

The Banque de France Foundation Newsletter – January 2008

A word from the Secretary

The Foundation's eleventh request for proposals attracted around 50 projects dealing with a broad range of topics of interest for central banks: monetary policy; prudential policy; credit derivatives; financial stability, etc. Four projects were finally selected in July 2007, with total funding EUR 120,000. The twelfth request for proposals for 2008 has already been launched. Around 50 projects have been submitted, as many as in 2006, which will be examined in the first half of 2008.



The Banque de France Foundation's sixth *Journées* were organised jointly with the CEPR. The *Journées* brought together nearly 150 participants from varied backgrounds: central banks, private banks, academia, international organizations and public administrations. The diversity of the participants made for fruitful discussions on the topic "Banking and asset markets: developments, risks and policy issues", which is of common interest to financiers, regulators and researchers. A total of 14 papers were presented and discussed,¹ dealing in particular with market liquidity, risk transfer mechanisms and financial stability, and their implications for monetary policy. Against the background of the subprime crisis, its interpretation was naturally in the minds of the participants and gave rise to a lively discussion about the causes and consequences of the turmoil linked to high-risk mortgages. In particular, Philipp Hildebrand, Vice-President of the Swiss National Bank, Jean-Pierre Landau, Deputy Governor of the Banque de France and Béatrice Weder, economic advisor to the German Government, each gave their view of the subprime crisis.

I wish you all the very best for 2008!

Henri Pagès

¹ The list of papers is available on the Banque de France Foundation's website: <http://inbdf/gb/fondatio/index.htm>.

The Foundation's sixth *Journées*: 29 and 30 November 2007

The Banque de France Foundation's sixth *Journées* were organised jointly with the Centre for Economic Policy Research on the topic "Banking and asset markets: developments, risks and policy issues". Some 14 papers were presented, including 3 financed by the Foundation (those of **V. Acharya**, **P. Strahan** and **L. Guiso**). The *Journées* brought together close 150 participants from central banks, private banks, academia, international organisations and public administrations.

In his welcome address, **M.-O. Strauss-Kahn** (Banque de France) highlighted three main issues: the link between liquidity and systemic risk; the dilemma between the growth in customised products and market liquidity; and the measures needed to reinforce the stability of the financial system (notably in the areas of product standardisation, market transparency and liquidity, and the appropriate level of capital for financial institutions).

During the first session, which was devoted to "Liquidity and Risk", **E. Kole**² (Erasmus University) analysed the optimal strategy for a speculator during a bubble using a statistical model. **H. Naqvi** (National University of Singapore) investigated the ambiguous role of lender of last resort when it contributes to resolving crises but is also a source of moral hazard in an imperfect market. **P. Mistrulli** (Banca d'Italia) presented a model for the spread of liquidity shocks using interbank lending data, comparing it with that derived from theoretical models based on maximum entropy. **V. Acharya** (London Business School) presented a "clinical" study of the Ford and General Motors downgrade in May 2005 to establish a link between correlation risk and liquidity risk.

The second session, on the topic of securitisation, was chaired by **H. Pagès** (Banque de France Foundation). **J.-P. Krahen** (Goethe University Frankfurt) assessed the impact of CDOs³ on bank risk. He concluded that CDO issuance is positively correlated with issuing banks' risk appetite. **P. Strahan** (Boston University) suggested that the government sponsored enterprises Freddie Mac and Fannie Mae, which refinance mortgages in the United States, help to lessen the impact of interest rate conditions on loan supply. **J. Santos** (Federal Reserve Bank of New York) assessed the degree to which the CDS⁴ market has lowered the cost of corporate debt. His conclusions were mixed given that the "originate and distribute" model appears to reduce the collateral provided by the lead bank in a banking pool.

A panel discussion brought together **J.-P. Landau** (Banque de France), **R. Portes** (London Business School and CEPR) and **B. Weder** (University of Constance, also a member of the German government's council of economic experts). **R. Portes** attempted to put the scale of the liquidity crisis into perspective (preferring the term "turbulence"), while acknowledging that a turnaround in the situation remains uncertain. He touched on the markets' negative perception of the lack of co-ordination between central banks in their liquidity injections. **B. Weder** was more pessimistic as to the magnitude of the crisis and its impact on growth. Three-month interbank rates have remained very high; German banks have large exposures; published estimates of losses related to the subprime crisis vary (between USD 100 billion and USD 500 billion). She remarked that, on the basis of IMF data, nearly three-quarters of the risks incurred on credit derivatives are borne directly or indirectly (via structured investment vehicles – SIVs) by banks. **J.-P. Landau** also highlighted the worrying uncertainty surrounding the current situation. He raised a number of questions: To what extent should the demand for market liquidity be met? How, when the need arises, should financial institutions be recapitalised in a period where the cost of capital is increasing (falling stock markets)? How can the performance of rating agencies and asset valuation be improved? He set out two conclusions: There is currently less room for manoeuvre for monetary policy in the euro area. The crisis illustrates the

² The names refer to the speakers at the conference; co-authors are therefore not cited.

