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Net worth and credit allocation

There is now a relatively large theoretical body of literature showing that credit frictions and, more generally, financial market imperfections can amplify business cycle fluctuations. The most recent financial crisis has provided further impetus and stronger incentive for researchers to construct frameworks that incorporate such frictions and are suitable for quantitative business cycle analysis.

Although progress has been made, it is still true that the task of developing the required quantitative models is particularly challenging, since many of the relevant finance-related models display heterogeneity and frictions such as asymmetric information and costly contract enforcement. Heterogeneity is mostly needed to generate borrowing and lending, while informational and related frictions are required to give a genuine role for the capital structure. Hence, constructing models that belong to this class and can also be credibly matched to the data has proven to be more difficult than, say, calibrating a standard real business cycle model or, more generally, constructing and calibrating a DSGE model with nominal rigidities, where in the former class of models there is no heterogeneity or any kind of market failure. In the latter types of model, heterogeneity due to price rigidities is typically handled via a special (financial market) construct that effectively takes the modeller back to the representative agent framework.

Once we recognize that the market economy can fail to allocate credit most efficiently, that is to the most productive investment project, as credit transactions are subject to agency problems, it becomes evident that borrowers' net worth, or borrowers' balance sheet condition, as it is also known, occupies a central role in allocating credit across entrepreneurs, firms, households, industries and nations. Changes in the aggregate level of wealth as well as changes in the distribution of wealth consequently affect the equilibrium allocation of the credit, which, in turn, affects the patterns of investments.

The progress made in the microeconomics of financial markets and corporate finance over the last thirty years has, however, left in its wake a bewildering set of specific models with apparently conflicting results. Do the imperfections add persistence to the macroeconomic dynamics, or do they merely, or mainly, add volatility? If they drive fluctuations, is this because misallocation of credit creates recessions or because it creates boom-and-bust cycles? Do improvements in credit markets reduce or increase fluctuations? Does financial globalization alleviate or exacerbate credit market imperfections? These are just examples of the types of question to which researchers

have been trying to provide answers.

Aggregate implications of credit market imperfections are indeed rich and diverse, so no simple answer to these questions should be expected. The underlying reason for the richness and diversity is that the aggregate implications depend on the manner in which different agents or different investments interact with each other, which consequently affects amplification and propagation mechanisms. This suggests that caution should be exercised with one's intuition when studying only a particular family of models. The overall implication for incorporating a true role for financial factors in quantitative models of business cycle fluctuations seems, then, to be that we may need to focus on some simpler models of financial structure until there is a consensus on what aspects of financial market imperfections are model relevant. The ultimate goal seems to be, and perhaps should be, to then embed financial frictions into a DSGE structure to establish whether it all fits together in a coherent manner. This suggests that a truly interesting and challenging research agenda lies ahead of us.

Jouko Vilmunen

Strengthening the bank's research function: research fellows and scientific advisors

Increasingly, many central banks are thinking about the role of research in their overall strategy, revising their research policy to sharpen its focus and actively seeking ways to strengthen their research function. To the extent that being able to produce central bank research that also satisfies high academic quality requirements and publish that research in refereed international journals is an important element in central banks' research policy, building and maintaining close and active relationships with academia seems increasingly critical. There are alternative ways of establishing and maintaining such relationships, ranging from joint research ventures and joint seminars and workshops to various forms of visiting scholar arrangements, including, of course, networking at the level of individual central bank staff members and academic researchers.

The Bank of Finland is no exception to this rule. The research policy at the Bank is centred around the aim of producing focused policy-relevant research that meets the academic requirements for high quality research. Furthermore, networking through interaction with academic researchers has always been an important element of the Bank's research policy. This is reflected in the visitors' programme that has been running ever since the Bank grasped the nettle and reformed the foundations of its research function almost fifteen years ago. Three external research evaluations, the most recent one published in December 2009, also bear witness to the importance of openness and academic influence on the Bank's research.

As with the two previous evaluations, the most recent one provides the Bank with recommendations on how to improve its research function further. However, the Bank already decided in 2008 to further modify its research organization by introducing research fellow positions for established international academic researchers. In addition to conducting and publishing research on the core areas of the Bank's research, research fellows are expected to contribute by

helping staff members to interact and network with external academic researchers. Below, we introduce the Bank's new research fellows and also the scientific advisors with whom the Bank has already enjoyed a long and fruitful relationship.



