In 2000, the Bank of Italy invited me to visit the research department for a couple of months. At that point, with some other colleagues, I had developed econometric methods to study the dynamics of large panels of time series and I was interested in applying these methods to macroeconomic data to construct coincident and leading indicators of the business cycle.

When I arrived at the Bank, I was asked to teach a short course on the methodology my coauthors and I had developed and this was the first occasion to interact with a lively group of researchers involved in forecasting and short-term analysis for the Bank. When my visit was over, I was then asked to come back to start a big project on the construction of a coincident indicator of the euro area business cycle. The project started in 2001 and involved four academics (my coauthors and myself) and four researchers at the Bank of Italy. Our group was very diverse in terms of field of expertise and work experience and definitely the success of that project was due to the kind of interaction that we established. As academics, we had some strong ideas on the methodology, but, when we started, we were unaware of many issues: the non-synchronized nature of data releases, volatility of key economic time series and, in general, the problem of analyzing economic conditions in real time. I now smile at the naiveté of our first academic papers on coincident indicators. Without the collaboration with the researchers at the Bank, our methodology would have never jumped from theory to practice. The Bank of Italy was really bold to put so much resources on implementing a frontier methodology to construct a tool for the regular policy analysis at the Bank: months of work and full-time involvement of four staff members. At the end of 2001, Eurocoin, a coincident indicator of the euro area business cycle based on hundreds of macroeconomic and financial time series was born. The indicator is now regularly updated and, since January 2002 has been distributed each month through the web page of CEPR. The product of the collaboration between the Bank and the
The academic world became then a tool to be used not only internally for the Bank use, but also for the use of the larger community of academia and business cycle analysts in general.

This experience has been a successful example of collaboration between central bank researchers and academic researchers and went beyond the pure consultancy relation. That experience was followed by a project at the Federal Reserve Board, where I have been asked to apply a similar methodology to forecast output and inflation. My collaboration with the Fed has been designed in a very different way from the experience at the Bank of Italy, and is definitely more cautious. The Fed has asked me to carry on a sort of evaluation study of the methodology. They are providing me with excellent research assistantship and I have already spent some time there to understand their short-term forecasting exercise, but I am basically working at a distance, with very little use of their human capital resources. I imagine that, if the evaluation study turned out to be successful, some transfer of expertise should then be planned so that the method could be implemented on a regular basis.

Yet another model of collaboration is the one with the Swiss National Bank, where my research assistant and I spent an intensive week working with a group of the Bank’s researchers to teach the methodology and illustrate the software so as to put the Bank’s staff in the position of applying the techniques on their data. A collaboration more similar to the one with the Bank of Italy is now being designed by the ECB.

In sum, the form a collaboration between academic and central banks researchers may take depends on many factors, like the degree of specialization of the bank’s researchers, time availability, and so on. Independently of the form, however, there is a lot to learn from both sides. Pure academic research in macroeconomics and econometrics is very rarely aware of the practical problems of central banking and, vice versa, central banks economists, especially junior ones, have much to benefit from a training which goes beyond formal lectures, and from the input of researchers who, as academics, are a bit more distant from the details of every day concerns.
Research agendas vary considerably across central banks. Differences are often determined by staff size, the monetary policy strategy, and the degree of involvement in the monetary policy debate. At the Swiss National Bank (SNB), several responsibilities fall on the Research Unit. The foremost is to provide background material to support the Governing Board in making its decisions for monetary policy. This includes forecasting inflation, the evaluation of alternative monetary policy decisions as well as the analysis of a series of monetary indicators. The Research Unit delivers its analysis in a written report for the quarterly board meeting on monetary policy.

A further responsibility of the Research Unit is to support the Board in its communication of the current and future monetary policy stance. The Research Unit is involved in drafting press statements, writing speeches for board members and explaining the SNB’s policy in international forums hosted by the OECD, the IMF, or the BIS. It is also responsible for the editorial work for the scientific publications in the quarterly bulletin of the SNB.

The Research Unit currently consists of 12 PhD-economists and 4 research assistants. The research agenda has to address many of the short- and long-run issues related to the SNB’s current monetary policy strategy based on inflation forecasts. Many of the research projects are defined in terms of evaluating the monetary transmission mechanism in Switzerland and of seeking to improve the forecasting capabilities of economic models and indicators. Special attention is also devoted to a careful analysis of the money aggregates and their information content for monetary policy.

