of submissions:
This call for papers invites original research – theoretical, empirical or policy-oriented – on aspects relevant for the above topic. Some examples of fields of research include:

Sovereign debt dynamics, sustainability, and link with fiscal policy

- Drivers of sovereign debt dynamics, long-term projections/scenarios across countries
- Implications from secular trends such as ageing, eventual “normalization” of nominal/real interest rate levels, fiscal policies
- Role of non-securitized, non-traded public debt
- Role of sub-sovereigns, regions, municipalities, PPP and quasi-private subsidiaries in overall public debt
- Role of, and risks from, guarantees within the public sector and from the public to the private sector

Properties and functioning of sovereign debt markets

- New theoretical and empirical insights on sovereign debt markets since the onset of the crisis
- What drives the pricing of risk, what role for contagion among issuers
- Role of rating agencies and their models
- What drives the yield curve post-crisis
- Market linkages across countries (e.g. US-euro area) – are there changes since the crisis?
- Role and behaviour of sovereign debt derivatives, rise and fall of related derivatives products based on sovereign debt, sovereign debt repo markets
- Sovereign debt markets during times of negative yields
Sovereign debt demand, portfolio and risk management of sovereign debt portfolios/asset positions

- What will drive demand for sovereign debt in the medium and long term (forecasts, scenarios)
- New trends and techniques in sovereign debt portfolio risk management
- Links between sovereign and corporate bond yields, implications for portfolio management

Sovereign debt markets and monetary policy

- Changing role of central banks in sovereign debt markets (historical perspective, outlook, etc.)
- What should be central banks’ role in sovereign debt markets?
- Does monetary policy QE correct market distortions or generate them?
- How should tapering be done? How will/should central bank’s future holdings of sovereign debt evolve? Optimal strategies for QE tapering?
- What role might central banks play in providing safe assets?

Sovereign debt management post-crisis

- Factors driving sovereign debt issuing over the medium to long-term
- What has changed as a result of the crisis?
- Optimal issuing strategies at the current juncture (fixed vs. variable rate, long-term versus short-term, domestic versus foreign currency etc.)
- How to cope with tapering?
- What will be new normal for sovereign debt managers in several years?

Regulatory issues

- Capital adequacy treatment of sovereign debt
- Sovereign debt restructuring schemes
- Regulatory aspects of sovereign repo markets
- Regulatory aspects of sovereign derivatives markets

Proposals to pool/bundle parts of sovereign debt issues in the Euro Area

- Analysis of implications/pros and cons of various schemes
- Alternative, new proposals to pool/bundle parts of euro area sovereign debt
- Perspectives of core versus periphery sovereigns
- Central bank, regulatory perspectives

This list is non-exhaustive, other contributions fitting into the overall topic of the call for papers are welcome.

Formal Requirements and Procedure for Submissions:

The SUERF/UniCredit & Universities Foundation Research Prize is open to authors and co-authors who are citizens or residents/students in the EEA, Switzerland, and other countries in which UniCredit is present (in addition to EEA countries, the latter also include Bosnia and Herzegovina, Russia, Serbia, Turkey) and born after 30 September 1982. Prizes of EUR 2,500 gross will be awarded to up to two outstanding papers on topics related to this call for papers. The winning papers will be presented at a SUERF/UniCredit & Universities Foundation Workshop to be held at Vienna University of Economics and Business either in December 2017 or January 2018 (date to be confirmed). Subject to agreement by the authors, SUERF and the UniCredit & Universities Foundation, the papers may be published on the organisers’ respective websites.

Applications should be submitted in PDF format through the online submission form on the UniCredit & Universities Foundation website at www.unicreditanduniversities.eu by 15 October 2017, in English. Applications should be accompanied by a brief curriculum vitae including the candidate’s date of birth and a copy of current identity documents that confirm the author’s/authors’ date of birth(s) and eligibility. The prize is open to papers that have been finalised within the last 12 months prior to the deadline for submissions. Full terms and conditions of entry can be downloaded from the SUERF and UniCredit & Universities Foundation websites.

www.suerf.org/suerf-unicredit-and-universities-foundation
BOOK REVIEWS – BOOK REVIEWS – BOOK REVIEWS

Alexandre Lamfalussy - Selected Essays

By Ivo Maes (editor) in cooperation with György Szapáry, Magyar Nemzeti Bank/National Bank of Belgium

published by the Magyar Nemzeti Bank

Budapest 2017

405 pages

Reviewed by Sylvain Plasschaert, Emeritus Professor at the University of Antwerp (UFSIA) and the KU Leuven

Thanks to the joint initiative of the Central Banks of Hungary and Belgium, a book with a selection of 35 essays allow to illustrate the exceptional career of Alexandre Baron Lamfalussy, who died in 2015, at the age of 86; and to fathom his judicious opinions about the international monetary scene, of which he was a privileged observer and also a first-range architect. These essays reproduce his addresses to various sophisticated audiences.

