

## Editorial

Central banks have increasingly recognized the merits of transparency both for the communication of monetary policy and for the institutions' long-run stature.

Over the previous decade, many institutions have undertaken numerous reform measures to upgrade the level of transparency. One route that has not been followed by many is for central banks to invite international scholars to audit the current monetary policy framework and to determine if it is consistent with what are commonly recognized as "best practices". Professor Lars Svensson, Princeton University, who has participated in various Gerzensee conferences in the past, was asked on two occasions to document his observations and recommendations in an official report. In the lead article, he shares his experience in analyzing the Reserve Bank of New Zealand and the Norges Bank and discusses whether the recommendations have been carried out.

Professor Klaus Schmidt, University of Munich, teaches Microeconomics as part of Gerzensee's Swiss Program for Beginning Doctoral Students in Economics. His interview appears in this Newsletter and gives an insightful perspective on his views on the concept of fairness, its misconceptions, and how its definition fits in his research agenda on experimental economics. The third report in this Newsletter is devoted to the SNB's interactions with the Central Bank Course participants.

Dr. Andreas Fischer  
Program Director

- Independent Reviews of Monetary Policy
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- Academic activities

*Independent Reviews of Monetary Policy audit the policy strategy of central banks. The invited reviews, which require full compliance on the part of the central banks, are encouraged to make recommendations so that the best practices of central banking are fulfilled. While similar review practices are common at academic institutions and private firms, the number of central banks willing to participate in such audits remains limited.*

## Independent Reviews of Monetary Policy

On two separate occasions, I have been asked to review the monetary policy of a country, namely that of New Zealand and Norway. The purpose of the reviews was to provide a critical evaluation and to make recommendations for improvements. I also hoped the reviews would stimulate and improve the discussion of best practice inflation targeting. The reviews covered the objectives, the institutional organization, the decision-making process, the implementation, the actual policy decisions, the communication, and the accountability of monetary policy.



Lars E.O. Svensson is Professor of Economics at Princeton University

Many - but not all - of the reviews' recommendations have been implemented, and I hope they have made a positive contribution. I personally found the experience very rewarding, and I particularly appreciate the enthusiastic cooperation of the two central banks, the Reserve Bank of New Zealand and Norges Bank.

In May 2000, I was asked by the Minister of Finance to undertake an independent review of the operation of monetary policy in New Zealand. The Reserve Bank cooperated fully in the review. The result of the review was briefly summarized at a press conference in Wellington in February 2001 as follows:

"Monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting. The Reserve Bank compares well with best-practice central banks, like the Bank of England and the Bank of Sweden. But this has not always been the case. The period from mid 1997 to March 1999, when the Bank used a Monetary Conditions Index (MCI) to implement monetary policy, represents a significant departure from best-practice inflation targeting."



"With regard to governance and accountability structures, I have found some weaknesses. These weaknesses have not caused any problems because of the qualities of the current Governor, Dr Brash, but they could in different circumstances. Therefore I recommend some substantial changes."

I made several recommendations, including some modification of the inflation target, improvements in the accountability of the bank, and some technical improvements of the Bank's modelling and forecasting tools. Many of these recommendations have been acted upon, but not the most far-going recommendation, to introduce a formal internal monetary policy decision-making committee in place of the existing single decision-maker model.

In 2002, I was asked by the Centre for Monetary Economics (CME) at the Norwegian School of Management to chair a committee, Norges Bank Watch 2002, to review monetary policy in Norway. The committee included Kjetil Houg of Alfred Berg and Haakon Solheim and Erling Steigum of the Norwegian School of Management BI. Norges Bank cooperated fully in the review.

The result of the review was presented at a press conference in September 2002 and summarized as follows: "Monetary policy in Norway is equal to the best international practice of flexible inflation targeting. But the legal framework for monetary policy is among the weakest in the world."

The committee made several recommendations for changes in the Central Bank Law, to give Norges Bank a mandate for price stability, formal operational independence, and clear accountability for achieving the mandate. The committee also made several recommendations to improve the institutional framework within the existing law. Several of the latter recommendations have been followed, and a modest revision of the Law has been made. The committee also had a number of recommendations for improvements of the monetary-policy framework, mostly of a technical nature, and for research priorities at Norges Bank. Almost all of these have been acted upon by Norges Bank.

