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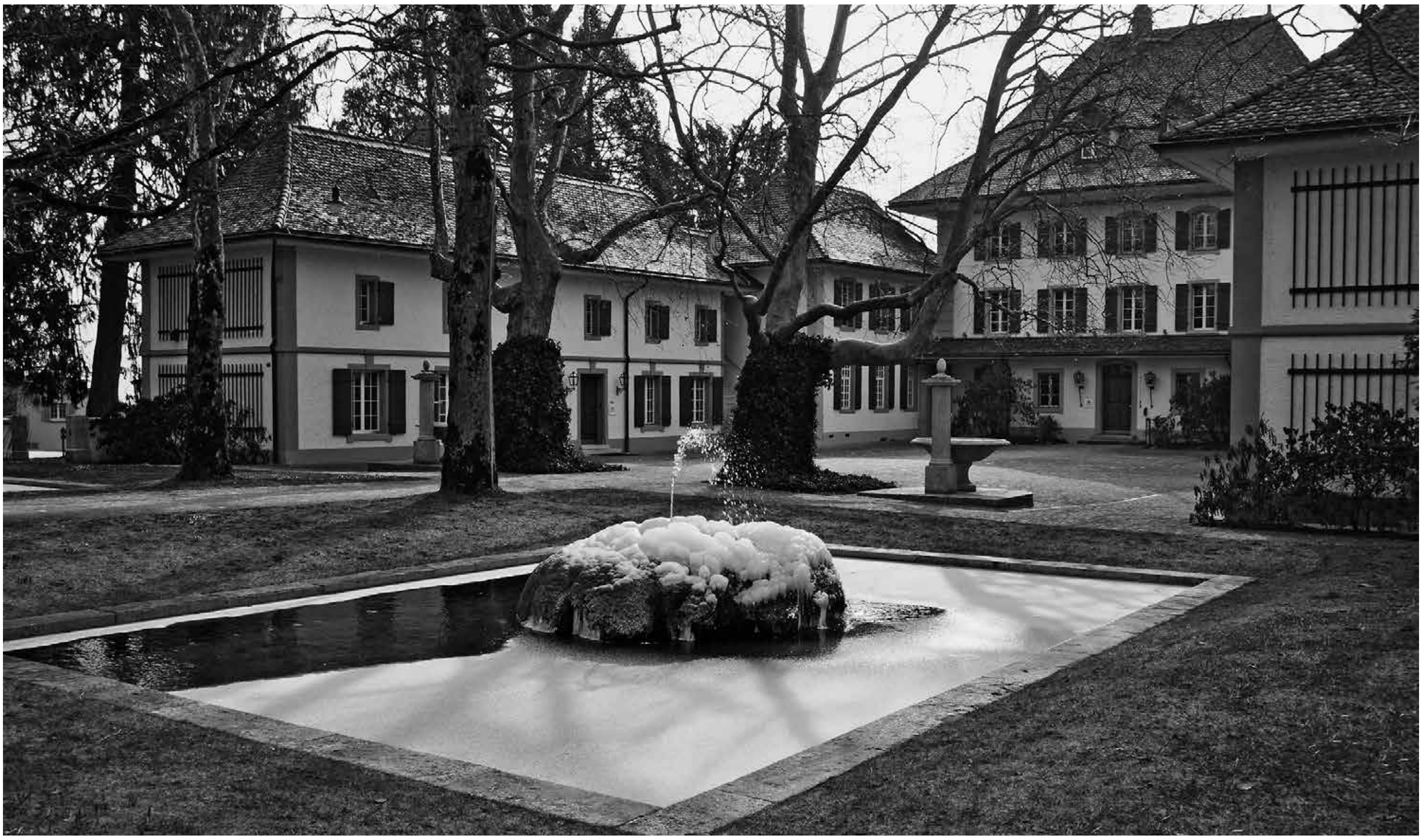
Foundation of the Swiss National Bank

STUDY CENTER
GERZENSEE

NEWSLETTER

2019



EDITORIAL

This Newsletter briefly reports about the Study Center's activities in the past year and the agenda for the months ahead. It also contains an interview with Charles W. Calomiris who taught one of the advanced doctoral courses in summer 2018, and informs about other developments at the Center.

