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AMONG MULTIPLE EQUILIBRIA

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# DEFAULT PENALTY AS A SELECTION MECHANISM AMONG MULTIPLE EQUILIBRIA<sup>1</sup>

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## Abstract

The possibility of the presence of multiple equilibria in closed exchange and production-and-exchange economies is usually ignored in macroeconomic models even though they are important in real economies. We argue that default and bankruptcy laws serve to provide the conditions for uniqueness of an equilibrium. In this paper, we report experimental evidence on the effectiveness of this approach to resolving multiplicity: a society can assign default penalties on fiat money so that the economy selects one of the equilibria. The laboratory data show that the choice of default penalty takes the economy near the chosen equilibrium. The theory and evidence together reinforce the idea that accounting, bankruptcy and possibly other aspects of social mechanisms play an important role in resolving the otherwise mathematically intractable challenges associated with multiplicity of equilibria in closed economies.

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Keywords: Bankruptcy penalty, financial institutions, fiat money, multiple equilibria, experimental gaming

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## 1. INTRODUCTION

In general equilibrium theory, closed exchange and production-and-exchange economies may have multiple equilibria. Macroeconomics and less abstract applications of many partial equilibrium models allow institutional and local considerations. In spite of its importance for reconciling policy decisions with theory, questions about multiplicity are often set aside or ignored in dynamic models of the macro-economy. We believe that institutions provide a politico-economic context that is sufficient to select a unique equilibrium. We suggest that fiat money, combined with bankruptcy and default laws, are sufficient, as a first order approximation, to select among multiple equilibria. In our model the worth of virtual money is manifested as a linear separable term in all utility functions.<sup>2</sup> By utilizing the institutional context that is already known to be theoretically sufficient to supply the conditions for uniqueness, this approach cuts the Gordian knot of equilibrium multiplicity for all practical purposes.

This project is an attempt to understand the role of financial institutions, such as bankruptcy laws and accounting rules, in resolving the multiplicity problems in closed economies. To this end, we point out the theoretical justification and conduct laboratory economies to explore whether, by introducing an appropriately chosen default (bankruptcy) penalty, the outcome of a closed economy can be directed to any targeted element in the set of equilibria of the unmodified economy. This is relevant, as fiat money and default laws are facts of life in any advanced economy. They are parts of the socio-political and legal context that imposes constraints on the functioning of the economy.

In a process model of a general equilibrium system as a playable game, presence of any borrowing necessitates default penalties to prevent strategic bankruptcy. But the bankruptcy conditions may also provide a way to select an equilibrium in presence of multiplicity. In static models of general equilibrium theory there is no “nice” general condition that selects a unique equilibrium in an economy with only the usual restrictions on smooth concave utility functions. The selection of bankruptcy and default laws calls for

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<sup>2</sup>In essence, it is merely an extension of Hicks’ marginal utility of income to the negative orthant. Linearity is of little theoretical importance, as long as the disincentive is high enough at the point of default and continues to be high enough. The choice of a linear penalty is merely a mathematical convenience. In legal and institutional fact the default penalties are best described as an algorithm manifested in the form of legal procedure with considerable flexibility in ad hoc settlements.

politico-economic action. In the context of a general equilibrium model, correctly chosen penalties can guide the selection of a specific equilibrium point; if chosen otherwise they still guide the economy, albeit to a non-optimal solution.

The following five mathematically describable restrictive conditions are known to be sufficient for the existence of a single competitive equilibrium in a closed exchange economy with  $n$  agents and  $m$  commodities:

1. There is a single agent ( $n = 1$ ).
2. There is a single commodity ( $m = 1$ ).
3. All individuals have the same utility function.
4. There is gross substitutability among all goods.
5. There exists a commodity that is in positive supply, is desired by all, and whose worth enters into the utility functions of all as a linear separable term.

In this paper we explore the last of these five conditions; and more specifically the role of institutional constraints like default penalties as instruments of equilibrium selection. Qin and Shubik (2008, 2011) suggest that penalty conditions are reasonable when one attempts to convert a general equilibrium structure into a playable game. They demonstrate that trading in markets with a fiat money and default penalties is a sufficient way to construct a model that selects among multiple equilibrium points. They establish formally that a precise specification of the penalties can select any one of the available competitive equilibria in such a manner that there is no strategic default. If penalties other than these special values are utilized, some individuals will elect to default and at the end of the game budgets will not balance.

In a dynamic model of an economy where individuals are strategically free to borrow, rules and penalties on default are a logical necessity (see Karatzas, Shubik, Sudderth and Geanakoplos, 2006). They are also an institutional fact in modern economies. In this paper, we experimentally examine the possibility to engineer the outcome of a three-equilibrium exchange economy constructed by Shapley and Shubik (1977)<sup>3</sup> through the choice of financial institutions in the form of a default penalty regime. The selection of penalties or a value of government money is equivalent to the fifth condition listed above. We find that the

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<sup>3</sup> The Shapley and Shubik (1977) example has been generalized by Bergstrom, Shimomura and Yamato (2008) so that many other examples of economies with three equilibria can easily be generated.

assignment of a proper value to a fiat money (which can be interpreted as a default penalty when net money holdings are negative) yields laboratory outcomes in proximity to a predictable unique equilibrium. For more detailed comment on the contrasts between statics and dynamics and between side-payment and no-side-payment games see Appendix 2

The paper is organized as follows: Section 2 introduces the Shapley and Shubik (1977) economy with multiple equilibria, describes its modification by Qin and Shubik (2008) through the introduction of a third commodity (a money) into a playable game, and presents testable hypotheses. Section 3 presents the experimental set up with the results in Section 4. Section 5 presents additional tests of robustness of the Section 4 results. Section 6 discusses some caveats and wider applications, followed by concluding remarks in Section 7.

## 1.1 RELATED LITERATURE

We have been unable to find other directly related experimentation with general equilibrium models recast as process models such as strategic market games. However, there is some gaming literature related to, yet different from, the central theme developed here. The work by Knez and Camerer (1994) introduces the concept of “expectational assets” that is manifested here in assigning a positive worth to left-over fiat money at the end of the game. An important but quite different source of multiplicity in open economic models is considered by Heinemann (2012) who deals with an experimental investigation of Diamond-Dybvig (1983) financial bubbles. Our stress is on the coordination aspects of bankruptcy laws. There appears to be no gaming literature on this topic. There is an allied literature on bankruptcy viewed as a cooperative game fair division problem (Herrero, Moreno-Tenero, and Ponti, 2002).

## 2. AN ECONOMY WITH MULTIPLE EQUILIBRIA

Consider the outcomes of an economy with two commodities and two types of traders modeled as a strategic market game with three competitive equilibrium points, one of which is unstable under Walrasian dynamics. The model considered is illustrated graphically in Figure 1. It displays an exchange economy with three competitive equilibria in an Edgeworth Box. The initial endowment of goods A and B  $(x, y)$  of each trader of Type 1 is  $(40, 0)$  and

the initial endowment of each trader of Type 2 is (0, 50). The utility functions of the individuals of Type 1 and 2 are, respectively,

$$\begin{aligned}
 U_1(x, y) &= x + 100(1 - e^{-y/10}), \text{ and} \\
 U_2(x, y) &= y + 110(1 - e^{-x/10}).
 \end{aligned}
 \tag{1}$$

The initial endowment point is the upper left of the box with coordinates (40, 0) and (0, 50) in Figure 1. The dotted lines represent the individually rational indifference curves going through the initial endowment point. The Pareto-optimal set of outcomes is given by  $C_1D_1X C_2D_2$ . The two curves that intersect three times on the Pareto Set are the response curves for each trader, calculated by varying price and asking each trader how much she would be willing to trade at each price. Supply equals demand only at the points of intersection of the two curves as is indicated by the three equilibria,  $CE_1$ ,  $CE_2$  and  $CE_3$ .

(Insert Figure 1 about here)

With only one trader on each side it can be regarded as a model of barter. With  $n$  traders on each side, it provides the simplest model of an economy where a market price can be formed by aggregating many bids and offers. Here the same figure can be regarded as representing type-symmetric trade outcomes in a market with  $n$  players on either side.<sup>4</sup>

Huber, Shubik, and Sunder (2009) conducted an experimental examination of this economy in their first treatment and reported that: (1) the selection of numeraire made no difference; (2) there was no convergence to any of the three CEs; (3) all runs approached or neared a point on the Pareto surface.<sup>5</sup> The data were closest to the central CE and the jointly maximum outcome (assuming interpersonal comparisons) was even closer. Those data, analysis and method serve as a useful benchmark for the experiment with the economy modified through introduction of money in the current paper.<sup>6</sup>

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<sup>4</sup> Type symmetry means that all traders of the same type take the same action. Thus, instead of needing a diagram in  $2n$  dimensions the 2-dimensional diagram given in Figure 1 is sufficient.

<sup>5</sup> There appeared to be three competing basins of attraction with no a priori tendency towards any one in particular; perhaps early moves influence the final outcomes.

<sup>6</sup> As the primary purpose here is to explore the power of introducing a bankruptcy penalty in selection of a type-symmetric non-cooperative equilibrium, we make several simplifying assumptions. One of them is that ten persons in a strategic market game are enough to yield outcomes for which we can use the CEs as reasonable surrogates. This would be reinforced if the average behavior of the players were myopic, more or less conditioning on the signal of the last price rather than on their oligopolistic power. In our discussion from here on we refer to the economy's CEs rather than NCEs.

## 2.1 MODIFICATION OF THE ECONOMY INTO A PLAYABLE GAME

When a linearly separable money  $M$  is introduced to economy (1) in addition to goods A and B, and the utility functions are modified by adding a monetary good  $z$  with constant marginal utility normalized to one, we get:<sup>7</sup>

$$U_1(x, y, z) = \mu_1 z + x + 100(1 - e^{-y/10}), \text{ and}$$
$$U_2(x, y, z) = \mu_2 z + y + 110(1 - e^{-x/10}), \quad (2)$$

where the  $\mu$ 's are parameters and the initial endowments now include an amount of money. This amount equals or exceeds the transactions amount needed at any one of the three CEs. This change, i.e., the introduction of money with a positive value (default penalty when net money holdings are negative) leads to a new unique equilibrium. The location of this equilibrium depends on the values of the two  $\mu$ 's.

Parameters  $\mu_i$  define the expected value of money at the end of the game. In theory, if fixed as the Lagrangian values at any one of the CEs, they can be interpreted as the rational expectations valuation of the marginal utility of money. When borrowing is permitted, and thus negative holdings are possible, a bankruptcy valuation must be specified and setting the marginal bankruptcy penalty equal to or above the marginal value of money is sufficient to discourage strategic bankruptcy.

For interpretation of the parameters  $\mu_1$  and  $\mu_2$  note that in an exchange economy there are two quite different forces that support the valuation of fiat money. The first is expectations of the future worth of money in exchange; this is essentially dynamic (see Bak, Norrellyke and Shubik, 1999). The second involves the magnitude of the penalties imposed by a society on individuals who default on their debts. In equilibrium in a society that uses a fiat, money must have the marginal utility of a unit of income no more than the marginal disutility of ending with a unit of debt (i.e., it does not pay to go bankrupt).

Although we have introduced a linear separable money, when the bankruptcy penalty is selected to coincide with the Lagrangian of one of the CEs, there are two ways we can model the game, with some form of outside or physical money present that does not net to zero; or with each individual granted a credit line based on (correctly) forecasted income. In

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<sup>7</sup> In order to make a meaningful comparison among equilibria, we need to normalize the economies so that the total value of all goods in the economy is the same under all equilibrium prices.

this instance the penalty selects the equilibrium without the use of a quasi-linear money. This structure implies the existence of an agency with omniscient forecasting skills. An alternative approach is to consider an economy with a small amount of quasi-linear money that provides enough liquidity to absorb a reasonable amount of error or heterogeneous behavior without causing bankruptcy. In essence a quasi-side payment game has been created that provides this flexibility to the dynamics.

When net trade in equilibrium is zero the game can be regarded as an NSP game and there is no need for money. When the penalties are different from any of the CEs of the model, the economy in essence selects a CE in the three dimensional space that involves a net transfer of money. In this case, the distortion of the price system will favor the individuals with negative cash flow. Thus the presence of the quasi-linear money absorbs error both in individual behavior and in setting penalties.

