31st SUERF Colloquium and Baffi Finlawmetrics Conference 2014
Money, Regulation and Growth: Financing New Growth in Europe

sponsored by Intesa Sanpaolo

held at the BAFFI Center on International Markets, Money and Regulation, Bocconi University, Milan

Report by Morten Balling, Marc Quintyn, Frank Lierman and Donato Masciandaro

On 4-5 June, approximately 110 participants gathered at Bocconi University’s BAFFI Center in Milan for a special joint SUERF Colloquium and Baffi Finlawmetrics Conference 2014. Opening the event, SUERF President Urs Birchler characterized the current state of the world economy as a situation with lots of money, a lot of regulation but not a lot of growth. The president mentioned that he had told the driver of the taxi from the airport that he was going to meet Mario Monti at a conference. The driver had been so excited that he would hardly accept to be paid for the trip to the city center of Milan. When the former Italian Prime Minister subsequently took the floor, his first remark was that Urs Bircher had been very lucky, when he chose the taxi. The outcome could have been very different! In his opening address, Mario Monti referred to the importance of money and regulation for growth, as well as referring to the recent SUERF conference in Paris, where SUERF had celebrated its golden jubilee.

The first keynote speaker was Anat Admati, Stanford Business School. She had chosen the headline “The False Tradeoff Between (Effective) Financial Regulation and Growth.” The steep decline in real GDP and the rise in unemployment since the 2008 crisis was not caused by regulation. Banks are much more important in Europe than in the US. From 1996 to 2012, total assets of the banking system divided by GDP increased in both regions, but at a much higher level in the EU. The balance sheets of the largest 28 global banks have grown faster than the balance sheets of other banks. The notional amounts of derivatives in which 21 large banks are contract partners grew from USD 409 trillion in 2006 to USD 661 trillion in
2013. It reflects that the banks are still exposed to a lot of risk. Systemic banks receive large subsidies. But there seems to be no evidence of scale economies in banks with total assets above USD 100 billion adjusting for subsidies. Book equity to total assets in American and British banks have with few interruptions declined during more than 100 years. J.P.Morgan Chase is an example of a very big and leveraged financial institution. On the asset side of bank balances, traditional loans represent in many cases less than 30 % of the balance sheet. In the third quarter of 2013, for Euro Area MFIs loans to non-financial companies represented on average only 15 % of total assets and loans to households 18 %.

According to the speaker, analogies to banks’ behavior could be either “polluting behavior” or speeding trucks with explosive cargo. Under both analogies, bailouts or government guarantees would imply moral hazard. Guarantees and subsidies enable and feed leverage ratchet and distort incentives. Basel II and Basel III capital requirements and leverage ratios are in the view of the speaker based on flawed analyses of tradeoffs. Non-banks rarely maintain less than 30 % equity in relation to total assets. Why should banks be allowed to operate with much lower solvency ratios? For the society, excessive bank leverage is expensive due to tax subsidies and safety net benefits. More equity reduces systemic risk, reduces deadweight cost of distress, default and crises, reduces excessive risk taking and improves the ability of banks to lend after losses. The speaker characterized the Basel risk weighting system as complex, manipulable and distortive. Hybrid capital like cocos with bail-in functions were called unreliable and complex. It is much more simple to mandate more equity. The Basel regulatory capital ratios do not measure leverage properly. Accounting measures do not show the true crisis situation. The speaker argued in favor of an equity requirement of 30 % of total assets, allowed to decline to 20 % with restrictions on payouts. The authorities should be able to mandate new equity issuance. Inability by a bank to raise equity should be interpreted as a failed “stress test”. Tightening capital requirements may – according to the speaker – reduce the growth of subsidized banks, but will have a positive effect for all (except possibly bankers). Better regulation is essential and possible, but the political will is missing.

The next keynote speech “How can the European Banking Union contribute to Growth?” was given by Franco Bruni, Bocconi University. The aims of European Banking Union (EBU) are to fight Euro Area fragmentation, to enhance financial stability and to complete the single market. During the sovereign debt crisis, interest rate differentials developed between euro-denominated bonds from different member countries, and this was interpreted as signals of a risk of a break-up of the Euro Area. The EBU has contributed to a convergence between the interest rates and to reduced volatility in financial markets. The EBU implies also a reshaping of banks’ business models in Europe. The speaker argued that in the long term only a denationalized banking system can support a denationalized currency. The EBU is essential for the “ins” (i.e. the Euro Area member states), but also desirable for the “outs”. If the “outs” (including Denmark, Sweden and the UK) do not participate in the EBU, Europe’s financial integration and multinational banking will turn out to be less sound and natural. Bail-ins, SRM and SRF aren’t aimed at dealing with systemic shocks. Systemic crises call for ESM actions. The speaker proposed that the ESM should play a role (backstop of last resort) also in dealing with legacy assets to hedge against systemic shocks originating from them.

At the end of the first day of the event, Olivier Blanchard, International Monetary Fund delivered the 2014 SUERF Marjolin Lecture on “Sustaining Growth in the Short and Medium Term”. The speaker distinguished between advanced economies (AEs) and emerging market economies (EMs). In the AEs, there are still output gaps implying a need for policies to raise output and employment. In the EMs, potential growth has also declined and there is a need for structural reforms. The slow recovery in the AEs is partly explained by legacies from the financial crisis: Large Government debt, private household and company debt and bank debt. Monetary policy in the AEs implies policy interest rates close to zero and large central bank balances. Fiscal policy aim at fiscal consolidation and lower interest spreads especially in the Euro Area periphery. Statistics on household debt to income is misleading. Net worth to income is more relevant. For firms, debt to equity is relevant. Banks’ Tier 1 capital as percent of risk-weighted assets has increased everywhere from 2005 to 2013. Deflation is dangerous because it increases the real value of debt, the real interest rate and because it can lead to a deflationary spiral. Currently, the economic policy breaks are loosened but at different rates in different countries. Stronger growth in AEs will stimulate exports from EMs. Economic growth in the future is challenged by long-term trends in demographics (ageing), education (drop-out rates), fiscal pressures and innovation. In a diagram from World Economic Outlook, AEs were plotted according to net Government gross debt at the beginning of 2014, and primary fiscal balance as percent of GDP. The
outliers in the diagram was Norway with positive net Government assets and a fiscal surplus, and Japan with a large Government debt and a fiscal deficit. In the years to come, economic growth in the EMs is expected to slow down but still to be much higher than in the AEs. In his concluding remarks, the Marjolin speaker recommended that the AEs reduced the speed of fiscal consolidation, recapitalized their banking systems, and normalized monetary policy. EMs should adapt to the new global environment and carry out supply-side reforms.

In keeping with the tradition of SUERF Colloquia, the remainder of the event was split into three parallel commissions.

**Commission 1** was chaired by Morten Balling, Aarhus University and Sylvester Eijffinger, Tilburg University. The Commission headline was “Monetary Policy and Growth”.

The first presentation in the commission by Michele Lenza, ECB, evaluated the effects of the 2012 announcements of ECB’s Outright Monetary Transactions (OMTs), first on bond yields and second on real activity. The speaker explained how these announcements impacted the yields of Italian and Spanish government bonds downwards. The macroeconomic effects were studied in a multi-country model of the financial linkages in France, Germany, Italy and Spain. The general outcome of the analysis was that the OMT announcements were associated with positive and quite sizeable effects on real activity, loans and consumer prices in Italy and Spain. The evidence pointed also to moderately positive spill-overs on real activity in France and even smaller in Germany.

**Gancho Ganchev**, South West University, Blavoevgrad, Bulgaria, examined the dynamics of the supply of credit and nominal GDP growth in Central and Eastern Europe. He looked at the relationship between lending and economic growth, using data from 10 CEE countries. In the middle term perspective, past changes of the volume of lending influence the dynamics of nominal GDP. The weak interdependence in the long term may, according to the speaker be viewed as confirmation of the long-term neutrality of money.

**Cécile Bastidon**, Université Toulon, presented a theoretical model of complex financial intermediation. She stressed the importance of household credit within banks’ balance sheets and in total outstanding credits. In France and Spain, household credit represents approximately 40% of banking intermediation activity and in the US much more. In Europe, household credit portfolios are a priori less sensitive to default risk compared to the US. The model presented proposes a transmission sequence of a shock on household credit portfolios to the whole financial system via the interbank market. Including household credit in the intermediation chain modifies the interpretation of the Taylor Rule.

**Pierre Siklos**, Wilfrid Laurier University, talked about central bank credibility. This credibility can be measured by inflation expectations, the mean reversion properties of inflation, the term structure and quality spreads, and indicators of exchange rate risk. He observed that credibility changes over time, that it is difficult to restore, when it has been lost, that credibility can be transmitted across countries and that policy errors make things worse. An interesting observation was that central banks have become far more “talkative” and focus on their ability to communicate with the public.

**Enisse Kharroubi**, BIS, presented a paper, which investigates the effect of cyclical interest rates and financial sector constraints on growth. Traditionally, economists have discussed stabilization policies and long-term growth separately. But the speaker took a different approach and asked if bank capital adequacy rules – in so far as they affect banks’ lending supply – can dampen or amplify the effects of cyclical interest rate policy on growth. According to the paper, a more countercyclical interest rate policy significantly enhances output growth in more financially or liquidity constrained industries.

