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EDITORIAL :

Bubbles, real misallocations and the size of the financial sector

One of the conclusions that could be drawn from the most recent financial crisis is that the financial sector absorbed far too big a share of the (US) economy's resources to be sustainable over a longer time span. This, in turn, suggests a policy implication that the size of the financial sector should be closely monitored to detect any signs of underlying unsustainable dynamic credit and asset price developments.

This concern that the financial sector tends to overgrow and absorb in particular skilled resources from the rest of the economy rests on the view that the prospect of large payoffs from trading highly innovative, frontier financial products like exotic, highly complex financial products ultimately results in a diversion of valuable human resources, most notably skilled labour, into financial activities and away from other productive and probably more efficient ones. Some empirical evidence exists to sustain this proposition, most notably from the United States, where the financial sector attracted a lot of skilled labour in the 1990s and 2000s, thanks to large income premia relative to the wages paid in other sectors.

The overgrowth of the financial sector is more often than not associated with exceptionally high, bubbly asset valuations. Recent literature has explored alternative ideas explaining the potential relationship between the two. One interesting alternative¹ builds on a standard overlapping-generations model wherein assets are subject to intergenerational trade at prices higher than their fundamental value and firm financing and asset trading require specialized intermediation services. This can be built into the model by eg assuming that there is a production as well as a financial sector in the economy and entrants choose where they want to work based on the expected payoff from each career.

Producers' income consists of wages, whereas financiers collect savings from producers, undertake portfolio investments and receive income from the intermediation margin they manage to obtain. This latter aspect of the model follows from the assumption that, due to

¹ See P. Cahuc and E. Challe (2009) Produce or Speculate? Asset Bubbles and Occupational Choice and Efficiency. Centre of Economic Policy Research, DP No 7602.

market frictions, producers are limited in their ability to put out a tender to alternative financiers, which induces rents in the financial sector. These rents then affect the relative returns from financial careers and, hence, allocation of the economy's labour resources across sectors.

This surprisingly simple structure has a number of interesting implications. Firstly, bubbles unambiguously lead to an increase in the size of the financial sector. Secondly, the welfare impact of asset bubbles depends on the extent of rent extraction in the financial sector. In particular, with sufficiently small rents, bubbly equilibria can be dynamically efficient. Thirdly, bubbles increase income and consumption inequalities. This implication seems to be consistent with the evidence from the United States in the 1990s and 2000s.

Although the model outlined above does not explain the emergence of asset bubbles, it presents an interesting mechanism for the bubbly growth of the financial sector and certainly points to a very important potential fact that asset bubbles affect real allocations in the economy. Furthermore, from a welfare point of view bubbles need not be inefficient, at least not in economies with an overlapping-generations structure. But clearly, further research is needed for us to be able to take a stand on the robustness of implications like those listed above.

Jouko Vilmunen

Towards a new research organization

After an external evaluation process of the Bank of Finland's research function was completed and the evaluation report published in December 2009, the board of the Bank of Finland decided to set-up a task force, chaired by Seppo Honkapohja, the board member responsible for research, to prepare a concrete proposal to reform the Bank's research function. The task force prepared a proposal by the summer of 2010 and after presentation to the board and initial board deliberations the proposal was accepted in its August 2010 meeting.

Many of the features of the new research organization are well in line with the recommendations made by the external evaluators in their final report from December 2009. However, some of the new features deserve special attention. First of all, the internal visitors' programme or system of rotation has been terminated. Through this system Bank staff members with the required research qualifications visited the research unit for a fixed period of time, typically 6 – 12 months, to undertake and publish research on pre-specified topics. The internal visitors' programme did not quite live up to its expectations, as the relative research output from the programme was consistently outweighed by that from the external visitors' programme. This observation provided the external evaluators with evidence that the internal visitors programme was more a tax on Bank's research than a resource.

The internal visitors programme has been replaced by new fixed, but longer-term assignments or positions in the research unit. By the end of 2010 the research unit recruited four PhD level economists from



Maritta Paloviita



Markus Haavio



Karlo Kauko



Juuso Vanhala

the Bank with the required research qualifications to work as research economists with, on average, 60% of their time allocated to research and the rest to policy work. If possible, the schedule for policy work should be set up in advance. The new research economist assignments are for a period of 4 – 5 years. The new research economists, Ms [Maritta Paloviita](#) (PhD), Mr [Markus Haavio](#) (PhD), Mr [Karlo Kauko](#) (PhD) and Mr [Juuso Vanhala](#) (PhD) will work with the former research supervisors (3), whose job titles have been changed to research advisors and will be later supplemented by additional research economists recruited from inside and probably also from outside the Bank.