We may rewrite the utility functions (2) in the form:

$$U_1(x, y, z) = z + \frac{1}{\mu_1} (x + 100(1 - e^{-y/10})), \text{ and}$$

$$U_2(x, y, z) = z + \frac{1}{\mu_2} (y + 110(1 - e^{-x/10})). \quad (3)$$

If individuals were permitted to borrow, and the marginal disutility of debt was less than the marginal utility of income, it would pay individuals to borrow more and to default. In the experiment we did not allow borrowing. When outside money is present, individual spending in excess of their income is the equivalent to default in an economy with no outside money. We therefore have the subjects earn points for their net money holdings at the end.

In this economy, subjects trade goods A and B for money in separate markets. The trader strategy has two dimensions, with type 1 offering a quantity of good A for sale and bidding a quantity of fiat money to buy good B (and vice-versa for traders of type 2). The introduction of fiat money with the parameters  $\mu_i$  is enough to guarantee a unique competitive equilibrium point for non-zero amounts of money (see Qin and Shubik 2008).



We fix  $\mu_1 = 1$  and vary  $\mu_2$  in three treatments to target the three equilibrium points (see Table 1).<sup>8</sup> Specifically, in treatments COa, COb, and COc,<sup>9</sup> we set  $\mu_2 = 0.28, 0.75,$  and  $5.07,$  respectively,<sup>10</sup> since these values correspond to the respective marginal values of income<sup>11</sup> at the three competitive equilibria of the economy. We examine the effect of varying  $\mu_2$  on outcomes of the economy.<sup>12</sup>

We conduct and present games in which after each move resources are re-initialized, as well as games in which balances are carried over from one period to the next. Theoretically, if resources are not re-initialized, the agents could end up trading to anywhere on the contract curve. However, seen in the results later, even without re-initialization, the three initial CEs serve as predictable basins of attraction and the outcomes of the experimental economies are clustered in a narrow band around the specific CE targeted by the choice of  $\mu_2$ .

The value of learning is more limited in the CO treatments, as holdings of goods are not re-initialized. Even in a static theory this makes a difference. If we reinitialize the holdings, traders have the opportunity to learn costlessly. Re-initialization clearly makes learning easier, as different strategies can be tried and individual decisions can be improved. In the other instance, i.e., when holdings of goods are carried over, a subject does not have the opportunity to recover from poor decisions made in the past. In particular, as the competitive equilibrium moves with each change in endowments, the process is stacked

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<sup>8</sup> With the same bankruptcy laws applicable to all, how could the penalties differ across traders? As demonstrated by the bankruptcies of General Motors and Chrysler in Spring 2009, default penalties are tailored by the legal process, and yield different opportunity costs for different agents.

<sup>9</sup> Treatment label CO stands for commodity and money balances being carried over from the end of one period to the beginning of the next, as contrasted with label RI for treatments in which the commodity and money endowments of subjects were re-initialized at the beginning of each period (to be described below).

<sup>10</sup> The same  $\mu_2$ 's are used in re-initialization treatments RIa, RIb, and RIc, respectively.

<sup>11</sup> A default penalty needs to be at least this strong to discourage strategic defaults.

<sup>12</sup> Multiple equilibria are rare in general as was shown by Debreu but are important in preventing any strong welfare interpretation of competitive market and also are a stumbling block in the development of dynamics. For example, Kumar and Shubik (2003) performed a sensitivity analysis to show precisely the somewhat narrow range of changes in the distribution of endowments of the two player types that would preserve the property of multiple equilibria.

against going to the initial CE. To account for this, and to observe whether learning takes place, we also conduct three re-initialization sub-treatments RIa, RIb, and RIc.<sup>13</sup>

Conjecture 1: *In carry-over Treatments COa, COb, and COc, as well as in re-initialization Treatments RIa, RIb, and RIc, the economy converges to one of the three equilibria targeted by the selection of parameters  $\mu$ .*<sup>14</sup>

As the money is a linear term, equilibrium can be reached with any net money holdings, depending on how prices evolve. We conjecture that subjects with relatively high marginal utility for procuring more goods will be ready to incur negative net money holdings (i.e., spend more than they earn). The theoretical possibility of zero net money holdings should occur for penalties set appropriately for any one of the three CEs. Thus for them the null hypothesis is.

Conjecture 2: *In all six treatments (COa, COb, COc, RIa, RIb, and RIc), net money holdings will be equal to the equilibrium level of zero.*

Ordinary individuals rarely make conscious economic decisions at a global level. Therefore, for understanding and analyzing an economy populated by agents whose behavior is mostly local, it is possible that the multiple equilibria obtained from global optimization in a formal mathematical model may be misleading or irrelevant. Moreover, virtually all experimental gaming has been conducted with open or partial equilibrium systems and we cannot assume that those results necessarily generalize to closed systems. On the other hand, global optima may form domains of attraction even in environments dominated by local behavior (e.g., Gode and Sunder, 1993 and Jamal et al., 2012). Whether this is true is an empirical question on which the present exploration can be expected to shed some light.

### **3. EXPERIMENTAL SETUP**

Subjects were given endowments of goods and money (A, B, M endowments of 40, 0, 100 to the five subjects of one type and 0, 50, 100 to the five subjects of the second type). The first type of traders who were endowed with good A were asked to state the number of

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<sup>13</sup> Ghosal and Morelli (2004) is a related paper concentrating on the theory of dynamics of perfect equilibria in strategic market games. Examination of this model in light of their work would be a natural extension of the present paper, which we leave for future research.

<sup>14</sup> If the  $\mu$ 's ( $\mu_1, \mu_2$ ) are not selected to coincide with the Lagrangians the books are balanced by a transfer of money as is shown in robustness tests presented in Section 5.

units of A they wished to sell (out of their endowment or the balance) and the number of units of money they wished to tender to buy good B. Similarly, the second type of traders who were endowed with good B were asked to state the number of units of B they wished to sell (out of their endowment or the balance) and the number of units of money they wished to tender to buy good A. Negative holdings in goods or money were not possible. Computer added the total amount of money bid for good A by the five subjects of the second type and divided it by the total number of units of good A offered for sale by the five subjects of the first type to determine the price of good A, and implemented the appropriate transfers of good A and money among the subjects. Similarly, computer also added the total amount of money bid for good B by the five subjects of the first type and divided it by the total number of units of good B offered for sale by the five subjects of the second type to determine the price of good B, and implemented the appropriate transfers of good B and money among the subjects.<sup>15</sup>

Subjects' earnings functions were common knowledge and were provided to them algebraically as well as numerically in a 50x50 payoff table (see the Appendix for condensed versions).

First type of traders: Points earned =  $A + 100 * (1 - e^{(-B/10)}) + \text{NET MONEY}$ ,

Second type of traders: Points earned =  $(1/\mu_2) * ((B + 110 * (1 - e^{(-A/10)})) + \text{NET MONEY}$ ,

where  $\mu_2 = 0.28$  in sub-treatments a, 0.75 in b, and 5.07 in c.

In the CO-treatments holdings of goods and money are carried over from one period to the next. The final payout is determined by the final holdings of goods and the net change in money holdings.

To allow less constrained learning and observe possible learning effects, holdings of goods are re-initialized after each period in three RI-treatments ( $\mu_2$  is varied again with values 0.28, 0.75, and 5.07). In  $RI_a$ ,  $Rb_b$  and  $RI_c$ , subjects start each of the 15 periods with 40, 0, 100 or 0, 50, 100 of goods A, B, money, and they have only one transaction to reach their desired holdings of goods and money. Points earned by each subject are added up over

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<sup>15</sup> Huber et al. (2010) compare the properties of three basic market mechanisms in a general equilibrium setting, including the buy-sell mechanism used here and the double auction mechanism often used in experimental economies—mostly partial equilibrium. The buy-sell mechanism is simpler to implement, more efficient, and is at least as applicable to the general equilibrium setting of the economy examined here as the double auction mechanism.

periods and converted into money at a predetermined rate. Average payment was 20 dollar for each subject in each of the approximately 60-minute sessions.

We conducted six independent runs for each of COa, COb, and COc, and four independent runs for each of RIa, RIb, and RIc, each with a different cohort of 10 students. We thus have 30 runs with a total of 300 students. Nine runs were conducted at Yale University, and 21 at the University of Innsbruck, Austria. All subjects were BA or MA students in Management or Economics. All sessions were carried out using a program written in z-Tree (Fischbacher, 2007).

#### 4. RESULTS

Figure 2 presents the development paths of end-of-period holdings of goods A and B for COa (left panel), COb (center), and COc (right) in multiple (top row of panels) and individual (bottom row of panels) runs. In the top row of panels average holdings of the traders in each of the six runs of each sub-treatment are displayed. Holdings at the end of each period are marked with a diamond and periods of a single run are connected with a black line. In the lower row of panels, a single run (always the second of the six) of each sub-treatment is displayed. In addition to the average individual holdings of the groups of traders, the holdings of the individual traders are also displayed by small circles to convey the dispersion of holdings.

(Insert Figure 2 about here)

Defining the salvage value and default penalty of money leads the economy towards a unique equilibrium in each sub-treatment. This unique equilibrium is shown as a black diamond for sub-treatments a, a triangle for b, and a square for c, while we still display the former equilibria in unfilled white markers for the sake of easier comparison across the sub-treatments. The paths in the three sub-treatments are distinct from each other, and each path approaches the vicinity of its respective equilibrium. To test whether manipulation of salvage values/default penalties for money (parameter  $\mu_2$ ) can select different equilibria as claimed in Conjecture 1, we supplement the graphic presentation in Figure 2 with 2-sided Mann-Whitney U-tests comparing average final holdings of good A for COa with those of COb, COa vs. COc, and COb vs. COc. These tests are repeated for good B. All six statistical tests yield p-values smaller than 0.01 (N=6), confirming that choosing different  $\mu_2$ 's generated

significantly different final holdings. To test whether the targeted equilibria were approached we conduct 2-sided t-test (N=6) to compare average end-of-period holdings of goods A and B to the respective equilibrium holdings. Here none of the six tests reveals a significant difference, i.e., holdings of good A are indistinguishable from the respective equilibria in all three tests, as are those of good B from their respective equilibrium values. Thus, all test results are in line with the theoretical predictions of the model. Hence, we cannot reject Conjecture 1 on the choice of default penalty leading the economy to the targeted equilibrium.

The three sub-treatments differ with respect to the trading volume it takes to reach the respective equilibria. In *COa* ( $\mu_2 = 0.28$ ), with holdings of goods relatively more valuable for traders initially endowed with good B, those endowed with A should sell most (36.78 out of 40) of their holdings of A, while those endowed with B should hold on to most (39.77 out of 50) of their goods to reach equilibrium. The development of cumulative market trading volume over periods is displayed in Figure 3 (market volumes should be five times the per capita trades given above). In each market the trading volume is high in early periods and falls off rapidly until trading stops between periods 8 and 15 (when the volume drops below the threshold of 0.2 units of either good). We also see that the predicted market volumes (horizontal lines with diamond markers) provide support for the observed market volumes in the six runs in each of the three panels of Figure 3.<sup>16</sup>

(Insert Figure 3 about here)

Figure 4 shows that efficiency, defined as the percentage of total equilibrium payoff actually earned by the subjects, increases markedly over time, as subjects' holdings of goods A and B approach the respective equilibria. In all but one of the runs trading stops in the period with the highest overall efficiency or one period later, which is in line with rational expectations. The final efficiency levels reached are between 92.0 and 99.6 percent with an average of 97.8 percent.

(Insert Figure 4 about here)

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<sup>16</sup> All six 2-sided Mann-Whitney U-tests comparing average trading volume between the three sub-treatments deliver p-values below 0.01 (N=6), while all 2-sided t-tests comparing average trading volume to its respective equilibrium prediction deliver insignificant results (2 results are significant on the 10-percent level, but none on the 5- or 1-percent level).