**Hans Degryse**, KU Leuven and CEPR, has together with colleagues studied how banks’ lending techniques affect funding to SMEs over the business cycle. In their paper presented at the Colloquium they observe that the positive impact of relationship lending in a downturn is strongest for smaller and more opaque firms and holds independently of the legal and institutional environment in which the bank operates. He showed also, that distance reduces the positive impact of relationship lending. That observation explains probably the paper’s remarkable headline: “When arm’s length is too far.”

**Alex Cukierman**, Tel-Aviv University and CEPR, focused on the behavior of American Banks after the collapse of Lehman Brothers in September 2008. The huge injection of liquidity by the FED has not resulted in an increase in inflation as the quantity theory of money would predict. The speaker made an interesting comparison with the German inflation in 1923. The US banks increased their liquidity reserves – according to the speaker because they reacted to an increase in bailout uncertainty. At the same time, credit expansion decelerated sharply after September 2008. An important consequence of the cautious bank behavior is that only a minor part of the huge quantitative easing operations of the FED are transmitted to the real economy, which leads to both anemic growth and subdued inflation.

**Lola Hernandez**, De Nederlandsche Bank, presented a paper concerning determinants of the rate of the Dutch unsecured overnight money market. Transaction data comes from the Dutch segment of Target 2. The pattern of interest rate movements changes considerably before, during and after the crisis. A strong impact is observed in October 2008, when ECB introduced fixed
rate full allotment tender procedures. Modifications in the monetary policy framework in 2004 succeeded in reducing the volatility of the interest rate, but the unconventional measures during the turmoil period after the collapse of Lehman Brothers were not able to reduce the volatility of the rate.

**Robert Krainer**, University of Wisconsin-Madison, looked at alternative specifications of bank lending in France and Germany. He found that a capital budgeting model based on equity valuations in France provides a better specification of bank lending than the typical demand factors of bank lending rates and an income variable like GDP. For Germany the results were mixed. Conventional monetary policy assumes that there is an interest rate channel in bank lending. If the central bank alternatively believes in a stock market channel, it could (if it had the authority) make open market operations in stocks.

**Neeltje Van Horen**, De Nederlandsche Bank, analyzed the sovereign debt crisis, which has highlighted the close connection between the fates of sovereigns and banks. European banks own not only domestic government bonds, they own also foreign government bonds, including Greek, Irish, Italian, Portuguese, and Spanish government bonds (ie. Bonds from the GIIPS-countries). Concerns about counterparty risk and higher sovereign risk may impact negatively on lending by the banks, who own them. The empirical analysis shows that banks with relatively large holdings of GIIPS government bonds increased their syndicated lending less than banks that were only marginally exposed to these bonds.

**Salih Fendoglu**, Central Bank of the Republic of Turkey, looked at the effectiveness of macroprudential policies in Turkey. This country has in recent years devised new policy tools such as an asymmetric interest rate corridor and a reserve option mechanism. One of the aims of the new monetary policy instruments was to create a buffer against volatile cross-border capital flows. The new policy framework has been successful in achieving a soft landing in the economy and in lessening the financial stability risks.

**Diego Valiante**, CEPS, studied financial integration in the Euro Area. Governments compete on funding costs by supporting “their own banks” with state aid, which distorts the playing field. The retrenching hampers the transmission of monetary policies and—potentially—economic growth. The speaker argued in strong words in favor of a common financial backstop to a privately funded recapitalization/resolution fund and a blanket prohibition on state aids.

Taken together, the 12 papers presented in Commission 1 answered several of the research questions that were posed in the call for papers for the Colloquium.

**Commission 2** was chaired by **David Llewellyn**, Loughborough University and **Marc Quintyn**, IMF. The headline of the commission was “Financial Regulation and Growth”. The twelve papers presented can be divided in two groups: Six papers focused mainly on the interactions between bank behavior and the governmental and regulatory environment, while the other six papers dealt with policy-oriented issues.

A paper with the headline “The Winner’s Curse: Evidence on the Danger of Aggressive Credit Growth in Banking” was presented by **Thomas Kick**, Deutsche Bundesbank. The speaker and his co-authors use a data set of loan loss provisioning at the bank portfolio level and show that, if banks go beyond the “organic growth” of their credit portfolios, they tend to under-estimate the general risk level in the credit market and will suffer disproportional write-offs on loans in subsequent years.

**Razvan Vlahu**, De Nederlandsche Bank, presented a paper “Risk-taking incentives of modern banks”. The speaker and his co-authors explain that high franchise value allows a bank to borrow more, so it can take risk on a larger scale. The bank can achieve high leverage and go outside its core business thanks to the institutional environment. The analysis can be applied, when policy makers look at limits on leverage ratios as regulatory instruments.

**Edward Kane**, Boston College, gave a presentation on “Shadowy Banking”. This kind of financial activity is, according to the speaker, engineered to extract implicit subsidies from Government safety nets. The shadows obscure organizational forms and transaction strategies that circumvent regulatory restraints and extract subsidies by regulation-induced innovation. Safety nets are implicit contracts that offer loss-absorbing equity capital from taxpayers. The speaker argued that taxpayers should be given more say as stakeholders in financial institutions.

**Bálint Horváth**, Tilburg University, presented a paper “The Impact of Taxation on Bank Leverage and Asset Risk”. Interest deductability encourages debt financing, but regulatory and market constraints create dependency between bank leverage and risk. The author used a large international sample of banks to estimate the short- and long-run effects of corporate income taxes (CIT) on bank capital structure and portfolio risk. A higher statutory CIT-rate is according to the sample associated with higher bank leverage and a reduction in the average riskweight of assets. Taxation induces portfolio reallocation toward less lending. The results suggest that elimination of the tax-bias of debt may not improve bank stability.

Peter Andrews, Financial Conduct Authority (FCA), called his presentation “Shadow banking from the perspective of a securities regulator”. Shadow banking is not easy to define. A common definition is, however, credit intermediation involving entities and activities outside the regular banking system. It is relevant to...
consumer protection, market integrity and competition, which are all according to the UK Financial Services Act (2012) objectives of the FCA. Shadow banking makes credit quality and liquidity harder to assess and complicates documentation, transparency and risk evaluation. Measuring the costs and benefits of regulating shadow banking is extremely difficult.

Alessandro Scopelliti, University of Warwick, presented a paper “Securitisation and Bank Capital in European Banking: Does Regulation Affect Risk Retention Decisions?”. The paper was awarded the 2014 Marjolin Prize as the best contribution to the Colloquium by an author below the age of 40. The speaker focused on the issuances of structured products by European banks from 1999 to 2010. He found that regulatory incentives had a strong impact on the decisions regarding the retention of credit risk and the composition of bank assets and liabilities after securitization. Banks changed their risk-weighted capital and leverage ratios after securitization, by considering structured issuances with different collateral, rating and nationality. The paper has policy implications for the impact of the collateral framework on the risk retention behavior of banks and for current reforms of prudential regulation.

The first paper that belongs to the set of policy-oriented papers was a presentation on banking supervision and growth by Mario Quagliariello, European Banking Authority (EBA). Historically, GDP and credit growth tend to be correlated. It is, however, difficult to establish whether financial development is cause or effect of economic growth. The importance of the supervisory capital levels in relation to the expected default frequencies has changed in the last few years. Bankers and economists do not agree on the question whether the request for more equity in banks reduce growth or not. Regulation in the EU goes beyond the provisions agreed at the global level. Capital conservation buffers and countercyclical buffers combine micro- and macro-prudential regulation. Increasing banks’ resilience in difficult times as well as leaning against the wind are used to explain macro-prudential policies. According to the speaker, financial regulation can deliver a sounder banking sector by imposing stricter capital and liquidity standards, but it is not a tool for managing the real economy. Automatic stabilizers, however, improve the chances of early intervention.

Mark Mink, De Nederlandsche Bank, presented a paper “Spillovers from Systemic Bank Defaults”. The speaker and his co-author examine to what extent banks’ stock market values during the 2007 to 2012 financial crisis were driven by increases in the default risk of banks designated as globally systemically important (GSIFIs) by the Financial Stability Board. Stock market values of the individual GSIFIs seem hardly to respond to changes in their own default risk. There seems, however, to be an impact of these risks on changes in other banks’ market values.

Iftekhar Hasan, Fordham University, gave a presentation “Regulations, Foreign Banks and Income Inequality”. The speaker and his co-authors examine empirically the impact of bank regulatory policies on the income distribution in different countries. Data from the period 1973 to 2005 came from 87 countries. Dependent variables are the Gini Coefficient and the income share of the lower 10 % or 20 % of the income distribution. It turns out that more liberalized banking systems are associated with lower Gini values. Failing to liberalize banking sectors hurts the poor. Abolishing credit and interest rate control decrease inequality. High foreign bank ownership is expected gradually to benefit equality.