³ Collateralised debt obligations.

⁴ Credit default swaps.

advantage of a decentralised prudential system. A discussion then ensued among the conference participants about the performance of private rating agencies compared with public rating systems.

The third session, which was chaired by **R. Portes**, addressed the topic of financial systems. **S. Champonnois** (University of California, San Diego) linked the different modes of external financing to differences in company size, in turn attributed to differences in productivity. **L. Guiso** (European University Institute) presented an assessment of the cost of banking regulation based on the historical experience of the 1936 Italian Banking Act, with liberalisation generally leading to a narrowing and convergence of yield spreads and a rise in bad debts in regions where, prior to the reform, the banking system had previously been more tightly regulated.

In the special guest-speaker session, **P. Hildebrand** (Vice-President, Swiss National Bank) commented on the current turmoil linked to the subprime market. He began by emphasising the importance of financial stability for central banks' monetary policy and drew two significant conclusions. First, he wondered whether central banks hadn't gone too far in terms of transparency, notably with respect to injections of liquidity into markets. Second, he suggested that central banks should perhaps take account of the interbank rate (the three-month LIBOR) as the natural objective for monetary policy.

Session IV – “Issues for Monetary Policy” – was chaired by **C. Borio** (BIS). **O. Loisel** (Banque de France) analysed monetary policy responses to the formation of bubbles resulting from herd behaviour. **J. Jorge** (University of Porto) gave a presentation on the role of interbank markets in monetary policy in a context of information asymmetry and rationing. To finish off, **E. Kharroubi** (Banque de France) examined the interactions between monetary policy, inflation and long-term growth against a backdrop of credit constraints.

All in all, the conference was a great success.

The programme for the *Journées* was as follows:

Banking and asset markets: developments, risks and policy issues
Palais Brongniart, Paris, 29 – 30 November 2007

29 November 2007

08:45 – 09:15

Registration

09:15 – 09:30

Welcome address

Marc-Olivier Strauss-Kahn (Banque de France)

Session I: Liquidity and Risk

Chair: Jaume Ventura (Universitat Pompeu Fabra and CEPR)

09:30 – 10:15

Riding bubbles

Erik Kole (Erasmus University, Nadja Guenster, Erasmus University)

Discussant: Lev Ratnovski (Bank of England and University of Amsterdam)

10:15 – 11:00

Banking crises and the lender of last resort: how crucial is the role of information?

Hassan Naqvi (National University of Singapore)

Discussant: Natacha Valla (Banque de France)

11:00 – 11:30

Coffee Break

11:30 – 12:15

Assessing financial contagion in the interbank market: maximum entropy vs. observed interbank lending patterns

Paolo Emilio Mistrulli (Bank of Italy)

Discussant: Lucy White (HEC Lausanne, Harvard Business School and CEPR)

12:15 – 13:00

Liquidity risk and correlation risk: a clinical study of the General Motors and Ford downgrade of May 2005

Viral Acharya (London Business School and CEPR, Stephen Schaefer, Yili Zhang, London Business School)
Discussant: David Thesmar (HEC School of Management and CEPR)

13:00 – 14:30

Buffet

Session II: Securitization

14:30 – 15:15

Chair: Marc-Olivier Strauss-Kahn (Banque de France)

Does credit securitization reduce bank risk? Evidence from the European CDO market

Jan-Pieter Krahnert (Goethe University Frankfurt, Dennis Hänsel, Goethe University Frankfurt)

Discussant: Viral Acharya (London Business School)

15:15 – 16:00

Securitization and the declining impact of bank finance on loan supply: evidence from mortgage acceptance rates (Foundation Fellowship)

Philip Strahan (Boston College, Elena Loutschina, University of Virginia)

Discussant: Vikrant Vig (London Business School, London)

16:00 – 16:30

Coffee Break

16:30 – 17:15

Has the CDS market lowered the cost of corporate debt?

