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Foundation of the Swiss National Bank

STUDY CENTER
GERZENSEE

NEWSLETTER

JANUARY 2013

EDITORIAL

This Newsletter briefly reports about the Center's activities in the recent past and the plans for the months ahead. It also contains an interview with Douglas Gale of New York University who taught one of the advanced doctoral courses in the summer, and informs about developments at the Center and staff news.

Looking back, the academic activities at the Study Center were as diverse and exciting as ever. The biannual conference with the Journal of Monetary Economics featured six papers on "Financial Markets, Financial Policy, and Macroeconomic Activity" and attracted academics and central bank economists from Europe and overseas. At another conference, organized jointly with Swiss institutions and marking the tenth anniversary of the Swiss "Debt Brake", academics, central bankers and government officials discussed the merits of institutional constraints on fiscal policy makers. The President of the Swiss Confederation, Ms Eveline Widmer-Schlumpf, kindly delivered the opening address at this conference. The traditional meetings of the Swiss Finance Institute and the Centre for Economic Policy Research as well as the central bankers' and doctoral courses brought together world-class academics, excellent lecturers as well as interested and motivated course participants. I would like to warmly thank them all for their appreciated support.

Looking forward, we plan a series of courses and conferences in 2013. We also start an "Open Course Ware" initiative, making the teaching material of selected courses publicly available. Further information and links to the teaching material can be found on the Study Center's homepage.

With best wishes,

Dirk Niepelt
Director

INTERVIEW WITH DOUGLAS GALE

FINANCIAL CRISES AND (LIQUIDITY) REGULATION

What do you think were the origins of the financial crisis that began in 2007?

The origins of the crisis are very complicated. In the United States, it was caused by a combination of government policy going back to the 1990s, paired with loose monetary policy, innovation in the financial system, and moral hazard problems in bank and mortgage lending. All of these things came together in a way that was quite disastrous – perhaps implausibly so. If we look back at each of these components of the crisis, there was probably a failure to act on what we knew at the time, which made the crisis worse. In that sense, the crisis was avoidable. But at the same time, the combination of factors was very special, and it was very hard to predict exactly how all these things were going to play out. I think that is why people were caught unawares and the policy makers at the Fed did not realize how serious it was going to be, even after it was clear that some kind of crisis was building up.

Which specific monetary, fiscal or regulatory policies caused or failed to prevent the offset of the crisis?

There were a number of shocks: the collapse of the dotcom bubble in 2001 followed sharply by 9/11. Both had a very negative impact on the economy. The Fed's position at that time was that the American economy was in danger of deflation, and it kept interest rates low. Although there was a reason for keeping interest rates low, they probably had some effect on building the house price bubble. I think most bubbles – at least the very bad cases – had their origin in credit market liberalization or loose monetary policy. The subprime mortgage crisis, which was really the spark that set everything off, was just the result of government policy. The government policy was to increase the number of families owning homes and, in particular, to extend home ownership to people of low and moderate incomes. In order to do that, the government was using the Housing & Urban Development Department (HUD) and the Justice Department to put pressure on banks. The pressure was exercised sometimes through regulation and sometimes in other ways, such as moral suasion, to lend to people who basically could not afford it. At the end of the 1990s, a policy statement by HUD argued that the banking system had to find innovative ways of providing mortgage finance to people who could not afford the down payment or the repayment of the mortgage. How do you do that without defaults?

How was it possible that a shock to the US housing market, which on a global scale looks like a relatively small shock, nearly brought a complete meltdown of the global financial system?