The independent reviews can be downloaded at the following addresses:

- Svensson, Lars E.O. (2001), "Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance," February 2001, [www.princeton.edu/~svensson](http://www.princeton.edu/~svensson).
- Svensson, Lars E.O., Kjetil Houg, Haakon Solheim and Erling Steigum (2002), "An Independent Review of Monetary Policy and Institutions in Norway," Norges Bank Watch 2002, Centre for Monetary Economics, Norwegian School of Management BI, September 2002, [www.princeton.edu/~svensson](http://www.princeton.edu/~svensson).

LARS E.O. SVENSSON has published extensively in scholarly journals on monetary economics and monetary policy, exchange-rate theory and policy, and general international macroeconomics. He is a member of the Royal Swedish Academy of Sciences, a member of Academia Europe, a foreign member of the Finnish Academy of Science and Letters, a foreign honorary member of the American Academy of Arts and Sciences, a fellow of the Econometric Society, a research associate of the National Bureau of Economic Research, and a research fellow of the Centre for Economic Policy Research, London. He was chair of the Prize Committee for the Alfred Nobel Memorial Prize in Economic Sciences during 1999-2001, member during 1993-2002, and secretary during 1988-1992.



## Central Bankers Courses Visits to the Swiss National Bank

One objective of the Central Bankers Courses is to enhance the interaction within groups as well as the communication between participants and lecturers. At the same time, however, it is important to establish ties between course participants and our parent organization, the Swiss National Bank. To achieve this, both practitioners and researchers from the SNB are regularly invited to the Study Center to offer presentations on specific topics such as reserve management, banking regulation, or the structure of the Swiss financial system. The picture would not be complete, however, without a visit to one of the SNB's headquarters. This visit to either Zurich or Berne has thus become a traditional part of the Gerzensee courses.



**Philipp Harms leading the group in Zurich**

Swiss monetary policy, given by one of the bank's senior researchers. The presentation highlights recent changes in the SNB's operating procedures and focuses on topics such as the Bank's definition of price stability, the procedures applied to compute and communicate inflation forecasts, and the use of the 3-month LIBOR as an operating target. A further subject, which has drawn considerable interest in recent years, is Reserve Management practices. This is discussed in the context of the new Bank Act and recent Gold Sales. Thereafter, lunch provides an opportunity to continue the discussion in a rather informal environment. Later in the day, participants are introduced to particular aspects of monetary policy implementation as well as to the SNB's practice of conducting repo auctions, and - technical circumstances allowing - get the opportunity to witness a live

auction. The official program often ends with a presentation by a member of the governing board, offering his perspective on the potential policy dilemmas that confront the future course of Swiss monetary policy.

The specific genius loci of the SNB's boardroom combined with the diverse backgrounds of the audience usually guarantees a lively exchange of views. In the evening, the CBC participants are given the opportunity to dine in town before returning to Gerzensee.



**Talk by the SNB senior researcher Thomas Jordan**

The program offered by the SNB usually starts with a talk on conceptual issues of



## The Role of Fairness in Behavioral Economics

***How did you develop an interest for issues concerning fairness in experimental economics?***

My background is in game theory and contract theory. This is a field in which economic theory has been very successful over the last 15 to 20 years. However, there are some well-known experimental results that are highly disturbing, because they show that many of the game theoretical predictions are systematically refuted by what we observe in the real world. At some point, one needs to take these anomalies seriously and start addressing them.

My starting point was a discussion with Ernst Fehr, University of Zurich, on these disturbing results. The challenge was not to offer an explanation for one particular experimental game, such as the ultimatum game, but to develop a theory that is able to explain a large class of experiments. (The "classic" ultimatum game is a simple bargaining game between two players. They are given a sum of money that they can share. The rule of the game is that player 1 makes a proposal as to how to split the pie, whereas player 2 can either accept or reject this proposal. If player 2 rejects the proposal, then both players come away empty handed. The standard prediction of game theory is that the proposer takes almost everything for himself and that player 2 accepts as long as his share is positive. However, the experimental evidence shows that such offers are frequently rejected). Ernst had conducted many of these experiments and was eager

to find a theoretical interpretation. I had no experience in carrying out experiments but I had done some theoretical work and was bothered by the fact that the experiments did not confirm the theoretical predictions. So we started doing some joint work and came up with the theory of inequity aversion that was able to explain qualitative and quantitative results for a wide class of experiments.