Soon afterwards he was solicited to become the economic advisor of the Bank for International Settlements (BIS) and head of its Monetary and Economic Department, where he acceded to the top position of General Manager in 1985. In 1994, he accepted the exacting task of establishing and managing a new institution, the European Monetary Institute (EMI), which had to prepare the launch of the European Central Bank (ECB), and of a new currency, the EURO proper. As agreed upon with the EU leadership, Lamfalussy directed the EMI during 3 years and may be viewed as a primary originator of the EURO.

Those who are interested in hearing more about such outstanding career, are referred to the 'Dialogue', which also contains several worthwhile anecdotes about the background of the Euro, such as the involvement of top leaders as Jacques Delors and Helmut Kohl. I must naturally focus here on the ‘Selected Essays’, which contain a brief introduction by Ivo Maes about Lamfalussy’s career, and whose selections are rubricated over the main periods of the author’s career. Yet, I can obviously refer only to a few of the 35 ‘selected essays’.

In his successive positions, Lamfalussy has naturally been a much solicited speaker. He took care in writing out his addresses, when they were slated for publication, as was most often the case. His papers share a few characteristics. Firstly, his opinions were expressed with great clarity, careful nuancing and within a well-designed lay-out. Secondly, he was not interested in surveying the whole course of a given problem – in fact still evolving – but rather

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Overview of his curriculum

The young Alexandre was able to reach Belgium, where he studied economics, with outstanding results, at the Catholic University of Louvain; he proceeded with a Ph D degree at Oxford. He entered the (then) Banque de Bruxelles as economist, and became a member of the (top) Management Committee, which he headed from 1971.¹ In 1961-62 he had been invited to teach at Yale University. In October 1974, a loss at the Banque, resulting from uncovered foreign exchange transactions, led him to resign.

¹ In 1961-62 he had been invited to teach at Yale University where he prepared a book on “The United Kingdom and the Six”.

In his successive positions, Lamfalussy has naturally been a much solicited speaker. He took care in writing out his addresses, when they were slated for publication, as was most often the case. His papers share a few characteristics. Firstly, his opinions were expressed with great clarity, careful nuancing and within a well-designed lay-out. Secondly, he was not interested in surveying the whole course of a given problem – in fact still evolving – but rather
in identifying new developments in the international financial arena, which then became topical, and to scrutinize them systematically, even if he had not yet ready answers but could solely adduce some elements to the analysis. Depending on their particular interests, and the length of their retrospection, the readers of the ‘Selected essays’ will find authoritative views on the many problems which have plagued the field of international finance.

Indeed, during the long span of Lamfalussy’s career, that area has almost never been peaceful. Let me recall the dispute about the Bretton Woods mechanism and its replacement in 1973 by a floating-rate system; as well as the search for a stable relationship between European currencies.

**His training in economics**

His outstanding scores in economics at the University of Louvain predestined the young Alexandre for a doctoral follow-up. He got a scholarship for Oxford, where from 1953 to 1955 he prepared a PhD thesis, directed by Prof. Philip Andrews (Industrial Economics) while Prof. John Hicks (the future Nobel laureate in 1972) acted as chief reader. The Macmillan editing house was interested in a printed version of the thesis. The book, entitled “Investment and Growth in Mature Economies. The Case of Belgium” has been published in 1961 and has fast established the reputation of Lamfalussy as an outstanding economist. His main message was that the weak performance of the industry in Belgium, and of similar countries, was attributable to their addiction to ‘defensive investments’, whereby firms in the traditional heavy industry sectors, such as steel, stuck to expand their output along traditional lines, instead of attempting new products. These views have been vindicated by the deep crisis that afflicted the heavy industry in Belgium, a few years later.

**In his management role at the Banque de Bruxelles**

Having joined the Banque de Bruxelles, as from 1955, he became a member of the Management Board, and then its chairman in 1971. Apart from his assignment as Economic Counsellor and directing the expanding ‘investment banking’ activities, he was also tasked with the supervision of the Bank’s branches in its Walloon region, thus familiarizing him with the panoply of typically commercial banking operations.