Stefano Zedda, University of Cagliari, asked: “Will the bail-in break the vicious circle between banks and their sovereign?”. Banking crises impact on public finances and sovereign debt crises impact on bank balance sheets. The speaker proposed a computational approach to quantify the effects of this circular relationship. The method is tested on four countries. The results show that, while limited crises tend to be absorbed by the system, serious crises tend to exacerbate at each turn, so that it becomes impossible to stop them without external intervention. Results show that a bail-in of 8 % of the total balance sheet can be really effective in breaking the vicious circle and preventing contagion between banks and public finances.

Javier Villar Burke, European Commission, presented a paper “The Resolution Fund and Incentives”. The goal of some resolution fund initiatives is to make the financial sector repay the costs of the last crisis. Other funds aim to make private funding available for financing future resolutions of banks as an alternative to bailing out financial institutions with public funds. The speaker argued that a resolution fund, if not designed properly, can have unintended consequences by exacerbating the cycle and promoting perverse incentives. A well designed resolution fund should promote financial stability as a preventive tool. This can be achieved through contributions based on a dynamic factor, which would depend on asset growth and income.

Jordi Gual, La Caixa, gave a presentation “Prudential regulation and the cost of bank funding”. The new Basel requirements have two goals: To deal with potential losses and to ensure less risk is taken. The question is if higher prudential requirements will imply less actual risk-taking. The capital requirements directive (CRD IV) include Tier 1-, Tier 2- capital and a capital conservation buffer, a countercyclical buffer and for SIFIs additional buffers. The new EU bail-in requirements have also potential impact on capital. Since 2008, there has been a sharp increase in regulatory capital ratios. Risk weighted assets (RWAs) are, however, a poor proxy for the actual
risk of an institution. On theoretical grounds, we cannot take for granted that higher capital requirements will imply less actual risk taking.

**Commission 3** “Economic Growth and Financial Institutions and Markets” was chaired by Frank Lierman, Belfius Bank and Pierre Siklos, Wilfrid Laurier University.

In the first presentation, Massimiliano Affinito, Banca d’Italia, focused on the convergence in banking and the real economy within clubs of countries. He posed the question: “Is the Euro Area a blunder?” The main indicators used were deposits to GDP, loans to GDP and per capita income. 65 countries were grouped within 17 potential clubs such as for instance the Euro Area, EU 27, OECD, G 20, OPEC and NAFTA. The analysis via 4 econometric methods covered the period from 1964 until the outbreak of the financial crisis in 2008. It seems that the Euro Area is the only area with clear signs of banking convergence. The Euro founders show high convergence. Banking convergence has a positive impact in fostering real convergence. Euro Area enlargements must be implemented very carefully, because in the past they reduced the degree of convergence.

Michael Koetter, Frankfurt School of Finance and Management, presented the link between banking competition and opaque firms. His dataset was composed of more than 700,000 year observations of German SMEs for the period 1996-2006. Do banks act as referees concerning the information they receive from SMEs? Banks need sufficient margins to generate the necessary private information in order to allocate financial funds efficiently. Banks can improve the economy because they can make firms more productive or help productive firms to grow. Regional markups in banking are beneficial because they permit the generation of important private information needed for an efficient selection and monitoring of risks and, ultimately, growth. Even small banks may extract rents from lock-in firms that depend heavily on external finance, which may entail negative growth. Hence, regional market conditions should matter for antitrust policies rather than considerations of bank size alone.

 Debora Revoltella, European Investment Bank, presented the role of EIB in the launching of the European recovery. Her starting point was the weak performance of the economy: EU potential growth declined by more than 1% between 2007 and 2013, investments fell by 14.9%, unemployment jumped to 12%, competitiveness deteriorated. Financial market fragmentation and continuing deleveraging are major handicaps for SMEs to obtain bank financing. Differences among countries are huge. Other economic challenges are the weak intra EU convergence, energy security and also the external policies. Each year the EIB issues AAA bonds for some EUR 76 billion. In fact, they can be considered as forerunners for the so-called Eurobonds. The group of customers of the EIB is quite broad: banks, non-financial companies and social organizations. The projects to finance are mainly linked to SMEs, innovation, strategic infrastructure and climate change. New areas of financing are explored via innovative and higher risk products, even equity capital in order to foster innovation.

Alessandra dal Colle, Banco Prossima, analyzed the influence of financial liberalization on growth. No empirical evidence was given. As long as financial liberalization leads to lower fixed costs of financial intermediation, the competition within the financial sector increases. In order to stimulate economic growth via financial liberalization it is not useful to lower the barriers to entry in the form of fixed income, but proper account has to be taken of their relationship to macroeconomic fundamentals of the liberalized economy.

Stavros Vourloumis, London School of Economics, tried to answer the questions: can the financial system supply the economic recovery and the growth process with capital? And has the state a role in this process? The financial sector limits its intermediation due to regulation, structural reform, insufficient size and level of development. The role of the state has to increase beyond a Keynesian public expenditure policy and the traditional industrial policies. The state has to become a strategic investor via seed capital to help SMEs, which occupy a strategic role for productivity, innovation, employment and growth.

Yuan Xie, Fordham University, focused on the influence of private information concerning pending approval of patents on bank loan spreads. Banks incorporate borrowers’ pending approval patent info in debt contracting. More than 2650 firm year observations on patents for the period 1987-2006 were used. Banks charge lower loan spreads for borrowers with such info, and borrowers with high patents pending approval have higher expected economic values.

Harald W. Stieber, European Commission, looked at the determinants of capital structure in non-financial companies. Via a series of panel analyses, the leverage drivers were determined. The dataset is composed of nearly 1.2 million firms with more than 6.3 million firm year observations. There is huge heterogeneity across countries, industries and regions. Respectively, size, industry leverage and growth, and tax shield are increasing the leverage ratio, while profitability and liquidity are reducing it. Tangibility has a positive impact on the firms that use long-term debt financing. International capital allocation has also a strong impact. Corporate taxation needs to be part of macro prudential policy frameworks in view of the important effects of national tax codes on leverage ratios.

The work in Commission 3 was concluded by a panel on experiences from financial institutions and markets. The
Bank financing of SMEs suffers in all considered countries, but for different reasons. In Spain and Portugal the financial structure of many companies is weak, and banks are still in their deleveraging and de-risking process. A bottom seems to have been reached, but the upward movement is very slow. In Latin America, the US and the UK, the revival is much more pronounced and a return of the financing activity to pre-crisis levels is on the way. In Italy, the credit quality is deteriorating, which implies increasing loan loss provisions. Italian banks are too much leveraged but up to now no tax money was necessary to bail out some banks. Credit demand is increasing but it is a more risky demand. The financial fragility of the companies must be decreased and bank dependency must be lowered. The development of public guarantee schemes for credits to SMEs could be an appropriate measure to stimulate the financing of the Italian economy. At the same time, business models of banks must be changed via a decrease of the huge volume of government bonds on the balance sheet in favor of more performing credits to the SMEs. A consolidation of the banking sector, mainly within the group of small and regional banks, is urgently needed. The revitalization of the Italian economy is only possible via an increased injection of equity capital in companies and more discipline in public spending in order to stop the progressive impoverishment. Healthy shadow banking via organic financial innovation is a necessary and useful urgent step to deploy on the largest possible scale. This implies more securitization, ABS, commercial paper, IPOs etc.

In Germany, the capital structure of most companies improved substantially thanks to the severe attitude of the banks, referring to the Basel II capital requirements. The equity capital increased from some 16 % in 1997 up to 27.5 % of their balance sheets in 2012, while long-term debt represents some 40 %, down from 47.2 %. The German economy faces a decline of investments, which is a danger for the maintenance of its actual strength. The net savers status of private persons and companies since 2009 is a danger for the growth potential, which declined from 3 % to only 1.5 %. A real credit crunch is not observed. Credit conditions are quite normal and interest rates have never been so low. The interest charges represent only 1.2 % of the total costs of the companies. Bank margins are extremely low. Many companies intend to expand their investments but are not looking for bank financing according to a Commerzbank survey in April 2014. Alternative financing channels are offered by insurance companies, institutional investors, hedge funds, crowd funding, etc. Banks could stimulate the “Schuldscheinen” (corporate bonds), as an alternative to traditional bank credits. These papers are unlisted privately placed senior debt instruments. They have earlier been used with success.

All panelists considered an ECB interest rate cut to be insufficient to stimulate the European economy. The huge dispersion of rates on loans to companies between core and peripheral countries proves that the transmission of monetary policy to credit rates remains ineffective. More unconventional measures are welcome such as ABS, LTRO with conditionality of use of the obtainable funds, purchase of government bonds, etc. The ECB must work together with the European Commission, the EIB, the EBA and other regulators, but also with national governments to create as soon as possible a real European level playing field in favor of SME-financing. Europe needs a new ambitious project to revitalize its economy and to increase the confidence of the population and the companies, if not a long disappointing growth period will be ahead of us.

The closing plenary session was chaired by Ernest Gnan, Oesterreichische Nationalbank. The panel members were Elena Carletti, Bocconi University, Michala Marcussen, Société Générale Corporate & Investment Banking, and David Llewellyn, Loughborough University.

