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Foundation of the Swiss National Bank

STUDY CENTER
GERZENSEE

NEWSLETTER

JANUARY 2011

EDITORIAL

Twenty-five years ago, the Study Center opened its doors for the first Central Bankers Courses. Thousands of central bank economists and lecturers from all over the world have since then come to Gerzensee. Over the years, they have been joined by students participating in the Swiss Program for Beginning Doctoral Students in Economics, students and faculty members taking part in the Advanced Courses in Economics as well as in Law and Economics, and researchers attending the Center's numerous conferences.

Twenty-five years on, the Study Center has built a reputation among central bankers for high quality teaching. It has helped to transform doctoral education in economics in Switzerland. It has also become a preferred meeting point for leading international academics who appreciate the Center's professional and conducive environment.

This Newsletter briefly reports about the Center's course and conference activities in the recent past and the plans for the months ahead.

Looking back, the academic activities during the past year were as diverse and exciting as ever. They noticeably reflected the heightened interest among academic economists and practitioners alike in matters related to the financial crisis and its consequences. In particular, the conference with the Journal of Monetary Economics focused on the lessons from the crises and directions for macroeconomics. Sessions of the conference with the Swiss Finance Institute and of the symposia with the Centre for Economic Policy Research addressed questions of market design, financial regulation and topics in macro-finance. One of the advanced doctoral courses, taught by Harrison Hong, focused on behavioral finance (see also the interview on page 2). Furthermore, a commission of experts including Ernst Baltensperger and Thomas Jordan, both affiliated to the Center, submitted a proposal for regulatory reform in the financial sector to the Swiss Federal Government.

The academic activities scheduled for the anniversary year 2011 include the Swiss Program, Advanced and Central Bankers' Courses as well as a host of conferences. The European Summer Symposium in Economic Theory will be organized for the 20th time at Gerzensee, the European Summer Symposium in International Macroeconomics for the first time. We look forward to these conferences as well as to all the other events, which will bring many of this Newsletter's readers back to Gerzensee.

Dirk Niepelt
Director

INTERVIEW WITH HARRISON HONG

BEHAVIORAL FINANCE AND FINANCIAL CRISES

Professor Hong, in parts of your research you study whether smarter financial markets are better financial markets. Could you explain what you find?

The premise of this research is that financial markets have become markedly smarter over the last thirty years. The vast majority of assets are now managed by intermediaries such as mutual funds or hedge funds. The high wages in the finance industry have also attracted many of the most talented from our society. In the Hayek-Friedman theory of efficient markets, as the I.Q. of the marginal investor in financial markets rises, markets ought to become more stable in the sense that price should deviate less from its fundamental value. Yet, the financial market turmoil and crises over the last thirty years suggest otherwise.

My research provides a rationale for why trading by sophisticated investors can be destabilizing. My model focuses on a very popular (almost ubiquitous) type of strategy employed by many professional investors called momentum trading in which these funds buy assets that have recently appreciated and short-sell assets that have recently depreciated. Suppose that the technology for some market participants is such that information about a company diffuses gradually as it gets spread via friends or family. Price then under-reacts to the arrival of information and as information gradually diffuses, it generates positive serial correlation in returns. This gradual information diffusion makes momentum trading profitable on average as hedge funds help accelerate the reaction of price to information with their trend changing strategies. But my model shows that these strategies lead to over-shooting as the momentum trading might be triggered by previous rounds of momentum trading as opposed to the arrival of news. Early momentum buyers profit but at the expense of late momentum buyers who bought at too high a price. Price is on average more volatile with these momentum traders than without. In this sense, smarter markets are not necessarily better as the quicker reaction of price to information comes at the expense of over-shooting and excessive volatility.

You also study the role that disagreement plays in financial markets. Could you briefly summarize the role of disagreement?

The idea is that investors can draw different conclusions from looking at the same set of data or public news, and this disagreement is a leading cause of the high levels of trading volume and potentially speculative bubbles in financial markets. Worldwide trading volume each year totals around 50 trillion dollars. Most economists view this high level of trading as being difficult to reconcile with standard models of liquidity or rebalancing. And speculative episodes in financial markets are often associated with extremely high volume. Over the last decade, I have tried to build asset pricing models based on such disagreement about fundamental value. This approach yields simple and tractable models that can better capture bubble and crash dynamics than those based on risk sharing or liquidity. For instance, when there are short-sales constraints, disagreement leads to over-pricing as only the valuations of the optimists are reflected in prices since pessimists simply sit on the sidelines. And asset price bubbles can arise as investors value an asset not only for its fundamental value but also for its resale option. Corrections to over-pricing arise due to increased supply and crashes can periodically arise as hidden information regarding pessimists' valuations due to short-sales constraints are revealed when optimists' valuations fall. These dynamics fit with much of what we know about speculative episodes and the crashes that follow.