International recruitments are now an essential part of the new research organization and the Bank participated in the international job market for economists in Denver (Colorado, USA), as organized by the American Economic Association, as part of its annual meeting in January 2011. The objective is to recruit one or two recently-graduated or soon to graduate PhD economists to work in the research unit as research economists. Research Fellow's continue to be a very important part of the research organization, even to the extent that the objective is to use the position more actively in the future.

Finally, the previous two research programmes, modelling monetary policy and the future of the financial services sector have now been combined into a one programme or research focus and will be called the interaction and stability of the financial markets and the macroeconomy. Obviously, the message here becomes the most recent financial crisis and the subsequent global recession. It suggests that, in the end, we should not make a too strong a separation between finance and macro and that we urgently need more systematic research on the interaction between the two and how this impinges upon the stability of the macroeconomy and financial markets. With the new research organization we are building research resources to respond to this particular challenge. An interesting agenda lies ahead of us.

Jouko Vilmunen

How does one forecast China's economic performance?



Iikka Korhonen

As China's importance in the world economy has increased, so too has the level of interest in forecasting its economic performance. Consensus Economics, which specialises in collating economic forecasts, currently reports on forecasts of China's key economic indicators produced by nearly 20 different international research organisations. At the same time, however, doubts have been raised about whether China's statistical data are able to give a realistic picture of the huge country's economic situation. For example, a revision of China's national accounts in 2005 resulted in a full 16.8% upward adjustment in GDP, and some smaller adjustments have been made since then. Such a situation confronts both users of the data and forecasters with hard choices as they face the task of forecasting future developments.

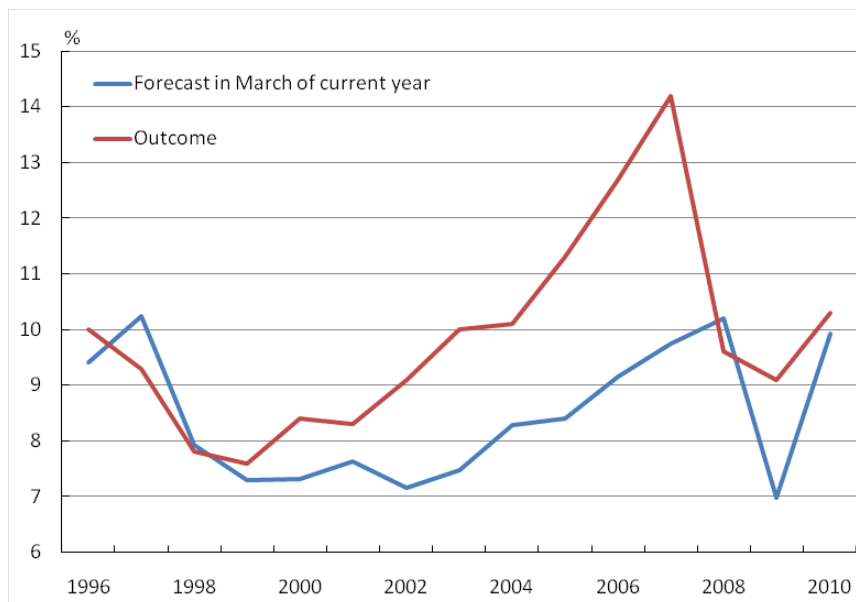
The Bank of Finland Institute for Economies in Transition (BOFIT) publishes its own forecast for China twice a year and has in progress several research projects that deal with forecasts of the Chinese economy as well as forecasting in a slightly broader context. The studies involved will be reported soon in the BOFIT Discussion Paper series. These include a study by Aaron Mehrotra (BOFIT) and Jenni Pääkkönen (Government Institute for Economic Research, VATT) that compares China's published GDP statistics with several other macroeconomic indicators. The purpose is to examine whether the economic dynamics portrayed by the official GDP statistics accord with other types of coincident indicators. The alternative indicators are coalesced by using factor analysis to combine data on a broad array of macroeconomic variables. The estimated factors are then compared with published GDP growth figures for 1997–2009, a period that included the Asian economic crisis of the late 1990s, the global economic crisis of 2008 and 2009, as well as China's own robust growth performance, especially in the second half of the last decade.

The authors found that the published GDP growth figures are generally in line with the alternative indicators and that the discrepancies tend to be very short-lived. This suggests that there are no systematic errors in China's GDP growth figures. However, the significance of the different factors changes over time, which is probably a sign of ongoing structural change in the Chinese economy. The study also compares the picture of Chinese economic dynamics given by the factor analysis with those of two published coincident indicators - China's own official one and that of the US Conference Board. It became clear that the three depictions of economic conditions in China are very closely aligned.