The Bank of Finland's scientific advisor **Iftekhar Hasan** is Cary L. Wellington Professor of Finance at the Lally School of Management and Technology in Rensselaer Polytechnic Institute. He is also Director of the International Center for Financial Research, Co-Director of the Ph.D. Program and Area Coordinator of Accounting and Finance. Professor Hasan completed his MA studies at the University of Houston, from where he also obtained his PhD.

Professor Hasan focuses his research on international banking issues, the economics of stock exchanges, privatizations in emerging markets, and new ventures. In addition to his research contributions to the field, Professor Hasan plays an active role in several research institutions in the United States and elsewhere. In addition to his role as a scientific advisor at the Central Bank of Finland in Helsinki, he is a research associate at the Berkley Center for Entrepreneurial Studies of the Stern School of Business in New York and a visiting scholar at the Federal Reserve Bank of Atlanta, Georgia.

Professor Hasan has over 200 publications in print, including 120 academic journal articles in reputed finance, accounting and economics journals, such as the *Journal of Financial Economics*, *Journal of Financial & Quantitative Analysis*, *Journal of Business*, *Journal of Monetary Economics*, *Journal of International Money and Finance*, *Journal of Money Credit and Banking*, *Journal of Banking and Finance*, *Journal of Financial Intermediation* and *European Finance Review*. He is a co-author of several books and edited volumes, including the widely-cited book *Quantitative Methods for Finance and Investment*. Professor Hasan serves on the editorial boards of a number of journals such as the *Journal of Money Credit and Banking*, the *Journal of Banking and Finance* and the *Journal of International Money and Finance*. He also serves as Managing Editor of the *Journal of Financial Stability*.



Martin Ellison, since mid-November 2009 the Bank's research fellow in macroeconomic research, is Professor of Economics at the University of Oxford and Michael Cohen Fellow of Exeter College. Professor Ellison is a monetary macroeconomist interested in understanding situations where the central bank and private agents are not perfectly informed about each other's actions nor certain about how the economy works. He has published on central bank learning and the learning of private agents in leading international journals such as the *Journal of Monetary Economics*, *Journal of Money, Credit and Banking* and *Review of Economic Dynamics*. More recently, in work with Professor Thomas Sargent from New York University, Professor Ellison is looking for evidence that the Federal Open Market Committee in the United States has been following policies that reflect doubts about how the economy works. Before taking up his position in Oxford he was Professor of Economics at the University of Warwick and a consultant at the Bank of England. Professor Ellison is fluent in Finnish and Italian after studies at the University of Oulu and obtaining a PhD from the European University Institute in Florence.



Finally, **Timo Korkeamäki**, the Bank's research fellow in financial market research, is Aktia Professor of Finance at the Hanken School of Business in Helsinki. Professor Korkeamäki's research interests are within empirical corporate finance. In his published papers, Professor Korkeamäki has studied the connection between security design and firms' subsequent investment behaviour. He has also studied the area of law and finance, with particular focus on the valuation effects of law changes in Finland. Among his current research projects, he is studying the sensitivity of a firm's stock returns to changes in interest rates and foreign exchange rates. He has published research in these areas in the *Journal of Finance*, *Journal of Financial Stability*, *Journal of Corporate Finance* and *Journal of International Economics and Finance*. Before joining Hanken he was Assistant Professor of Finance as well as Associate Professor of Finance at the Gonzaga University (Spokane, WA), where he completed his MBA studies in 1996. Professor Korkeamäki obtained his PhD from the University of South Carolina (Columbia, SC) in 2001. He visited the Bank in 2007 as a visiting scholar.

Jouko Vilmunen

Conferences and seminars

11th Annual Bank of Finland/CEPR Conference: Banking in emerging economies, 7–8 October 2010

The Bank of Finland (Research Unit and BOFIT) and the CEPR ([Centre for Economic Policy Research](#), London) will jointly host a scientific conference titled *Banking in emerging economies*. The conference is co-organized by Rensselaer Polytechnic Institute, [Lally School of Management & Technology](#) (New York).

This topical conference aims at bringing together scholars from the different fields of economics and finance to present and discuss the latest research on banking and financial markets in emerging markets as well as their impact on the rest of the economy.

The programme will be available at [the conference site](#) by the end of June.