Looking back to 2018, the Study Center organized and hosted numerous academic activities. Many central bank practitioners, academics and Ph.D. students from around the world came to Gerzensee. Conference highlights included the event with the Journal of Monetary Economics, jointly with the Swiss National Bank, featuring papers on "Money Creation and Currency Competition," as well as the traditional meetings co-organized with the Swiss Finance Institute and the Centre for Economic Policy Research. Six central bankers' courses and many doctoral course weeks completed the academic program. For the first time, the Study Center also offered a seminar for board members of Swiss financial institutions.

Looking ahead, we plan a series of events in 2019. These include the bi-annual conference with the Journal of Economic Dynamics and Control, co-organized with the Federal Reserve Bank of St. Louis, the Swiss National Bank, and the University of Bern; conferences with the Swiss Finance Institute and the Centre for Economic Policy Research; six central bankers' courses; a new instance of the Swiss Program for Beginning Doctoral Students; six advanced courses in economics; and two law and economics courses.

At the Study Center, we benefit from the collaboration with excellent partner institutions and the support of many individuals. We very much appreciate this support and work hard to utilize it for courses and conferences of the highest quality.

I am looking forward to welcoming some of this Newsletter's readers as well as many "newcomers" to the Study Center in the near future.

With best wishes,
Dirk Niepelt, Director

INTERVIEW WITH CHARLES W. CALOMIRIS

How did you get to study economics?
I grew up in a business family; my father was in the real-estate development business. He was extremely well selfeducated in the area of monetary economics and banking. By the time I went to college, it was clear for me that I wanted to become an economist and when I graduated from college, I immediately went to the PhD program.

A straight path?
Very much. I have to say that my father was definitely a big influence. I have to credit him with making me see that economics was something interesting.

You have also worked in a bank for several years.
When my father died in December 2000, the shareholders of the bank he had just started a few years before asked me to become Chairman. As Chairman, I was head of the credit committee. I got to learn a little bit about how banks make loans from close-up. It was actually a very nice experience because I think most of the banking literature was looking at the right things. I ended up feeling that the world of practice and the world of research were very well aligned. At least this is true for empirical research, but also for theoretical research in the area of bank lending.

In a small book, you wrote that the financial regulatory changes after the 2007/08 crisis were "largely a flop". Why is that?
First, I want to point out that I used the word "flop" intentionally. I think academics often do not speak plainly but use words such as "there are some limitations", or "we could improve". Instead, I picked a simple, four-letter word 'flop' that conveys the message that the regulatory changes are not what they pretend to be. It applies to both Dodd-Frank and to Basel III. Now, why are the new regulations a flop? We can evaluate the quality of regulations along three dimensions. First, does the regulation deal with the problems that it is supposed to deal with? Second, are the costs of compliance as low as they could be? Third, is the regulatory process that was created of good quality and does it conform to the rule of law? The regulatory changes enacted after the financial crisis are doing badly in all three dimensions.

What is an example illustrating how costs of compliance are not as low as they could be?
A good example is the Credit Card Act that was passed in the U.S. in 2009 shortly before Dodd-Frank. It was an attempt to limit the pricing of risk in credit cards. You can guess what happened. Because of the Act, we have seen a huge decline in credit card supply for people with high default risk. Credit cards used to be a way to avoid state usury laws because credit cards are intermediated through national chartered institutions. With the Act, many people living in states with strict usury laws now cannot get any credit at all. This is one of the reasons why the number of low-income people served by banks has decreased dramatically since the financial crisis.

