

**e-Newsletter No 4****December 2009****Welcome to the fourth issue of the FINESS electronic newsletter!****In this issue****Project developments****Research news****FINESS steering group meeting****FINANCIAL SYSTEMS, EFFICIENCY AND STIMULATION OF  
SUSTAINABLE GROWTH****Purpose of the project**

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 broad 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. The comparative approach is especially useful to uncover catalysts and bottlenecks in the architecture of financial systems. Empirical analysis will be done using

elaborated econometric methods. 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**

The FINESS project successfully started in February 2008 with a 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. 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>. Up to the end of January 2009 **30 FINESS working papers** were published there. The FINESS Policy Briefs contain non-technical summaries of policy-relevant conclusions and are provided to the European Commission. Electronic newsletters are published at the semi-annual frequency and are distributed to more than 2000 addresses covering different target groups. This is the third newsletter of the project. All FINESS working papers, policy briefs and newsletters are also available to the broad scientific community for download from the website.

On February 2, 2009 an **Advisory Committee Meeting** was organised in Berlin, where the project participants presented their research output. Active discussion led to a huge number of useful comments and constructive proposals from inside the team. The papers were presented at the **International Scientific Conference** of the FINESS network in Berlin in March, 5-6. More than 50 researchers attended the conference. In addition to the comments obtained from the advisory committee members, the papers were discussed by external experts well-known by the international scientific community.

Moreover, researchers from cooperating networks like **FINNOV** and **POLHIA** participated in the event and improved the discussion of the papers. Immediately after the conference, the **2nd Steering Group Meeting** took place. Further steps in the project and organisational

issues were discussed. The 3rd **Steering Group Meeting** was held in Berlin September 14 2009. Apart from discussing new working papers that were finished in the meantime the new third **Policy Brief** was prepared. It was published in January 2010 and focused on Financial Market Institutions and Heterogeneous Agents. Insights gained by our recent research into the working of institutions and of heterogeneous agents representing the supply and demand side in financial markets were explained. The 4th **Steering Group Meeting** is planned for March 2010.

The team attached great importance regarding the dissemination of results. After the publication on the Internet the authors started presenting their working papers at relevant workshops and conferences and publishing them as discussion papers. In general, the team advanced successfully towards the implementation of the research plan. All major objectives for the sub-period were achieved.

Furthermore, we invite all relevant ongoing research projects to exchange ideas with FINESSE. For any cooperation proposals, please do not hesitate to contact the scientific coordinator, Christian Dreger, email: cdreger@diw.de.

## **Research News**

A number of new papers were produced over the recent months. For example, we have worked on the development of the process of financial integration process in Europe, and looked at the implications of the design of mortgage markets on the transmission of monetary policy. We have explored the relationships between bank ownership and the capital structure of firms, and investigated the relevance of bank competition for the growth of private enterprises. We have discussed the effects of financial and product market frictions for the allocation of consumption risk in an international framework and studied gender differences in investment decisions.

### **Claudia Buch, Katja Neugebauer: Bank-Specific Shocks and the Real Economy**

Government interventions into the financial system in the form of bail out operations are usually justified with the systemic importance of large banks for the real economy. In this paper, we test whether idiosyncratic shocks hitting large banks have effects on real GDP growth. We employ a measure of idiosyncratic shocks which follows Gabaix (2009). He shows that idiosyncratic shocks at large firms have an impact on GDP growth in the US. We apply this idea to the banking sector. We find no consistent evidence that shocks occurring at large banks have a long-run impact on the real economy.

### **Claudia Buch, Katja Neugebauer: Diversification of Banks' International Portfolios: Evidence and Policy Lessons**

Over the past decades, banks have significantly increased their cross-border asset positions. The ongoing crisis on international financial markets has raised the question whether this increase in cross-border activities has allowed banks to diversify risks and to what extent it has increased banks' exposure to systemic risks. In this contribution, we review the existing empirical evidence.

### **Oleg Badunenko, Saloni Deva, Dorothea Schäfer and Michael Viertel: What's banking sector concentration got to do with Private Equity market?**

The paper investigates the link between bank concentration and a country's buyout market. We perform a macro level analysis for 15 European countries during 1997-2007. We estimate the elasticity of the country *i*'s buyout market to country *i*'s concentration in the banking sector. Our major finding suggests that the more concentrated the banking sector is, the better it is for the size of the buyout market. The elasticity ranges from 1 up to 3 percent depending on which bank concentration measure is employed and what segment of buyout market we look at. We also find that bank concentration is irrelevant for the average deal size. To the best of our knowledge, this is the first paper to analyze the link between banking sector developments and the market for leveraged buyouts.