Theory predicts that holdings of goods A and B should approach the respective equilibrium levels, while money holdings should remain unchanged at the endowment level. This prediction for goods is generally supported by the data, but is not supported for money. In COa, where goods are more valuable to traders initially endowed with good B, who thus bought, while those endowed with goods A mostly sold, money accumulated with those initially endowed with good A. The reverse holds in COc, where money mostly ends up with traders initially endowed with good B. To provide a quantitative measure Figure 5 shows the development of average absolute deviations of holdings of goods A, B, and money from the respective equilibrium predictions over periods. To make the numbers comparable they are given in percent of initial holdings (40, 50, and 100, respectively, for goods A, B, and money). Especially in COa and COc holdings of goods move closer to equilibrium predictions over time, while holdings of money move away, i.e., money moves from one trader type to the other. Two-sided t-tests reveal that in COa and COc dispersion of money holdings is significantly larger than dispersion in holdings of goods A and B.<sup>17</sup> Thus, heterogeneity in the end is mostly for money holdings, while holdings of goods A and B are more homogeneous and much closer to the equilibrium predictions.

(Insert Figure 5 about here)

#### **4.1 Sub-treatments RIa, RIb, RIc (holdings of goods and money reinitialized)**

To allow for (costless) learning and to better observe possible learning effects we implement three RI sub-treatments, where holdings of goods are re-initialized after each period.

Figure 6 displays period-by-period average holdings of goods A and B in RIa, RIb, and RIc (with the final period shown by an enlarged marker). The lines connecting the markets allow us to follow the outcome of trading, i.e., the average end-of-period holdings over the sequence of 15 periods. The top panels show the first and second independent runs for each of the three sub-treatments, while the bottom panels present the third and fourth. The paths in the three sub-treatments are quite distinct from one another in each of the panels, and

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<sup>17</sup> p-values below 0.05, N=6 for all six tests in COa and COc. No significant difference in COb with p-values between 0.143 and 0.229 for the four tests. There is no significant difference between the average absolute deviations of holdings of goods A and B with all p-values above 0.2.

each run approaches its respective equilibrium.<sup>18</sup> The RIb- and RIC-equilibria are essentially reached in the second period, while in RIa it took a few periods longer to approach the equilibrium. To explore whether average final holdings differed across sub-treatments we conduct Mann-Whitney U-Tests with one observation per run (average holdings of goods A, B in the last period), separately for goods A and B, comparing the four runs of RIa with the four of RIb, RIa to RIC, and RIb to RIC. All six tests delivered p-values of 0.029 on a two-sided test, thus confirming that different  $\mu_2$ 's suffice to produce different outcomes.<sup>19</sup>

The RI treatments demonstrate that the selection of the default penalty is suitable to select among multiple equilibria, thus corroborating the result from CO treatments that Conjecture 1 is not rejected.

(Insert Figure 6 about here)

In all three RI sub-treatments the largest increase in efficiency occurred during the first period, moving from autarky to the market economy. As can be seen in Figure 7 this is followed by smaller increases in efficiency of repetitions over subsequent periods (period 0 is efficiency associated with autarky and 100 percent is the efficiency of the respective competitive equilibria). In most runs efficiency levels of more than 90% are reached in the first period, i.e., when moving from autarky to a market economy.

(Insert Figure 7 about here)

The upper row of panels in Figure 8 replicates for the RI-treatments what Figure 5 presented for CO treatments: the development of the average absolute deviation of holdings of goods A, B, and money from the respective equilibrium predictions over time. Again all numbers are given in percent of initial holdings. The results are comparable to Figure 5: in RIa and RIC money holdings move away from the equilibrium prediction of zero, while holdings of goods A and B quickly drop toward equilibrium holdings. Again, heterogeneity

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<sup>18</sup> Note that each marker in Figure 6 shows the holding achieved in a period starting every period with the endowment point in the northwest corner. We have joined the markers with a line to indicate the sequence of periods in order to point out that the outcomes got generally closer to the respective equilibrium holdings in the later periods of the runs. In contrast, in the CO-treatments (without reinitialization), the northwest corner was the endowment point only at the beginning of period 1, and the change in holdings in all subsequent periods was incremental relative to the end of the preceding period.

<sup>19</sup> We also conducted six two-sided t-tests (N=4) to test whether final holdings of goods A and B were different from the respective equilibrium predictions. There is no significant difference in five of the six tests; only holdings of good A in RIa are significantly different from the equilibrium.

in final holdings is greater for money than for goods. The lower row of panels presents the averages of the four runs given in the upper panels.

(Insert Figure 8 about here)

#### 4.2 Net Money Holdings in CO and RI Treatments

In all our sub-treatments the respective equilibria can be reached with net money holdings of all traders at zero or at any other desired level, as money holdings are a result of prices which are set endogenously by traders' bids and offers. Net money holdings of zero are the equilibrium prediction and they are achieved when the ratio between the prices of the two goods is equal to the respective values of  $\mu_2$ .<sup>20</sup> However, this would lead to a very uneven distribution of final points earned, e.g., in COc and RIc with  $\mu_2 = 5.07$  subjects starting with good B would have to buy 7.74 units of good A at a price five times higher than the price they get for each of the 39.26 units of B they sell in equilibrium. They would end up with relatively small holdings of the goods and thus earn only 10 percent of the points that A-holders earn.

Figure 9 presents the development of average net money holdings of traders initially endowed with good A over time in all six sub-treatments (the runs of COa and RIa are in the left panel, COb and RIb are in the center and COc and RIc are on the right) contrasted with the CE holdings of zero.<sup>21</sup> We see that the CE-proposition does not serve as a good benchmark in most of the runs, as net money holdings are rarely close to zero and mostly move away from zero over time. Only in COb and RIb do the net money holdings remain relatively small. Net money holdings of subjects in the last period are significantly different from zero in all 20 runs of COa, RIa, COc, and RIc ( $p < 0.01$ , Mann-Whitney U-Tests,  $N=10$  for each test). For COb and RIb the final money holdings in five of the ten runs are significantly different from zero ( $p < 0.05$ ). Thus Conjecture 2 is rejected.

(Insert Figure 9 about here)

Conjecture 2, while consistent with theory, leaves out both the imperfections of learning and error to be expected in even as simple an environment as this. To explore if the

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<sup>20</sup> Recall that  $\mu_1 = 1$  in all treatments.

<sup>21</sup> Average net holdings of traders initially endowed with good B are simply the net holdings of A multiplied with (-1).



subjects took into account the impact of their offered volume on prices, we calculated the correlation coefficients between the changes in prices from period  $t-1$  to period  $t$  and the change in total volume offered from period  $t$  to period  $t+1$ . This is done separately for good A and good B in each of the 12 runs of RIa, RIb, and RIc. Learning subjects should offer fewer goods when prices are comparatively low and more goods when prices are high, i.e., we should observe positive correlation coefficients. We find that in 21 of 24 cases the correlation is positive, with an average correlation of 0.30 for good A and 0.34 for good B. This suggests that subjects reacted to changes in relative price levels, i.e., they offered fewer goods after prices dropped, and more goods when prices rose in the preceding period.

Furthermore, the perceived extreme asymmetry especially of the CEs in RIa and RIc is such that we might expect a deviation from the balanced budget condition. We think an aversion to results with a very uneven earnings distribution, which might be considered unfair, play a role here (see e.g., Fehr and Schmidt 1999, Fehr and Gächter 2000). Further experimentation is called for to resolve why budgets do not balance, as predicted by equilibrium.

## 5. ROBUSTNESS CHECK

We have shown that the economy can be guided to any of the desired equilibria of the original economy by proper selection of default penalty. But what happens if the parameters selected do not coincide with the marginal values of income at any of the three original equilibria? An equilibrium exists for any parameter value above zero but it is not one of the three CEs of the original economy. Any selection of penalty which is different from the CE penalties will lead to a unique equilibrium with a net transfer of money from one class of agents to the other.<sup>22</sup> We examine this possibility as a robustness check by setting  $\mu_1 = \mu_2 = 1$  in order to consider a case where the solution should be a unique equilibrium with allocations different from all three equilibria in the original model. When both  $\mu$ 's are set to 1 the unique equilibrium coincides with the joint maximum, i.e., the point where the sum of the earnings of the two trader types is maximized.<sup>23</sup>

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<sup>22</sup> Thus, for a complete representation we would need a three-dimensional diagram.

<sup>23</sup> For any value of  $\mu$  the equilibrium is also a joint maximum. The important game theoretic distinction between the treatment where all  $\mu$ 's are set to 1, and the three other cases involving the CEs, is that the latter illustrate

One might ask why bother with penalty levels other than those that support one of the three original equilibria. One reason is to stress our concern with the role of rules and institutions in the economy. We believe that the government can have only an approximate and general knowledge of the preferences and assets in the economy which is normally insufficiently accurate to guess a penalty level that would support one of multiple equilibria. If it guesses incorrectly the number of bankruptcies would signal that it needs to adjust the penalties. This could be tested experimentally by having the government as a player trying to select an appropriate penalty but having some uncertainty concerning endowments and preferences.<sup>24</sup> The present experiment does not include such a test, and is confined to verifying if the predictability of the outcomes is robust to the choice of penalties that deviate from the original equilibrium levels.

*Conjecture 3: In the robustness check the unique equilibrium defined by the chosen default penalties  $\mu_1$  and  $\mu_2$  is approached.*

To ensure comparability with the main experiment, we conduct one sub-treatment where holdings of goods are carried over (CO-R) and one in which the endowments are reinitialized after each period (RI-R). Two runs with one cohort of 10 subjects are conducted for CO-R and one run with a different cohort of students for RI-R.

## 5.1 Results

Figure 10 presents the development of holdings of goods over time in the two runs of CO-R (see the last row of Table 1). The two runs are quite similar to each other, and end in the vicinity of the unique equilibrium (joint maximum) marked by a dark triangle. Final holdings of goods are not significantly different from the holdings in the joint maximum in both runs (Mann-Whitney U-test,  $p > 0.1$  in both runs,  $N=10$ ), and Conjecture 3 is not rejected. Two panels of Figure 11 show the development of cumulative trading volumes and

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equilibria in no-side-payment games which means that the books balance and there is no net transfer of money. In the other instance the books do not balance and there is a net transfer of money with bankruptcy possible.

<sup>24</sup> When there is no exogenous uncertainty active bankruptcy is caused by inappropriate penalties or human error. In an economy with exogenous uncertainty an optimal bankruptcy law can only be reflected by taking into account society's attitude towards risk. It is a form of public good; and even without human error it will involve active bankruptcy.

efficiency of time. With convex paths for both, these figures show no remarkable departures from the results of the main experiment presented in Section 4.

(Insert Figure 10 and 11 about here)

This is corroborated by the run RI-R (with re-initialization, see the last row of Table 1), presented in Figure 12. In the left panel we see that the average final holdings of traders of the first type are in the vicinity of the unique equilibrium. The right panel shows that efficiency increases over time (it is high in the first period, lower in the next two, and increases gradually but steadily from period 3 to the end).

(Insert Figure 12 about here)

Equilibrium prediction is that the final net money holdings will be -2.3 for traders endowed with 40/0 and +2.3 for traders endowed with 0/50 of goods A/B. In the two runs of CO-R average final money holdings are -3.9 and +3.9 for traders endowed with 40/0 and 0/50, respectively (in RI-R final money holdings are -1.4 and +1.4, respectively). The algebraic sign of the net money holds is the same as the equilibrium predictions, although the actual amounts deviate significantly (just as they do in the main experiment in Section 4).

## 6. DISCUSSION

Both, formal economic analysis and experimental gaming, in their own, albeit different, ways call for stringent simplification. Our introduction of both a bankruptcy penalty and linearly separable money is a radical simplification. In an error free world, as a means for selecting among competitive equilibria, only the penalty is required as the “money” nets to zero. In actual economies, money coexists with many assets which permit much secured lending that helps ameliorate the damage from defaults and provides a more economical solution to the distribution of risk and the redistribution of assets. In our models the ideal money we introduce is a crude metaphor for the more complex arrangements in an asset rich economy.

Although the existence of multiple equilibria has been proved generally, the calculation of a reasonably robust example proves tricky. The choice of utility functions shows that the existence of a linear separable term in every utility function is not enough. One requires that the commodity with this property must be the same for all agents. In spite of the special features of the example used we suggest that the results hold in full generality

for any economy with multiple equilibria. The key point is that the grafting onto the economy of the linear term for a virtual commodity is a politico-economic act encompassing the economy. A society with creditors in political control can be expected to develop different default and bankruptcy laws than one in which debtors are in control.