Elena Carletti gave a presentation “The impact of the regulatory framework on investment in the European Union”. The speaker gave an overview of recent regulatory reforms in the EU, and referred to the Vickers and Liikanen reports. She expected no major changes in the structure of the financial system. Regulatory reforms are expected to have only a modest impact on cost of funding, and thus on level of investment and aggregate output. Bank lending rates to companies remain divergent. The resolution of the Eurozone crisis and the creation of the banking union seems to be the most important regulatory reform going forward. It will help to restore flow of funds to the real economy.

Michala Marcussen discussed the new macro-prudential dimension of central bank policy. Price stability is different from financial stability. In the OECD area, total debt divided by GDP has increased almost every year since 1980. In addition to the traditional task of maintaining...
price stability, major central banks have in recent years assumed responsibilities to maintain financial stability. They have developed new macro-prudential toolkits. Financial policy committees are likely to become more common.

David Llewellyn called his presentation “The Post-crisis Regulatory Regime: Help or Hindrance?” The objectives of regulation are to lower the probability of bank failures and to lower the social costs of bank failures. Because there were no resolution arrangements in place, the tax-payers became the insurers of last resort in the recent crisis. The current approach to bank regulation is excessively complex. Bank business models are endogenous to regulatory regimes, but regulatory regimes are also endogenous to business models. Consequently, regulators and supervisors are always shooting at a moving target. There are limits to what regulation can achieve. There is a danger of incremental over-regulation. In the future, resolution arrangements should aim at protecting depositors and tax-payers. Shareholders should not be protected and non-insured creditors should share the costs.

At the end of the Colloquium, the president of SUERF Urs Birchler awarded the 2014 Marjolin Prize to Alessandro Scopelliti, University of Warwick. The president closed the Colloquium by thanking the authors, speakers, chair persons, organizers and the representatives of the host institution Bocconi University for their hospitality and contributions to a memorable event.

**Report from the 2014 SUERF General Assembly**

This year's SUERF General Assembly was held during the 31st SUERF Colloquium and Baffi Finlawmetrics Conference in Milan on 4 June 2014. Urs Birchler opened the meeting and welcomed those attending the General Assembly. He gave thanks to Philipp Hartmann, who had recently stood down from the Council of Management after serving for nine years, including two terms as the association’s Vice-President, and welcomed Gabriel Fagan (ECB) on board as an observer. Frank Lierman was reconfirmed as Vice President of the Association, serving a second term from 1.5.2014 until 30.4.2017. Roberto Blanco (Banco de España), Carl-Christoph Hedrich (Commerzbank), Michala Marcussen (Société Générale CIB) and Debora Revoltella (EIB) were all elected to the Council of Management, having been observers to the Council of Management since the last General Assembly.

In addition, the mandates of Morten Balling (Aarhus University), Allard Bruinshoofd (Rabobank), Jakob De Haan (DNB), Patricia Jackson (EY), Esa Jokivuolle (Bank of Finland), Frank Lierman (Belfius Bank), Donato Masciandaro (Bocconi University) and Jens Ulbrich (Deutsche Bundesbank) were renewed for a further three years (from 1.1.2015-31.12.2017). Since the last General Assembly held in Amsterdam, there have been conferences in Paris, London and now Milan, with a Research Prize Workshop in Vienna, and event planning for 2014-15 is currently underway for conferences in Reykjavik, Madrid, Vienna (as well as another workshop in Vienna), Helsinki and London, with the 32nd SUERF Colloquium to be held in Frankfurt on the topic of "The SSM at I" in the third quarter of 2015.

Publication activities have continued to consist of SUERF Studies, although a far-reaching review of the association’s publication policy is currently ongoing – SUERF Members are to receive a questionnaire about how the association’s publication strategy should be developed.

Michael Bailey reported on behalf of SUERF’s Honorary Treasurer, Donato Masciandaro, that SUERF’s financial position remains sound, thanks to the support of the Association’s membership, in particular Corporate Members and Central Bank Members. Finally thanks were given to the organizations with which SUERF has organized events in 2013-2014 as well as to the partner who have already committed to organize joint events with SUERF in 2014-15.

Michael Bailey, Executive Secretary
Findings from a SUERF/Central Bank of Iceland Conference in Reykjavik.¹

By Ernest Gnan, Secretary General, SUERF

Seven years after the onset of the financial crisis, economic recovery is uneven and in many countries lacklustre. Although many reforms of banking and financial system regulation and supervision have been undertaken, key issues remain unsolved regarding the structure of the banking system, cross-border banking activity and post-crisis business models. Important questions remain to be answered regarding the “new normal” and post-crisis potential output growth, as well as how we can build a sustainable financial system that serves the real economy. Against this background, this conference brought together top academics, senior policy makers and financial industry leaders to take stock of these issues and discuss strategies to promote post-crisis economic recovery and the reconstruction of the financial sector. Possible stumbling blocks as well as linkages between real and financial recovery were given special attention.

¹ The conference presentations can be found on the SUERF website http://www.suerf.org/index.php?option=com_k2&view=item&id=497&Itemid=170, with the password being “Harpa2014”.

Már Gudmundsson, Central Bank of Iceland, opened the conference, recalling that at the last joint SUERF-Central Bank of Ireland conference on the topic of “The interaction of monetary policy and financial stability in small open economies” worries about mounting imbalances and risks for financial stability were articulated. The discussion then about what instruments to use against emerging imbalances has meanwhile been answered by the creation of macro-prudential policy. But the financial crisis eventually turned out much more severe than expected or feared. Iceland experienced the biggest financial crisis in the country’s history, as the internationally very active Icelandic banks, which had grown rapidly and become very big compared to the economy of their home country, were hit hard by the panic in international banking and financial markets. Forceful crisis management by central banks contributed towards successfully avoiding another Great Depression, but the recovery is lacklustre. The risk of secular stagnation is not off the table, and is attributable to a combination of demand and supply side factors; unresolved legacy issues including high debt levels and fragile banking systems are certainly important. While banks are currently very actively adjusting to the tightened regulatory framework
and reinforcing their capital levels, the aim of re-establishing a reliable financial system that serves the real economy is far from being achieved. The too-big-to-fail problem is yet to be solved. The deeply flawed framework for cross-border banking is still pending to be satisfactorily reformed. The optimal interplay of the financial sector with regulation and safety nets still needs to be studied more deeply.

Iceland’s crisis featured, for one thing, a traditional credit boom fuelled by international capital inflows, which at some point stopped suddenly. For another, it was a collapse of three major banks with huge foreign exchange exposure and maturity mismatch, which lacked an adequate backstop given their huge size compared to Iceland’s economy. This latter aspect was quite unprecedented. Given the huge shock, the resulting recession was comparatively modest, given the costs of the banking crisis were largely borne by other countries and that the crisis hit mostly the financial and construction sectors, while exports were boosted by a low real exchange rate. The recovery since 2011 has been quite vigorous, with economic slack disappearing and unemployment having fallen to 5%, and inflation being slightly below the central bank’s inflation target. Private, public and foreign debt levels, while still very high, are on a declining trend. The biggest challenge yet to be solved are the comprehensive capital controls which turn out to become an increasing impediment for economic development.

Barry Eichengreen University of California, Berkeley, delivered the Keynote speech on the topic of “Designing a financial system for the post-crisis period: a view from economic history”. The economic literature on the link between financial development and economic growth is rather technical, large and yet inconclusive. The recent financial crisis prompted further questions on such link. The Asian financial crisis raised the issue that bank-based financial systems may maximise forced capital accumulation at the cost of efficiency and stability, and thus led to a push towards securitisation. The 2008/2009 financial and economic crisis in turn cast doubts on securities markets as efficient allocators of resources and on the efficacy of universal banks that combine commercial and investment banking functions. Currently, the issue arises whether China is pursuing a similarly hazardous road as it liberalizes its financial markets, facilitating the growth of shadow banking and liberalising its capital account with the aim of internationalising the renminbi.

Eichengreen drew four lessons from economic history for the design of the post-crisis financial system: First, history casts a long shadow, financial systems reflect other economic circumstances and policy decisions in the past, they are networks and are also for this reason hard to change. So, while history is not destiny, policy makers seeking to change the financial system should build on history rather than ignoring it. Second, major events can shock financial systems out of an established equilibrium. Historically, such shocks were associated with wars and their financing needs, but also financial crises that worked to discredit inherited structures and motivated fundamental financial reforms. One will see whether the recent financial crisis will act as such a trigger. Third, the close connection between government and finance is unavoidable, as much as some would like it otherwise. Governments fulfil an essential role in creating the institutional framework and a level playing field, within which financial institutions and markets develop. It is naive to think that financial institutions and markets develop spontaneously. Government regulation can help or hinder the development of an efficient financial structure, suited to the needs of the economy. Regulation can also serve mechanisms through which incumbents maximize their rents, deter entry and slow the adaptation of the financial system to changing economic circumstances. Finally, the distinction between Anglo-Saxon market-based and bank-based financial systems à la Germany and Japan has been given more weight than it deserves. Banks and securities markets are complements, not substitutes. A deep and liquid financial market can enhance the efficiency of the banking system. Banks and securities markets have different comparative advantages in dealing with different customer segments and in carrying out different functions. Banks matter most where relationships matter, financial markets meet the needs of large borrowers better and are good at financing uncertain, competing technologies. The question for Asia or Europe is, thus, not banks or jump-starting securities markets.