Even when we knew that there was a big problem with the housing market and with subprime mortgages, people just thought that this was too small to cause a global crisis. I think this had to do with the way in which the securities, which were backed by these assets, mortgages and other kinds of asset-backed securities, were financed. In the run-up to the crisis, all kinds of financial institutions were relying more and more heavily on wholesale funding rather than retail deposits. They began to package these mortgages into more and more complex types of bonds and structured financial vehicles. Because of the fact that these different assets had been put into different kinds of securities (CDOs, MBS, SIVs, Conduits), people were uncertain about exactly where these toxic assets were. Generalized fear of where these toxic assets must be led to a run on the funding markets. Suddenly, the traditional banking and shadow banking system were faced with a loss of funding. The increased haircuts required in the repo market were equivalent to drastic reductions in their borrowing capacity. Theoretically, securitization is supposed to allow risk transfer, but in fact a number of banks (Citi, Lehman Brothers and to some extent Bear Stearns) that had been issuing these securities ended up holding large amounts of the equity tranche. Relatively small amounts of losses really eat into the capital if the banks are heavily leveraged. The combination of the market demanding much higher haircuts, or refusing to lend altogether, and reductions in the bank's capital have an enormous multiplier effect on the size of the balance sheet that can be supported. Banks were unable to finance their asset positions, which led to fire sales, and some institutions made huge losses or went bust. Beyond that, some degree of asymmetric information must have explained some of the results. What seemed like perfectly safe assets were marked down to prices that just did not make any sense. It may be that people were just so fearful that they became extremely risk-averse and didn't want to touch these assets. It is hard to understand why, in a well-functioning market, this contagion spread as wide as it did.

In your recent research you study the "freezing" of the interbank market during the recent financial crisis. What were the main reasons for this freezing?

It was partly counterparty risk, or the fear of counterparty risk. Also, it was the fear that market liquidity would not be there in the future. Even banks in a very strong position and still able to borrow and lend, were hoarding liquidity because they feared that a simple rumour might shut them out of the funding market. But, of course, if one bank is hoarding liquidity, that liquidity is not available to another. Everybody was trying to be self-sufficient, to hoard enough liquidity to manage on their own without going to the markets. Although it is individually rational, it is certainly not efficient. Also, the self-sufficient system requires much more liquidity than is compatible with the set of assets that are actually available. It was a really self-destructive move on the part of the banking system. Fortunately, the central banks (ECB, BoE or the Fed) are able to issue reserves with the stroke of a pen and stepped in with a range of liquidity facilities. If the central banks had not done that, it would have been a very serious problem.

The Basel Committee proposes to regulate bank liquidity using new measures. What is your opinion on the proposed regulation?

I am a bit puzzled by what is being proposed by Basel III. I can see why they are concerned about liquidity. If you think of liquidity as simply access to cash on reasonable terms, the crisis showed that there is a problem. There was quite a lot of maturity transformation: people have been borrowing short-term in order to fund long-term assets. Suddenly, that source of funds disappeared, and they were in need of liquidity. But the markets on which they could trade these assets had in some cases disappeared. There were bonds you just could not find a market for. So, in that sense, there was a high degree of illiquidity during the crisis and that was a major problem for the banks. A solvent, but illiquid, bank turns into an insolvent bank if the liquidity crisis is bad enough and forces the bank to sell assets in a fire sale. I think that this is what Basel III is reacting to. Instead of addressing the macro-prudential question on how to regulate liquidity in order to avoid a future freeze of a major funding market, the proposals for new regulation really are addressing the supervisory question of how to resolve a single bank that is having funding problems. From that point of view, the Liquidity Coverage Ratio and the Net Stable Funding Ratio are buying time, because if a bank's short-term funding disappears, then there are still plenty of liquid assets. With the disposal of liquid assets, usually government bonds or treasury bills, the loss of funding is not a problem and the regulator can step in and find out the true condition of the bank and resolve it in an orderly way. I think Basel III goes too far in the sense that, if the problem is purely one of illiquidity, then the fact that other banks have liquidity ought to be

Professor Douglas Gale is a Silver Professor and Professor of Economics at New York University, where he has also served as chairman of the Department of Economics. He has taught at the University of Cambridge, where he obtained his PhD, and at the London School of Economics, the University of Pennsylvania and MIT. He was made a Fellow of the Econometric Society in 1987, was an Extraordinary Fellow of Churchill College, Cambridge from 2003-06, and is currently a Senior Fellow of the Financial Institutions Center at the Wharton School and a Research Associate of the Financial Markets Group at the LSE. He has served on the editorial boards of Econometrica, Economic Theory, Journal of Economic Theory, Journal of Mathematical Economics, Macroeconomic Dynamics, Research in Economics, Games and Economic Behaviour and Review of Economic Studies and is currently a co-editor of the International Journal of Central Banking. His research interests include the strategic foundations of general equilibrium; money and banking; experimental economics and theories of bounded rationality. He is the author of several books, including Understanding Financial Crises (co-authored with Franklin Allen), and a large number of articles in leading journals on economic theory and financial economics.