In contrast with the important goals of macroeconomic applications approached from the “top down”, in this paper we are concerned with a “bottom up” approach in utilizing a microeconomic approach to studying market economies. Building rigorous foundations of macroeconomics calls for the static general equilibrium models to be integrated with general process models. Strategic market games help us achieve this goal because setting them up forces us to specify complete and consistent process models. By their very nature, they are amenable to examination by both mathematical analysis and experimental gaming.

Selection of the three levels of linear penalties associated with each of the underlying CEs has the strong theoretical property that all budget constraints are met and the net transfer of money is zero. When the penalties chosen are other than the values that select one of the three equilibrium points, there is active bankruptcy and a need for the transfer of money to balance the books. For experimental simplicity, we have utilized a linear separable money that may be regarded as producing a unique equilibrium in a three- rather than a two-commodity world.<sup>25</sup>

By using the linear penalty and settlement in our experiments, we do not address the complexities of the income effect of bankruptcy laws. Doing so would call for a consideration of the highly important aspects of collateral and secured lending. Hellwig (1982) was the first to consider collateral. Geanakoplos and Zame (2007) have developed an understanding of the role of collateral in providing settlements based more endogenously on the ownership of real assets than on the pure political enforcement of a bankruptcy law.

Selection of a single equilibrium from a set of equilibria raises another question: is there any societal reason to favor a specific equilibrium over the others? Creditors and

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<sup>25</sup> A rigorous consideration of games where the bankruptcy penalties are not set to reflect the Lagrangians at the three CEs requires a careful description of either conditions on the issue of inside money by the central bank in exchange for individual IOUs, or the existence of a sufficient amount of a linearly separable commodity money held by all parties. These extra features merit a separate paper showing the full interlinkage between the side payment and no-side-payment games and how the CEs differ. As our key results consider primarily the equilibria where no net transfer is required, we defer developing the conditions on active transfer of money at equilibrium for a separate study.

debtors have been noted above; however another reasonable condition for picking a penalty is to select the equilibrium which minimizes the need for cash. Any process model that is a playable game must specify how trade takes place and thus provides the conditions to be able to calculate the cash flows. By selecting the equilibrium that requires the least amount of money relative to overall wealth, society would economize on the use of “trust pills” as individual trust is a prerequisite for acceptability of fiat money. As a New England saying puts it: “In God we trust, all others pay cash.”

## 7. CONCLUDING REMARKS

Societies, and the politicians acting on their behalf, continually face choices among a multiplicity of possible outcomes. Long-term legislative actions often involve trading off utilities across individuals or groups. In this paper we explored empirically the practical feasibility of such choices. We demonstrated that by introducing an appropriately chosen default (bankruptcy) penalty,<sup>26</sup> the outcome of a closed economy can be directed to any targeted element in the set of its equilibria. Two goods were traded for money in laboratory markets. Our experiment showed that default (bankruptcy) penalty of a fiat money can be chosen to achieve any of the given equilibria of the economy, or more generally, any desired point on the contract curve (see the robustness check). Our central experimental task was to examine the suggestion from theory that the institutional arrangements in a society provide the means to resolve the possibility of multiple equilibria in an economy. This was answered affirmatively. We also observed that final holdings of money were more heterogeneous than of goods.

The results provide some empirical support for the attitudes of macroeconomists who do not regard the non-uniqueness of competitive equilibria as a problem of practical significance for their work. Societies may implicitly solve the uniqueness problem in the guidance of a competitive economy by selecting default penalties that link the value of money directly to the preferences of individuals. The need for societies to add the

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<sup>26</sup> In actuality the government selection is made under lack of common knowledge, hence at best it is a crude guess. In fact, in any modern society there is some percentage of the members of the economy who wind up in bankruptcy.

institutional details and extra parameters is forced by the requirement to specify how to handle all outcomes from a dynamic process.

The robustness check demonstrated that by proper selection of a default penalty any desired outcome on the contract set can be targeted and approximately attained. However, we stress that although a societal selection of the extra parameters is sufficient to obtain a unique equilibrium, unless the parameters coincide with the values of the Lagrangian variables at an equilibrium of a static exchange economy, the static equilibrium solution to the new game will not coincide with any of the original equilibria.

Summarizing, we showed how a pair of socially engineered parameters could serve to select any of the equilibria, but this requires a “fine tuning” of the equilibrium values and detailed knowledge of the preferences and parameters of the economy. In a society with dispersed knowledge and perennial political and bureaucratic battles, neither such knowledge nor the fine-tuning seems feasible or likely. Fortunately, even poorly tuned parameters resolve the multiplicity problem, and societies may resort to successive adjustments of their values over extended periods of time to discover acceptable levels.

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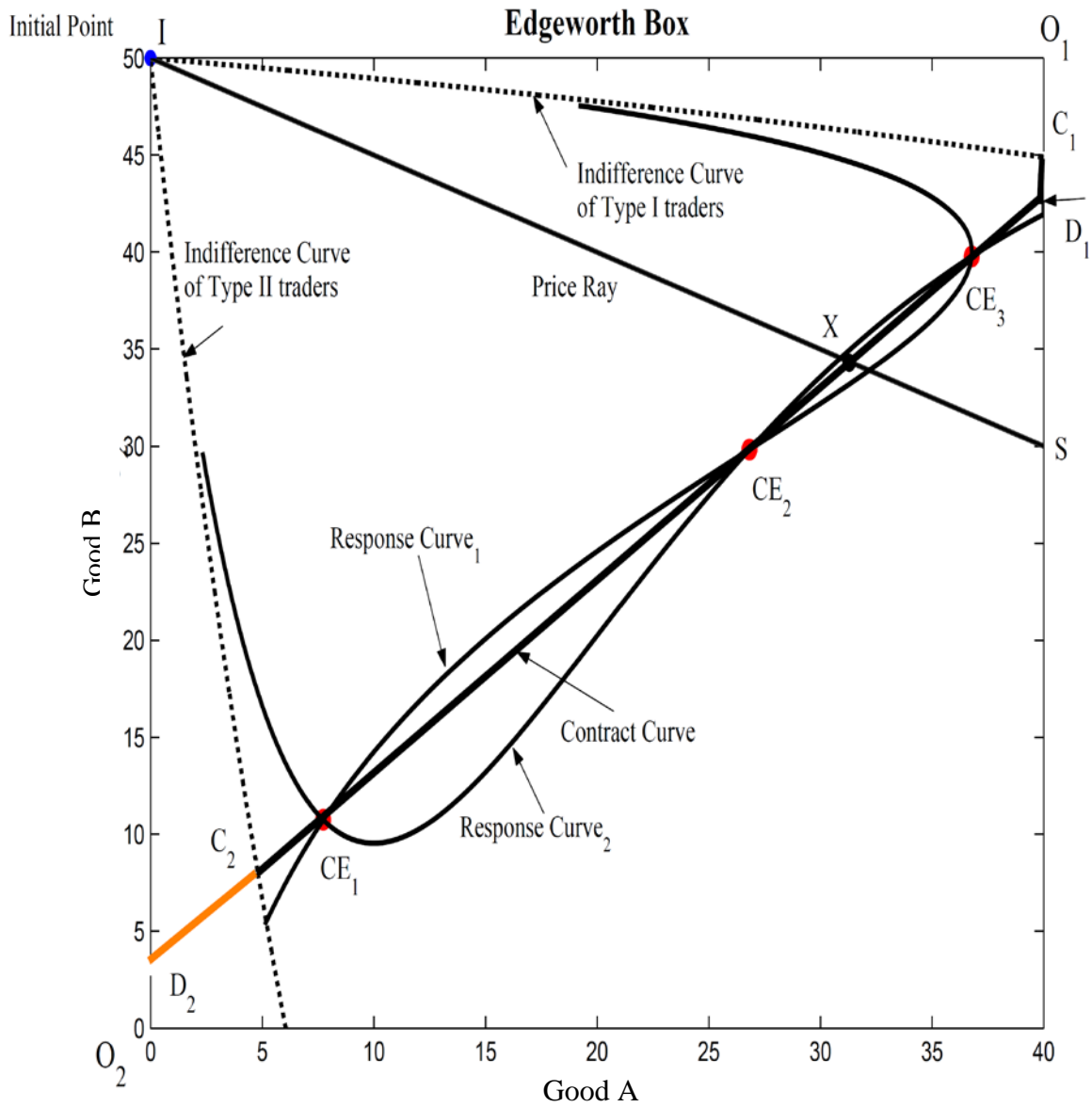
**Table 1: Experimental Design**

Ten subjects in each run (five of type 1 each with endowment of (A=40, B=0, M=100), and five of type 2 each with endowment of (A=0, B=50, M=100))

	<b>Parameters</b>	<b>CO (Carried over)</b>	<b>RI (Re-initialized)</b>	<b>Equilibrium Allocations of goods A and B to type 1 subjects*</b>
<b>Main Runs</b>	$\mu_1 = 1, \mu_2 = 0.28,$	Six 15-period runs	Four 15-period runs	(36.78, 39.77)
	$\mu_1 = 1, \mu_2 = 0.75,$	Six 15-period runs	Four 15-period runs	(26.83, 29.82)
	$\mu_1 = 1, \mu_2 = 5.07,$	Six 15-period runs	Four 15-period runs	( 7.74 , 10.74)
<b>Robustness Checks</b>	$\mu_1 = 1, \mu_2 = 1,$	Two 15-period runs	One 15-period run	(26.97, 23.03)

\*Equilibrium allocations of type 2 subjects are the complements of allocations of type 1 given in the table. Equilibrium trading volume is the difference between endowment and equilibrium allocation.

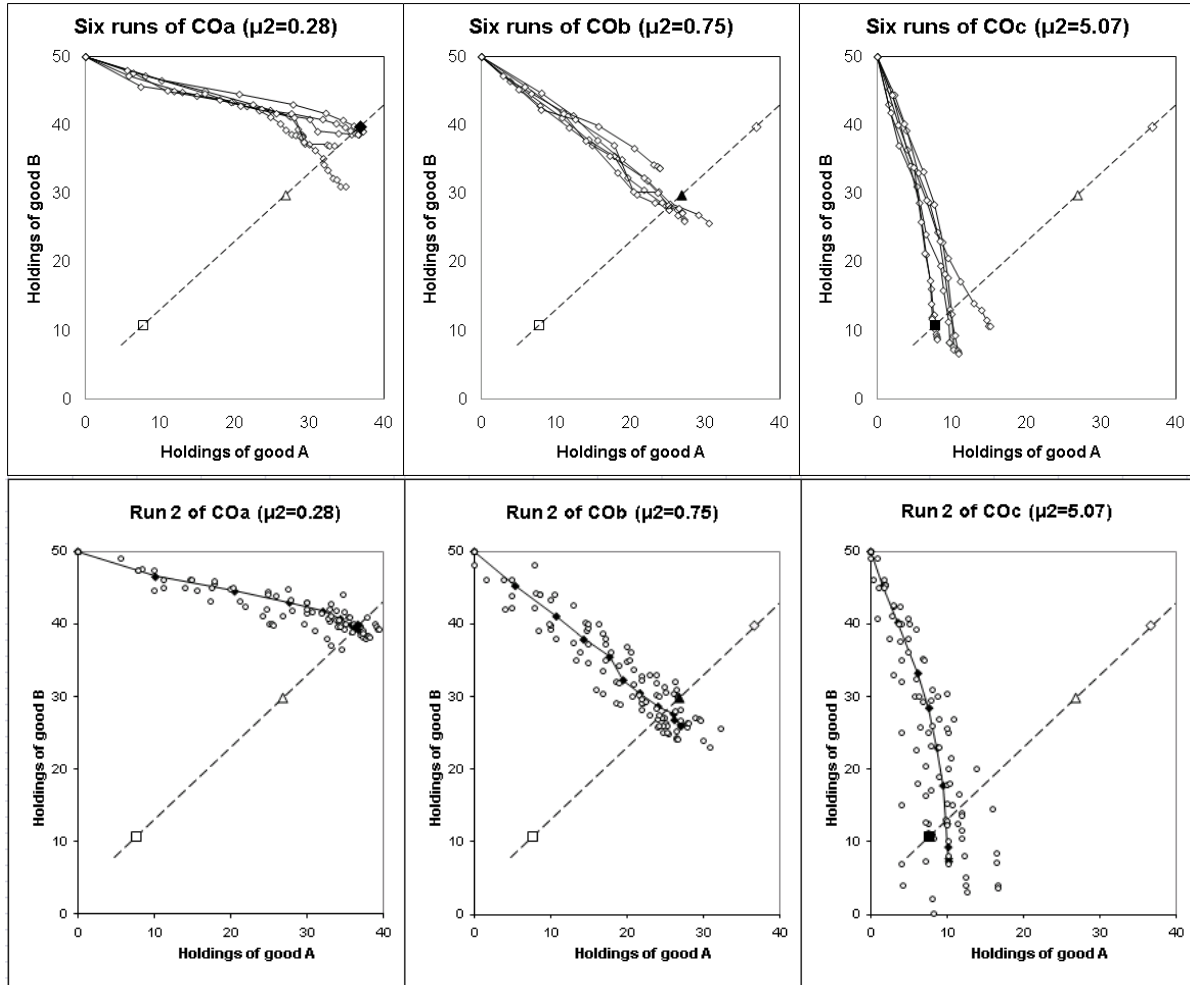
**Figure 1: An Exchange Economy with Two Goods and Three Competitive Equilibria**  
 (Reproduced from Shapley and Shubik 1977, Fig. 1, p. 874)



