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Editorial

Two special events in the fall 2002 coincided with the activities of the Study Center. First, the committee for the Nobel Prize in Economics gave recognition to the role of Behavioral Economics by attributing the prize to Daniel Kahneman and Vernon Smith in October. In the same month, the Study Center organized, jointly with the Journal of Monetary Economics and the Swiss National Bank, a conference on Behavioral Macroeconomics. The thought-provoking papers presented were written specially for the conference and are described in the following pages.

Second, 2002 represents the tenth anniversary of Switzerland's membership to the Bretton Woods institution, the International Monetary Fund and the World Bank. This membership is associated with a position of executive director in both institutions and allows Switzerland to participate actively in the decision process of these institutions and propose its initiatives. This membership is also important in establishing close links with the set of countries that share our constituency, as explained by Werner Hermann, Swiss National Bank, in the lead article. The Study Center regularly invites central bank economists from these countries and occasionally offers special courses for the constituency. This was the case in October, when we organized a special course in monetary economics for transition economies.

Prof. Philippe Bacchetta
Director

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Training Central Bankers in Switzerland

The Study Center Gerzensee has gained a reputation for teaching outstanding central bankers' courses at a high level and attracting the best candidates. Many graduates from Gerzensee now hold senior positions in central banks all over the world. When I meet central bankers from other countries and they hear that I work for the Swiss National Bank, a frequent reaction is: "Oh, I know the Swiss National Bank. Some years ago, I attended an excellent course in Gerzensee". This happens to me not only in the West but also increasingly in the formerly communist part of the world.



At the request of a central bank governor from Central Asia, last fall the Study Center held a Central Banking Course tailored to the needs of central bank economists of CIS (Community of Independent States) countries. Switzerland has a special relationship with some of these countries because we work together closely at the World Bank and the International Monetary Fund.

The executive boards of the World Bank and the International Monetary Fund have 24 seats. Therefore, only the most powerful of the over 180 members can occupy a chair of their own on the executive boards of these institutions. The others can nevertheless participate in the debate and cast their votes at the executive board level by joining a constituency. Switzerland forms a constituency together with Azerbaijan, the Kyrgyz Republic, Poland, Tajikistan, Turkmenistan, Uzbekistan and the Federal Republic of Yugoslavia. The rather mixed composition of our constituency is the result of a historical coincidence. When Switzerland joined the World Bank and the Fund in the early nineties, other countries that were becoming or had recently become members were looking for allies to form a constituency. Teaming up to form a constituency of our own was therefore a logical step.

It has been suggested that constituencies should be formed of countries that have more in common. But mixed constituencies have their benefits. One of them is that in a more diverse group there are more opportunities to assist each other. Training presents such an opportunity. Training is obviously important, and some CIS central banks wish they had training facilities similar to Gerzensee. Depending on the

circumstances, establishing a training center might or might not be recommendable. For many forms of training, the required technical infrastructure is minimal and training is possible without devoting a separate building to it. Since resources are usually scarce even in money-issuing institutions, it is important to get the priorities right.

In order to set priorities, it might be helpful to ask: what are the expected benefits of training? The answer is that a central bank with a well-trained staff can do things it could not do otherwise. So training makes for better decisions. Better decisions can mean more appropriate decisions, or it can mean that the same decisions are made in a more timely manner. It can even mean that the outcome of the decision remains the same, but that the central bank is able to substantiate it better. However, experience suggests that training employees off the job is not sufficient to achieve this goal. The issues of implementation are crucial. Training provides the tools for better decisions, but it does not guarantee that they will be applied. Institutions have a tendency to resist change. It is easily overlooked that training does not automatically translate into action.

Two more steps are needed to make sure the goal of making better decisions is reached. First, the skills acquired in training have to be applied to a specific situation. Better decisions are always based on additional insights that lead to a clearer picture of the pros and cons of the choices available. Collecting and analysing data might be needed to gain these insights. This can take a considerable amount of time and resources and may require the support and encouragement of the staff by the management. It might be appropriate to ask newly trained staff what management can do to get the most out of their training.

The second necessary step towards success is that decision-makers actually have to base their decisions on the insights gained. Often, decisions are not made by the same person who has analysed the situation. This is certainly true for far-reaching decisions. Decisions about monetary policy, for instance, are often made by a committee. An atmosphere of openness and mutual trust between those who prepare a decision and those who actually make it brings about clear and principled decisions.

The Study Center Gerzensee is good at training people off the job. But we need more than just people who have the capacity to analyse and solve a problem. We would like training to make a difference in practice. When the preconditions for success are met, the Swiss National Bank is ready to supplement the efforts Gerzensee make on the implementation side in areas where the Swiss National Bank possesses outstanding expertise. Currently, experts are working with staff members of a small group of central banks, one to one, on building the capacity to make better decisions.