***Fairness can mean many things - unconditional kindness, reciprocity, equity, trust, altruism. What is your definition?***

There are some important distinctions, which are often glossed over in many papers including some of mine. First, there is a clear distinction between altruism and concerns for fairness or reciprocity. Altruism says that I always like it if other people are better off. This is clearly not the case in reality. In fact it is the opposite, many are unhappy if others are better off because they feel envy or they feel that an act of injustice has been committed. Fairness is something different. It says that I want to be kind to someone who has been kind to me and I want to punish those who have harmed me. This definition is very close to the concept of reciprocity. I think this motivation is driving much of human behavior. However, it turns out to be difficult to model this type of reciprocity in a game theoretic fashion because it means I have to form beliefs about your intentions. This gives rise to multiple self-enforcing equilibria. For this reason Ernst and I decided not to model

fairness as intention-based reciprocity but rather as "inequity aversion". Strictly speaking this means that people do not care about intentions, but only about the actual allocation that arises. So if you get a higher payoff than I do, I do not like the inequality, no matter how the difference came about. There are clearly some situations, in which it makes a big difference whether people are motivated by intention based reciprocity or inequity aversion. However, it turns out that in many games inequity aversion is a good short-cut to model the effect of intentions as well. Personally, I believe that inequity aversion is not more important than intention-based reciprocity, but as a modeling tool it is much simpler and has a strong predictive power.

***So does this mean you are not interested in ethical questions related to the concept of fairness? Is it solely a tool to understand human behavior?***

I don't find the philosophical questions uninteresting; but they are not driving my research agenda. I want to understand what people actually do, not what they should do.

***We observe that many people are concerned about fairness. Is this culturally determined or is it hardwired in our genes?***

This is a very interesting question. There is a 1991 AER paper by Al Roth and his co-authors that seeks to answer your question by looking for differences in outcomes of the ultimatum



game across different countries: Israel, Slovenia, US, and Japan. They conducted the experiment under the same conditions in the four countries. What they found was that the behavior was surprisingly similar. There are small exceptions: the Israelis tend to be a bit tougher than the Japanese but it's hardly statistically significant. This seems to support the view that fairness is not culturally determined.

However, there are some more recent and very fascinating experiments conducted with isolated, small-scale societies, e.g. tribes in the Amazon jungle or native populations from remote Indonesian islands. Anthropologists and economists took the ultimatum game to 15 different tribes. Again, the question was whether there are behavioral differences between these isolated societies. They found quite strong differences in human behavior. Two extreme examples are the Machiguenga and the Lamelara. The Machiguenga are a small Amazonian tribe, who make their living



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through individualistic tasks: fishing and gathering. These activities do not require much cooperation and trade. It turns out that when the Machiguenga play the ultimatum game they behave very uncooperatively. The other extreme, the Lamelara from Indonesia, are whale hunters. This is a very dangerous activity that requires mutual trust among the hunters. Here, the experimental evidence shows that there is a high level of cooperation. The Lamelara were almost always willing to share 50-50, and if less than 50% was offered it was frequently rejected. This evidence suggests that the level of cooperation in a society affects the development of social preferences.

My personal belief is that our social preferences are deeply rooted. When I look at my three young daughters, I observe that equality is extremely important to them, although it is not something that my wife and I consciously encouraged. The girls have considerable differences in age and in their capabilities, yet each feels that they should be treated exactly in the same way. On the other hand, the precise form of how this expresses itself is determined by culture. Which factor, i.e., culture versus genes, is more important is difficult to say, but I don't think it matters very much.

What I think is more interesting is how concerns of fairness can survive evolution. We should not forget that people who are concerned about fairness behave inefficiently. They give up resources to help or to punish others even if this does not pay off for them directly. This means that the egoist should do better, because he saves the resources that are spent by the fair-minded guy in order to have more offspring. Therefore, an interesting question is how preferences for fairness survive evolution.