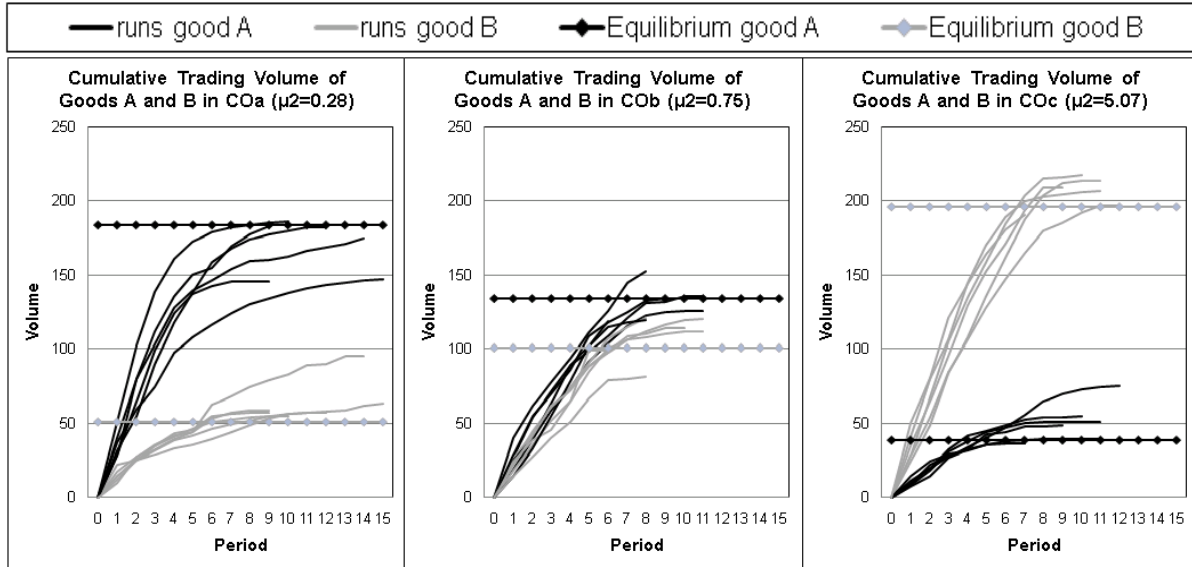
**Figure 2: Paths of Holdings of Goods A and B over Periods in treatment CO**  
 (with goods and money balances carried over period-to-period).

Top Panels: Trader-type averages in six independent runs for each default penalty.

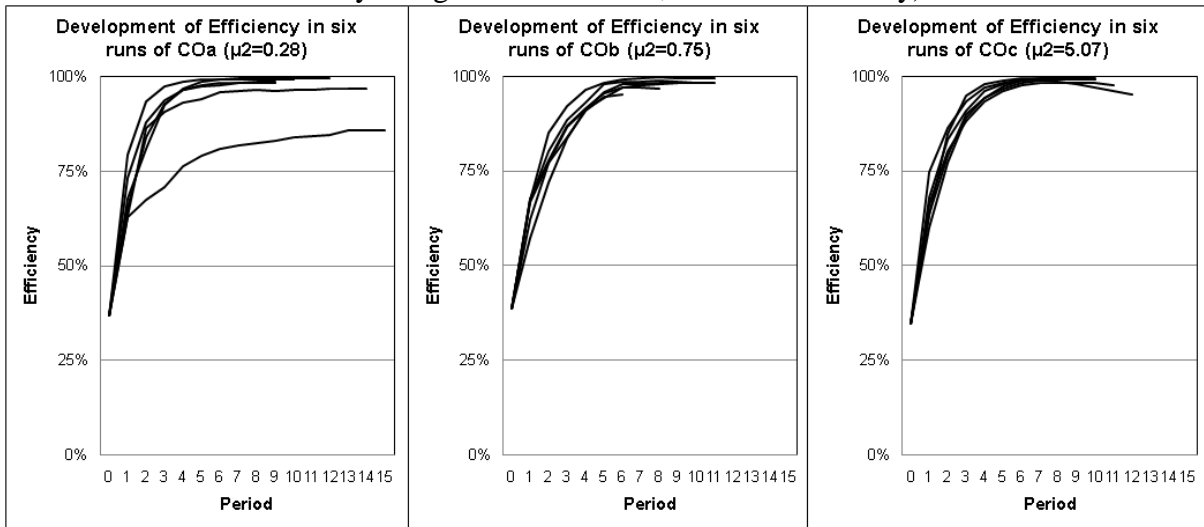
Bottom Panels: Trader-type average and individual holding details of run 2 for each default penalty.



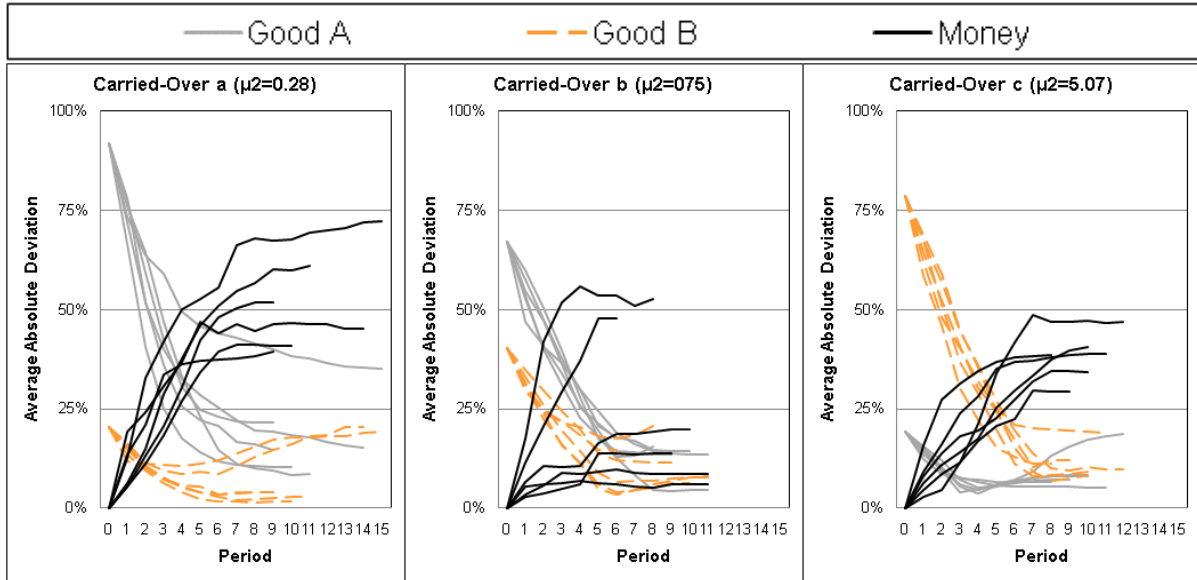
**Figure 3: Time Series of Cumulative Trading Volume for Goods A and B (in six independent runs for each default penalty with money and goods carried over period-to-period; Period 0=autarky)**



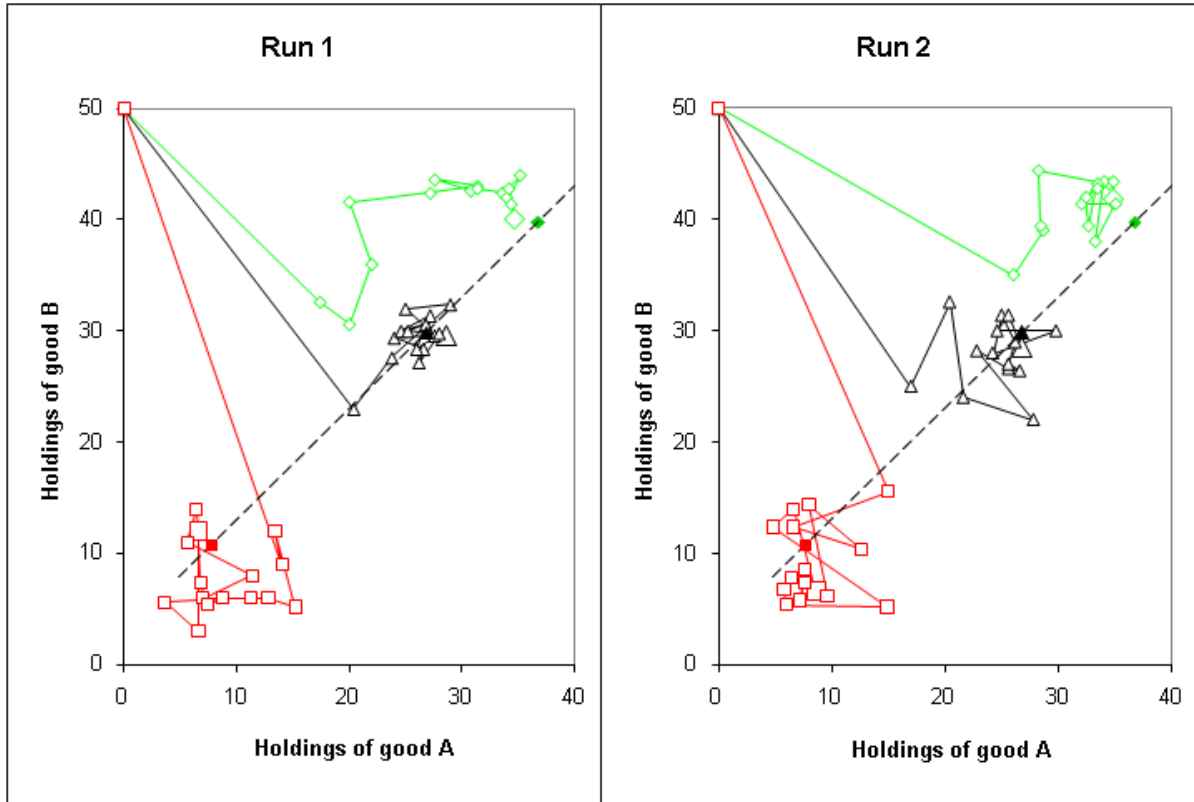
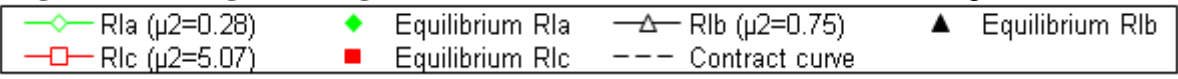
**Figure 4: Development of Efficiency (in six independent runs for each default penalty with money and good carried over; Period 0 = autarky)**

