FINESS

SEVENTH FRAMEWORK PROGRAMME

Project funded under the Socio-economic Sciences and Humanities

e-Newsletter No 2

European Commission

November 2008

Welcome to the second issue of the FINESS electronic newsletter!

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FINANCIAL SYSTEMS, EFFICIENCY AND STIMULATION OF SUSTAINABLE GROWH

Project summary

The main purpose of FINESS is to get a clear understanding of the implications of ongoing financial market integration in Europe on economic growth, employment and competitiveness, to identify likely future paths of the development and to draw policy relevant conclusions. On the macroeconomic level, the role of financial systems and their transmission channels on growth is being explored by innovative and tailor made econometric techniques, taken dynamic interactions between financial, product and labour markets into account. A range of indicators to measure the degree of financial integration will be constructed, and their development in time will be addressed. Insights into the working of financial institutions will be provided for the microeconomic level from the perspective of heterogeneous agents. Empirical analysis will be done using elaborated econometric methods.

The main purpose of FINESS is to get a clear understanding on the implications of ongoing financial market integration in Europe on the path of real economic growth, employment and competitiveness. In addition, likely future paths of the development are identified and policy relevant conclusions are drawn. By exploring the impacts of financial systems from the perspective of heterogeneous agents, new insights into the working of financial systems and for the optimal policy design in integrated financial markets are provided. In particular, the project investigates the role of the financial structure, for example, the banking sector, markets for private equity and venture capital, for improving efficiency and sustainable growth of start ups and established firms. Specific issues regarding the transition period of the new member states and the gender dimension are also addressed.

Project developments

FINESS successfully started in February 2008 with a project Kick-off meeting in Berlin. At this meeting the consortium established the project management structure, including the Steering Group and the Advisory Committee, and approved the detailed plan of activities until the end of the year. At the end of February the project partners announced in several languages the official project launch at their websites.

Since March 2008, the project has developed an increasing dynamism in the implementation of its work programme.

In April 2008 the project website was launched at http://www.finess-web.eu

In June 2008 FINESS published its first e-Newsletter and distributed it to more than 2000 addresses covering different target groups.

In July 2008 the project started publishing at the website its first working papers. Till the end of November **seven FINESS working papers** were published there.

Following the project's logical scheme, the research in the first project period concentrated mostly on the macroeconomic effects of the financial markets integration. Respectively, most output came from the macroeconomic workpackages. Other workpackages achieved good progress in the development of advanced analytical tools and databases promoting the research output in the forthcoming months.

On September 8 the **1st Steering Group Meeting** was organised in Berlin where the authors presented their research output. Active discussion on methodological issues resulted in a big number of useful comments and constructive proposals from inside the team.

In October-November the revised papers have been reviewed by the Advisory Committee.

The team attached great importance to the early start of the dissemination of results. Immediately after the publication on the Internet the authors started presenting their working papers at relevant workshops and conferences and publishing them as discussion papers. The FINESS Policy Brief containing non-technical summary of policy-relevant conclusions was provided to the European Commission. All FINESS working papers are available to the broad scientific community on the project website.

In general, the team advanced successfully towards the implementation of the research plan. All major objectives of the first project sub-period were achieved.

Research news

In this issue of the FINESS e-Newsletter we shortly present our first research results. The full texts of the working papers are available at http://www.finess-web.eu/publications.htm

The paper "***Financial Integration in the European Stock Markets"*** by Burcu Erdogan examines the integration of stock markets in Germany, France, Netherlands, Ireland and UK over the January 1973 - August 2008 period at the national market and industry level.

The paper considers the following industries: basic materials, consumer goods, industrials, consumer services, health care and financials. The analysis is conducted by using correlation analysis, □-convergence and □-convergence methods. The author finds evidence for an increasing degree of integration both at the national level and also at the industry level, although some differences in the speed and degree of convergence exist among stock markets. The only industry, which does not show a significant degree of convergence, is the heath care industry. One common observation for all countries and industries is that, in the mid 2000s, the degree of stock market integration falls considerably. The author also finds evidence that the investigated stock returns are gradually more explained by common EU news rather than by US news.