Against this background, collaboration between academic economists and staff economists is actively encouraged through long term projects. Currently, three projects with outside academic economists are being pursued. Professor Peter Kugler (University of Basel), who acts as an external advisor, comes to the Bank once a week and helps to develop structural models for inflation forecasts. Another ongoing project is with Professor Lucrezia Reichlin (ECARES, Université Libre de Bruxelles) on data reduction techniques for developing alternative measures of core inflation and inflation forecasts. A further project still in its infancy is to develop a dynamic general equilibrium model for the Swiss economy. This project is headed by Professor Harris Dellas (University of Berne). The Research Unit also closely collaborates with economists from other Units within the SNB.

The sponsorship of economic conferences is another channel where central banks have profited in promoting and gathering ideas. A gain, there are many strategies to follow in developing this type of interchange between central banks and academic economists. The SNB has been organizing a well-known conference with the Journal of Monetary Economics and the Study Center Gerzensee. Two other initiatives were taken in recent years. The first is the Monetary Policy Workshop, which is organized and held jointly with the Bank of Canada and the Federal Reserve Bank of Cleveland. The Workshop is attended by roughly 40 staff and academic economists. The most recent workshop’s topic was "Dynamic Models of Monetary Policy" and took place in Ottawa under the aegis of the Bank of Canada. The next Workshop is planned to be held in Cleveland. The second workshop conference series is with the Deutsche Bundesbank and Austrian National Bank. This workshop operates in a smaller crowd of about 20 staff economists. The 2004 conference will be in Zurich.

The research agenda also allows staff economists to pursue their own research activities, which is recognized as a fundamental step towards developing links with economists from the academic world or from other central banks. In a similar manner, the SNB has supported the opportunity that its economists lecture at Swiss Universities or actively participate in government supported expert groups.
The European Summer Symposium in Economic Theory, organized by CEPR and sponsored by the Society of Economic Analysis took place from July 14 - 18, 2003. It brought together experienced and junior researchers who are working in the field of theoretical microeconomics. This was the 8th time the symposium took place in Gerzensee. The papers presented dealt with topics as diverse as industrial organization, law and economics, and political economy. The main program organizer was Benny Moldovanu, (University of Bonn.)

Particular sessions were reserved for contributions that established a link between economics and technical or natural sciences: in a first session on Computer Science and Economics, Noam Nisan (Hebrew University of Jerusalem) presented a paper on "Rationality as Paradigm for Internet Computing", Timothy van Zandt (INSEAD, Fontainebleau) talked about "Communication Complexity and Mechanism Design" and Eva Tardos (Cornell University) analyzed "The Price of Aarchy in Some Network Games".

The second session on Biology and Economics had Arthur Robson (University of Western Ontario) introduce "A ‘Bioeconomic’ View of the Neolithic and Recent Demographic Transitions", Ted Bergstrom (University of California) gave a paper entitled "Storage for Good Times and Bad: Of Squirrels and Men", and Kenneth Binmore (University College London) discussed the "Evolution of Focal Points". During the workshop, the mornings and evenings were reserved to presentations, while the afternoons provided ample time for discussion and cooperation.

The European Summer Symposium in Financial Markets (ESSFM) was held from July 21 - 25, 2003. The ESSFM is an annual event, and is also sponsored by CEPR and the New York Stock Exchange. The program organizers were Mike Burkart (Stockholm School of Economics) and Bernard Dumas (Insead). This year’s edition of the ESSFM was shortened from its usual two weeks to one week because of construction work at the Study Center. The first focus session was entitled The Economics of Voluntary Information Disclosure and included talks by Ron Dye (Northwestern University), A nil A rya (Ohio State University), and Chandra Kanodia (University of Minnesota). The aim of this focus session was to bring together financial economists and accounting researchers, in order to examine firms' incentives to disclose voluntarily key accounting information. This topic has taken on especial relevance in light of the recent accounting scandals.

The second focus session was entitled Financial Market Equilibrium under Imperfect Common Knowledge. Papers were presented by Hyun Song Shin (LSE), Philippe Bacchetta, and Wei Xiong (Princeton University). Its main topic was models of asset prices and exchange rates under heterogeneous beliefs. This session brought together financial economists and macroeconomists, each of whom brought a unique perspective to a common set of issues. The remaining papers addressed a wide variety of important issues in financial economics, including the term structure of interest rates, option pricing and the allocation of capital allocation. On the final day of the conference, two papers on behavioral finance were presented, both of which examined the phenomenon of investor overconfidence.