In another study, Iikka Korhonen (BOFIT) and Maria Ritola (Demos Helsinki) examine how forecasts of GDP and inflation are carried out in different research organizations in the large emerging economies. It appears that in many countries the so-called consensus forecast (average of all forecasts) for GDP growth is unbiased, ie the average forecast error is zero. But this is not the case for China, where GDP growth forecasts have been notably overly cautious during the peak years. The forecast error - outcome versus consensus forecast of March of the same year - is about two percentage points for the last decade or so, but clearly larger for the years 2002-2007. The forecasters were unable to foresee China's highly robust economic

growth during that period. On the other hand, the forecasts were better on average during the international economic crisis (see chart).

Accuracy of forecasts of China's GDP growth



Sources: Consensus Economics and Chinese authorities

According to the results for the indicator models, China's national account figures accurately relate economic developments. For this reason, the systematic forecast errors cannot be explained by statistical problems, at least not for the years 2006 and 2007, when the errors were the largest. It may be the case that the forecasters placed too much trust in the possibilities of economic policy for restraining economic growth and avoiding economic overheating. Correspondingly, the inflation forecasts for 2007 and 2008 were below the outcomes.

Ilkka Korhonen

Conferences and seminars

On 22–23 September 2011, a conference entitled 'The Future of Risk Management' will be held in Helsinki. The conference will be jointly hosted by the Bank of Finland Research Unit together with both the CEPR ([Centre for Economic Policy Research](#)) and the SUERF ([Société Universitaire Européenne de Recherches Financières](#)), and also in co-operation with the Journal of Financial Intermediation. The call for papers is open until 31 March 2011 at the [conference site](#).

On 16-17 May 2011, the Bank of Finland Institute for Economies in Transition (BOFIT) will host a research workshop devoted to Chinese monetary and exchange rate policy. The event is organized by, and is the launching event for, the new "Central bank-Academia network on the Chinese economy", a joint venture between the Chinese Economic Association (CEA) and BOFIT. The call for papers is open until February 28, 2011 at the [workshop site](#)

Bank of Finland Research Seminars

Friday 4 February 2011 at 14.00–15.30

Rauhankatu 19, Auditorium

Prof. [John B. Taylor](#)

Stanford University

Can a Rule for Monetary Policy Be Legislated?

Thursday 3 March 2011

Prof. [Jagjit Chadha](#)

University of Kent

Roundheads versus Cavaliers: An Early Assessment of Quantitative Easing

Tuesday 17 March 2011 at 10.00–11.30

Rauhankatu 19, Auditorium

Prof. [Viral Acharya](#)

Stern School of Business, New York University

Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance

Research seminars organized by the Bank of Finland's research unit are held on the first Thursday of the month at 13.30–15 in Rauhankatu 19, 3rd floor big meeting room (unless indicated otherwise). Research seminars are open to all interested parties. Please register in advance at seminars@bof.fi by noon of the preceding day. For further information please visit the [seminar site](#).

BOFIT seminars

Wednesday 8 Feb 2011

Linlin Niu (Xiamen University)

Forecasting Inflation in China with Bayesian Model Averaging

BOFIT seminars, open to all interested parties, are held on Tuesdays at 10.30 in Rauhankatu 19, 3rd floor big meeting room (unless indicated otherwise). Please register in advance via Liisa Mannila (firstname.lastname@bof.fi, + 358 10 8312268). For further information please visit the [seminar site](#)

Recent Bank of Finland research publications

Bank of Finland Research Discussion Papers

22/2010

Juha-Pekka Niinimäki:

[Moral hazard in the credit market when the collateral value is stochastic](#)

21/2010

Pasi Ikonen:

[Effect of finance on growth through more efficient utilization of technological innovations](#)

20/2010

Pentti Pikkarainen:

[Central bank liquidity during the financial market and economic crisis: observations, thoughts and questions](#)

19/2010

Katja Ahoniemi – Markku Lanne:

[Realized volatility and overnight returns](#)

18/2010

Seppo Orjasniemi:

[The effect of openness in a small open monetary union](#)

17/2010

Esa Jokivuolle – Ilkka Kiema – Timo Vesala:

[Credit allocation, capital requirements and output](#)

BOFIT Discussion Papers

20/2010

Pierre Pessarossi, Christophe J. Godlewski and Laurent Weill:

[Foreign bank lending and information asymmetries in China](#)

19/2010

Michael Funke and Michael Paetz:

[What Can an Open-Economy DSGE Model Tell Us about Hong Kong's Housing Market?](#)

18/2010

Tuuli Koivu:

[Monetary policy, asset prices and consumption in China](#)

17/2010

Zuzana Fungáčová, Laurent Weill and Mingming Zhou:

[Bank capital, liquidity creation and deposit insurance](#)

Forthcoming Bank of Finland Research Discussion Papers

Hanna Freystätter::

Financial factors in the boom-bust episode in Finland late 1980s and early 1990s

Yiwei Fang – Bill Francis – Iftekhar Hasan – Haizhi Wang:

Product market relationships and cost of bank loans: evidence from strategic alliances

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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>