How can the current regulations not conform to the rules of law?
Because enforcement allows for a huge amount of discretion by part of the regulators and they abuse it. I will give you one of several examples. Under the Obama administration, the Department of Justice together with the regulators realized that they could achieve certain objectives by using financial regulatory tools as an extra-legal enforcement mechanism. Apparently, the department of justice made a list of 30 types of activities they did not like. Lotteries, ammunition, pay-day lending, pornography, and so on. All of them perfectly legal – which does not mean they are virtuous, by the way. The regulators went to banks that allowed businesses in these sectors to have checking accounts at their bank, and told the banks to close the checking accounts. If the banks did not close the checking accounts, the regulators would increase the banks' capital requirements. The argument was that allowing these businesses to have checking accounts could result in a loss of reputational capital for the bank. Do you think there is any evidence for banks ever losing their reputational value because they allowed somebody to have a checking account in a perfectly legal business? It should be offensive to anyone in a free society when regulators use their discretion in such a way.

Which problems are regulatory changes still not addressing?
One of the main pre-crisis problems was the subsidization of mortgage risk. Dodd-Frank pretends to fix theproblem, by introducing the qualified mortgage standard (QM) and the qualified residential mortgage standard (QRM). The idea was to establish new standards to limit issuance of risky mortgages. Initially, the intention was to put limits on down-payment ratios and on debt-income ratios. The standards were immediately lobbied by vested interests. In the end, they got rid of any down-payment limits and they set the debt-to-income limit to a very high level. That is bad enough. But even worse, they included a loophole in the regulations: Any mortgages purchased by Fannie Mae and Freddie Mac would automatically be deemed to be in compliance with the rules. Barney Frank himself called this the "loophole that ate the standard". Basically, mortgages are exempted from all the new standards if they go through Fannie Mae and Freddie Mac. Not surprisingly, almost all mortgages in the U.S. are now going through Fannie Mae and Freddie Mac. As a result, we are at a point where the percentage of risky mortgages in the system is back to a very high level, and it is rising. Most people who are tracking this would say that we are 3–5 years away from another major problem, based on exactly the same problem of the subsidization of credit risk through these government guarantees.

Politically, who is pushing for the subsidization of mortgage risk?
Before the crisis, it was a coalition consisting of big banks, builders, real-estate brokers and urban activist groups. The latter are organizations that purport to represent poor people in cities. Once the merger wave was completed, the big banks ceased to have a strong incentive to participate in the coalition (which was the quid pro quo they paid for getting other coalition members to support their proposed mergers). In order to stop subsidization of mortgage risk, one needs to think how to peel off support from the political coalition that supports it. My proposal is to get rid of all the mortgage subsidization apparatus (Fannie Mae and Freddie Mac) and substitute in its place down-payment matching for low income people on a means-tested basis. For instance, the government could add 5'000 USD if such a household puts up 5'000 USD for a mortgage down-payment. This way, with a down-payment of 10 %, a low income household can afford a 100'000 USD house. This would be a much more effective way to make houses affordable compared to the current subsidization of leverage for everyone.

Since the crisis, has prudential regulation improved?
One thing we learned from the financial crisis was that book capital requirements can

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be very misleading about the true economic capital a bank has. Citibank had a book value ratio relative to risk-weighted assets of 11.8 % in December 2008, even though the bank was clearly insolvent at that time. The ratio of the market value of equity to assets was close to zero. The market value ratio of Citibank decreased steadily after 2006. The regulator should have intervened at some point and ask Citibank to restore their capital. However, because people focused only on book value, this did not happen. And we did not fix the problem. As I like to say: Basel III wants to make sure that banks are just as safe and sound in the future as Citibank was in December 2008.

How can the market value of equity drop so far below the book value?

One reason are hidden losses that are not being accounted for. However, an even more important reason is when the bank's intangible assets disappear while their intangible liabilities do not. Then the bank's market value can fall a lot. Citibank, as well as other banks, had market-to-book ratios of less than one for several years after the crisis. This had mainly to do with these intangibles.

What would be an example of such an intangible?