### **Oleg Badunenko, Christopher F. Baum, and Dorothea Schäfer: Does Private Equity change the performance of a European firm in which it invested?**

The paper investigates whether or not the presence of Private Equity (PE) investors in European companies influences its performance. Previous studies documented unambiguous merit of a buyout during 1980s and 1990s in US and UK markets for listed firms. This study analyzes such influence in both listed and unlisted European firms during 1992–2007. Our major finding is that the firms backed by PE perform in terms of return on assets on par with firms not backed by PE. We also show that PE does not have an effect on firm's performance irrespective of number of years PE was among shareholders in this firm.

### **Sven Blank: International Consumption Risk Sharing and Monetary Policy**

This project aims at analyzing the impact of monetary policy on the international allocation of risk in a two-country dynamic stochastic general equilibrium model with sticky prices and international portfolio choice. The model features endogenous firm entry which influences the evolution of equity in each country and alters real exchange rate dynamics. Preliminary results show that there may be substantial deviations from efficient consumption risk sharing in the presence of monetary policy when there are frictions in goods as well as asset markets.

### **Gábor Pellényi, Péter Bilek: Foreign Currency Borrowing: The Case of Hungary**

We use household survey data from Hungary to analyse the determinants of foreign currency (FX) borrowing. We do not find evidence that Hungarian FX borrowers are better educated, wealthier or more risk-loving than their peers. In fact, FX borrowing is a common phenomenon driven mostly by macroeconomic factors: high interest rate spreads, a relatively stable exchange rate and the competition of foreign owned banks. Although FX borrowing is widespread, our analysis suggests that loan losses directly attributed to it may be limited, given currency fluctuations up to autumn 2009.

### **Christian Dreger, Jarko Fidrmuc: Drivers of exchange rate dynamics in selected CIS countries: Evidence from a FAVAR analysis**

We investigate the likely sources of exchange rate dynamics in selected CIS countries (Russia, Kazakhstan, Ukraine, Kyrgyzstan, Azerbaijan, and Moldova) over the past decade (1999-2008). The analysis is based on country VAR models augmented by a regional common factor structure (FAVAR model). The models include nominal exchange rates, the common factor of exchange rates in the CIS countries, and global drivers such as gold, oil and share prices. Global, regional and idiosyncratic shocks are identified in a standard Cholesky fashion. Based on the decomposition of the variance of forecast errors, their relevance for exchange rates is explored. As a quite robust finding, CIS exchange rates have become more vulnerable to global shocks towards the end of the sample.

### **Georgy Ganev: Costs and Benefits of Euro Adoption in Bulgaria**

This study presents a cost-benefit analysis of euro adoption for the case of Bulgaria. Based on a review of existing similar studies for other East European EU member states, it outlines the basic types of potential costs and benefits of euro adoption, and applies them to the specific Bulgarian economic and economic policy context. The most important relevant features of the Bulgarian economy with respect to the analysis are found to be the catching-up status of the country and the currency board arrangement. In this context the study finds that a net benefit of above 15 % of GDP in a 20 year horizon can be expected for Bulgaria due mainly to enhanced capital inflows and to a smaller extent to a boost in trade with the EU and to higher domestic saving in light of enhanced policy credibility. Along the way the study attempts to draw attention to important nuances which may be of relevance for the analysis of euro adoption in Eastern Europe in general.

### **Nataliya Barasinska: The Role of Gender in Lending Business: Evidence from an Online Market for Peer-to-Peer Lending**

This study analyzes the role of lenders' gender in lending business by looking at the behaviour of individuals who engage in lending transactions at an online market for peer-to-peer lending. In particular, I address two research questions. Firstly, it is investigated whether lenders' gender is relevant for the ex-ante return and risk characteristics of loans. Secondly, it is scrutinized whether loans granted by female lenders perform differently from loans granted by males in terms of generated returns, ex-post default rates and loan service behaviour during the repayment period.

### **Oleg Badunenko, Nataliya Barasinska, Dorothea Schäfer: Risk Attitudes and Investment Decisions across European Countries – Are Women More Conservative Investors than Men?**

This study questions the popular stereotype that women are more risk averse than men in their financial investment decisions. The analysis is based on micro-level data from large-scale surveys of private households in five European countries. In our analysis of investment decisions, we directly account for individuals' self-perceived willingness to take financial risks. The empirical evidence we provide only weakly supports the gender differences argument. We find that women are less likely to invest in risky financial assets. However,

when the probability of investing is controlled for, males and females are found to allocate equal shares of their wealth to risky assets.