During the span of his career in commercial banking he has written a fair number of essays. Amongst those that are retained in the ‘Selected Essays’, one should mention his address at the IMF, in 1969, in the prestigious Per Jacobsson Lecture, on the ‘Role of monetary gold over the next ten years’. The role of gold as a reserve asset was then declining, and heavily criticized ‘; in August 1971, President Nixon ended the convertibility of the US dollar into gold. This was a period of turbulence in the financial world: I remember having read then in ‘The Economist’, that “it would be unthinkable that the dollar could be devalued”, and yet, this happened soon afterwards, in 1973 and signalled the end of the fixed-exchange regimes. In his address in Washington, the speaker drew attention to the deep structural changes in the international economy, and pleaded for more flexibility in the exchange markets and for the dethroning of gold in its monetary role.

The “Selected Essays” also contains two articles about the Euro--bond market, and its rapid development as from 1968, according to a formula, concocted by Anglo-Saxon merchant banks: to circumvent the imposition of a withholding tax on the coupons of such bonds, the latter were issued formally by a thinly capitalized subsidiary in a tax-free jurisdiction, typically in Luxembourg, but under the guarantee by the parent company. A host of American firms, constrained in their ability to export capital, have accessed that new international market, often by way of convertible bonds. As most major banks in Europe; the Banque de Bruxelles was involved in placing bonds, and sometimes in co-managing them, as well as participating in large so-called Eurocurrency consortia loans in US dollars.

**At the helm /of the Bank for International Settlements 1976-1993**

In a rapidly globalizing world, beset by monetary turmoil, the role of the BIS has become more involved and focal. This is not at all surprising: their staffs is renowned for its analytical acumen and the depth of its research; the BIS has also become the instigator of worldwide monetary statistics; it is the regular meeting place for the world’s top leaders in monetary matters, allowing the BIS experts to sharply observe the world’s financial scene. The BIS is called upon to coordinate actions by central banks and national authorities. The BIS can properly be viewed as the symposium of Central Banks. Thus, soon after Lamfalussy had joined, the BIS became a main actor in the currency crises, that were hitting Mexico and other Latin American countries, and which, to an extent, were the result of the recycling of the surpluses of the OPEC countries, deposited
During his long association with the BIS, Lamfalussy’s authority was widely and increasingly respected. Under his governance, the BIS has strengthened its reputation of excellence. The annual report of the BIS, in which those familiar with Lamfalussy’s style recognize his stamp, was hailed as a highly authoritative source of insights.

Amongst the addresses during his governance at the BIS, let me refer to two of them. In December 1994, he spoke at a joint luncheon of the American Economic Association and the American Finance Association about “The Changing Environment of Central Bank Policy”. He drew attention to four interconnected “evolutionary processes” viz. disinflation (then a major concern, as just reminded), internationalization, innovation and deregulation. In this succinct, but profound text, the speaker warns against the negative impacts which such newly emerging tendencies exert on the stability of international finance. Let me only cite three sentences, which revealed his growing concerns and somewhat foreshadowed the global 2007-08 financial tsunami.

– “In general, financial impulses emanating from the United States are transmitted remarkably quickly to other financial centres, despite fairly generalized floating” (p. 213).
– “This process (of financial innovations) is fuelled by market participants’ desire to hedge against the uncertainty generated by interest and exchange rate volatility (and is thus partly a reflection of inflationary developments) to circumvent regulations or to avoid taxes, to take up opportunities offered by deregulation or new technology, or simply to respond to market pressures” (p. 215).
– And thirdly - this appropriate comment by an accomplished macro-economist: economic analysis should concern itself with the process of change, with its succession of cumulative or compensating imbalances, rather than with movement around some identifiable state of equilibrium” (p.217).

The other address I like to remind was pronounced in 1988 at the famous Jackson Hole annual conference, convened by the Federal Reserve Bank of Kansas City. It dealt with “Globalization of Financial Markets, International and Regulatory Issues”. He drew attention to the disruptive impacts of the new developments in the financial markets, and advanced a strong plea for supervision and, to the extent possible, for international cooperation, on account of “the worldwide character of financial markets and the geographical mobility of both financial transactions and financial institutions (p. 243).