Bank of Finland Research Seminars

Invited speakers:

Thursday 6 May 2009 13.30–15.00

Prof. [Markku Lanne](#)

Helsinki University

[Optimal Forecasting of Noncausal Autoregressive Time Series](#).

Thursday 2 September 2010 13.30–15.00

PhD [Erkko Etula](#)

Federal Reserve Bank of New York

(Topic TBA).

Thursday 7 October 2010 13.30–15.00

PhD [Jirka Slacalek](#)

European Central Bank

(Topic TBA)

Research seminars are open to all interested parties. Please register in advance with Marjut Salovuori at seminars@bof.fi by noon of the preceding day. For further information please visit the seminar site at <http://www.bof.fi/en/tutkimus/konferenssit/tutkimusseminaarit/>.

BOFIT seminars

Tuesday 4 May 2010 10.30

PhD Asel Isakova

European Bank for Reconstruction and Development

Currency Substitution in the Economies of Central Asia: How Much Does It Cost?

Tuesday 11 May 2010 10.30

MSc Markus Eller

Oesterreichische Nationalbank

What do Russians think about transition?

Wednesday 12 May 2010 10.30

PhD Zuzana Fungáčová (BOFIT) ja Laurent Weill (University of Strasbourg)

Bank Capital, Liquidity Creation and Deposit Insurance

For further information please visit the seminar site http://www.bof.fi/bofit_en/tutkimus/seminaarit/tiistai. Please register in advance via Liisa Mannila (firstname.lastname@bof.fi, + 358 10 8312268).

Recent Bank of Finland research publications

Bank of Finland Research Discussion Papers

Macroeconomic research

12/2010

Juha Kilponen – Torsten Santavirta

[New evidence on implicit contracts from linked employer-employee data](#)

11/2010

Efrem Castelnuovo – Salvatore Nisticò

[Stock market conditions and monetary policy in an DSGE model for the US](#)

6/2010

Patrick M. Crowley

[Long cycles in growth: explorations using the new frequency domain techniques using US data](#)

Financial market research

10/2010

Hanna Putkuri

[Housing loan rate margins in Finland](#)

9/2010

Antti J Tanskanen – Petri Niininen – Kari Vatanen

[Risk-based classification of financial instruments in the Finnish statutory pension scheme TyEL](#)

8/2010

Syed Mujahid Hussain

[Simultaneous monetary policy announcements and international stock markets response: an intraday analysis](#)

7/2010

Paavo Miettinen

[Information acquisition during a Dutch auction](#)

BOFIT Discussion Papers

5/2010

William Pyle and Laura Solanko

[The composition and interests of Russia's business lobbies: A test of Olson's "encompassing organization" hypothesis](#)

4/2010

Allen N. Berger, Iftekhar Hasan, Mingming Zhou

[The effects of focus versus diversification on bank performance: Evidence from Chinese banks](#)

3/2010

Zuzana Fungáčová, Laura Solanko and Laurent Weill

[Market power in the Russian banking industry](#)

2/2010

Laurent Weill

[Do Islamic banks have greater market power?](#)

1/2010

Anatoly Peresetsky

[Bank cost efficiency in Kazakhstan and Russia](#)

Forthcoming discussion papers

Bank of Finland Research Discussion Papers

Juha-Pekka Niinimäki

Moral hazard in the credit market when the collateral value is stochastic

BOFIT Discussion Papers

Vladimir Sokolov

Bi-currency versus Single-Currency Targeting: Lessons from the Russian Experience

Yu-Fu Chen, Michael Funke and Nicole Glanemann

Off-the-Record Target Zones: Theory with an Application to Hong Kong's Currency Board

Alexei Karas, William Pyle and Koen Schoors

The Effect of Deposit Insurance on Market Discipline: Evidence from a Natural Experiment on Deposit Flows

Allen N. Berger, Iftekhar Hasan, Iikka Korhonen and Mingming Zhou

Focus – Diversification Strategies and the Risk – Return Tradeoff in Banking: Evidence from Russia

Subscriptions to electronic alerts for Bank of Finland research publications

Bank of Finland website

http://www.bof.fi/en/julkaisut/sahkoisten_julkaisujen_tilaaminen/index.htm.

SSRN (Social Science Research Network) http://hq.ssrn.com/Pub_Login.cfm?iacm=y.

RePec (Research Papers in Economics; NEP, new economics papers on central banking)

<http://lists.repec.org/mailman/listinfo/nep-cba>.