The full program is available on our homepage at www.szgerzensee.ch/conferences.
Doctoral Courses

Swiss Program for Beginning Doctoral Students in Economics

Last March, 11 students of the full 2002 program graduated and 37 students passed partial exams. The teachers of the 2003 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. John H. Moore, London School of Economics

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

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

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:

The Law of Property, Torts, Contracts and Regulation in Light of recent Developments in Economics, Psychology and Sociology.
May 19 - 23
Prof. Robert D. Cooter, University of California at Berkeley

European Integration and Enlargement,
June 2 - 6
Prof. Katharina Pistor, Columbia University School of Law

Central Bankers Courses 2003

In 2003, 125 economists from 98 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 Ebel, Andreas Fischer and Philipp Harms), by our teaching assistants, and by distinguished guest speakers. The following courses were organized:

Monetary Policy in Developing Countries,
August 4 - 22
Prof. Sebastian E. Edwards, UCLA

Instruments of Financial Markets,
September 15 - October 3
Prof. Erwan Morellec, and Prof. Michael Rockinger, University of Lausanne

Monetary Theory and Monetary Policy,
February 3 - 21
Prof. Harris Dellas, University of Berne

Advanced Topics in Empirical Finance,
March 24 - April 4
Prof. Casper de Vries, Erasmus University Rotterdam,
Prof. Thierry Foucault, Groupe HEC, Paris, and
Prof. Michael Rockinger, University of Lausanne

Banking Regulation and Supervision,
April 28 - May 16
Prof. Xavier Freixas, Universitat Pompeu Fabra,
and Prof. Anthony Saunders, New York University
Your recent work on country size makes predictions across different economic fields. What is the common thread and what was the initial spark that spawned this line of research?

The common thread is a simple economic tradeoff between the benefit of size through the economies of scale and the cost of heterogeneity. Whereby the costs of heterogeneity I mean different people with different preferences have to agree on a set of common policies, which leads to compromise. Therefore, the aggregate degree of satisfaction and economic efficiency is lower the higher the degree of heterogeneity. With this simple tradeoff, we began to seek answers in economic terms to the events surrounding the collapse of the Soviet Union and the formation of new borders.

In my opinion, a good way of thinking about the challenges facing Europe is in terms of the same tradeoff. If we define Europe as a union of countries represented through the European Union, then the benefit is a big Europe and the cost of heterogeneity is one of many diverse populations. As such, the basic tradeoff has a lot of applications not just for country size but also for considerations of localities, military coalitions, trade regimes, and supranational organizations.

Your assumptions of endogenous border formation paint a somewhat pessimistic outlook for heterogeneous societies: i.e., limited gains from the peace dividend, compromised solutions in transferring national powers to supranational institutions, continuous splitting of countries. Are you a pessimist by nature?

I am not sure that pessimistic is the right word. The pessimistic element of this research is the view that different people have different preferences and sometimes they do not get along with each other. These different preferences are related to different religion, different skin color, and different ethnic origin. I think there is a fair amount of empirical work that suggests that more racially fragmented societies work less well than homogeneous societies. This is a fact of life.

I would also like to add that there are strong economic reasons why heterogeneity may be good, because it can spark innovation and creativity. I think the USA is a perfect example. Some of the worst problems of the U.S. have to do with race and inner city conflict, but some of the most successful aspects of U.S. society are precisely being a successful melting pot - that offers a lot of creativity because the people coming from different places. So there is a dark side of heterogeneity and also a positive side, and the question is how we bring out the best out heterogeneity.

Should the government reduce heterogeneity?

One needs to be careful. People should feel free as they are. Of course we would like to eliminate racism or discrimination, but we need to be very careful in forcing homogeneous views. The public school system is an example. I think, well taken. Why is it that most countries provide public education as opposed to giving money to get their own private education? One reason is simply that the state is trying to create a common culture.

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**Interview**

Prof. Alberto Alesina

is professor of economics at Harvard University. He received his Ph.D. from this university in 1986. After two years at Carnegie Mellon University, he returned to Harvard in 1988. He has published extensively in major academic journals in the area of political economy and macroeconomic policy and he is an editor of the Quarterly Journal of Economics. He has published three books and two more are scheduled to appear in 2003.
Should (long-run) financial investors be interested in your research?

Yes. One implication for the investor is that in integrated markets size does not matter. Another aspect of this line of research is that the meaning of a country is changing. In the 19th century, under the time of the nation-state, a country’s borders were thick in the sense that they fully enclosed the political entity. Instead, today we have local, national, and supranational borders, so that national borders are only one that encircles people’s decisions today.

You have often mentioned that fragmented societies breed mistrust, so why does this not apply to currency unions, heterogeneous neighboring countries, or supranational institutions?

I think it does. I think the same sort of story goes through. Let us consider currency unions. It is simply a union of countries, where the benefit offers less frictions and larger economies of scale. However, the cost is precisely heterogeneity - measured in asymmetric business cycles.

Your prediction for small, fragmented, and aging societies says these countries operate with high costs. Is Switzerland a special case or are we predestined for a period of low productivity?