The paper "***European Financial Market Integration: A Closer Look at Government Bonds"*** by Sebastian Weber analyses the integration processes at the government bond markets.

A number of papers have tried to gauge the degree of integration for various financial markets looking at the convergence of interest rates. A common finding is that government bond markets are quite well integrated. In this paper stochastic Kernel density estimates are used to take a closer look at the dynamics that drive the process of interest rate convergence. The main finding is that countries with large initial deviations from the mean interest rate do indeed converge. Interestingly, the candidates least suspected namely the countries initially with interest rates at the mean level show a pattern of slight divergence.

The paper "***Does the Nominal Exchange Rate Regime Affect the Real Interest Rate Parity Condition?"*** by Christian Dreger explores the long-term convergence of real interest rates across countries and the role of the nominal rate regime in this process.

The real interest parity (RIP) condition combines two cornerstones in international finance, uncovered interest parity (UIP) and ex ante purchasing power parity (PPP). The extent of deviation from RIP is therefore an indicator of the lack of product and financial market integration. This paper investigates whether the nominal exchange rate regime has an impact on RIP. The analysis is based on 15 annual real interest rates and covers a long time span, 1870-2006. Four sub-periods are distinguished and linked to fixed and flexible exchange rate regimes: the Gold Standard, the interwar float, the Bretton Woods system and the current managed float. Panel integration techniques are used to increase the power of the tests. Cross section correlation is embedded via common factor structures. The results suggest that RIP holds as a long run condition irrespectively of the exchange rate regimes. Adjustment towards RIP is affected by the institutional framework and the historical episode. Half lives of shocks tend to be lower under fixed exchange rates and in the first part of the sample, probably due to higher price flexibility before WWII. Although barriers to foreign trade and capital controls were substantially removed after the collapse of the Bretton Woods system, they did not lead to lower half lives during the managed float.

This paper is published at Discussion Papers of DIW Berlin 2008, No. 819.

The paper **"*Bank Market Structure and Firm Capital Structure in Europe*"** by Lieven Baert and Rudi Vander Vennet investigates the link between bank market structure and corporate leverage decisions.

The authors explore the impact of concentration in the banking markets on the capital structure of publicly quoted non-financial firms in the EU15 over the period 1997- 2005, an era marked by intensive merger activity in the banking sector. More specifically, they empirically examine the relationship between the degree of concentration of European bank markets and the capital structure of non-financial firms. The results lend empirical support to the market power hypothesis, which states that more concentrated bank markets will lead more market power for the banks which translates into less bank financing. The authors found a negative and significant relationship between the degree of concentration of European bank markets and the market leverage of non-financial firms. When bank market concentration variables are substituted for indicators of bank competition based on the observed behaviour of banks, the results remain unaltered. Since endogeniety of bank market structure, alternative sources of external finance and the firm-specific factors driving the demand for leverage are controlled for, these findings reflect a supply-side effect, implying that the ongoing consolidation of bank markets may impose an external debt finance constraint on non-financial firms. However, firms with effective access to the bond market are not constrained in their choice of leverage, stressing the importance of alternatives to bank financing.

In any case the results imply that the ongoing (domestic) consolidation of the banking industry in Europe can potentially hamper the access of firms to bank financing. From a policy perspective, this calls for renewed efforts to increase the contestability and integration of bank lending markets in Europe.

The paper "***M3 Money Demand and Excess Liquidity in the Euro Area"*** by Christian Dreger and Juergen Wolters[1] explores the stability of money demand in the euro area and provides measures for excess liquidity as a future inflation potential.

The second interrelated paper *"**Money Velocity and Asset Prices in the Euro Area"*** by Christian Dreger and Juergen Wolters explores the relationship between the real and financial wealth and monetary growth.