**Nataliya Barasinska, Dorothea Schäfer, Andreas Stephan: Financial Risk Aversion and Household Asset Diversification**

This paper explores the relationship between self-declared risk aversion of private investors and their willingness to hold diversified portfolios of financial assets. The analysis is based on household survey data from the German Socioeconomic Panel (SOEP) that provides a reliable measure of individual attitude towards financial risk. Our empirical findings suggest that more risk averse investors tend to hold incomplete portfolios that consist mainly of a few safe assets. We also find that for private households the propensity to diversify is highly dependent on whether liquidity and safety needs are satisfied.

**Christian Dreger, Jürgen Wolters: Liquidity and asset prices: How strong are the linkages?**

The appropriate design of monetary policy in integrated financial markets is one of the most challenging areas for central banks. One hot topic is whether the rise in liquidity in recent years has contributed to the formation of price bubbles in asset markets. If strong linkages exist, the inclusion of asset prices in the monetary policy rule can eventually limit speculative runs and negative effects on the real economy in the future. We explore the impacts of liquidity shocks on real share and house prices and the influence of wealth prices on liquidity. VAR models are specified for the US and the euro area. To control for international spillovers, global VARs are also considered. Differences in the results can provide a measure on the impact of financial market integration. The specifications point to some impact of liquidity shocks on house prices, while asset prices are not affected.



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## SEVENTH FRAMEWORK PROGRAMME



# FINES

## 3<sup>rd</sup> Steering Group Meeting

September 14, 2009

DIW Berlin, Mohrenstr. 58, 10117 Berlin

Room 12008 (2<sup>nd</sup> Floor)

## Agenda

- 10.30-11.00 Overview of the project progress**  
Presentation by Christian Dreger and WP leaders
- 11.00-13.00 Presentation of delivered research papers**
- 11.00 -11.30 ***Bank-specific shock and the real economy (D2.3)***  
Presentation by Claudia Buch (UoT)  
Discussants: Kerstin Bernoth (DIW), Sean Holly (UCAM)
- 11.30 -12.00 ***Bad Banks and Recapitalization of the Banking Sector (D3.1b)***  
Presentation by Dorothea Schäfer (DIW)  
Discussants: Sean Holly (UCAM)
- 12.00-12.10 Coffee break
- 12.10 -12.30 ***Does Private Equity change the performance of a firm in which it invested? (D3.3)***  
Presentation by Oleg Badunenko (DIW)  
Discussion by Claudia Buch (UoT), Georgy Ganev (IME)
- 12.30 -13.00 ***Are women more risk averse lenders than men? Evidence from a natural experiment***  
Presentation by Nataliya Barasinska (GC-DIW)  
Discussion by Gabor Pellenyi (ICEG)
- 13.00-14.00 Lunch**
- 14.00-16.00 Presentation of delivered research papers**
- 14.00 -14.30 ***International Consumption Risk Sharing with Incomplete Goods and Asset Markets (D4.2)***  
Presentation by Sven Blank (UoT)  
Discussant: Oliver Hülsewig (ifo), Burcu Erdogan (DIW)
- 14.30 -15.00 ***Private equity and venture capital in the New Member States (D3.5)***  
Presentation by Gabor Pellenyi (ICEG)  
Discussion by Georgy Ganev (IME), Kerstin Bernoth (DIW)
- 15.00 -15.30 ***Foreign Currency Borrowing: The Case of Hungary (D5.4)***  
Presentation by Gabor Pellenyi (ICEG)  
Discussion by Oliver Hülsewig (ifo), Roberta Colavecchio (DIW)
- 15.30 -16.00 ***Costs and benefits of Euro adoption in Bulgaria (D5.3)***  
Presentation by Georgy Ganev (IME)  
Discussion by Oleg Badunenko, Burcu Erdogan (DIW)
- 16.00-16.20 Coffee break
- 16.20-17.45 Project reporting and planning**
- 16.20 -16.40 ***Preparation of third policy brief***  
Presentation by Dora Schäfer (DIW)  
General discussion
- 16.40-17.00 ***Structure of second interim activity report***  
Presentation by Christian Dreger (DIW)
- 17.00-17.20 **Planning and approval of work program for the next period**
- 17.20-17.30 Any other business
- 17.30 Continuation of informal discussion (dinner)**