Academic Conferences

Behavioral Macroeconomics

From October 10 - 12, the Study Center Gerzensee hosted its seventh conference organized jointly with the Journal of Monetary Economics and the Swiss National Bank. This year's topic was "Behavioral Macroeconomics", a topic that was especially fitting due to the 2002 Nobel prize for a pioneer in behavioral economics, Daniel Kahneman. As the Nobel prize committee emphasized, the special contribution of Kahneman was to have "integrated insights from psychological research into economic science, especially concerning human judgment and decisionmaking under uncertainty". Behavioral macroeconomics continues along this path by examining the implications for boundedly rational – but psychologically well-founded – behavior for wage-setting, asset-pricing, and monetary policy. Conference organizers Philippe Bacchetta, Robert King (Boston University) and Ulrich Kohli (Swiss National Bank) selected six papers to be presented, as well as the excellent discussants.

The conference was opened by Julio Rotemberg of Harvard University, who spoke about "Customer Anger at Price Increases, Time Variation in the Frequency of Price Changes and Monetary Policy". As the title suggests, Rotemberg considers customer anger as a source of price rigidities. He argues that consumers' demand for a good does not react negatively to price changes that are perceived to be fair. Rotemberg cites survey evidence reported

in Kahneman, Knetsch and Thaler (1986) that increases in price due to cost increases were deemed to be fair. It may, however, be difficult for consumers to observe producers' costs, so that they must rely on aggregate economic signals to decide whether a price change is fair or not. If such signals are infrequent, then fairness considerations can induce some price rigidity.

Ricardo Reis, of Harvard University, presented an alternative view of behaviorally induced price rigidities, which was developed together with his co-authors Gregory Mankiw of Harvard University and Laurence Ball of Johns Hopkins University. In their paper, "Monetary Policy for Inattentive Economies," agents are inattentive in the sense that they do not use all information available. The rationale is similar to that of a paper presented by Chris Sims at the JME Conference in 2000: agents may simply have a limited capacity for processing information. Hence, they will only update their information on monetary policy infrequently. Ball, Mankiw and Reis derive implications for optimal monetary policy, and advocate price-level targeting on the part of central banks. This suggestion led to a great deal of discussion, with most participants defending more established approaches to monetary policy. In the next session, Ernst Fehr of the University of Zurich, presenting joint work with Lorenz Götte of the University of California at Berkeley, also took up the topic of fairness-induced price rigidities. In their paper, "Robustness and Real Consequences of Nominal Wage Rigidity," Fehr and



Ricardo Reis, N. Gregory Mankiw, and Laurence Ball

Götte focus on downward nominal wage rigidities. Previous empirical work has found evidence of downward nominal wage rigidities in times of high nominal GDP growth. However, high nominal GDP growth may make downward wage adjustments unnecessary, so that their absence does not necessarily indicate unwillingness to cut wages. Fehr and Götte focus on Switzerland in the 1990's, which provides a natural experiment for the study of downward wage rigidities in a low-growth, low-inflation environment. They find evidence of downward wage rigidity even in an environment in which wage cuts would be economically expected.

Hanming Fang and Giuseppe Moscarini of Yale University also focus on behavioral aspects of wage setting. In their paper, "Overconfidence, Morale and Wage-Setting Policies," the focus is on the

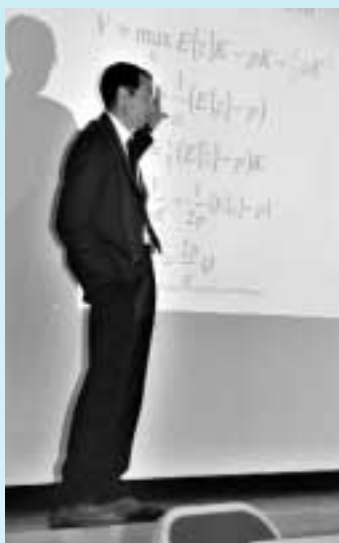
damaging impact on morale of performance-based wages, and on worker overconfidence. Although conditioning wages on output should – by principal-agent analysis – provide effort incentives, such performance-based wages are not broadly employed. The authors provide a model in which any negative signal on the workers' performance may damage morale, and may ultimately prove detrimental to effort. If workers are also overconfident, any news they receive on their performance is likely to be subjectively perceived as bad, providing a further channel by which performance evaluations may harm effort.

The final group of papers concentrated on behavioral aspects of asset pricing, a field which has become known as behavioral finance. Charles Himmelberg of the Federal Reserve Bank of New York and Columbia



Julio Rotemberg

University, presenting joint work with Simon Gilchrist of Boston University and Gur Huberman of Columbia University, examined the influence of stock price bubbles on corporate investment. In particular, the authors make use of recent evidence that traces the origins of stock market bubbles to differences in investor opinion. The authors use variance of earnings forecasts as a proxy for bubbles, and investigate whether bubbles are associated with real changes in investment. The main finding is that behaviorally induced bubbles may indeed have real effects on corporate investment.