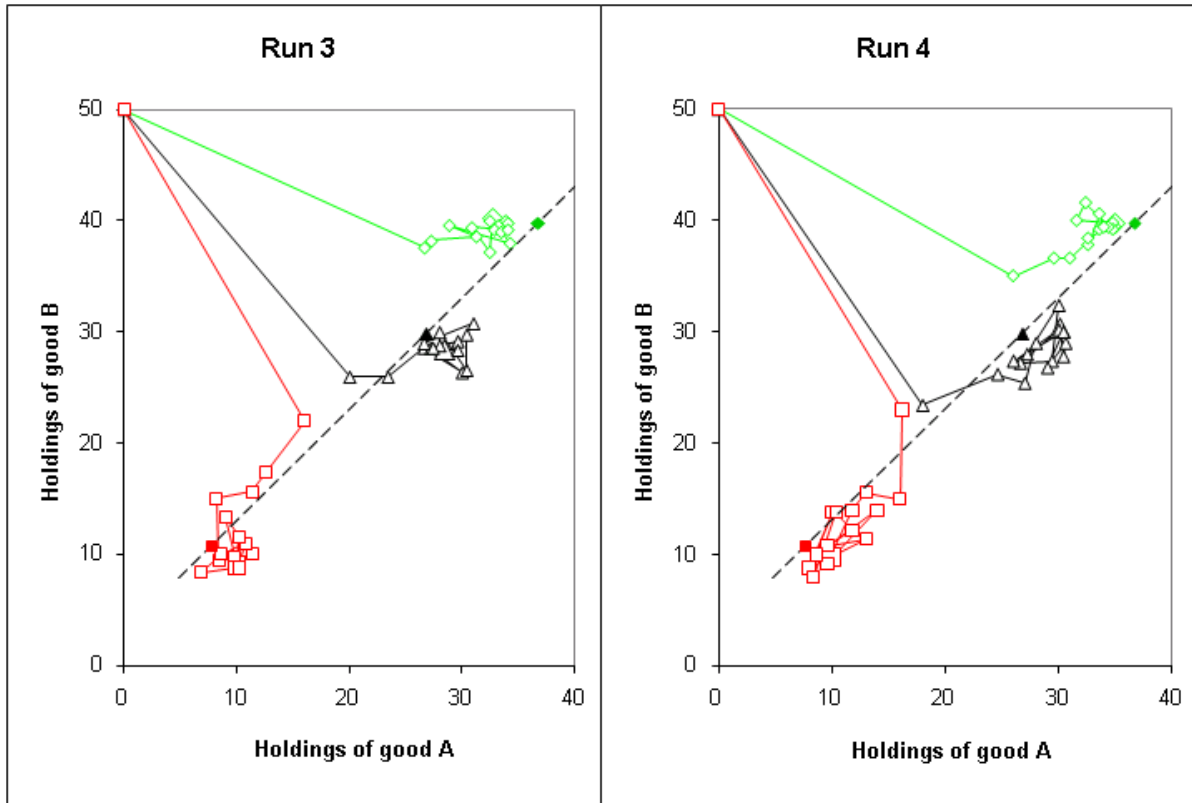


**Figure 5: Development of Average Absolute Deviation of Holdings of Goods A, B and Money Holdings from the Respective Equilibrium Predictions in Percent of Initial Holdings in Treatment CO (six runs for each default penalty, Period 0 = autarky)**



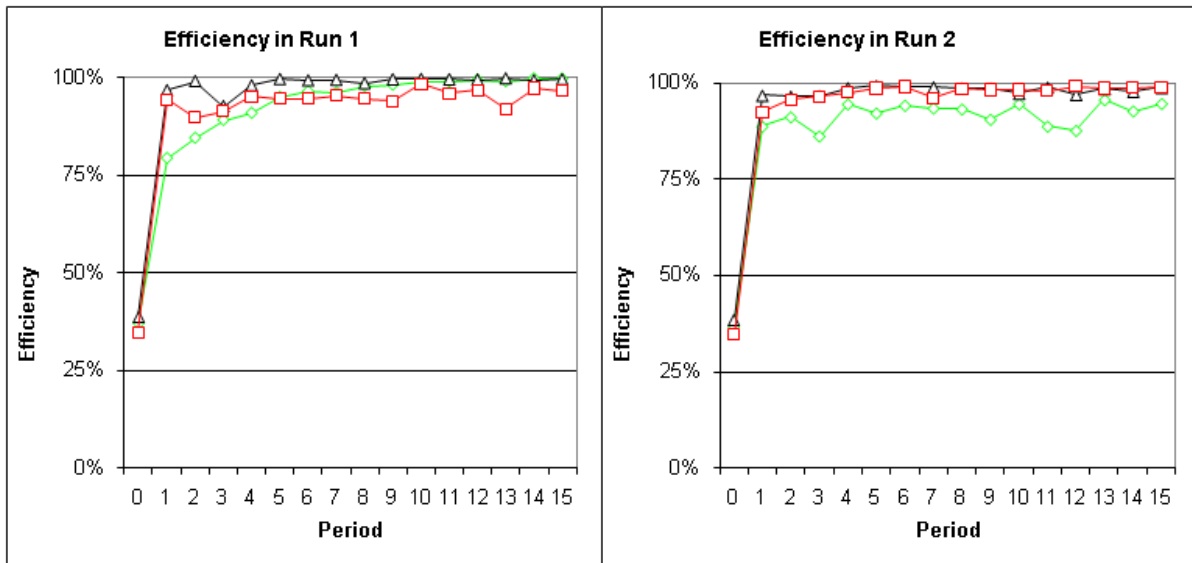
**Figure 6: Average Holdings of Goods A and B in Treatment RI (holdings reinitialized)**

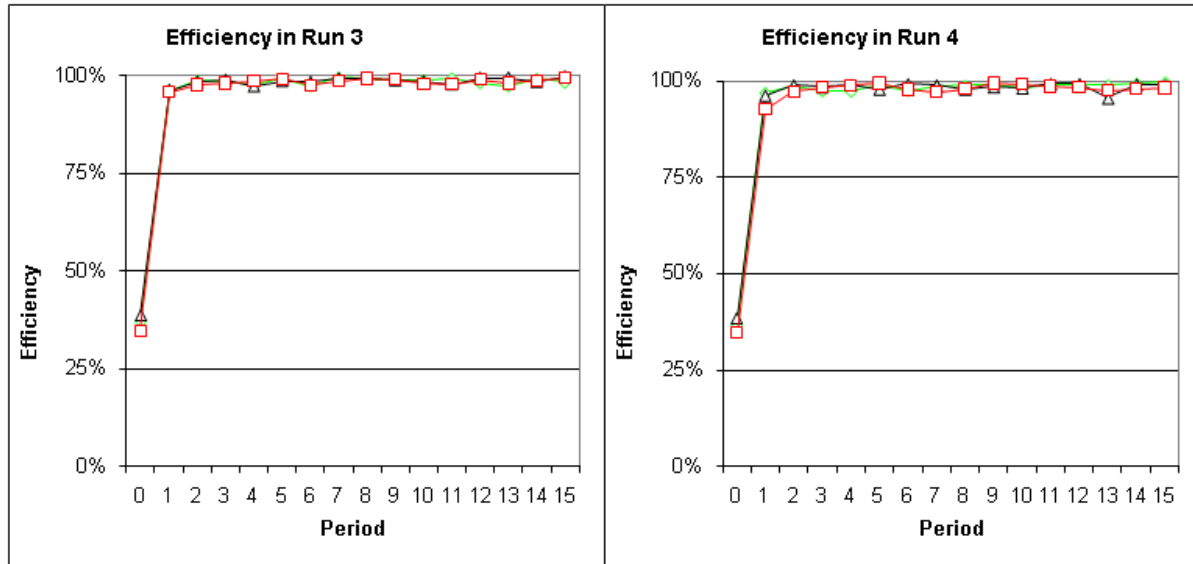




**Figure 7: Development of Efficiency in Treatment RI (reinitialized, Period 0 = autarky)**

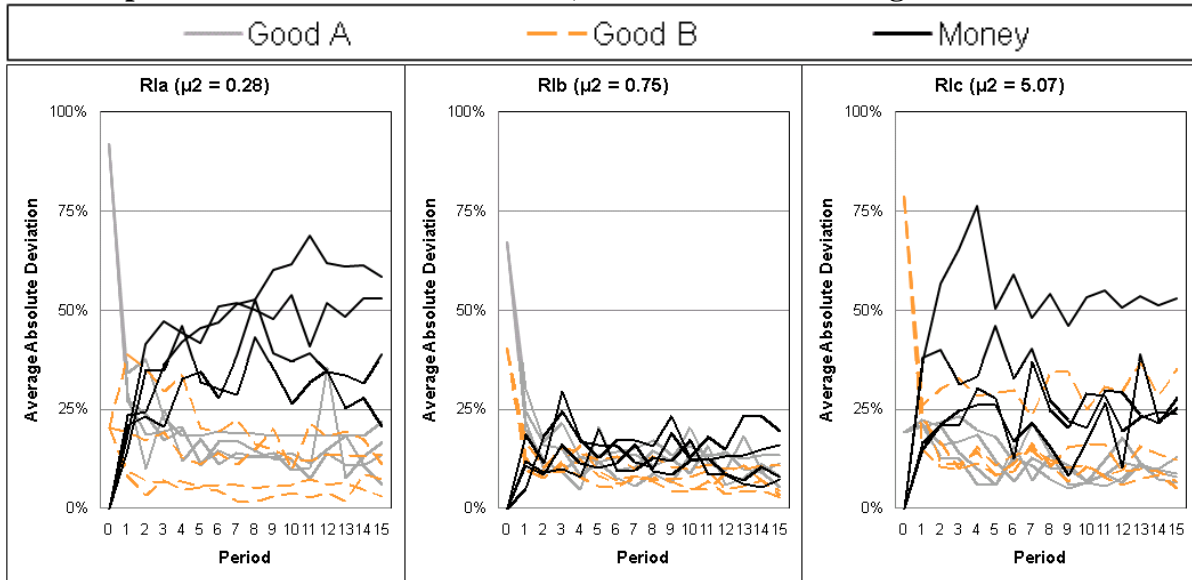
◆ R1a ( $\mu_2=0.28$ )   
 ▲ R1b ( $\mu_2=0.75$ )   
 ◻ R1c ( $\mu_2=5.07$ )