Money growth in the euro area has exceeded the ECB target since 2001. Likewise, recent empirical studies did not find evidence in favour of a stable long run money demand function. The equation appears to be increasingly unstable if more recent data are used. If the link between money balances

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[1] Juegen Wolters is professor at the Free University of Berlin, collaborating with the FINESS project.

and the macro economy is fragile, the rationale of monetary aggregates in the ECB strategy has to be doubted. In contrast to the bulk of the literature, the authors in their first paper were able to identify a stable long run money demand relationship for M3 with reasonable long run behaviour. This finding is robust for different (ML and S2S) estimation methods. To obtain the result, the short run homogeneity restriction between money and prices is relaxed. In addition, a rise in the income elasticity after 2001 is taken into account. The break might be linked to the introduction of euro coins and banknotes. The monetary overhang and the real money gap do not indicate significant inflation pressures. The corresponding error correction model survives a battery of specification tests.

A rise in the income elasticity that has been observed after 2001 may reflect the exclusion of real and financial wealth in conventional specifications of money demand. This presumption is explored in the second paper by means of a cointegration analysis. To separate income from wealth effects, the specification in terms of money velocity is preferred. Evidence for the presence of wealth in the long run relationship is provided. In particular, both stock and house prices have exerted a negative impact on velocity after 2001 and lead to almost identical equilibrium errors. The extended error correction model is stable over the entire sample period and survives a battery of specification tests.

Both papers are published as Discussion Papers of DIW Berlin 2008 No. 795 and No. 813.

The paper Money Velocity and Asset Prices in the Euro Area" has been just published in Empirica, Springer, November 2008.

The paper "***Credit Frictions and Labour Market Dynamics"*** by Atanas Hristov studies the dynamics of entrepreneurial net worth and investment, on the one side, and household employment, on the other, over the business cycle in a unified theoretical framework.

For this aim a special DSGE model is developed, in which two real frictions are embedded into an otherwise conventional New Keynesian model: a labour search problem in the labour market and a costly state verification problem in the credit market. The first friction allows for endogenous equilibrium unemployment while the latter introduces riskiness of capital management. The claim of this paper is that credit markets may play an important role for the dynamics of labour market. To illustrate the above proposition, the author presents a simple framework to analyze the joint behaviour of access to credit and labour market prices. He considers the responses of unemployment in the economies to a monetary shock, a technology shock and a government consumption shock. Differences in credit market can play role for propagating shocks that originate outside the financial sector that and in turn increase the persistence and impact of labour market variables.

The paper shows that higher credit frictions amplify the transmission of shocks that move output and price in the same direction. Monetary policy shocks fall into this category. This means that restrictive monetary policy slows down employment creation for a longer period and to a higher extent in an environment with "higher" financial frictions. They mitigate the effects of other shocks.

FINESS Research Conference 2009

FINESS International Research Conference is scheduled for **March 5- 6 2009 in Berlin**.
It will present and discuss the latest project research results.

Conference premises:

Berlin-Brandenburg Academy of Sciences

(Berlin-Brandenburgische Akademie der Wissenschaften)

Einstein Hall

Jägerstrasse 22-23

10117 Berlin

Conference programme will be available at the FINESS homepage in January 2009.

All interested parties are invited to participate. To register, please contact the project managing coordinator, Tatjana Ribakoff (tribakoff@diw.de) before February 23, 2008.

Cooperation with other projects

FINPROP

The FINESS project has its roots in the project “Financial Integration in Europe and the Propagation of Shocks” – FINPROP - of the 6th Framework Programme. The results of this project are published at: http://www.finprop.de. Five of the FINPROP team members are now participating in FINESS. Several other FINPROP participants (currently working at ECB, Tilburg University, NIESR, ETH Zurich, Kiel University) are invited to be discussants of FINESS research papers at the forthcoming FINESS Research Conference 2009 .

VICO

We established cooperation with another ongoing 7th Framework Programme project – “Financing Entrepreneurial Ventures in Europe: Impact on innovation, employment growth and competitiveness” (VICO). Both projects hope to benefit from the complementarities of their research programmes.

We included VICO researchers in our emailing list and started exchanging the first research results. We agreed to establish mutual links to the homepages and actively participate at the dissemination activities of each other. As a first step, we invited the VICO team to delegate discussants to our FINESS research conference 2009. At more advanced stages both teams intend to actively participate at the major dissemination events of each other planned for 2010 and 2011.