In the following discussion, he forecast that ultimately the European Central Bank would conduct more outright securities purchase; for lack of sufficient volumes of other paper, this will imply more buying of government bonds. Regarding corporate governance of financial institutions, economic history studies confirm that this matters very much for financial and economic outcomes. For example, outside directors in boards can greatly
improve communication of financial institutions with the public. He suggested that banks would, without active or passive encouragement by governments, for mere reasons of economies of scale or scope, not become as large as they did in history.

Session 1, devoted to “Post crisis economic recovery: challenges and remedies”, was chaired by Arnór Sighvatsson, Central Bank of Iceland. Athanasios Orphanides, MIT Sloan School of Management, opened the session with a presentation on “Reconstructing Europe: Beyond the Politics of Disintegration”. He argued that over the past decade, particularly since the onset of the economic and financial crisis, Europe’s share of world GDP has continuously declined. While the Great Recession hit the US and the Euro Area alike, the Euro Area recovery has been lagging behind since 2012, and is forecast to do so over the remainder of the current decade. While, according to OECD estimates, between 2007 and 2015 the US will have lost 5% in the level of potential output, Euro Area countries except Germany will have lost up to one third (Greece and Ireland; Spain: 22%, Finland: 19%, Portugal: 14%, Italy 12%). Germany, by contrast, will have lost a mere 3% (followed by Austria: 7%, Belgium, France and the Netherlands with 9%); indeed Germany’s GDP per capita growth has been outperforming that of the US since 2011, while the rest of the Euro Area has stagnated. The divergence in the trend of unemployment mirrors this economic divergence.

A key question in the context of economic crises is, who pays for the costs of economic crises? Proper crisis management minimizes the total cost of financial crises and ensures a fair burden sharing. The euro deprived individual member countries of crisis management tools, while not ensuring the necessary political structural to encourage solidarity and cooperation in crisis management. National politics led governments to focus on shifting losses to others. Massive destruction in some member states and a much higher than unavoidable total cost for Europe as a whole resulted. As examples for this proposition, the author asked who had benefited from the postponement of the resolution and by the injection of credit risk into euro area sovereign debt by the introduction of private sector involvement, in the context of Greece’s sovereign debt crisis? The timing and sequencing of crisis-related policy decisions had important distributional consequences among member states. Orphanides concluded by stating that the status quo of the euro area is unsustainable, the euro in its present form poses a threat to European integration. A reshuffling of political power is thus necessary to move beyond the politics of disintegration. If this proves impossible, plans to unwind the euro should be advanced to preserve the European project.

Stephen G. Cecchetti, Brandeis International Business School, talked about “Debt, growth and recovery”. He started out by pointing out the different developments of public and private debt since 2007 among advanced and emerging economies (EMEs). In the former, public debt rose by 35 percentage points to 112% until 2013, while corporate debt stagnated at around 90% and for private households it fell by 7 percentage points to 75%. By contrast, in EMEs, public and private household debt rose moderately by 5 and 8 percentage points to 43% and 30% respectively, while corporate debt increased sharply by 34 percentage points to 92%. As a result, total public and private sector debt to GDP has sharply increased in most advanced economies (Ireland, Portugal, Greece, Spain, France, UK, US) and in several emerging economies (China, Hong Kong, Singapore). Despite methodological difficulties, empirical studies tend to show non-linear effects in the sense that at low debt levels, higher economic growth is associated with higher debt, while very high debt levels are associated with lower growth. Thresholds for the latter effect are empirically found at around debt ratios of 80-100%. A number of countries are above this threshold now. The economic rationale for such non-linear effect is that up to a certain point, debt allows the smoothing of consumption, investment and production, it enables capital deepening and improves allocative efficiency. Too high debt ratios result in a debt overhang and trigger financial crises. While high public debt seems to hamper economic recoveries, there is no such empirical relationship for private debt.

Tjörvi Ólafsson, Central Bank of Iceland, talked about “Post crisis recoveries: the role of cross-border credit and sectoral misallocation”. The fact that the post-crisis recovery has been slow and uneven despite extraordinary and long monetary accommodation reflects the nature of boom-bust cycles, where resource misallocations and debt overhangs built up during the boom need to be painfully corrected in the following bust phase. In small open economies, domestic financial cycles were lengthened and amplified by interactions with global cycles, spill-overs, foreign funding of credit booms and protracted real exchange rate misalignments, particularly in the late stage of the boom, thereby magnifying resource and credit misallocation to be corrected in the aftermath of the bust. Recovery thus requires, first, resource reallocation in the real economy and, second, balance sheet repair in the financial sector.

Iceland used capital controls to limit the damage of the bust, to re-establish macroeconomic stability and to create breathing space for needed structural adjustments. It was stressed from the outset that capital controls should not postpone the needed adjustments. Iceland’s recovery was primarily export-driven, while former boom sectors (in particular banking and construction) shrunk, with labour being reallocated in a large scale to more sustainable and competitive sectors. The fact that the capital stock
is still contracting reflects the excessive corporate debt accumulation during the boom, the correction of which takes a long time. The extensive debt restructuring has strengthened private balance sheets, so that households’ and firms’ equity position is now similar to the pre-boom period. However, given continued high debt levels, the economic recovery has been credit-less, and the process of balance sheet repair is going to continue. It is vital that post-crisis economies stay clear of “hysteresis” effects. Labour market flexibility, the availability of finance and the creation of confidence are conducive to post-crisis reform processes, while conversely temptation to delay reforms, rigid labour markets, credit constraints and uncertainty pose threats to reforms and to the economic recovery. Central banks face serious communication challenges and have to operate within complex broader policy frameworks with increased political economy risks.

Session 2, chaired by Ernest Gnan, Oesterreichische Nationalbank and SUERF, dealt with the topic of “Reconstructing the financial sector to serve the recovery”. Adrian Blundell-Wignall, OECD, started the session with a presentation on “Post crisis recovery and the finance sector”, which addressed some major challenges currently facing global financial stability and economic growth. The Asian industrial revolution is based on state capitalism and supply chain management of importing to re-export to the West. Beggar-thy-neighbour exchange rate targeting supported by capital controls have made the world exchange rate regime dysfunctional. The huge Asian current account surpluses have to be recycled through capital outflows; but these outflows do not necessarily go to where asset prices have fallen the most, and are not used for example to recapitalize European banks or to lend to sovereigns. Instead they are invested in destinations to secure future food and resource supply. Asian state-owned enterprises benefit from subsidized cost of capital for these FDIs. To offset damage in the traded goods sector, industrialised countries have responded with ultra-easy monetary policies, which are for example reflected by very low real US bond rates since the start of the millenium. Given the close empirical relation between saving and investment in emerging market economies, and given their strongly rising share in world GDP, their model of export-led growth cannot go on indefinitely. Either economic policies will trigger the necessary adjustments, or it will happen through major financial disruption in a future crisis.

Prior to the crisis, the financial sector made up far too big a share of market capitalisations and earnings in the economy. In the future, banking and finance will need to undergo very far-reaching adjustments. Basel equity requirements are far too complex, allowing banks to reduce the ratio of risk-weighted assets to total assets through various “optimization” techniques, and thus to maximize their return on equity. In any case, there is no ex ante reasonable capital rule that is enough in a major crisis. Basel III has not addressed banks’ business model issues that are at the heart of the too-big-to-fail related under-pricing of risk. Moving derivatives towards exchanges and CCBs will alleviate the need for banks to hold capital. Global derivatives volumes have reached levels of 12 times global GDP, and have hardly declined since then. Banks’ gross credit exposure reached USD 5,000 bn in 2008, representing a huge margin call on all exposed banks, compared to which equity volumes were far too small. Commercial banking thus subsidises investment banking through implicit state guarantees for systemically important, too-big-to-fail banks. This is why the OECD supports initiatives to separate commercial from investment banking activities.

Shadow banks, or in the OECD’s terminology: non-bank intermediaries, which comprise e.g. investment funds, pension funds, insurance companies, sovereign wealth funds, private equity funds, hedge funds, and exchange-traded funds, have become very important. They will gain even more weight in the future, as banks come under regulatory pressure, and as the financing of long-term investment and large pension savings in a low-inflation, low-interest rates world need to be matched. Price discovery in securities markets is being hampered by the spreading of passive fund management, index products etc. Small and medium-sized companies face a shortage of equity, since investors no longer make the effort to discover and research such companies.

In the euro area, the asset quality review will remain the big issue in 2014: US banks show much safer distance to default than many euro area banks. This problem is reflected in falling credit volumes in many Euro Area countries, which is not conducive to an economic recovery. The euro implies loss of individual, national monetary and exchange rate policies. But it also implies that, contrary to countries with their own currencies, individual euro area countries can indeed fail; this is reflected in sovereign risk premiums, as compared for example to Japan, the US or the UK. As the euro is, for political reasons, not going to break up, the only other choice is to move towards fiscal union. Otherwise, peripheral euro area countries might face a long period of stagnation and emigration towards more prosperous countries, as had been the case in Ireland in the late 19th century.