João Santos (Federal Reserve of New York, Adam Ashcraft, Federal Reserve of New York)

Discussant: Günter Franke (University of Constance)

17:15 – 18:00

Originate and Distribute: lessons from the subprime mortgage crisis

Panel session: Jean-Pierre Landau (Banque de France), Richard Portes (London Business School and CEPR), Béatrice Weder (University of Constance)

30 November 2007

Session III: Financial Systems

Chair: Richard Portes (London Business School and CEPR)

09:00 – 09:45

Comparing financial systems: a structural analysis

Sylvain Champonnois (Princeton University)

Discussant: Falko Fecht (Deutsche Bundesbank)

09:45 – 10:45

Invited Speaker

Philipp Hildebrand (Vice-President, Swiss National Bank)

Financial stability: objectives and challenges for central banking

10:45 – 11:15

Coffee Break

11:15 – 12:00

The cost of banking regulation (Foundation Fellowship)

Luigi Guiso (University of Rome, Paolo Sapienza, Northwestern University, Luigi Zingales, University of Chicago and CEPR)

Discussant: José Jorge (Universidade do Porto)

12:00 -14:30

Buffet

Session IV: Issues for Monetary Policy

Chair: Claudio Borio (Bank for International Settlements)

14:30 – 15:15

Monetary policy and herd behaviour in new-tech investment

Olivier Loisel (Banque de France, Aude Pommeret, HEC Lausanne, Franck Portier, Université de Toulouse)

Discussant: S. Kapadia (Bank of England)

15:15– 16:00

The role of interbank markets in monetary policy: a model with rationing

José Jorge (Universidade do Porto, Xavier Freixas, Universitat Pompeu Pabra and CEPR)

Discussant: Stefan Gerlach (Institute for Monetary and Financial Stability and Johann Wolfgang Goethe University of Frankfurt)

16:00 – 16:45

Monetary policy, credit constraints and growth

Enisse Kharroubi (Banque de France, Philippe Aghion, Harvard University and CEPR)

Discussant: Philippe Moutot (European Central Bank)

Scientific Council Meeting (30 November 2007)

The Scientific Council, to which six new members contributed (see “The life of the Foundation” below), convened on 30 November 2007, during the Foundation’s *Journées*. This meeting provided the opportunity to take stock of the Foundation’s activities and strategy.

Seminars (within the framework of the Foundation's requests for proposals)

22 February, Luigi Guiso (European University Institute), "The cost of banking regulation", macroeconomics seminar, Paris I/PSE Jordan.

28 February, Adrian Pop (Banque de France doctoral thesis prize), "Beyond the third pillar of Basel II: taking bond-market signals seriously", Banque de France.

5 April, Philip E. Strahan (Boston College), "Securitization and the declining impact of bank finance on loan supply: evidence from mortgage rates", HEC Research Seminar.

26 September, Viral Acharya (London Business School), "Liquidity risk and correlation risk: a clinical study of the General Motors and Ford downgrade", Banque de France.

26 October, 2007 Denis Gromb (Associate Professor of Finance, London Business School), "Financially constrained arbitrage and cross-market contagion", IHP.

24 January, 2008 J. Gali (University Pompeu Fabra), "The macro-economic effects of oil price shocks: why are the 2000s, so different from the 1970s", PSE.

Other seminars (2007)

14 March, William A. Branch (University of California Irvine), "Monetary policy, endogenous inattention, and the volatility trade-off".

20 March, Anindya Banerjee (European University Institute), "Measuring long-run exchange rate pass-through".

21 March, Edward Nelson (Federal Reserve Bank of Saint-Louis), "An estimated DSGE model for the United Kingdom".

18 April, Robert E. Krainer (University of Wisconsin-Madison), "Portfolio and financing adjustments for US banks – some empirical evidence".

24 May, Hashem Pesaran (Cambridge University), "Lumpy price adjustment: a microeconomic analysis".

Guest researcher programme (2007)

Harris Dellas (University of Bern), “Imperfect information and inflation dynamics. (March)

Edward Nelson (Federal Reserve Bank of St Louis), “The great inflation of the 1970s in France” (March).

Robert E. Krainer (University of Wisconsin), “The role of a stock-market in allocating bank credit in Europe: a comparison with the US. (February-May)

N. Oulton (LES), “Competition and economic performance: some areas for research on France using company level data”. (October and December).