The book with essays also contains two texts of addresses in Hungary, Alexandre’s home country. One, in 1991, following close upon the collapse of the Iron Curtain, looked at “Priorities for Eastern Europe”; in it, while rejoicing about the turn of events in the Eastern Bloc, but acknowledging that Hungary had in 1968 already taken some steps towards a market economy, his address conveys a sober analysis of the challenges still awaiting the new EU-member states. The other address, upon the 10 the anniversary of the new banking system in Hungary, in 1897, looked ahead at the problems that would confront the banking system, on account of the innovations that occurred already in Western Europe, including the impact of digitalization.

The European exchange rate predicament
At the BIS, the fate of the foreign exchange relations between the EU member-states remained a problem of constant attention. The concept of a common EU currency had already been aired much earlier, and had been attempted in various variants of the so-called ‘European Monetary System’ but which were not particularly successful. Monetary stability was only achieved when a profoundly revolutionary solution, that of a really unified currency became a possibility, when it was strongly pushed by Delors, President of the Commission and by Chancellor Kohl. In June 1988 the so-called Delors Committee was set up to investigate its feasibility and shape. Aside from Delors himself, Lamfalussy was one of the few members. He apparently was initially not a staunch supporter of the common currency, realizing that the prospective Euro was weak on its fiscal (= budgetary) flank, with the EU budget barely reaching 1 % of the overall GDP of the prospective members and with the chances for substantial own revenues for the EU being blocked by the unanimity rule in tax matters. Lamfalussy was tasked with the analysis of that fiscal side of an ‘optimal currency area’, under reference to existing federal states. His 1989 text is reproduced in the ‘Selected Essays’. He duly drew attention to the fiscal
deficiency in the EU-currency project, and the need for “appropriate arrangements” (p. 264). In hindsight, he may have been more demanding, but as he has noticed in the ‘Dialogue’ (p. 170), the two main member states, Germany and France, did not respect the 3% ceiling on budget deficits, and the financial tsunami of 2008-09 was ignited by US financial institutions and their unrestrained subprime lending. One may add, that the early years of the new century were tainted by widespread optimism about the world’s financial stance; it was erroneously claimed that, according to the theory of ‘efficient markets’, financial markets were capable of self-correcting. Moreover, the Greek tragedy has been basically caused by the top politicians of that country.

So, the Maastricht Treaty (1993) decided to introduce the European currency union and thereto to create a European Central Bank. A European Monetary Institute (EMI) would prepare the launch of the European common currency. That Euro currency should become reality not later than January 1, 1999. After much prodding, Lamfalussy, then 65 years old, accepted to direct the EMI, during a period of 3 years, a rather ‘barbaric but efficient’ time limit, as Lamfalussy has called it.

This was, on all counts, a daunting challenge. Lamfalussy had to start his work with a small staff; he took care to select himself the other staff members, up to 300 all in all, but had obtained the assurance not to be encumbered by national quotas. The logistical problems to be solved were staggering: not only the policy tools which the ECB should apply, had to be designed but the technicalities of setting up a new central bank, including the interconnecting of the digital information systems of the participating central banks, had to be efficiently implanted. In this connection, he had to convince a large number of banks to install such costly equipment. He also had to overcome the widespread aversion of the German banking community vis-à-vis the Euro. But thanks to the group spirit he was able to instill in his staff, eager to participate in an exciting novel project, and a real diplomatic talent, the Euro banknotes were delivered, on schedule, into the pockets of the citizens of the Euro-member states, on January 1, 1999. The conversion of the former national currencies into the Euro occurred in a smooth way, and the money and bond markets were also run in the new currency. An outstanding technical feat, indeed.

After his retirement from the EMS

Lamfalussy, invoking his age of over 70 years, declined the suggestion by some member states to act as the first governor of the ECB. Yet, subsequently, he has still become embarked in a major European project: in 2000, he was asked to chair a ‘committee of wise men’, tasked with achieving a more efficient and integrated system of supervision of the European Securities markets, which hitherto was a “mind-boggling patchwork” (of differentiated national rules) (p. 386). He undertook this analysis with a small group of self-selected experts. The report has allowed to derive general principles, that have greatly contributed to a more uniform regulation of securities markets; it has acted as a stepping stone to the creation, after the 2008-09 financial crisis, of European supervisory authorities, in the securities area but also in the banking field. The ‘Selected Essays’ contain a detailed paper on the objectives of this committee, and its main proposals. Central banks, and in the Eurozone the ECB, are now exercising the supervision over the large, systemically important banks - a proposal which Lamfalussy has long defended.