Andrew Abel



Philippe Bacchetta, Bruno Gehrig, and Ulrich Kohli



Charles Goodhart, Ulrich Kohli, and N. Gregory Mankiw

Bill Dupor of the University of Pennsylvania tied together two of the macroeconomic themes of the conference, asset price bubbles and monetary policy. His presentation, entitled "Stabilizing Non-Fundamental Asset Price Movements under Discretion and Limited Information," seeks the optimal response of monetary policy to an environment in which agents' non-fundamental beliefs lead to asset bubbles. When the central bank must formulate monetary policy under limited information, the added uncertainty due to possibly non-fundamental asset price movements may lead to smaller responses of monetary policy to given shocks.

This last contribution emphasizes that monetary policy cannot only be impacted by behavioral elements directly as in the contributions of Rotemberg and Ball, Mankiw and Reis, but also indirectly via asset markets.

Overall, the conference provided valuable insights on the many ways in which

behavioral economics can enrich the study of monetary policy, labor markets and asset markets, and provided all participants with stimulating discussions and interesting topics for future reflection. After the papers have gone through the usual refereeing process, they will be published, if accepted, in a special issue of the *Journal of Monetary Economics*. The papers are currently available on our web site.

Program

Julio Rotemberg, Harvard University
"Customer Anger at Price Increases, Time Variation in the Frequency of Price Changes and Monetary Policy"
Discussants: V.V. Chari, University of Minnesota
Monika Büttler, University of Lausanne

Hanning Fang and **Giuseppe Moscarini**, Yale University
"Overconfidence, Morale and Wage-Setting Policies"
Discussants: Laurence Ball, Johns Hopkins University
Rochelle Edge, Federal Reserve Board

Ernst Fehr, University of Zurich and
Lorenz Götte, University of Berkeley
"Robustness and Real Consequences of Nominal Wage Rigidity"
Discussants: Jordi Galí, CREI and Universitat Pompeu Fabra
Philipp Harms, Gerzensee and University of Konstanz

Simon Gilchrist, Boston University,
Charles Himmelberg, Federal Reserve Bank of New York and Columbia University, and
Gur Huberman, Columbia University
"Do Stock Price Bubbles Influence Corporate Investment?"
Discussants: Andrew Abel, University of Pennsylvania
Ignazio Angeloni, European Central Bank

Laurence Ball, Johns Hopkins University,
N. Gregory Mankiw, Harvard University and
Ricardo Reis, Harvard University
"Monetary Policy for Inattentive Economies"
Discussants: Jeffrey Fuhrer, Federal Reserve Bank of Boston
Charles Goodhart, The London School of Economics

Bill Dupor, University of Pennsylvania
"Stabilizing Non-Fundamental Asset Price Movements under Discretion and Limited Information"
Discussants: Jeffery Amato, BIS
Shigenori Shiratsuka, Bank of Japan



Doctoral courses

Swiss Program for Beginning Doctoral Students in Economics

Last March, 13 students of the full 2001 program graduated and 23 students passed partial exams. The teachers of the 2002 program were the following:

Microeconomics

Prof. Klaus Schmidt,
University of Munich
Prof. Jean-Claude Rochet,
Université des Sciences Sociales, Toulouse
Prof. Mathias Dewatripont,
Université Libre de Bruxelles
Prof. David Martimort,
Université des Sciences Sociales, Toulouse

Macroeconomics

Prof. Robert G. King,
Boston University
Prof. Sergio T. Rebelo,
Northwestern University
Prof. Jordi Gali,
Universitat Pompeu Fabra

Econometrics

Prof. Mark W. Watson,
Princeton University
Prof. Bo. E. Honoré,
Princeton University

Advanced Courses for Doctoral Students and Faculty Members

Our four one-week summer courses, taught by the best specialists in their fields, were a big success. The courses were:

International

Macroeconomics,
July 29 - August 2
Prof. Assaf Razin,
Tel Aviv and Cornell Universities

Panel Data Econometrics,

August 5 - 9
Prof. Manuel Arellano,
CEMFI, Madrid

Monetary Economics,

August 19 - 23
Prof. Carl E. Walsh,
University of California at Santa Cruz

Economic Geography,

August 19 - 23
Prof. Tony Venables,
London School of Economics

Courses in Law and Economics

As in previous years, the Study Center offered two one-week courses to doctoral students in both law and economics. The following topics were covered:

Corporate Law,

March 24 - 28
Prof. Hideki Kanda,
University of Tokyo

The Political Economy of Federalism: The U.S. and Europe,

May 13 - 17
Prof. Daniel Rubinfeld,
University of California at Berkeley



Juan José Dolado and students

Central Bankers' Courses

In 2002, 187 economists from 99 central banks attended our central bankers courses. These courses were taught by external teachers listed below, by members of our academic staff (Philippe Bacchetta, Monique Ebell, Philipp Harms, and Jeffrey H. Nilsen), by our teaching assistants, and by distinguished guest speakers. In addition to the Summer Symposium for Central Bankers held in June and described in our Newsletter of September 02, we organized the following courses:

Central Bank Strategy, Monetary Institutions and the Performance of the Economy,

February 4 - 15
Prof. Alex Cukierman,
University of Tel Aviv

Monetary Theory and Monetary Policy,

April 8 - 26
Prof. Harris Dellas,
University of Berne

Advanced Monetary Economics,

May 20 - 31
Prof. Juan José Dolado,
Universidad Carlos III, and
Prof. Frederic S. Mishkin,
Columbia University

Banking Regulation and Supervision,

July 29 - August 16
Prof. Xavier Freixas,
Universitat Pompeu Fabra,
and Prof. Anthony Saunders,
New York University

Instruments of Financial Markets,

September 2 - 20
Prof. Ludger Hentschel,
Rochester University

Special Course on Monetary Theory and Monetary Policy for our Constituency,

October 14 - 25



Participants for the Special Course for our Constituency

02.08

Monique Ebell
and Christian Haefke:
"Can Barriers to Entry
Help Solve the European
Unemployment Puzzle?"

02.07

Philipp Harms:
"Deregulation and
the Current Account"

02.06

Philipp Harms
and Stefan Zink:
"Growing into and out
of Social Conflict"

02.05

Philippe Bacchetta
and Eric van Wincoop:
"Why Do Consumer Prices
React less than Import
Prices to Exchange Rates?"

02.04

Robert Bichsel
and Jürg Blum:
"The Relationship Between
Risk and Capital in Swiss
Commercial Banks:
A Panel Study"

02.03

Andreas M. Fischer:
"Fluctuations in the
Swiss Franc: What Has
Changed since the Euro's
Introduction?"

02.02

Ricarda Demarmels
and Andreas M. Fischer:
"Understanding Reserve
Volatility in Emerging
Markets: A Look at the
Last Thirty Years"

02.01

Michael J. Dueker,
Andreas M. Fischer
and Robert D. Dittmar:
"Stochastic Capital
Depreciation and the
Comovement of Hours
and Productivity"

Agenda 2003

Conferences

On May 16 - 17, the Study Center will host a conference for the Research Training Network on the **Analysis of International Capital Markets**. This conference is jointly organized with CEPR in London and NCCR FINRISK in Zurich. In July 2003, the Study Center will again organize with CEPR both traditional **European Summer Symposia**, in Economic Theory and in Financial Markets.

Central Bankers Courses

Based on the success and demand of the last few years, we will offer new editions of highly respected central bankers courses. Since many countries are facing difficulties in financial liberalization, our **"Banking Regulation and Supervision"** course fits an important need. Professors Anthony Saunders and Xavier Freixas will illustrate the essential aspects of banking theory and practice.

Our course on **"Advanced Topics in Empirical Finance"** taught by Professors Michael Rockinger, Thierry Foucault, and Casper de Vries will explain how central bankers can exploit the information implicit in the prices of financial instruments for monetary policy purposes. For central bank middle managers, we present a full slate of interesting and challenging courses: **"Monetary Theory and Monetary Policy"**, a concentrated macroeconomics course that gives a well-rounded understanding of recent monetary theory with empirical and policy applications; **"Instruments of Financial Markets"**, a thorough survey of finance theory and practice, and last but certainly not least, our **"Monetary Policy in Developing Countries"**, a brilliant in-depth examination of policy taught by Professor Sebastian Edwards who conveys some deep economic insights to central bankers.

Cultural Calendar 2003

Do make a note to join us for the following events. CHF 10.- admittance, all performances begin at 20.00h. For reservations, please call 031 780 3131.

February 12
Beatrix Hauri
(Homage to George Gershwin)

May 7
Quatre in Toulouse
(Ska-Band)

September 10
Lapsus
(Comic Actors)

October 15
Michael Thalmann
(Piano Concert)

November 5
Wolverines
(Jazz band with US-Guests)

December 4
SoundStream Choir
(Gospel Night)

Publication

Conference on the "Taxation of Financial Income"

In January 2003, the *Journal of Public Economics* publishes a special issue for the TAPES conference held at Gerzensee in May 2000. Eight of ten papers presented at the conference have successfully gone through the refereeing process. The guest editors for this issue were Philippe Bacchetta and Roger Gordon, University of California at San Diego.

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