Let me give you one example. When monetary policy sets the interest rate to zero, and it is expected to stay there for several years, then the value of having retail deposit relationships drops. The value of retail deposit relationships for banks is that they can pay low interest on checking accounts. This compensates for the overhead costs of running the branches. Now what happens if the interest rate goes to zero? The market value associated with this intangible (the retail deposit relationship) actually turns negative, because banks still need to pay the costs for maintaining the branches. This is just one example where the market value of banks can drop below their book value.

What would a better capital regulation look like?

We should find a way to encourage banks to keep their true market value ratio of equity over assets above 10 % on some sort of long-term moving average basis. Richard Herring and I constructed a proposal how this could be done using CoCos (contingent convertibles). Banks would be required to issue CoCos that would be converted if the market value ratio of equity over assets dropped below 10 %. The conversion would happen on a dilutive basis, which would prompt timely equity offerings by bankers seeking to avoid a dilutive conversion. The CEO would immediately lose his job if such a conversion occurred. As a result, the bank would always stay away from the insolvency point. You then have a dynamic structure where the banker has an incentive to replace equity as soon as the equity ratio falls.

Why are regulators so hesitant about incorporating market based measures into the regulatory process?

Because it takes discretionary control away from them. Under the current rules, regulators retain the option to use forbearance and they can use the rules in such a way to achieve outcomes they want to achieve. Our CoCo proposal would be much more automatic in its enforcement.

Besides changes to capital requirements, Basel III also introduced new liquidity requirements.

Yes, but to be effective cash-ratios and capital ratios should be integrated into the same requirement. Of course, that is not the case with Basel III. The conceptual background for Basel III is that capital requirements are dealing with a bank's fundamental risk and then cash-ratios are dealing with some exogenous, random liquidity shocks. However, that is not what liquidity risk is. Liquidity risk is an endogenous shock that is related to credit risk. So cash and capital ratios should not be treated as two separate requirements. Not having an integrated view of capital and cash ratios is a pretty deep failing.

The Fed recently denied a narrow bank access to its balance sheet. What do you think are the reasons for this rebuttal?

The attempt to open a narrow bank highlighted an inconsistency in the Fed's policy. The statute that authorized the Fed to pay interest on reserves clearly states that the Fed can only pay a rate that is less than or equal to the market rate. However, the Fed has been paying above the market rate. The Fed likes to use the gap between the interest on reserves and the market rate as a policy tool to encourage or discourage bank lending. This is useful to them because they do not want to use standard open market operations now. The reason is that, under existing accounting rules, this would require them to recognize capital losses on those securities, if there were capital losses, which would contribute to the government deficit. Politically, this would be very dangerous, as it would fuel a lot of anti-Fed sentiment in Congress. Since the Fed knows this, they prefer to use reverse repos and interest on reserves as monetary policy tools. The narrow bank would have taken away one of these tools from the Fed by depositing funds at the Fed, and paying above market rates to its customers. That arbitrage ultimately would have taken away the Fed's ability to break the law by paying interest on reserves above the market rate. I think this is a very interesting example how monetary policy is shaped by politics.

Final question: What advice would you give to graduate students?

I will answer this question by stating the Calomiris first-order stochastic dominance theorem. In an academic environment, you can work on questions that you find interesting, and make less money than elsewhere. However, you always have the option to go make more money, answering questions that others find interesting. So, as an academic, the strategy of trying to answer questions that you find interesting first-order stochastically dominates the strategy of getting a lower academic salary to answer questions that other people think are interesting.

Professor Calomiris, thank you very much for this interview.

Cyril Monnet and Lukas Voellmy conducted this interview.