Patricia Jackson, Ernst & Young and SUERF, asked “Have the lessons from the crisis been learnt?” In her assessment, much of the focus of reregulation of recent years was on capital and liquidity buffers, but not on the actual failures that led to the crisis. First, large opaque securitisation markets were a major source of the crisis. In the run-up to the crisis, as the market grew, disclosure was not sufficient to show the market’s fundamental change between 2004 and 2005 towards lower lending
standards and reduced due diligence. As the quality of underlying loans deteriorated, tranching, the use of credit enhancement and a range of new instruments (such as CDOs) proliferated; prospectuses were long and difficult to understand. Given the opacity of the markets and instruments, prices reacted too slowly to changing default rates. Similar problems could occur in the same or different global markets in the future, e.g. with assets generated by shadow banks. Regulation has so far not addressed core problems in securitisation. Ways forward to develop these useful markets would be to trade these securities on exchanges in order to encourage transparency and enhance liquidity. This would for example entail a standardisation of prospectuses as well as standards for, and oversight of, rating models. Recently, shadow banking momentum has been growing, leading to different types of structures and relying less on underlying credit assessment.

Second, risk transparency within financial firms needs to be substantially improved. Metrics must reflect risks and lean against disaster myopia, they must reflect true risk and not disguise it. Point in time calculation and assessment of risk created wrong risk perceptions. Value at risk (VaR) models for trading books under-read risk because a mere one-year data history was accepted; thus, VaR measures compress in low-volatility periods and expand too late when volatility rises. This has been addressed by stress VaR and proposed expected shortfall. But a general principle of through-the-cycle (rather than point-in-time) metrics has not been adopted. The point-in-time modelling of PDs (probabilities of default) carries the same risks. Instead, PD estimates should be scaled into through the cycle.

The third failure leading to the crisis was risk concentration and risk culture in financial firms. There was a mix of “disaster myopia” and “false sense of security”. Regulators should in the future focus on concentrated exposures to underlying risk factors. As a response to the crisis, financial firms have changed their internal frameworks for risk governance: the Chief Risk Officer (CRO) now usually holds a senior position within firms and the board is involved. By contrast, more work is still needed to embed risk appetite explicitly in the corporate culture and governance and to enhance risk transparency. Risk culture comprises the attitudes and behaviours of an organisation’s people that influence risks and affect outcomes. A firm’s culture is shaped by the way corporate values are translated into desired behaviours and by fundamental enablers. Risk culture is also influenced by external factors such as regulation. Summing up, Jackson urged regulators to study more thoroughly the true causes of the crisis. Misunderstanding the drivers creates the potential for wrong and ineffective solutions.

Cyrus Ardalan, Barclays PLC, offered a talk on “The Private Sector Perspective: Financial sector developments and reform”. The financial crisis has led to the biggest regulatory overhaul of the industry ever undertaken, addressing resilience, resolvability, market structure, governance and transparency, and an institutional revamping of supervision. In Europe, re-regulation has been even more intense with the creation of the European Banking Union. Overall, reregulation serves to strengthen the financial sector and will contribute to the economic recovery. Between 2007 and 2013, banks have strongly increased their CET1 (core equity tier 1) ratios – mostly through the issuing of equity, given that the return on equity of banks has been quite weak in recent years. However, the magnitude and speed of change has raised a number of issues surrounding global consistency, extraterritoriality, adequacy, cumulative impact and business models.

According to the EU Commission, while substantial progress has been made in the area of financial regulation, outstanding issues are structural economic reforms, the regulation of shadow banking, non-bank recovery and resolution frameworks, and better satisfaction of long-term financing needs. Risks identified by the Commission include regulatory arbitrage, risk concentration, growing asset encumbrance, disorderly deleveraging and excessive complexity of post-crisis regulation. IOSCO’s 2014 “Survey of Securities Markets Risk Trends” has identified regulatory uncertainty, banking vulnerabilities and volatile cross-border capital flows as major risks for banks; further risks include corporate governance issues, financial risk disclosure, shadow banking, search for yield, resolution and resolvability plans, central counterparties (“CCPs”), market fragmentation, and cyber crime. Ardalan also mentioned uncertainty about future macro prudential policy tools as a risk for banking. A critical review of the growth impact of reregulation is required. Given ongoing deleveraging in European banking, non-bank lending and capital market financing should be expanded in Europe. The biggest current challenge is shifting the focus from financial stability towards growth. Without growth, financial stability will
be undermined by the public and private debt overhang as well as by unemployment and social dislocation.

The conference concluded with a panel, chaired by Gillian Tett, Financial Times, as well as Már Gudmundsson, Central Bank of Iceland, David Llewellyn, Loughborough University and SUERF, and Fridrik Már Baldursson, University of Reykjavik, as panellists. The panel focused, inter alia, on the strategic way forward for regulation, on the role of, and experience with, capital controls, and the pros and cons, in the context of the financial crisis, of being inside or outside the euro area.²

Baldursson called for higher capital and better cross-border resolution. Cross-border resolution of banks has been a major problem during the crisis and still is not satisfactorily solved. This was and is also at the heart of the Icelandic banking crisis. The world should study and learn from the Icelandic experience. It is not clear that higher capital requirements for banks will result in higher borrowing costs. Aside from capital controls, both capital outflows and inflows may also be addressed under the aspect of macro-prudential measures. While capital controls were effective during the Icelandic crisis, they cannot stay forever. Many high-tech companies in Iceland are reacting to the capital controls by relocating their production. Regarding the issue of who should bear the cost of banking crisis, the Irish experience of the taxpayer possibly footing all or most of the bill contrasts as the Icelandic one: a proper cost-benefit analysis needs to be done on a case-by-case basis to determine the optimal burden sharing and the sequencing of measures.

Gudmundsson recalled that banking systems are the result of developments and decisions in the past. It is time, to actively ask whether our fractional banking system is the best one. This would not imply the abolition of a financial system altogether. But as long as we have the present system, it will never function without a safety net, which in turn creates moral hazard. Capital requirements on banks are the price to pay for this safety net. The roots of the crisis were too little capital in international banks and regulatory arbitrage. As long as resolution and backstops are not installed at an international level, banks from small countries need to observe limits on their international activity with respect to maturity transformation, foreign currency mismatch, and the collection of deposits at foreign branches. Their international activity should focus on serving foreign activities of the companies of the respective country. Specific risks need to be addressed by appropriate measures, even if this may be regarded as “sand in the wheels” by some. Iceland has for example reacted by imposing strict liquidity ratios and limits on foreign currency exposure on banks. The abolition of Icelandic capital controls needs to be done step by step, in line with the unwinding of problem banks and a solution to dealing with the stock of foreign claims against Iceland. Having one’s own currency, as opposed to being part of a monetary union, can be both a problem in a financial crisis and facilitate macroeconomic adjustment. We need a new and better growth model which is less debt driven and more globally balanced. The world will suffer from low growth for several years, bearing the risk of vicious spirals.

² A full video stream of the panel discussion can be found on the SUERF website: http://www.suerf.org/index.php?option=com_k2&view=item&id=497&Itemid=170
At the end of the day, the over 100 participants left with a better understanding of the core issues currently at stake, and of the different perspectives of financial practitioners, academics and policy makers. The conference highlighted that the reconstruction of the financial sector and the restoration of economic growth are mutually conditional. So, economic policy needs to address them simultaneously and as part of a comprehensive, consistent package. Financial crises are possible triggers for substantial reforms. But it is yet to be seen whether the recent financial crisis will act as such a trigger. The close connection between government and finance is unavoidable, if only since it is Governments that set the rules and incentives for financial institutions to operate, and Governments are thus also – at least partly - responsible for the outcome. The re-regulation of the banking and financial industry so far achieved is widely considered to be conducive to contributing to greater financial stability in the future. At the same time, it was criticized by some as being incomplete, not necessarily optimally targeted at the areas truly critical for financial stability, while others saw it as having reached a point beyond which the costs of further regulation might outweigh the benefits. For the euro area to function smoothly in the future and to restore growth also in the peripheral countries, many held the view that the hitherto observed continued focus on national interests needs to give way to a more fundamental and far-reaching reform of governance and of burden sharing. Substantial new financial stability risks are looming from global exchange rate distortions, and the resulting current account imbalances, mispricing of various asset classes and financial exposures.
### Programme

**Friday, 14 November, 2014**

08.30  *Registration*

09.00  **Opening and welcome**

**Elvira Rodríguez**, Chairperson, CNMV

**Urs Birchler**, President, SUERF, and University of Zurich

09.30  **Institutional Keynote and 2014 SUERF Annual Lecture**

Chair: **Elvira Rodríguez**, Chairperson, CNMV

**Sir Paul Tucker**, Senior Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School and Harvard Business School, former Deputy Governor of the Bank of England

10.15  **Coffee Break**

10.30  **Session 1 – Addressing investor protection issues in retail investment products: more information or more intervention**