enough. If a bank has assets, even if they are not what we normally think of as liquid assets, the bank should be able to borrow money to replace the funding lost in the interbank market. Conversely, I do not think Basel III does enough in the sense that, if there is a systemic crisis, I am not sure that these devices are actually going to help very much. Basically, these measures allow a bank to borrow short-term in order to invest in relatively short-term and safe liquid assets. But why would anybody bother doing that: there is no maturity transformation and therefore little profit in it. It is also not clear what economic function this has. Why is transforming short-term cash into treasury bills a useful thing to do? The lender to the bank might just as well buy treasury bills itself. Charles Goodhart summed it up nicely by saying that this is just an attempt to be kind to central banks. In fact, if you get a bunch of central bankers together in Basel to decide on regulation, this is the sort of thing you might expect them to come up with. The first thing that is going to occur to them is something that makes their life easier. In terms of addressing some of the rather shocking episodes of market freezes that we saw during the crisis, I am not sure that Basel III gets us anywhere close to that. Is it likely that we are going to have a similar kind of financial crisis in the next few years? I don't think so, at least not for the same reasons. The Eurozone seems to be in some difficulties, but that is a very different kind of crisis. Maybe it does not matter what kind of regulation they impose – except to the extent that this is a cost imposed on the banking system that is not going to do its job as effectively as it might. But I do not see that it makes the system in some fundamental sense more stable and robust.

Basel III adds new rules to the existing regulations, such as capital requirements. Is there any danger that regulation gets too complex, and thereby maybe easier to circumvent?

I think it is already too complex. If you're talking about regulation of the financial system in general, it is so complicated that it imposes a serious cost on the financial system. It is very hard to understand what effect these new regulations are having on the system and whether they are making things better or worse. I am not sure, whether we would be better off without this liquidity regulation. My prejudice would be that it makes things slightly worse. Banks will probably find a way around it, although I do not really know how. One can imagine finding ways to turn what looks like illiquid assets into liquid assets or make short-term funding look more like stable funding.

Apparently Basel III will not solve the macro-prudential issues: so what should be done instead?

It would probably take too long to sketch a view of new structure for the financial system. I would just say that I think that we saw things during the crisis that worked reasonably well, including some off-balance sheets entities. I think we learned that we do need a lender of last resort. In order to avoid some of the problems we saw, we might have to extend the rule of the lender of last resort much more widely. Dodd-Frank effectively bans bailouts – including loans – to financial institutions that are outside the formal banking system. Instead, we should include the shadow banking system within the regulatory circle and make the lender of last resort available to all these intermediaries. Of course, it has to be on the right terms and access to the discount window or to other lender of last resort facilities has to be contingent on good regulation and, in particular, restrictions on the shadow banks' activities. Banks are monstrous inventions. They do so many different things, but it is not clear why all the different activities should be under the same roof. They developed that way for various historical reasons, but if you were starting the banking system from scratch, you wouldn't necessarily create e.g. Citibank. Therefore, we might think about encouraging various kinds of narrow banks; not in the sense of Milton Friedman, but in the sense of creating banks with very specific functions and different types of funding. By keeping them simple, we make them easier to regulate and more transparent, and could reduce the risk of asymmetric information, which causes runs. So, there are lots of structural changes that might make the banking system more stable and more efficient.

What do you think about policies that try to separate investment banking from retail banking?

I am not sure that this is the right line to draw. I have never understood these people who say that getting rid of Glass-Steagall was clearly a mistake, and that if we kept Glass-Steagall, we would be in better shape. If you look at the banks that failed, they were not universal banks. They were either pure investment banks, like Lehman Brothers and Bear Stearns, or they were retail banks, like Wachovia and Washington Mutual. The one case where you had a universal bank that failed (or nearly failed) was Citi, but Citi had already had several near death experiences due to its gigantic and unwieldy structure. Such an organization probably never should have been created. I think there is an argument for breaking up these huge conglomerates, but I do not think there is any magic in separating something called "investment banking" from something called "retail banking". You can take on huge risks with enormously high leverage in retail banking just as you can in investment banking. But I think there is something to be said for separating activities because it makes the bank more transparent and it reduces the possibilities that a shock in one department of the bank is going to spread to other departments, causing other bigger problems. So perhaps smaller and more specialized banks could be a good solution.

Professor Gale, thank you very much for this interview.

Roland Hodler and Andreas Wälchli conducted this interview.