It almost seems conventional wisdom – especially in policy circles – that excessive compensation in the financial sector is to blame for excessive risk-taking and the financial crisis. Is this view consistent with what you find in your research?

Consistent with conventional wisdom in policy circles, I do find that compensation and risk-taking is correlated for finance firms during the period of 1992-2008. Residual pay (defined as total executive compensation controlling for firm size) is correlated with price-based risk-taking measures including firm beta, return volatility, the sensitivity of firm stock price to the ABX subprime index, and tail cumulative return performance.

However, in contrast to conventional wisdom in policy circles, I find compensation and risk-taking are not related to governance variables. The prevailing view in policy circles is that this risk-taking is a failure of governance. Instead I find that firms with high compensation and risk-taking are actually more likely to be held by institutional investors who tend to have short-termist preferences and the power to influence firms' management policies. My findings suggest that the correlation between residual pay and firm risk-taking is due to investors with heterogeneous short-termist preferences investing in different firms and incentivizing them to take different levels of risks.

At the moment there are discussions in many countries, including Switzerland, how one should address the problem that some banks are considered to be "too big to fail". What is your view about how countries should tackle this problem? Does behavioral finance offer us some insights that more mainstream economists might overlook?

Behavioral finance has a number of insights into financial markets that might be of use in thinking about "too big to fail". The first is that sophisticated institutions, especially if

Professor Harrison Hong is the John Scully '66 Professor of Economics and Finance at Princeton University, where he teaches courses in finance in the undergraduate, master and Ph.D. programs. Before joining Princeton in 2002, he was on the faculty of the Graduate School of Business at Stanford University. He received his B.A. in economics and statistics with highest distinction from the University of California at Berkeley in 1992 and his Ph.D. in economics from M.I.T. in 1997. His research has covered such topics as: behavioral finance and stock market efficiency; asset pricing and trading under market imperfections; incentives and biases in decision making; organizational form and performance; and social interaction and markets. He is on the editorial boards of the Journal of Finance and the Journal of Financial Intermediation. He is a Director of the American Finance Association and a research associate at the National Bureau of Economic Research. In 2009, he was awarded the American Finance Association's Fischer Black Prize, given biennially to the person under 40 who has contributed the most to the theory and practice of finance.

they are levered, can actually destabilize markets. Institutions have a tendency to herd and their herd behavior means that when their trades go badly, their forced selling (because of margin calls and because no one else is around who can evaluate their trades and buy from them) can lead prices to fall far below fundamental value, thereby triggering a need for government intervention or a bailout. Here leverage and herd behavior suggests that size itself may not be a sufficient statistic in thinking about "too big to fail". Leverage and correlatedness of trades emerge as additional important variables to tackle this issue.

The second useful insight is that the traders at these institutions themselves speculate and are prone to overconfidence, believing that they can profit during speculative episodes and get out before everyone else when things collapse. This excessive risk-taking and trading also needs to be addressed in conjunction with the "too big to fail" problem. Here, issues of compensation structures such as more extensive clawback rules and trying to tie pay closer to longer-term performance are also crucial. It isn't credible for governments to commit to no bailouts given the general tendency of governments to protect their banking sectors. So arrangements aimed at deterring excessive speculation are important.

What is your view on the sovereign debt crisis in Greece and elsewhere in Europe? Do you think this crisis was driven by fundamentals, or did prices depart from fundamentals?

Part of current sovereign debt crisis in Europe originated in the credit market and real estate bubbles. The mispricing of risks in credit and housing across many countries led to too much easy credit and hence over-leveraging and over-building or over-consuming. The deleveraging and the unwinding of these excesses are contributing to these sovereign debt concerns as excessively rosy projections for GDP growth are revised and poor investments and losses are put onto the countries' balance sheets. The process of deleveraging often entails some over-shooting of fundamentals but it is hard to say how much.

Rating agencies have received quite some attention in recent years. First they were blamed for their good ratings of mortgage investments that turned out to be bad. And this year when international credit rating agencies downgraded government bonds of Greece, Spain and Portugal, they were blamed for exacerbating price distortions. What do you think of the role of rating agencies in financial markets in general, and in the last few years in particular?