Chairperson: **Juan Fernández-Armesto**, Former President CNMV

**Michalis Haliassos**, Chair for Macroeconomics and Finance, Goethe University, Frankfurt am Main

**ESMA and investor protection**

**Laurent Degabriel**, Head of Economics and Financial Stability, ESMA

**Protecting financial consumers and retail products: a case for smart intervention and better information**

**Theodor Kockelkoren**, Member of the Executive Board, AFM, and Chairman OECD Task Force on Financial Consumer Protection

**Beyond information: the role of banks and financial entities in educating investors**

**Juan Carlos Ureta**, President Renta4 and President Fundación de Estudios Financieros

12.15  **Coffee Break**

12.30  **Session 2 – Fostering financial literacy: experience and perspectives**

Chairperson: **Fernando Restoy**, Deputy Governor, Banco de España

**José Manuel González-Páramo**, BBVA, Member of the Board of Directors, Chief Officer, Global Economics, Regulation & Public Affairs

**Financial literacy and education: facts, fiction and practical implications**

**Henriëtte Prast**, Professor of Personal Financial Planning at Tilburg University


14.00  **Lunch**
15.15  Academic Keynote
Chairperson: Urs Birchler, President, SUERF, and University of Zurich
Andrei Shleifer, Professor of Economics, Harvard University

16.15  Coffee Break

16.30  Session 3 – Corporate governance issues in listed companies: do we need a stricter regulatory approach?
Chairperson: Manuel Conthe, Former President, CNMV
Antonio Vázquez, Chairman, International Airlines Group (IAG)
Happy Families and Hungry Hedge Funds: Have We Got It Right?
Colin P. Mayer, Said Business School, Oxford University
Eddy Wymeersch, Chairman, Public Interest Oversight Board

18.00  End of Conference

Conference Microsite: www.suerf.org/madrid2014

SUERF/OeNB/BWG Conference
Asset-liability management with "lowflation" and ultra-low interest rates
11th March 2015
Kassensaal (1st floor), Oesterreichische Nationalbank
Otto-Wagner-Platz 3
A-1090 Vienna, Austria

Conference Microsite: www.suerf.org/vienna2015

SUERF/Bank of Finland Conference
Market Efficiency and Liquidity
June 2015
Helsinki, Finland

Conference Microsite: www.suerf.org/helsinki2015
Call For Papers
Deadline for Submissions 30 September 2014

Motivation:
The economic, financial and sovereign debt crisis has triggered a wave of new regulation for banks and the financial sector at large. The aim is to avoid, or at least to reduce the probability, of future financial crises. First, to start with, through tighter and more comprehensive regulation as well as supervision, financial firms and markets are hoped to become more resilient; second, enhanced toolkits and sharply increased resources should put supervisors in a position to detect risks in the financial sector on time and to take appropriate countervailing action; third, new procedures for restructuring of financial firms and for bailing in owners and creditors aim to reduce ex post the cost for tax payers in the event of failure and to correct ex ante moral hazard and distortionary incentives arising from too-big-to-fail etc.

This new framework for regulation and supervision has been accompanied by a comprehensive body of new theoretical, empirical and policy-oriented research, much of which is still unfolding and developing further. Practical experience with the new regulatory and supervisory regime is only starting. Some advance quantitative estimations of the consequences of various types of new regulation showed sharply divergent effects.

This call for papers invites original research – theoretical or empirical, academic or policy-oriented – on the economic consequences and the costs and benefits of the reregulation of banks and the financial sector at large. Some examples for fields of research are:

- Macroeconomic impact on credit supply, economic growth
- Effects for monetary policy transmission and operation
- Effects on the future role and functioning of central banks
- Effects on the future business model of banks and other financial intermediaries, as well as for various financial market segments
- Effects on the size of the financial sector, on profits and salaries to be expected in the future
- Effects on the cost of financing and of financial services for the real sector
- Effects on the products offered (or no longer offered) by the financial sector in the future
- Likely effectiveness with a view to avoiding future financial crises
- Estimates on the size of the costs caused by the crisis, and thus on the costs hopefully to be avoided in the future
- Possible or already observed circumvention of the new regulation, possible further resulting rounds of regulation
- Possible regulatory arbitrage between countries and types of financial firms and markets (e.g. shadow banking)

This list is non-exclusive, other contributions fitting into the overall topic of the call for papers are highly welcome.
Information about the Prize:

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 Azerbaijan, Bosnia and Herzegovina, Russia, Serbia, Turkey and Ukraine) and born after 30 September 1979. Prizes of EUR 5,000 gross will be awarded to up to two outstanding papers on topics related to “Reregulation of the financial sector – economic consequences, costs and benefits”. The winning papers will be presented at a short SUERF/UniCredit & Universities Foundation Workshop to be held at Vienna University of Economics and Business on the morning of Thursday, 11 December, 2014. Subject to agreement by the authors, SUERF and the UniCredit & Universities Foundation the papers may be published on the organisers’ respective websites.

Information about Submissions:

Applications should be submitted through the online submission form on the UniCredit & Universities Foundation website at www.unicreditanduniversities.eu in PDF format by 30 September 2014, in English. Applications should be accompanied by 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.

Research Prize: www.suerf.org/researchprize
Workshop: www.suerf.org/vienna-uuf2014

New SUERF Members

Corporate Members

France
Olivier de Bandt
Autorité de Contrôle Prudentiel et de Résolution (ACPR), Paris
www.acpr.banque-france.fr

Portugal
Manuela Athayde Marques
Associação Portuguesa de Bancos (APB), Lisbon
www.apb.pt

United Kingdom
Michala Marcussen
Société Générale Corporate & Investment Banking (SGCIB), London
www.sgeib.com

Personal Members

Bulgaria
Rayna Dimitriov, SWU University, Blavoevgrad

Lithuania
Julius Vainoris, Bank of Lithuania, Vilnius

Slovenia
Vilma Hanžel Kratochwill, Bank of Slovenia, Ljubljana

Sweden
Mikael Wendschlag, Uppsala University, Stockholm
Joseph A. Schumpeter (1883-1950) was one of the most influential economists of the 20th Century. He was born in Trest in the former Austrian-Hungarian Empire and studied law and economics at Vienna University 1901-06. He was first affiliated with the University of Graz. After short periods as Austrian Minister of Finance (1919-20) and chief manager of an Austrian bank (1920-24), he became Professor at the University of Bonn in Germany in 1925. From 1932 up until his death in 1950, he was professor at Harvard University.

In most of his research publications, Schumpeter preferred to exceed the traditional limits of economic theory and to analyze economic phenomena in a broad historical, political, institutional and sociological framework. This broad research approach is exemplified by his by far most famous book “Capitalism, Socialism and Democracy”, which was first published in 1942 during the Second World War but reappeared in revised editions in 1946 and 1949.

The manuscript of the present book “Treatise on Money” was discovered among the papers left by Schumpeter on his death in 1950. The text revealed that he had worked on the book project “Geld und Währung” during many years. Some notes were written as early as in the late 1920s, while teaching economics at the University of Bonn.

The text was originally meant to be published as volume 36 of the huge “Enzyklopädie der Rechts- und Staatswissenschaft”, but Schumpeter later changed his mind. He revised the manuscript several times, but he never finished it. There has been a great deal of speculation as to why Schumpeter did not publish the book. Some observers have referred to the success of the contemporary outstanding British economist John Maynard Keynes, who in the 1930s published two very influential books: “Treatise on Money” (1930) and “General Theory of Employment, Interest and Money” (1936). The world-wide economic depression in the early 1930s changed the focus in economic research away from account settling and clearing functionality of financial markets and towards means to fight unemployment. Keynes saw the implications of this earlier than Schumpeter and provided a strong theoretical basis for activity stimulating policy instruments, in particular in various forms of fiscal policy.

Fritz Karl Mann (University of Cologne) took the initiative in the 1970s to publish the unfinished manuscript under the title “Das Wesen des Geldes”, with Vandenhock & Ruprecht, Göttingen in veneration for the old master and in accordance with the wishes of Schumpeter’s widow. A new German edition was published in 2008. The 2014 English edition based on the 2008 version is translated by permission of Vandenhoeck & Ruprecht. In the English translation, the title has been changed from “The Essence of Money” to “Treatise on Money”. This last title was used by Schumpeter himself in a reference to the unfinished manuscript in his own published work “Business Cycles”, (1939).

Schumpeter’s broad analytical approach is already visible in some of the words used in the chapter headlines. He writes about the history of money, the sociology of money, the doctrine of money, the capitalist economic process, the economic account in the Socialist Commonwealth, the theory of the price level and the money market as heart of the capitalist economy.