ACADEMIC CONFERENCES

RESEARCH DAYS AND SWISS DOCTORAL WORKSHOP IN FINANCE

June 3–5, 2018, jointly with Swiss Finance Institute

Plenary Session:
The Blockchain Folk Theorem

Academic Sessions
Ph.D. Parallel Sessions

EUROPEAN SUMMER SYMPOSIUM IN ECONOMIC THEORY

July 2–13, 2018, jointly with CEPR

Focus Sessions:
Markets for Information
Misspecified Models

EUROPEAN SUMMER SYMPOSIUM IN FINANCIAL MARKETS

July 16–27, 2018, jointly with CEPR

Focus Sessions:
Political Economy
Corporate Governance
Heterogeneity, Inequality and Asset Returns
Recent Advances in International Finance

OTHER EVENTS

Alumni Conference on October 22–23, 2018

Graduation Ceremony for the participants of the Swiss Program for Beginning Doctoral Students in Economics 2017/18 on November 29, 2018

CONFERENCE WITH THE JOURNAL OF MONETARY ECONOMICS

October 19–20, 2018, jointly with the Journal of Monetary Economics
and the Swiss National Bank

On the Equivalence of Private and Public Money
Authors: Markus Brunnermeier, Princeton University, and Dirk Niepelt,
Study Center Gerzensee and University of Bern
Discussant: Hans Gersbach, ETH Zurich

Private Money Creation, Liquidity Crises, and Government Interventions
Authors: Pierpaolo Benigno, Luiss Guido Carli, and Roberto Robatto,
University of Wisconsin-Madison
Discussant: Jean-Charles Rochet, University of Geneva

Deposit Spreads and the Welfare Costs of Inflation
Author: Pablo Kurlat, Stanford University
Discussant: Ester Faia, Goethe University Frankfurt

The Short Rate Disconnect in a Monetary Economy
Authors: Moritz Lenel, Princeton University, Monika Piazzesi and Martin Schneider,
Stanford University
Discussant: Oreste Tristani, European Central Bank

Some Simple Bitcoin Economics
Authors: Linda Schilling, Ecole Polytechnique CREST, and Harald Uhlig, University of Chicago
Discussant: Aleksander Berentsen, University of Basel

Can Currency Competition Work?
Authors: Jesús Fernández-Villaverde, University of Pennsylvania,
and Daniel Sanches, Federal Reserve Bank of Philadelphia
Discussant: Shengxing Zhang, London School of Economics

COURSES

CENTRAL BANKERS COURSES 2018

Inflation Forecasting and Monetary Policy
External lecturers: Pierpaolo Benigno, Carlo Favero, Daniel Kaufmann, SNB staff
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms, SNB staff
Financial Stability
External lecturers: Philippe Bacchetta, Martín Gonzalez-Eiras, Michael Rockinger, Ernst-Ludwig von Thadden, SNB staff
Monetary Theory and Policy
External lecturers: Roberto Chang, Behzad Diba, Charles E.A. Goodhart, Philipp Harms, Sarah Lein
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Stephanie Schmitt-Grohé, SNB staff
Instruments of Financial Markets
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger, SNB staff

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2018/19 AND 2019/2020

Microeconomics
Lecturers: Piero Gottardi, John Moore, Klaus Schmidt, Jörgen Weibull
Macroeconomics
Lecturers: Fernando Alvarez, Jordi Galí, Sérgio Rebelo, Ricardo Reis
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2018

Volatility Modeling
Lecturer: Tim Bollerslev
Quantitative Models for International Trade
Lecturer: Samuel Kortum
Financial Frictions and Incomplete Markets, jointly with Swiss Finance Institute
Lecturer: Yuliy Sannikov
Long-Run, Global Macroeconomics
Lecturer: Per Krusell
Disciplining or Protecting Banks? Theory and Evidence
Lecturer: Charles Calomiris

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2018

Law and Economics of Taxation
Lecturer: Dhammika Dharmapala
Behaviorally Informed Regulation
Lecturer: Ryan Bubb

SEMINAR FOR BOARD MEMBERS OF SWISS FINANCIAL INSTITUTIONS

Monetary and Regulatory Policy: Theory and Implementation in Switzerland
Lecturers: Jean-Pierre Danthine, Xavier Vives