ACADEMIC CONFERENCES

NCCR FINRISK RESEARCH DAY AND DOCTORAL WORKSHOP

June 11 – 12, 2012, jointly with Swiss Finance Institute

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

EUROPEAN SUMMER SYMPOSIUM IN ECONOMIC THEORY

July 2 – 13, 2012, jointly with CEPR

Focus Sessions:
Matching
Communication and Information

EUROPEAN SUMMER SYMPOSIUM IN FINANCIAL MARKETS

July 16 – 27, 2012, jointly with CEPR

Focus Sessions:
Dynamic Agency Models of Firm Financing
Banking and Government Policy
Financial Integration and the Real Economy
Credit Risk

CONFERENCE "THE SWISS DEBT BRAKE – TEN YEARS ON"

November 1 – 2, 2012, jointly with the Federal Finance Administration, the Swiss Society for Economics and Statistics, and the Universities of Lucerne and St. Gallen

European Fiscal Union in Europe: A Vision for the Long Run
Phil Gerson, IMF

Public Debt and Economic Growth: Is There a Causal Effect?
Ugo Panizza, UNCTAD and University of Geneva

Beyond the Fiscal Compact: How Well-Designed Eurobonds May Discipline Governments
Jakob de Haan, De Nederlandsche Bank and University of Groningen

Swedish Fiscal Policy Council and Intermediate Fiscal Policy Targets
Torben Andersen, University of Aarhus and Swedish Fiscal Policy Council

The Development of Independent Fiscal Institutions: Lessons from CBO
Barry Anderson, National Governors Association

The Swiss Debt Brake - has it been a Success?
Tobias Beljean, Swiss Federal Finance Administration

Fiscal Institutions at the Cantonal Level in Switzerland
Gebhard Kirchgässner, University of St. Gallen

Fiscal Institutions: the Case of Austria
Bernhard Felderer, Government Debt Committee, Vienna

Fiscal Institutions in Germany
Lars Feld, Walter Eucken Institut and University of Freiburg, and Christian Kastrop, German Ministry of Finance

CONFERENCE WITH THE JOURNAL OF MONETARY ECONOMICS

October 19 – 20, 2012, jointly with the Journal of Monetary Economics and the Swiss National Bank

Financial Markets, Financial Policy, and Macroeconomic Activity

Internal Debt Crises and Sovereign Defaults
Authors: Cristina Arellano and Narayana Kocherlakota, Federal Reserve Bank of Minneapolis
Discussants: Aleksander Berentsen, University of Basel, and Cédric Tille, Graduate Institute for International and Development Studies

Analyzing Fiscal Sustainability
Authors: Huixin Bi, Bank of Canada, and Eric Leeper, Indiana University
Discussant: Craig Burnside, Duke University

The Economic Stimulus Payments of 2008 and the Aggregate Demand for Consumption
Authors: Christian Broda, Duquesne Capital Management, and Jonathan A. Parker, Northwestern University
Discussants: Greg Kaplan, University of Pennsylvania, and Jordi Galí, CREI, Universitat Pompeu Fabra

The Social Value of Bank Capital and the Redistributive Effects of Financial Deregulation
Author: Anton Korinek, University of Maryland
Discussants: Robert Bichsel, Swiss National Bank, and Jean-Charles Rochet, University of Zurich

A Reconciliation of SVAR and Narrative Estimates of Tax Multipliers
Authors: Karel Mertens, Cornell University, and Morten Ravn, University College London
Discussants: Elmar Mertens, Board of Governors of the Federal Reserve System, and Matthew Shapiro, University of Michigan

Debt Maturity without Commitment
Author: Dirk Niepelt, Study Center Gerzensee and University of Bern
Discussant: Robert G. King, Boston University

OTHER EVENTS

Graduation Ceremony for the participants of the Swiss Program for Beginning Doctoral Students in Economics 2011 on April 27, 2012.

Workshop “Search and Matching Finance” on December 14 – 15, 2012.