Rating agencies as part of the structured finance machine rated thousands of securitized products AAA. There is now evidence that the ratings agencies used extremely naïve and non-robust models to evaluate the structured finance products at the heart of the crisis. For instance, an often-cited anecdote is that the models these agencies used to rate the mortgage-backed products did not allow for low to negative home price appreciation. Whether they did this because they were genuinely naïve, or if they had conflicts of interest since this business generated lots of revenue is hard to say since many other institutions also got it wrong. But the ratings game in which institutions can only buy a product if it was rated AAA no doubt contributed to a false sense of security on the part of these institutions and a mispricing of risk.

Their failure in the subprime debacle probably made rating agencies easy scapegoats for governments who do not agree with what they hear. Governments being the ultimate insiders are likely to be more optimistic in their reading of their growth prospects given the same public information than outside speculators or rating agencies.

Do you think we should still teach the efficient market hypothesis to economics students? If not, what should we teach instead?

Sure, efficient market models are a starting point in any analysis of financial markets. It is hard to know what deviation from fundamentals means without some sort of an efficient markets benchmark. Having said this, whereas this material would have been an entire semester in the past, I would now only spend one-third of the course before focusing on non-fundamental or speculative factors which matter greatly in shaping the risk-return trade-offs. These factors are first-order and force a rethinking of the types of variables we consider in modeling asset price movements. Rather than only estimating cash flow or consumption betas, behavioral finance suggests also focusing on speculative factors such as trading volume. These factors tend to be persistent and influence not only short-term price fluctuations but even returns over very long horizons. Behavioral finance research over the last two decades indicates that these sorts of non-fundamental risks can be modeled and estimated. Hence my belief is that in the not-too-distant future, these sorts of behavioral finance analyses, which are currently only considered by the most sophisticated of investors, will gradually be incorporated by more and more investment professionals as these materials are increasingly adopted in classrooms.

Professor Hong, thank you very much for this interview.

Roland Hodler conducted this interview.

ACADEMIC CONFERENCES

NCCR FINRISK RESEARCH DAY AND DOCTORAL WORKSHOP

May 21 - 22, 2010, jointly with Swiss Finance Institute

Selected Sessions:
Risk Management
Asset Pricing and Portfolio Management
Corporate Finance
Quantitative Methods in Finance

Program available at http://www.szgerzensee.ch/research/conferences/

EUROPEAN SUMMER SYMPOSIUM IN ECONOMIC THEORY

July 5 – 16, 2010, jointly with CEPR

Selected Sessions:
New Directions in the Theory of Choice
Market and Mechanism Design

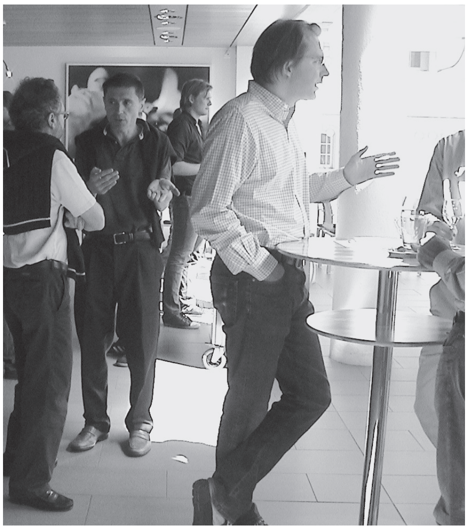
Program available at http://www.szgerzensee.ch/research/conferences/

EUROPEAN SUMMER SYMPOSIUM IN FINANCIAL MARKETS

July 19 – 30, 2010, jointly with CEPR

Selected Sessions:
Asset Pricing and Portfolio Choice with Options Data
Capital Constraints and Asset Pricing
Stock and Bond Market Volatility and Predictability
Investment-Based Asset Pricing
Unconventional Approaches and Actors
Financial Regulation
Finance and Macro

Program available at http://www.szgerzensee.ch/research/conferences/



CONFERENCE WITH THE JOURNAL OF MONETARY ECONOMICS

October 15 – 16, 2010, jointly with the Journal of Monetary Economics and the Swiss National Bank

Directions for Macroeconomics: What did We Learn from the Economic Crises?