Conclusion

The ‘Selected Essays’ are a fitting homage to a top-level artisan of the art of central banking in an almost constantly perturbed environment. He had a brilliant and clear mind. I remember that, already in his younger years, Albert Kervyn, his predecessor as economic advisor at the Banque de Bruxelles, himself a reputed economist, confided that, when economists met, the views expressed by the young Alexandre Lamfalussy carried most weight. Yet, they were conveyed in a quiet, unassuming manner; this modesty has not impeded—or perhaps has cemented? -- His successful stewardship of teams of outstanding financial economists, particularly at the BIS and the EMI. The testimony of Jacques de Larosière, former Managing Director of the IMF, aptly portrayed Alexandre Lamfalussy as somebody “who expressed himself with lucidity and often adopted controversial positions. In the light of subsequent events, we are compelled to acknowledge that his assessments were generally correct and far-sighted”.

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BOOK REVIEWS – BOOK REVIEWS – BOOK REVIEWS

Reviewed by Carlos Bourgeois

Jacques de Larosière, born in 1929, shares his career path with us while providing an overview of the various financial crises that gripped the post-war world. The main purpose of this book is to describe the crises and to link them to the different positions J. de Larosière occupied during his career, at both the national and international level.

He built a very distinguished career as an elite civil servant of the French State: it can be described as the unstoppable rise of a very able and intelligent man, loyal to France and to the State, staying above the fray when confronted with different political opinions, but always loyal to the authority that designated him in his functions.

Jacques de Larosière lived through the Second World War, first in Italy, then in Turkey and finally in the unoccupied ‘free zone’ in France. After he completed brilliant studies at the National School of Administration (ENA, Ecole Nationale d’Administration), he gained practical experience during ‘internships’ in London and Algeria, at the time when a new financial system was being installed following the country’s independence.

He started working at the Inspectorate General of Finances and then moved to the External Finance Office. He was appointed Assistant-Director for Multilateral Affairs, before becoming Head of Department of International Affairs at the Treasury at 42.

It was at that time that he was confronted with the first ‘crisis’ in the international monetary system. The idea of the U.S. dollar's fixed value against gold under the ‘Bretton Woods system’ of fixed exchange rates collapsed. It failed to provide means to cope with the economic change in the participating countries.

After the collapse of the Bretton Woods system, countries shifted toward more flexible exchange rate arrangements: the monetary snake was created as well as the tunnel, the European Unit of Account, the European Monetary System, the European Economic and Monetary Union and ‘finally’ (if we can put it that way) the euro.

Jacques de Larosière has seen these evolutions take place during the various functions he performed: Head of the Minister of Finance’s Private Staff in December 1973, Managing Director of the International Monetary Fund between 1978 and 1987, Governor of the Banque de France from 1987 to 1993 and President of the European Bank for Reconstruction and Development.

He had the opportunity to meet the elite from the financial and political circles of his time. With discretion, he tells us about the interactions he had with them. Those memories reveal that the problems that caused the successive crisis have not been dealt with yet: when Europe fails to focus as much on economic and social unity as it does on currency unity, we will face a substantial risk of seeing the euro disappear. What caused the crisis is that the fixed exchange rate regime was not suited to deal with changes at the economic and political level. However, flexible exchange rates were no solution either. On the contrary, international financial flows have been escalating and along with them the outstanding debt incurred by several countries.

As J. de Larosière writes in the afterword to his book, those debts, which at the time of the first oil shock were seen as a way to reduce the large imbalances caused by the sharp rises in oil prices, currently give rise to a certain pessimism.

This book tells the personal story of a successful man and at the same time it helps us to get an overview of the economic and political milestones of the past 50 years.
SUERF Publications

The following SUERF publication is currently in preparation: New Challenges in Central Banking: Monetary Policy Governance and Macropudential Issues, edited by Ernest Gnan and Donato Masciandaro.

SUERF Conference Proceedings 2017/1
Brexit and the implications for financial Services, edited by Patricia Jackson.

SUERF Policy Notes, Issue No 14
Banks or platforms: The digital future, by Patricia Jackson.

SUERF Policy Notes, Issue No 13
The political economy of central banking in the digital age, by Sir Paul Tucker.

SUERF Policy Notes, Issue No 12
(No) worries about the new shape of international capital flows, by Matthieu Bussiére, Julia Schmidt and Natacha Valla.

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