I think Switzerland is consistent with the spirit of this research that predicts it to be a federal country. Instead, if Switzerland were a centralized state, as France say, then I would predict that there would be clear tensions and it would not work.

You also have to remember, it is hard to measure the depth of fragmentation. On the one hand, Switzerland may appear fragmented in that it has four national languages. Yet on the other hand, maybe through hundreds of years of common history the differences in languages are overcome by having similar attitudes.

As you hinted in your question, there is obviously an economic cost in being able to maintain a local political structure. Nothing is for free. I suspect if this cost becomes prohibitive, then it may be necessary to give up some local independence or there is the fantastic prediction of having to split up. As for now, it appears that the Swiss are willing to bear the costs.

Reveal your preferences, what is your preferred virtual economy?

From a purely economic point of view, leaving aside security considerations or international relations. I think there is nothing wrong with small, open, homogenous countries that trade freely under a light political structure defined by a supranational institution that ensures that markets are open. So for Europe, I favor a political structure that does little more than ensures free trade, open markets, and competition. I am very skeptical of the so-called "deep integration" process.

There is, however, also the question of international relations. A second motivation for the European Union is to act as a counter balance to the U.S. This means that Europe needs a common foreign policy. What I fear by acting as a counter balance to U.S. interests is that this may mean opposing the U.S. This could be counterproductive not just in terms of foreign relations but may also have economic repercussions.
We are happy to announce Professor Niklaus Blattner as the new president of the Gerzensee Foundation Council. As of July 2003, Professor Blattner replaced Professor Bruno Gehrig, who headed the Foundation Council since 1996 (see Newsletter July 2003). Professor Blattner is currently Vice-Chairman of the Governing Board at the Swiss National Bank. In 1987, Mr. Blattner joined the Swiss Bankers Association in Basel as an Economic Advisor and member of the Executive Board. From 1998-2000 he was Chief Executive Officer and Delegate of the Board of Directors of the Swiss Bankers' Association. Since 1979, he has been an Associate Professor of Economics at the University of Basel where, in the same year, he founded the Labour Market and Industrial Organisation Research Unit (LIU).

After more than 15 years without major amendments, the Study Center has enlarged its cafeteria as well as its underground facilities for the hotel personnel (changing room, work, and storage rooms). The number of visitors to the Study Center has doubled since its opening in 1986 and these extensions were needed.

Since July the work has been proceeding with only modest disturbances for our guests. With our new cafeteria that was opened mid October, we can offer a more comfortable place for relaxation and discussions. As a fine side effect of the underground facilities, the hotel guest can now walk from his/her room to the restaurant dry-shod.

We are pleased to welcome Pinar Yesin as assistant professor. She studied mathematics at Bogazici University in Istanbul as an undergraduate. She obtained her M.A. in economics with a minor in mathematics in January 2001 and her Ph.D. in economics in September 2003 from the University of Minnesota. She was an instructor of several undergraduate courses during her Ph.D. studies. Currently, she teaches central bankers' courses at the Study Center Gerzensee and is an external consultant at the Swiss National Bank. Her research is in the fields of monetary economics, public economics and macroeconomics. She is currently working on optimal monetary and fiscal policy.

New cafeteria and underground extensions

Niklaus Blattner
Professor of Economics at the University of Basel where, in the same year, he founded the Labour Market and Industrial Organisation Research Unit (LIU).

Pinar Yesin
Assistant Professor

Working Papers

03.07
Reynard, Samuel:
"Optimal Cyclical Monetary Policy: Does Steady-State Inflation matter?"

03.06
Fischer, Andreas:
"Reuters News Reports versus Official Interventions: A Cautionary Warning"

03.05
Rime, Bertrand:
"The New Basel Accord: Implications of the Co-existence between the Standardized Approach and the Internal Ratings-based Approach"

03.04
Philipp Harms, and Matthias Lutz:
"Aid, Governance, and Private Foreign Investment: Some Puzzling Findings and a Possible Explanation"

03.03
Ricarda Demarmels, and Andreas M. Fischer:
"Understanding Reserve Volatility in Emerging Markets: A Look at the Long-Run"

03.02
Philippe Bacchetta, and Eric van Wincoop:
"Can Information Heterogeneity Explain the Exchange Rate Determination Puzzle?"

03.01
Michael J. Dueker, and Andreas M. Fischer
"Fixing Swiss Potholes: The Importance and Cyclical Nature of Improvements"

Staff News

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S T U D Y C E N T E R G E R Z E N S E E

P.O. Box 21
CH-3115 Gerzensee
Phone: ++41 31 780 31 31
Fax: ++41 31 780 31 00
e-mail: studienzentrum@szgerzensee.ch

www.szgerzensee.ch