Results for the eleventh request for proposals (July 2007)

The projects chosen by the Assessment Committee in the framework of the eleventh request for proposals were as follows (July 2007):

- **Charles Wyplosz, Aileen Gosselin-Lotz, Pierre Gosselin** "Central Bank transparency and the publication of interest rate forecasts"
- **Giancarlo Corsetti, André Meier, Gernot Müller** "International dimensions of fiscal policy transmission"
- **Anna Pavlova, Roberto Rigobon** "An asset pricing view of the current account"
- **Hyun Song Shin**, "Systemic risk and liquidity in payment systems".

The launch of the twelfth request for proposals in October 2007

The twelfth request for proposals for research projects has been announced. The total amount earmarked for the awards is EUR 150,000. Up to five grants will be awarded for projects that may take one year to eighteen months.

Topics of interest include - but are not limited to - policy-relevant work on money, finance and banking such as:

Monetary policy & prices

- Monetary policy under imperfect knowledge
- Monetary policy and financial system stability
- Monetary policy and globalization

Financial stability

- Financial market disruptions
- Interbank and other financial linkages

- Bank competition and regulation

International macroeconomics and globalization

- Financial integration
- Global imbalances
- Macroeconomic policies and growth

Each project should aim to produce a single paper suitable for submission to a major scientific journal. The Foundation's Scientific Committee and the Board will pre-select up to ten projects by mid-February 2008. The selected proposals will have an additional three-month period before being presented at an internal meeting attended by the Scientific Committee in May 2008 (possibly using video conferencing). Results will be announced in July 2008.

Some fifty candidates submitted proposals to the Foundation's twelfth request for proposals.

The 2007 monetary thesis prize

The Banque de France Foundation's monetary thesis prize was awarded to **Samuel Bates** for his thesis entitled "Effectiveness of monetary policy transmission channels". The viva for this thesis took place at the Université des Antilles et de la Guyane, with professor Fred Célimène.

The EUR 3,000 prize was awarded to the winner on 27 September during the annual *Association Française de Sciences Economiques* (AFSE) conference (Sorbonne University) by **Pierre Jaillet** (Banque de France). Note that this year the Foundation's prize was awarded at the same time as the AFSE prize. The Foundation also contributed to the AFSE prize.

Members of the Foundation thesis prize jury were as follows: **Antoine d'Autume** (Sorbonne University); **Olivier de Bandt** (BdF); **André Cartapanis** (IEP Aix en Provence); **Gilbert Cette** (BdF); **Eric Chaney** (Morgan Stanley); **Michel Dietsch** (Université de Strasbourg); **Denise Flouzat** (Fondation BdF); **Pierre Jaillet** (BdF); **Hubert Kempf** (Sorbonne University); **Anne Lavigne** (Université d'Orléans); **Valérie Mignon** (Université de Paris 10 Nanterre); **Jean-Marc Vittori** (*Les Echos* newspaper).

The life of the Foundation

Appointments

The Board meeting of 10 July 2007 appointed six new members to the Scientific Council:

- **Francesca Cornelli** (London Business School)
- **Xavier Freixas** (University of Barcelona)
- **Philippe Martin** (PSE)
- **Franck Portier** (IDEI – Toulouse)
- **Hélène Rey** (London Business School)
- **Béatrice Weder** (University of Mainz)

We welcome **Vélayoudom Marimoutou** as the co-opted Board member from the *Centre national de recherche scientifique* (CNRS), taking over from **Patrice Fontaine**. Mr Marimoutou is Deputy Scientific Director in the Department of Human and Social Sciences at the CNRS.

Louis Bê Duc joined the Banque de France Foundation as its Treasurer on 1 September 2007. Louis Bê Duc had been a Senior Economist at the European Central Bank from 1999.

Catherine Estrela was appointed as assistant at the Banque de France Foundation as of 14 May 2007. She had previously worked in the secretariat of the Directorate General Economics and International Relations.

Departures

Patrice Fontaine (CNRS) has stepped down from the Board and has been replaced by **Vélayoudom Marimoutou** (CNRS). He contributed a great deal to the Foundation by strengthening its ties with the *Association Française de Finance*, encouraging stronger links with academia and reorienting its programmes to place greater emphasis on finance.

Marie-Laure Dreyfuss, Foundation Treasurer from 2004, stepped down at the end of August 2007 to take up a post at the French Insurance Supervisory Commission. She has been replaced by **Louis Bê Duc**. She contributed a great deal to shaping and improving the Foundation's communication, the structures of which she strengthened. We would like to thank her warmly for her work.

Christine Feist, assistant at the Foundation from 2000, moved to the Directorate General Operations in April 2007. She was replaced by **Catherine Estrela**. We are very grateful to Christine for her competence, professionalism and commitment.