AGENDA

CONFERENCES 2019

Research Days 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 Economic Dynamics and Control, jointly with the Federal Reserve Bank of St. Louis, the Swiss National Bank, and the University of Bern

CENTRAL BANKERS COURSES 2019

Advanced Topics in Empirical Finance
External lecturers: Casper de Vries, Thierry Foucault, Michael Rockinger, Norman Schürhoff
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms, SNB staff
Banking Regulation and Supervision
External lecturers: Philippe Bacchetta, Martín Gonzalez-Eiras, Jean-Charles Rochet, Anthony Saunders, Heinz Zimmermann, Finma-, Postfinance- and UBS staff
Macroeconomic Forecasting
External lecturers: Daniel Kaufmann, Massimiliano Marcellino, Barbara Rossi, SNB staff
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Stephanie Schmitt-Grohé, SNB staff
Instruments of Financial Markets
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger, SNB staff

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2018 / 19 AND 2019 / 20

Microeconomics
Lecturers: Piero Gottardi, Johannes Hörner, John Moore, Klaus Schmidt, Jörgen Weibull
Macroeconomics
Lecturers: Fernando Alvarez, Jordi Galí, Sérgio Rebelo, Ricardo Reis
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2019

Behavioral Finance, jointly with Swiss Finance Institute
Lecturer: Kent Daniel
Recent Advances in Bayesian Macroeconometrics
Lecturer: Frank Schorfheide
HAM: Heterogenous Agents Models. Crafting, Calibration, and Estimation
Lecturer: Mariacristina De Nardi
Optimal Fiscal and Monetary Policy
Lecturer: Mikhail Golosov
Numerical Methods
Lecturer: Felix Kübler
The Macroeconomics of Credit and Asset Bubbles
Lecturer: Jaume Ventura

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2019

Deals: The Legal and Economic Structure of Business Transactions
Lecturer: Michael Klausner
Law and Economics of Regulation
Lecturer: Richard Revesz

WORKING PAPERS

2018

18.01
Nicole Aregger
"Asset Prices under Alternative Exchange Rate Regimes"

18.02
Dirk Niepelt
"Reserves for All? Central Bank Digital Currency, Deposits, and their (Non)-Equivalence"

18.03
Stephan Imhof, Cyril Monnet and Shengxing Zhang
"The Risk-Taking Channel of Liquidity Regulations and Monetary Policy"

VISITORS' PROGRAM

Martín Gonzalez-Eiras, University of Copenhagen, visited the Study Center in April and October to collaborate with Dirk Niepelt.

Rodney Strachan, University of Queensland, visited in August; Christian Schumacher, Deutsche Bundesbank, visited in November to collaborate with Sylvia Kaufmann.

Fabrizio Mattesini, University of Rome Tor Vergata, visited in November to collaborate with Cyril Monnet.

FOUNDATION COUNCIL

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PUBLICATIONS

Articles
Nils Herger
"Interest-Parity Conditions during the Era of the Classical Gold Standard (1880–1914) – Evidence from the Investment Demand for Bills of Exchange in Europe", Swiss Journal of Economics and Statistics 154; 9, 1–12.

Dirk Niepelt
"Financial Policy", CEPR Discussion Paper 12755.

Dirk Niepelt
"Reserves For All? Central Bank Digital Currency, Deposits, and their (Non)-Equivalence", CEPR Discussion Paper 13065, CESifo Working Paper 7176.

STAFF NEWS

Among the teaching assistants, Lea Wirth left the Study Center for UBS in March. Simon Beyeler obtained his doctoral degree from the University of Bern and joined the Swiss National Bank in June. Christian Myohl obtained his doctoral degree from the University of Bern and left the Study Center at the end of August. Lorenz Driussi and Fabienne Schneider, both Ph.D. students at the University of Bern, joined the Center as teaching assistants with the objective to complete their doctoral theses.

ABOUT

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Foundation of the Swiss National Bank

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