***How do institutional concepts of transparency and governance enter your discussion of fairness?***

Let me try to answer it this way. People differ quite strongly in their concerns for fairness. What is interesting is the interaction between these different types of individuals that is often shaped by institutions. Consider a public good game as an example. In such a game each of us has to contribute to a public good. For the group it is optimal that each of us contributes as much as possible, but for each individual the free riding strategy dominates. If there are enough fair-minded players, an equilibrium with positive contribution levels can be sustained. Suppose now that an

institutional change allows for more transparency, so that players are better able to observe shirking. This could induce the fair-minded players to retreat their contributions to the public good, so it may be that the contribution levels go down quickly. On the other hand, if the fair players can punish the free-riders, more transparency may lead to higher contribution levels.

***Experiment Design is a black box for me. How do I set up an experiment?***

The first step is always to have a clear question that the experiment is supposed to answer. It is important that the experiment is set up in such a way that it is indeed possible to discriminate between different hypotheses. This also requires enough data to allow for robust statistical tests. Furthermore, the experiment should be as simple as possible. This sounds trivial but it is often underestimated.

A simple experiment is always an abstraction of reality. Therefore, it is important that the subjects are able to understand abstract situations. This is one reason why it is so popular to use students as subjects, because they are used to such situations. I once made an experiment with senior citizens that turned out to be a nightmare. Although they were intelligent people who had held good jobs, they found it difficult to think in an abstract way as required by the experiment. The technical equipment is not so important. Many good experiments have been con-

ducted without a fancy computer lab.

***Should we be ready to give up the self-interest hypothesis?***

No, I don't think we have reached this state yet and I am not sure whether we ever will. Models based on the self-interest hypothesis are still very useful and make accurate predictions for competitive markets with standardized goods. Yet an ever increasing amount of economic activity is taking place outside of competitive markets - in markets with a small number of participants, in markets with informational frictions, under incompletely specified and incompletely enforceable contracts. A major challenge for future research is to develop models that are able to encompass all these different situations and are still as tractable as the self-interest model.

This edited interview was conducted by Andreas Fischer



<sup>1</sup> See Henrich et al. (2001) 'In Search of Homo Economicus: Behavioral Experiments in 15 Small Scale Societies,' *American Economic Review Papers and Proceedings* 91, 73-78.

## Academic activities

### Summer Symposium

In July 2004, the Study Center will again organize with CEPR in London the *European Summer Symposia in Economic Theory and in Financial Markets*.

### Conference

From October 1-2, the Study Center will host the biannual conference organized jointly

with the *Journal of Monetary Economics* and the Swiss National Bank. This year's topic will be *Macroeconomics and Political Economy*.

### Central Bankers Courses

The course titled *Instruments of Financial Markets*, a thorough survey of finance theory and practice, will be offered again from August 30 to

September 17. Starting on October 11, the Study Center will organize its special two-week course in *Monetary Economics for Transition Economies*. The program is mainly offered to Central Asian participants from the IMF/World Bank constituency group of Switzerland.

### Program for Advanced Doctoral Students in Economics 2004

Also this summer, the Study Center will offer four advanced courses as follows:

**02.08 - 06.08 Financial Intermediation** taught by Prof. Douglas W. Diamond, University of Chicago

**02.08 - 06.08 Econometric Policy Evaluation** taught by Prof. James J. Heckman, University of Chicago

**09.08 - 13.08 Open Economy Macroeconomics** taught by Prof. Eric van Wincoop, University of Virginia

**16.08 - 20.08 The Theory of Monetary Policy** taught by Prof. Michael Woodford, Princeton University

## Obituary Jean-Jacques Laffont

The economics profession is deeply afflicted by the death of Professor Jean-Jacques Laffont who most regrettably passed away on May 1, 2004.

Jean-Jacques Laffont's contributions to public economics and the theory of contracts are invaluable, and he lastingly shaped the way in which economists analyze the role of incentives under asymmetric information.

At the Study Center where Jean-Jacques Laffont taught in the Swiss Program for Beginning Doctoral Students in Economics and attended various academic conferences, students and faculty will miss an inspiring lecturer, an ingenious researcher, and an admirable personality.



## New Corporate Identity

The Study Center is in the process of developing a consistent visual identity. In a first stage, the logo of the Study Center has been thoroughly redesigned. While keeping the original image of the manor, it has been modernized and simplified for wider applicability. The logo was introduced in the Spring and the entire corporate image will be gradually renewed in the next few months. The font used in the logo is Frutiger. This font was created by Adrian Frutiger, a Swiss graphic designer from the Canton of Bern.

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