Dealing with Consumer Default: Bankruptcy vs Garnishment
Authors: Satyajit Chatterjee and Richard G. Gordon
Discussants: Per Krusell and Leonardo Martinez

Financial Crises, Bank Risk Exposure and Government Financial Policy
Authors: Mark Gertler, Nobuhiro Kiyotaki and Albert Queralto
Discussants: Philippe Bacchetta and Ernst-Ludwig von Thadden

Financial Crises and the Optimality of Debt for Liquidity Provision
Authors: Gary Gorton, Bengt Holmstrom and Tri Vi Dang
Discussants: Aleksander Berentsen and Jean-Charles Rochet

Business Cycle Variation in the Risk-Return Trade-Off
Authors: Hanno Lustig and Adrien Verdelhan
Discussants: Jean-Pierre Danthine and Amir Yaron

Targeted Transfers and the Great Recession
Authors: Hyunseung Oh and Ricardo Reis
Discussants: Valerie Ramey and Fabrizio Zilibotti

Wage Rigidities, Reallocation Shocks, and Jobless Recoveries
Author: Robert Shimer
Discussant: Rafael Lalive

Program available at http://www.szgerzensee.ch/research/conferences/

OTHER CONFERENCES

Ausschuss Geldtheorie und Geldpolitik of the Verein für Socialpolitik held its meeting with the Swiss National Bank from February 12 to 13, 2010.

Swiss Economics Abroad held their annual conference on December 21, 2010.

Information available at http://www.szgerzensee.ch/research/conferences/

COURSES

CENTRAL BANKERS COURSES 2010

Advanced Topics in Monetary Economics I
Lecturers: Giancarlo Corsetti, Harris Dellas, Juan José Dolado

Monetary Policy, Exchange Rates and Capital Flows
Lecturers: Philippe Bacchetta, Stefan Gerlach, Philipp Harms

Inflation Forecasting and Monetary Policy, jointly with the Swiss National Bank
Lecturers: Volker Wieland, SNB-Staff

Capital Flows and Monetary Policy with Special Reference to Eastern Europe and Central Asian Economies, jointly with Joint Vienna Institute
Lecturers: Philippe Bacchetta, Martín Gonzales-Eiras, Philipp Harms

Advanced Topics in Monetary Economics II
Lecturers: Frank Schorfheide, Carl Walsh

Instruments of Financial Markets, jointly with Swiss Finance Institute
Lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

Regulatory Responses to the Financial Crisis, jointly with the Swiss National Bank
Lecturers: Philippe Bacchetta, Urs Birchler, Randall Kroszner, Michael Rockinger, Ernst-Ludwig von Thadden

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2010

Microeconomics
Lecturers: Mathias Dewatripont, John Moore, Jean-Charles Rochet, Klaus Schmidt

Macroeconomics
Lecturers: Jordi Galí, Robert King, Sérgio Rebelo

Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2010

Recent Developments in Mechanism Design
Lecturer: Stephen Morris

New Dynamic Public Finance
Lecturer: Iván Werning

Behavioral Finance
Lecturer: Harrison Hong

Program Evaluation Methods
Lecturer: Guido Imbens

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2010

Introduction to Law, Economics and Business
Lecturer: Robert Cooter

Introduction to Empirical Legal Studies
Lecturer: Kathy Zeiler

AGENDA

CONFERENCES 2011

European Summer Symposium in International Macroeconomics, ESSIM, jointly with CEPR
Research Day and Swiss Doctoral Workshop in Finance, jointly with Swiss Finance Institute
European Summer Symposium in Economic Theory, ESSET, jointly with CEPR
European Summer Symposium in Financial Markets, ESSFM, jointly with CEPR
Conference with the Journal of Money, Credit and Banking, jointly with the Swiss National Bank and University of Bern

Information available at http://www.szgerzensee.ch/research/conferences/

CENTRAL BANKERS COURSES 2011

Advanced Topics in Empirical Finance, jointly with the Swiss National Bank
Lecturers: Casper de Vries, Thierry Foucault, Michael Rockinger

Monetary Policy, Exchange Rates and Capital Flows
Lecturers: Philippe Bacchetta, Stefan Gerlach, Philipp Harms

Banking Regulation and Supervision
Lecturers: Philippe Bacchetta, Xavier Freixas, Anthony Saunders

Monetary and Fiscal Policy
Lecturers: Philippe Bacchetta, Behzad Diba

Advanced Topics in Monetary Economics II
Lecturers: Lawrence Christiano, Carl Walsh

Instruments of Financial Markets, jointly with Swiss Finance Institute
Lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

Information available at http://www.szgerzensee.ch/courses/central-bankers/

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2011

Microeconomics
Lecturers: Mathias Dewatripont, Piero Gottardi, John Moore, Klaus Schmidt