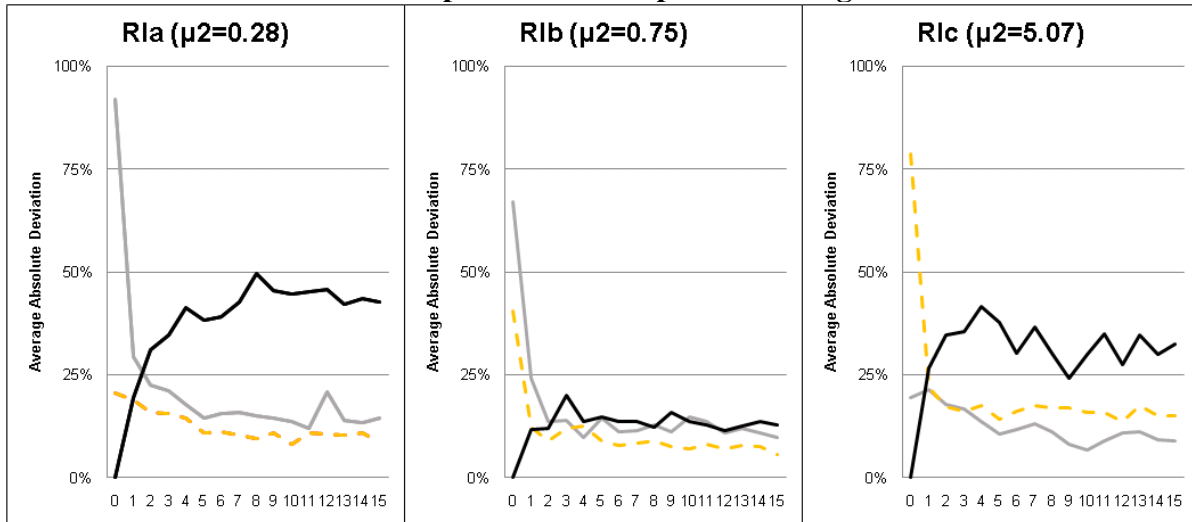




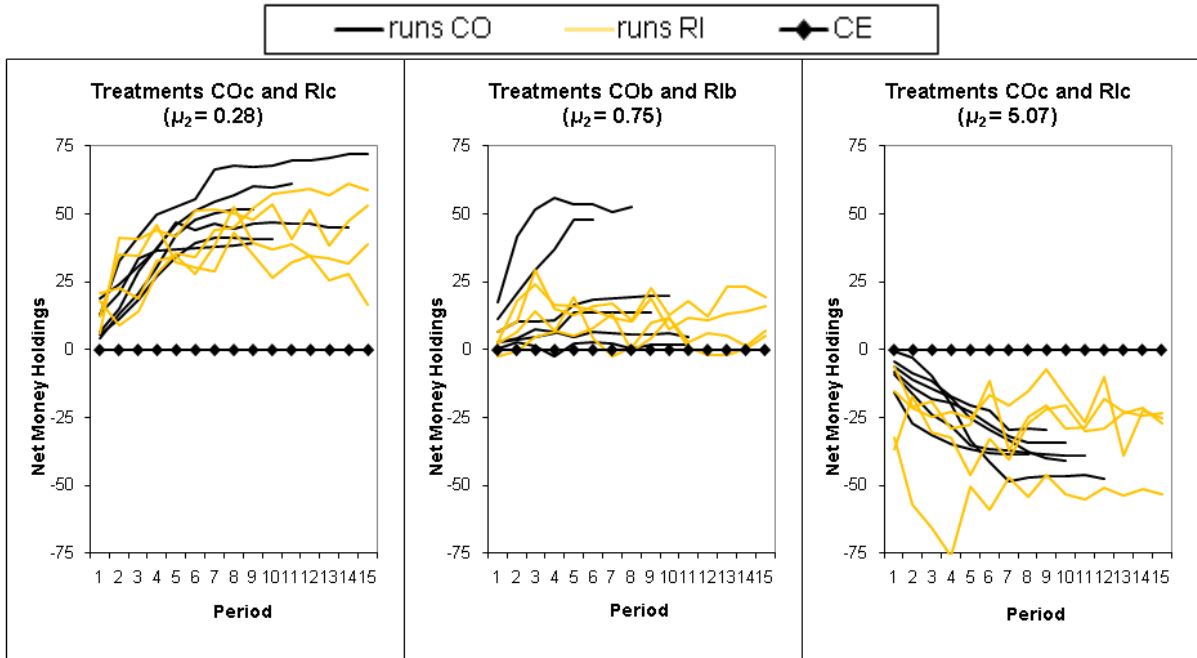
**Figure 8: Development of Average Absolute Deviation of Holdings of Goods A, B and Money Holdings from the Respective Equilibrium Predictions in Percent of Initial Holdings in Treatment RI (four runs for each default penalty, Period 0 = autarky)**  
**Top Panels: data of individual runs; Bottom Panels: Averages across 4 runs**



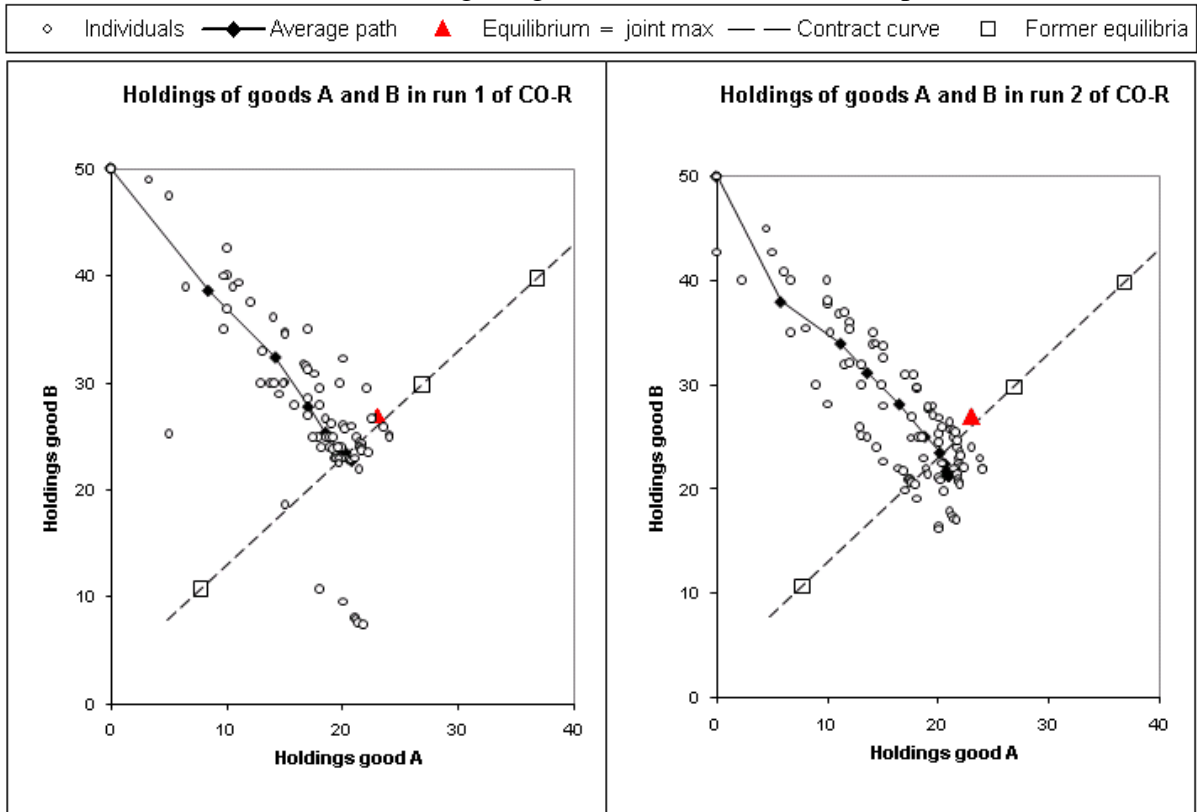
**For comparison: the respective averages**



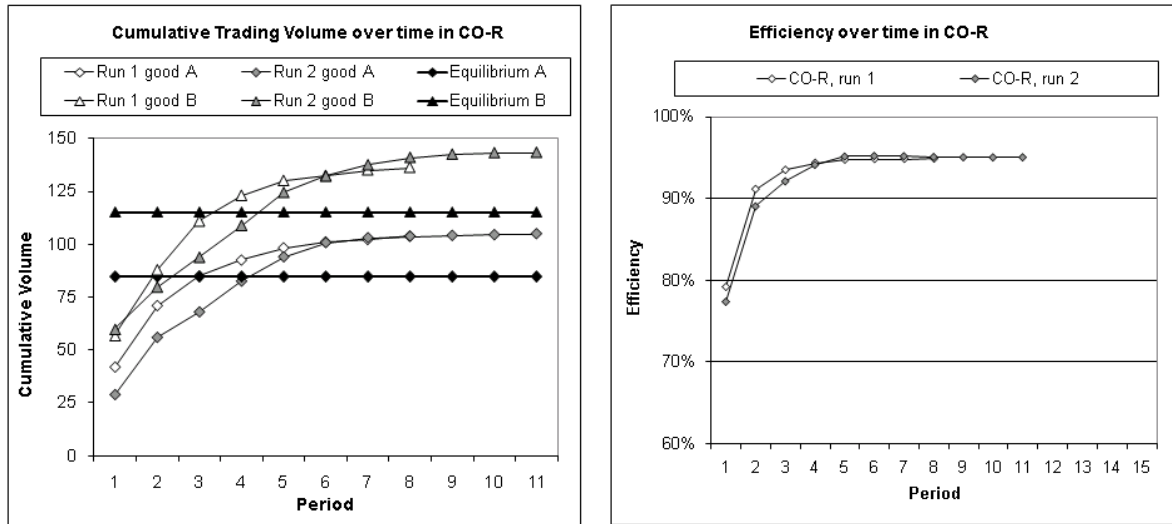
**Figure 9: Development of Average Net Money Holdings for Subjects endowed with Good A in Treatments CO (holdings carried over) and RI (holdings re-initialized)**



**Figure 10: Holdings of Goods A and B in the two Runs of Treatment CO-R (Robustness check with holdings of goods carried over from one period to the next)**



**Figure 11: Time Series of Cumulative Trading Volume (left Panel) and Efficiency (right Panel) per Period in Treatment CO-R. Run 2 is shaded grey.**



**Figure 12: Holdings of goods A and B (left Panel) and Efficiency (right Panel) per Period in Treatment RI-R (holdings re-initialized)**

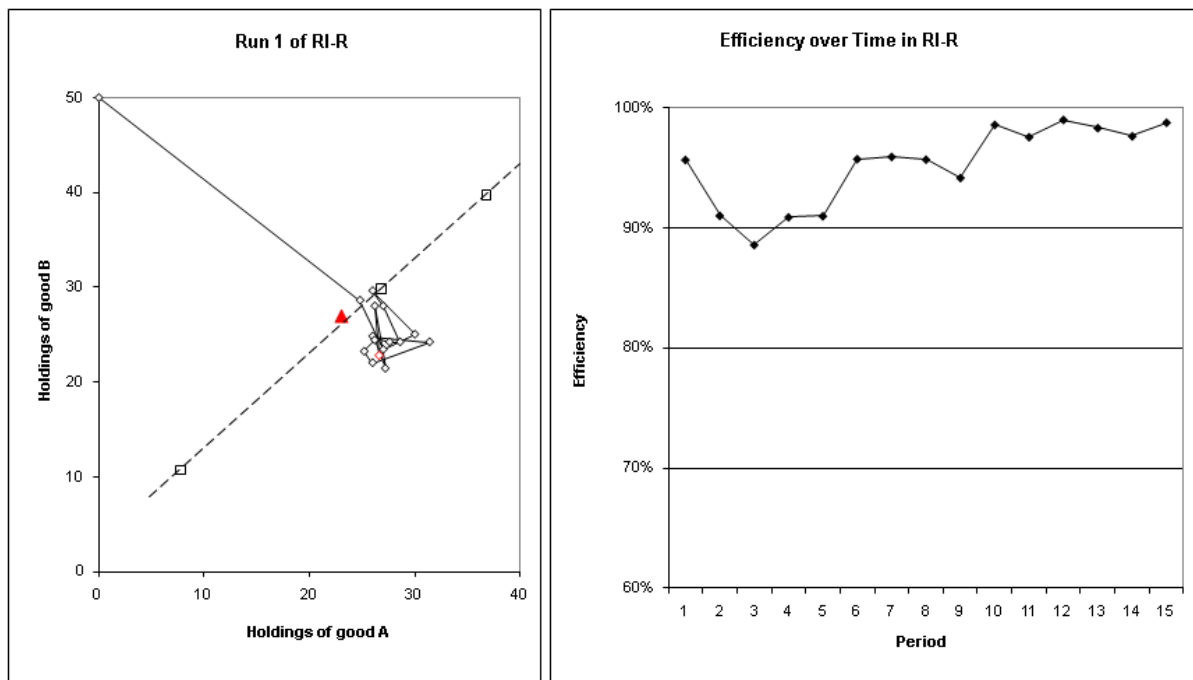
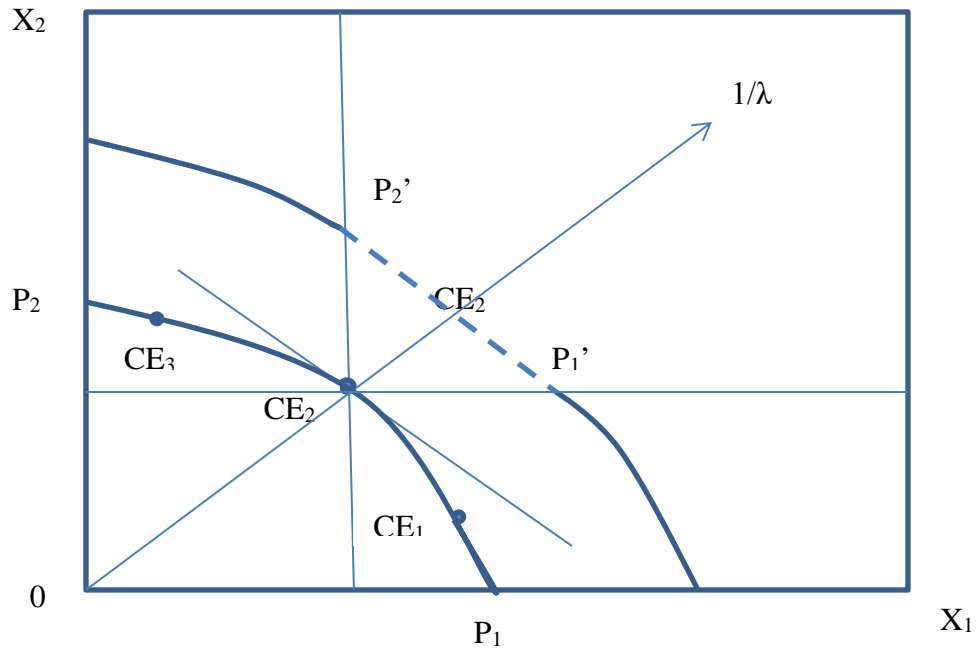


Figure 13: Flattening of the Pareto Surface



## Appendix 1: Instructions for Treatments RI and RI-R (only $\mu_2$ varied)

### General

This is an experiment in market decision making. If you follow these instructions carefully and make good decisions, you will earn more money, which will be paid to you at the end of the session.