COURSES

CENTRAL BANKERS COURSES 2012

Advanced Topics in Macroeconometrics
External lecturers: Philippe Bacchetta, David DeJong, Juan José Dolado
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms
Inflation Forecasting and Monetary Policy, jointly with the Swiss National Bank
External lecturers: Pierpaolo Benigno, SNB-staff
Financial Stability, jointly with the Swiss National Bank
External lecturers: Philippe Bacchetta, Martín Gonzalez-Eiras, Ernst-Ludwig von Thadden, Michael Rockinger, SNB-staff
Monetary Policy in Developing Countries
External lecturers: Sebastian Edwards, Philipp Harms
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Carl Walsh
Instruments of Financial Markets, jointly with Swiss Finance Institute
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2012

Microeconomics
Lecturers: Piero Gottardi, John Moore, Klaus Schmidt, Jörgen Weibull
Macroeconomics
Lecturers: Jordi Galí, Robert King, Sérgio Rebelo
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2012

Liquidity Regulation
Lecturer: Douglas Gale
Bayesian Econometrics and its Applications
Lecturer: John Geweke
The Political Economics of Development Clusters
Lecturer: Torsten Persson
Information and Expectations in Macroeconomics
Lecturer: George-Marios Angeletos

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2012

Antitrust Law and Economics
Lecturer: Daniel L. Rubinfeld
Banking: Law and Economics Issues after the Financial Crisis
Lecturer: Geoffrey Miller

AGENDA

CONFERENCES 2013

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

CENTRAL BANKERS COURSES 2013

Advanced Topics in Empirical Finance, jointly with Swiss Finance Institute
External lecturers: Casper de Vries, Thierry Foucault, Michael Rockinger
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms
Banking Regulation and Supervision
External lecturers: Philippe Bacchetta, Jean-Charles Rochet, Anthony Saunders
Monetary and Fiscal Policy, jointly with Joint Vienna Institute
External lecturers: Philippe Bacchetta, Behzad Diba
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Carl Walsh
Instruments of Financial Markets, jointly with Swiss Finance Institute
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2013

Microeconomics
Lecturers: Piero Gottardi, John Moore, Klaus Schmidt, Jörgen Weibull
Macroeconomics
Lecturers: Jordi Galí, Robert King, Sérgio Rebelo
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2013

Financial Crises and Regulatory Responses
Lecturer: Patrick Bolton
Time Series Econometrics
Lecturer: James Hamilton
International Finance
Lecturer: Gita Gopinath
Liquidity
Lecturer: Randall Wright

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2013

Introduction to Law, Economics and Business
Lecturer: Robert Cooter
Law & Economics of Bankruptcy
Lecturer: Jesse Fried

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WORKING PAPERS

12.01
Filippo Brutti and Philip Sauré
"Transmission of Sovereign Risk in the Euro Crisis"

12.02
Martín Gonzalez-Eiras and Dirk Niepelt
"Economic and Politico-Economic Equivalence"

12.03
Toni Beutler
"Forecasting Exchange Rates with Commodity Convenience Yields"

STAFF NEWS

Sylvia Kaufmann joined the Study Center in October as the new deputy director. Ms Kaufmann studied in Switzerland and held positions at the Universities of Bern, Vienna and Basel as well as the Austrian and the Swiss National Bank. Her research interests are in the areas of macroeconomics and econometrics.

Among the teaching assistants, Samuel Müller left the Study Center at the end of June to pursue his doctorate in combination with a part-time job in the private sector. Toni Beutler obtained his doctoral degree from the University of Lausanne and left the Study Center at the end of September to take up a position at the Swiss National Bank. Maria Bolboaca and Claudio Margarita started as assistants in December with the objective of writing their doctoral theses.

Gertrud Beyeler, our appreciated long-serving administrative manager for the central bankers' courses, will be retiring next spring. Committed and reliable, she has provided valuable assistance to the Study Center over many years. Susanne Senn, currently administrative manager for the doctoral courses, will assume Ms Beyeler's responsibilities and will hand over to Nina Weibel who joined the staff in December.

Sylvia Kaufmann

Gertrud Beyeler

VISITORS' PROGRAM

Martín Gonzalez-Eiras, Universidad de San Andrés, Buenos Aires, visited the Study Center in May to collaborate with Dirk Niepelt.

Thorsten V. Koeppl, Queen's University, Canada, visited the Study Center in December, working with Cyril Monnet on a project entitled "CCPs: Procyclical Margins and Aggregate Risk".

Rodney W. Strachan, Australian National University, Canberra, visited the Study Center in December to collaborate with Sylvia Kaufmann.

ABOUT

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STUDY CENTER
GERZENSEE

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