The book is extraordinary rich in terms of references to classical philosophers and economists. Schumpeter has studied and quotes extensively the works of Charles de Secondat Montesquieu, Adam Smith, Thomas Robert Malthus, David Ricardo, David Hume, John Locke, John Stuart Mill, Karl Marx, Léon Walras, Alfred Marshall, Gustav Cassel, Knut Wicksell, Vilfredo Pareto, Eugen von Böhm-Bawerk, Étienne Laspeyres, Hermann Paasche, A.C.Pigou, Carl Menger, John Maynard Keynes and many many others. So, in addition to monetary theory the book provides a very well written survey of the history of economic ideas.
Schumpeter wants the reader to understand that money is an important subject. Already on page 1 he writes: “a people's monetary system exercises a fundamental influence on its economic activity and its destiny in general”. On page 2 follows the impressive sentence: “Nothing demonstrates so clearly what a people is made of than how it conducts its monetary policy”. After having referred to the German inflation in the 1920s, he describes the disorganizing effect of a currency breakdown on national character, morality, and all branches of cultural life. Some of Schumpeter’s sentences are very long. From time to time, the reader is reminded of the fact that the author originally formulated them in German. Nevertheless, the text is clear. His discussion of the goal of monetary policy (p. 7-11) – price stability or inflation below a certain level – sounds surprisingly modern.

In chapter 2 regarding the sociology of money, Schumpeter explains that it is impossible to write a satisfactory history of the monetary system independently of theory. He explains the four functions of money: medium of exchange, measure of value, standard of deferred payments and store of value.

Chapter 3 contains an outline of the development of the doctrine of money. The author describes monetary theory in the Ancient World, in the Medieval Period, in the Early Modern Period and in the Modern Age. Schumpeter was a great admirer of David Ricardo. “The nature of money was very clear to him, and it was this which kept him from explicitly saying that material value does not essentially appertain to money” (p.74).

Ricardo knew (!) that the stability of purchasing power is the decisive factor in assessing a monetary system (p.75). Another economist held in high regard by Schumpeter was Léon Walras. In the 1886 edition of “Théorie de la Monnaie”, Walras brings the principle of cash-holding in as the cornerstone of the theory of money (p.83). Gustav Cassel is credited for the development of the theory of purchasing power parity (p.84).

The economic account in the Socialist Commonwealth makes up the economic account (p.94). Schumpeter explains that resource allocation in such an economy presupposes a unit of account as well as of entitlement and that the institution of money can fulfill this need.

In chapter 5 and 6, Schumpeter discusses the capitalist economic process and the roles of households and firms in this process. In a market economy, the production process does not proceed with a conscious plan, nevertheless a certain order prevails and not anarchy. Entrepreneurs and merchants play a decisive role. Households earn income in many forms: wages, rents, quasi rents, monopoly profits, speculative and windfall profits, entrepreneurial profits, interest and dividends. Household expenses consist of consumer spending, investments, debt repayment and interest payments. If incomes and expenditures are not in balance, bank deposits and bank loans are used to accommodate imbalances. Firms earn income by selling their products, and the fundamental expenditure items of firms are payments for purchased means of production including wages and cost of maintenance and operation and cost of expansion or modification of installations. Entrepreneurial profits are the premiums that in the capitalist economy are set for the successful implementation of an innovation in the economic process (p.139).

Banks and the central bank are discussed in more detail in chapter 7. Schumpeter describes the role of banks in the financial system and the most important items in banks’ income statements and balance sheets. From time to time, Schumpeter applies dramatic language: “Cash on hand – can be a real reserve with respect to borrowed funds in the sense of being kept ready to form a first line of defense against an onslaught of “depositors” when they make withdrawals, not as part of ongoing activity but with the intention temporarily or permanently to retire from bank transactions, as it wont to happen in panics” (p.161). Schumpeter stresses the role of the central bank as a bank for the private banks (p.166). Central bank independence is important (p.169). The list of monetary policy instruments comprise open-market operations, discount rate policy and moral suasions. An interesting point concerns the “profit interests of the central bank” (p.178). In Schumpeter’s view, there are no serious conflicts in the longer term between the profit interests of the central bank and the broader public interest. Depending on the legal framework, the central bank can prevent functionless panic-inspired damage to the economic process. It can iron out short-term fluctuations in the discount rate that otherwise might cause serious disturbance to such a sensitive money organism –. Especially in connection with exchange-rate policy –” (p.180).
Chapter 8 deals with bank-mediated money creation. Provision of checking and giro balances to households and firms are essential parts of banking business. These credit items are “cash” for the households and companies concerned, available quite as easily and for the same purposes as when furnished with an equal amount of physically held coins (p.190). When banks acquire assets, they create bank liabilities that for other people are cash. Bank credits create bank deposits. For individual banks, the derived deposits partly goes to other banks, but for the banking system as a whole the principle holds. Through the interbank market liquidity deficits and surpluses can be accommodated. This is essential to the understanding of the bank-mediated settlement process. The banking system can create purchasing power (p.202).

The headline of chapter 9 is the essence of money. Schumpeter applies the idea of social central bookkeeping, which registers all economic activities and makes it possible to explain how payment processes are related to economic life. Money is used as a means of payment for the provisional adjustment of credit relations deriving from the non-simultaneity of the services and counter-services entering into the economic clearing process (p.218). With reference to Léon Walras, Schumpeter discusses how to determine the value of money. It can be done arbitrarily or it can be based on a commodity, for instance gold (p.232). Schumpeter has harsh remarks about gold coverage provisions in central bank legislation. “What is at play here is primarily a deliberate defense on the part of public opinion that has learned from abuse and disasters, and legislation following in its wake. The memorial to this mentality, that pays homage to a naïve but in practice often very healthy metallism and that views bank-mediated money creation as a shameful thing to be opposed” (p.239).

In chapter 10, Schumpeter draws some conclusions. Money is nothing more than a technical tool of social clearing (p.241). Money is not a good and not a commodity. Coins can in principle continue to circulate endlessly and facilitate economic transactions. The velocity of circulation reflects the change of hands that coins undergo. It is not strictly correct but practically allowable to speak by analogy with the velocity of the circulation of coins, of the velocity of the circulation of deposits (p.247).

Chapter 11 is a very long and detailed discussion of price index problems. Schumpeter explains the implications of changes in goods combinations and quality of goods. Weightings should have economic meaning (p.286).

In chapter 12, which is the final and incomplete chapter of the book, Schumpeter starts with the equation of exchange: \[ M \times V = P \times T \]

where \( M \) is money supply, \( V \) velocity of circulation, \( P \) is an index of the price level and \( T \) a measure of the quantity of goods transacted. Even though the equation seems to have tautological features, it can help us to understand the payment processes and the essence and materialization of the national accounts (p.296). Only with an understanding of the money and credit side of the economic development can we begin to understand the capitalist money process. The economy tends to show self-motion with a wave-like character. Entrepreneurs play a key role both in up-turns, where they borrow in order to introduce better methods of production and innovations, and in down-turns. The money market is, according to Schumpeter, the heart of the capitalist economy. Monetary theory has to take the multiplicity of interest rates into consideration. Science was and often still is inhibited in the task of unbiased recognition of the contours of reality in this area (p.325).

A reviewer has an obligation to decide if he wants to recommend a book to a wider readership. Schumpeter’s book will be of interest to readers who are also interested in monetary and economic history and in an overview of the contributions of classical philosophers and economists to monetary theory. Such readers will enjoy the exciting text written by an intelligent and hardworking economist with a deep understanding of the interplay between money, finance and politics. Readers, who are more interested in implications for monetary policy in the 21st century, may prefer other sources in light of the far-reaching changes over the 60+ years that have passed since Schumpeter’s death.
SUERF Council of Management

Urs W. Birchler  
President

Frank Lierman  
Vice-President

Ernest Gnan  
Secretary General

Donato Masciandaro  
Hon. Treasurer

Morten Balling  
Managing Editor

Roberto Blanco  
Editorial Board

Allard Bruinshoofd  

Jakob De Haan

Alain Duchâteau

Gabriel Fagan

Carl-Christoph Hedrich

Patricia Jackson

Esa Jokivuolle

Ryszard Kokoszcynski

David T. Llewellyn

Michala Marcussen

Robert N. McCauley

Debora Revoltella

Jens Ulbrich

Natacha Valla
The Council of Management has approved the following forthcoming events in 2014-15. Further information about each event can be found, in the first instance, by consulting the respective event microsite.

14 November 2014
Madrid, Spain
SUERF/CNMV Conference
Challenges in Securities Markets Regulation: Investor Protection & Corporate Governance
Conference Microsite: www.suerf.org/madrid2014

11 December 2014
Vienna, Austria
SUERF/UniCredit & Universities Foundation Workshop
Title to be announced - Workshop for SUERF/UUF Research Prize
Event Microsite: www.suerf.org/vienna-uuf2014
Call for Papers closes 30.09.2014

11 March 2015
Vienna, Austria
SUERF/OeNB/BWG Conference
Asset-liability management with "lowflation" and ultra-low interest rates
Conference Microsite: www.suerf.org/vienna2015

June 2015
Helsinki, Finland
SUERF/Bank of Finland Conference
Market Efficiency and Liquidity (working title)
Conference Microsite: www.suerf.org/helsinki2015

3rd Quarter 2015
Frankfurt, Germany
32nd SUERF Colloquium
The SSM at 1
Colloquium Microsite: www.suerf.org/c32

Further information about all forthcoming events is available from the SUERF website at www.suerf.org