New FP7 projects

Several new FP7 projects of potential interest to FINESS started in autumn 2008. To clarify the fields of mutual research interest and possible cooperation opportunities FINESS contacted the projects

PEGGED - “Politics, Economics and Global Governance: The European Dimensions”, and

POLHIA - “Monetary, Fiscal and Structural Policies with Heterogeneous Agents”.

We sent detailed information on the FINESS research to project coordinators and invite them to participate at our forthcoming research conference.

We invite all relevant ongoing research projects to exchange ideas with FINESS. For any cooperation proposals, please do not hesitate to contact the project coordinators, Christian Dreger (cdreger@diw.de) and Tatjana Ribakoff (tribakoff@diw.de).

EUROFRAME Conference 2009

The coordinator of the FINESS consortium, DIW Berlin is member of the EUROFRAME research association founded 10 years ago with the aim to combine the knowledge of ten leading independent research institutes from nine European countries in providing quantitative analysis, forecasts and policy recommendations for the European Union and for national decision makers.

Since 2004 the EUROFRAME has been organising the annual June EUROFRAME conference on topical issues of “Economic Policies in the European Union”. The sixth conference will be organised in June 2009 in London and devoted to the “***Causes and consequences of the current financial crisis”*** - the topic closely connected to the FINESS research.

FINESS intends to organise a special session at this conference to present its related policy-relevant research results. Three members of the local organising committee from NIESR were participants of the FINPROP project of the 6th Framework Programme. Kindly providing this presentation opportunity to the FINESS project NIESR is contributing to the continuity and further development of research ideas within the Framework Programmes of the European Commission.

In agreement with the conference organisers we are publishing below the first announcement and call for papers for this conference. Further details will be available at: http://www.euroframe.org

6TH EUROFRAME CONFERENCE
ON ECONOMIC POLICY ISSUES IN THE EUROPEAN UNION

Causes and consequences of the current financial crisis: what lessons for European Union countries?

Friday, 12 June 2009, London

Call for Papers

The EUROFRAME group of research institutes (CASE, CPB, DIW, ESRI, ETLA, IfW, NIESR, OFCE, PROMETEIA, WIFO) will hold its sixth annual Conference on Economic Policy Issues in the European Union in London on 12 June 2009. The aim of the conference is to provide an economic forum for debate on economic policy issues relevant in the European context.

The Conference will focus this year on **causes and consequences of the current financial crisis with a view to draw lessons for EU countries**. Contributions should address in particular issues related to: ***Causes of the current financial crisis*** (search for high profitability, growth based on indebtedness and capital gains, functioning of global finance: banks' behaviour, derivative products, financial bubbles, failure of financial mathematics; failures in the national and international regulatory frameworks); ***Financial crises and the real economy***, analysing consequences and solutions to the problems they have caused (evidence for the links between financial crises and consumption behaviour; links between banks, equity markets and firms in financial crises; what can we learn from previous advanced economy financial crises); ***The development of the current crisis and policy answers*** (vicious circles in banking, financial and equity markets, failures and successes of government measures to restore the functioning of the financial and banking systems). ***Towards a new Financial System***? (less finance or finance without bubbles?, World growth without imbalances?, New banking and financial regulations?, A new European regulatory framework? A new global financial architecture? A new functioning of financial markets?).

Submission Procedure

Abstracts should be submitted by e-mail before 13 March to catherine.mathieu@ofce.sciences-po.fr. Abstracts (2 pages) should mention: title of communication, name(s) of the author(s), affiliation, corresponding author's e-mail address, postal address, telephone number.

Corresponding authors will be informed of the decision of the scientific committee by mid-April.

Full papers should be received by e-mail by 25 May.

Scientific Committee

Karl Aiginger (WIFO), Ray Barrell (NIESR), Michiel Bijlsma (CPB), Marek Dabrowski (CASE), Christian Dreger (DIW), Markku Kotilainen (ETLA), Paolo Onofri (PROMETEIA), Iulia Siedschlag (ESRI), Henri Sterdyniak (OFCE), Catherine Mathieu (OFCE, Scientific Secretary).

Local Organising Committee (NIESR, London)

Ray Barrell, Dawn Holland, Simon Kirby, Philip Davis (NIESR and Brunel University).