Macroeconomics
Lecturers: Jordi Galí, Robert King, Sérgio Rebelo

Econometrics
Lecturers: Bo Honoré, Mark Watson

Information available at http://www.szgerzensee.ch/courses/doctoral/

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2011

Panel Data Econometrics
Lecturer: Manuel Arellano

Financial Crisis and Financial Stability
Lecturer: Jeremy Stein

Monetary Economics and Imperfect Information
Lecturer: Ricardo Reis

Recent Advances in International Trade
Lecturer: Pol Antràs

Information available at http://www.szgerzensee.ch/courses/doctoral/

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2011

Law and Economics of Torts and Medical Malpractice
Lecturer: Jennifer Arlen

Corporate Law and Economics
Lecturer: Robert Daines

Information available at http://www.szgerzensee.ch/courses/doctoral/

FOUNDATION COUNCIL

STAFF NEWS

Gertrud Beyeler, Administrative Manager Central Bankers Courses, celebrated her 20 year-jubilee in March.

WORKING PAPERS

10.01
Roland Hodler, Simon Loertscher and Dominic Rohner, „Biased Experts, Costly Lies, and Binary Decisions"

10.02
Dennis Reinhardt, „Into the Allocation Puzzle – A Sectoral Ananlysis"

10.03
Philipp Harms, Mathias Hoffmann and Christina Ortseifer, „The Home Bias in Equities and Distribution Costs"

10.04
Roland Hodler, „Compulsory Voting and Public Finance"

10.05
Roland Hodler and Paul A. Raschky, „Foreign Aid and Enlightened Leaders"

PUBLICATION

Ernst Baltensperger, Dirk Niepelt and Boris Zürcher
„Wirtschaftspolitik nach der Krise"
ISBN 978-3-9523361-2-0, 2010

TOO BIG TO FAIL RISKS

A commission of experts appointed by the Swiss Federal Government, including SNB vice president Thomas Jordan and Ernst Baltensperger of the Study Center, submitted a regulatory reform package designed to limit the "too big to fail risks" posed by big banks. With its two international banking giants UBS and CS, Switzerland is particularly exposed to this type of risk. Central elements of the proposed reform are strengthened capital requirements backed up by new capital instruments and organizational measures ensuring the maintenance of systemically relevant functions in case of a crisis. The proposal is compatible with the new, strengthened international standards recommended under "Basel III", but goes substantially beyond these.
Capital requirements include a component rising progressively with the banks' degree of systemic relevance, as measured by balance sheet size and market shares, creating an incentive for banks to limit their systemic relevance. Based on current conditions, overall capital required for CS and UBS under the plan amounts to about 19% of risk weighted assets. 10% of this would have to be held in the form of common equity, while the remainder could be issued in the form of contingent convertible bonds (CoCos), a new type of capital instrument. These bonds are automatically converted into equity capital when the issuer's common equity ratio drops below a predefined level.
Organizational measures are designed to ensure the maintenance of systemically important functions, particularly payment services, deposit business and business lending, in case of insolvency. If a systemically important bank's capital ratio falls below a predefined level, preexisting emergency plans are triggered under which the systemically important functions are transferred to a new legal entity ("bridge bank") within a short period of time, while the remainder of the bank is sent into a process of resolution or wind-down. The simultaneous conversion of the bank's CoCo capital ensures that the emergency plan can be implemented with an adequate capital base and adequate time.
The proposed policy mix is designed to protect the state from the need to step in and bail out systemically important banks in case of a crisis.

Ernst Baltensperger

VISITORS' PROGRAM

Martín Gonzalez-Eiras (Universidad de San Andrés, Buenos Aires) visited the Study Center in order to work with Dirk Niepelt on projects concerning the composition of government budgets in politico-economic equilibrium and the equivalence of fiscal policies.

David M. Arseneau (Federal Reserve Board of Governors, Washington D.C.) visited the Study Center in June to work on an open economy labor search model designed to identify a model-based estimate of the effect of the threat of offshoring on global wages and labor market allocations.

Mario Jametti (Università della Svizzera Italiana) stayed for one week in July, working on a research project on tax competition in federations and interacting with members of the Study Center.

ABOUT

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EDITING Corinne Conti Ambühl, Dirk Niepelt
CONTRIBUTORS Ernst Baltensperger, Corinne Conti Ambühl, Roland Hodler, Dirk Niepelt
PHOTOS Toni Beutler, Corinne Conti Ambühl, Dennis Reinhardt
DESIGN Manuela Affolter, Satz und Gestaltung – Peter Gaffuri AG, Bern

P.O. Box 21, CH-3115 Gerzensee, Switzerland
Phone +41 31 780 31 31, Fax +41 31 780 31 00
studienzentrum@szgerzensee.ch