This session consists of several periods and has 10 participants. At the beginning of each period, each of the five participants will receive 40 units of good A, and each of the other five will receive 50 units of good B. In addition each participant will receive 100 units of money at the start of each period. In each of some 10 to 20 period you will have the opportunity to offer your goods for sale and to buy the other goods.

Each participant is free to offer for sale any part or all the goods he/she owns each period. You earn points for your holdings of good and money at the end of each period. Holdings of goods and money are not carried over from period to period; you start each period with 100 units of money and either 40 units of A or 50 units of B.

During each period we conduct a market in which the price per unit of A and B will be determined. All units of A and B put up for sale will be sold at their respective price, and you can buy units of A and B at the same price. The following paragraphs describe how the price per unit of A and B will be determined.

In each period, you are asked to enter the cash you are willing to pay to buy the good you do not own (say A), and the number of units of the good you own that you are willing to sell (say B) (see the center of Screen 1). The cash you **bid to buy cannot exceed your money balance (100)**, and the units you **offer to sell cannot exceed your holdings of that good (40 of A or 50 of B)**. You receive the income from the sale of any goods to be paid in money at the end of each period.

The computer will calculate the sum of the amounts of good A offered by all participants ( $= \text{Sum}_A$ ). It will also calculate the total number of units of money offered to buy the goods ( $\$ \text{Sum}_A$ ) and determine the price of A expressed in terms of money,  $p_A = \$ \text{Sum}_A / \text{Sum}_A$ . The same is done with good B.

If you offer  $q_A$  units of A for sale, you will get an income of  $q_A * P_A$ . If you bid  $b_A$  units of money to purchase A, you will get  $b_A / P_A$  units of good A.

**Screen 1: trading screen for a trader endowed with good B**

Period	1	Remaining time [sec]: 24
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You have:

Units of good A you own: 0

Units of good B you own: 50

Units of money: 100

Units of B you sell

Amount you offer to pay to buy A

Both goods are perishable and must be either sold or consumed in the current period. The number of units of A and B you own at the end of the period,  $c_A$  and  $c_B$  (unsold units of owned good and purchased units of the other good) will be consumed and determine the number of points you earn for the period. Traders initially endowed with A earn:

$$\text{Points} = (1/\mu) * (A + 100 * (1 - e^{-(B/10)})) + \text{NET MONEY}$$

COMMENT:  $\mu = 1$  in R-R, 0.28 in Ra, 0.75 in Rb, and 5.07 in Rc.

And traders endowed with B earn

$$\text{Points} = B + 110 * (1 - e^{-(A/10)}) + \text{NET MONEY}$$

*Example: If at the end of any period you are endowed with B and have 30 units of A and 15 units of B you earn  $15 + 110 * (1 - e^{-(30/10)}) = 119.5$  points.*

Your cash balance holdings will help determine the points you earn. At the end of each period the starting endowment of 100 units of money will be deducted from your final

money holdings. The resulting net holdings (which may be negative) will be added to (or subtracted from) your total points earned.

Screen 2 shows an example of calculations for Period 2. There are 10 participants in the market, and half of them have 40 units of A, the other half 50 units of B. Here we see a subject starting with 40 units of good A.

Information on bids and transactions in good A

Information on bids and transactions in good B

Earnings calculation

Cumulative earnings so far. This number/60 will be the US-\$ you get

Period		2		Remaining time [sec]: 28			
Total amount offered for A    333 Units of A offered for sale    179 Price of A    1.9  Units of A you sold    35 Proceeds from sales of A    65  Units of A you own at end of period    5	Total amount offered for B    104 Units of B offered for sale    71 Price of B    1.5  Amount you offered for B    10 Units of B you buy    7  Units of B you own at end of period    7	Money at start of period    100 Proceeds from selling A and B    65 - Payment for buying A and B    10 Money balance at end of period    155  Points earned <b>Your earnings this period: 68</b> =0.2 * (A+100(1-e <sup>-B/10</sup> ))) + net change in money					
period	price A	consumption of A	price B	consumption of B	Money	earnings	cumulative earnings
1	1.8	10	1.3	7	161	74	74
2	1.9	5	1.5	7	155	68	141

The earnings of each period are added up in the last column. At the end they will be converted into real Dollars at the rate of 60 points = 1 US\$ and this amount will be paid out to you.

**How to calculate the points you earn (in sub-treatments COc and RIc):**

The points those initially endowed with A earn each period are calculated as:

$$\text{Points} = (A + 100 * (1 - e^{(-B/10)})) + \text{Net Money}$$

And the points those initially endowed with B earn each period are calculated as:

$$\text{Points} = 1/5.07 * (B + 110 * (1 - e^{(-A/10)})) + \text{Net Money}$$

The following tables may be useful to understand this relationship. They show the resulting points from different combinations of goods A and B (assuming net money to be zero).

**Table for those initially endowed with A:**

		Units of good A you hold at the end of a period										
		0	5	10	15	20	25	30	35	40	45	50
Units of B you hold	0	0.0	5.0	10.0	15.0	20.0	25.0	30.0	35.0	40.0	45.0	50.0
	5	39.3	44.3	49.3	54.3	59.3	64.3	69.3	74.3	79.3	84.3	89.3
	10	63.2	68.2	73.2	78.2	83.2	88.2	93.2	98.2	103.2	108.2	113.2
	15	77.7	82.7	87.7	92.7	97.7	102.7	107.7	112.7	117.7	122.7	127.7
	20	86.5	91.5	96.5	101.5	106.5	111.5	116.5	121.5	126.5	131.5	136.5
	25	91.8	96.8	101.8	106.8	111.8	116.8	121.8	126.8	131.8	136.8	141.8
	30	95.0	100.0	105.0	110.0	115.0	120.0	125.0	130.0	135.0	140.0	145.0
	35	97.0	102.0	107.0	112.0	117.0	122.0	127.0	132.0	137.0	142.0	147.0
	40	98.2	103.2	108.2	113.2	118.2	123.2	128.2	133.2	138.2	143.2	148.2
	45	98.9	103.9	108.9	113.9	118.9	123.9	128.9	133.9	138.9	143.9	148.9
50	99.3	104.3	109.3	114.3	119.3	124.3	129.3	134.3	139.3	144.3	149.3	

**Table for those initially endowed with B:**

		Units of good A you hold at the end of a period										
		0	5	10	15	20	25	30	35	40	45	50
Units of B you hold	0	0.0	8.5	13.7	16.9	18.8	19.9	20.6	21.0	21.3	21.5	21.6
	5	1.0	9.5	14.7	17.8	19.7	20.9	21.6	22.0	22.3	22.4	22.5
	10	2.0	10.5	15.7	18.8	20.7	21.9	22.6	23.0	23.3	23.4	23.5
	15	3.0	11.5	16.7	19.8	21.7	22.9	23.6	24.0	24.3	24.4	24.5
	20	3.9	12.5	17.7	20.8	22.7	23.9	24.6	25.0	25.2	25.4	25.5
	25	4.9	13.5	18.6	21.8	23.7	24.8	25.5	26.0	26.2	26.4	26.5
	30	5.9	14.5	19.6	22.8	24.7	25.8	26.5	27.0	27.2	27.4	27.5
	35	6.9	15.4	20.6	23.8	25.7	26.8	27.5	27.9	28.2	28.4	28.5
	40	7.9	16.4	21.6	24.7	26.6	27.8	28.5	28.9	29.2	29.3	29.4
	45	8.9	17.4	22.6	25.7	27.6	28.8	29.5	29.9	30.2	30.3	30.4
50	9.9	18.4	23.6	26.7	28.6	29.8	30.5	30.9	31.2	31.3	31.4	



## Appendix 2: Money side payments and dynamics

In static GE models multiple equilibria may exist. Shapley and Shubik (1977) present an example of a simple economy with two types of traders trading in two goods that has 3 competitive equilibria. Since the existence of money is a phenomenon involving dynamics, in our experiments we consider dynamic games based on the Shapley Shubik example. In order to do so the market mechanism, the means of payment, and the initial and terminal conditions and the final payoffs are specified.

In our experiment we consider the existence of a money that appears as a linear separable term that can be interpreted equally well as either a commodity or a fiat money. In essence, the difference between the two is that a commodity money is a durable asset, which at any time has two alternative uses. It can provide a stream of services as a production or consumption good (e.g., gold as jewelry or as high conductivity coating in semiconductors) or it can be used in transactions as a money; but it cannot serve the two functions simultaneously. Fiat money, in contrast, has only the second of the two functions. In a finite horizon game, say ending at time  $T$ , both the fiat or the commodity money are durable (non-depreciating) assets that must be left over after the game. In order to completely define the game we may set time  $T+1$  as the day of final settlement—when scores are totaled and agents paid. In modeling, a decision must be made as to whether any terminal valuation is attached to the left over money. A fairly natural answer is yes. If the salvage value is positive this prevents the backward induction proof that the only equilibrium is no trade (this “theorem,” while logically valid, is not supported by most experimental evidence.)

The interpretation is clear, if the game is a time slice out of a continuing process the salvage value is the expectation of the future worth of the asset, but this implicitly takes into account the dynamics of money. The linearity of the worth of the money is not intrinsic to its worth in the utility function; but it is to its dynamically induced worth in its shadow price satisfying the cash flow constraints.

If we are concerned with conditions that promote the chances of a CE being approached in the play of the game, the natural setting for the salvage value of money at the end is  $\min(\mu_{1j}, \mu_{2j})$  where  $j = 1, 2, 3$  identifies one of the three competitive equilibria, the  $\mu$ 's are the Lagrangian multipliers for type 1 and type 2 traders at that CE. There are 3 pairs of  $\mu$ 's, one for each of the three CE. Without loss of generality we have a degree of freedom

that we can use to set  $\mu_1=1$ . Figure 13 shows what happens in an economy when we select an equilibrium point and pour in money at ratio of  $\mu_{2j}/\mu_{1j}$ .  $P_1$  to  $P_2$  is the Pareto surface when no money is added. As the money is added and has a worth to each of  $\mu_{1j}(m_1)$  and  $\mu_{2j}(m_2)$  (where  $m_i$  is the amount) of money held by trader type  $i$ ) the individual rationality point moves out along  $O$  towards  $CE2$  and the new Pareto optimal surface has a flat area as indicated by  $P_1'$  to  $P_2'$ . The CE of the new game with enough money poured in will be at  $CE2'$ . This has the property that each individual at equilibrium ends up with his initial supply of money and the same goods distribution as at  $CE2$  without money. The difference between the two is that the money has acted as a catalyst permitting the exchange to satisfy the cash flow as well as the wealth constraints.

(Insert Fig 13 around here)

We may construct a linear part of the Pareto optimal surface and show two CEs, one for the no-side-payment economy and the other for the side-payment economy for each of the three CEs. Our construction both in theory and laboratory picks out a unique CE and satisfies cash flow constraints.

We now may ask a different question and go for a different construction. Could there be any reason or way that the economy is guided away from the CEs. It is here that bankruptcy enters. Imagine a passive government that sets the rules. It decrees a bankruptcy penalty: it is willing to lend money at  $\mu^*$ , but deducts  $\mu^*$  times the amount owed if they are unable to pay. It is easy to see that if  $\mu_1 < \mu^* < \mu_2$ , the first type will not wish to borrow, but the second type will. Their borrowing will be bounded as they obtain more goods. (The specific mathematical model of two types and two goods are given in Quint and Shubik book, pp. 113-4). This leads to a boundary equilibrium away from the CEs.

Select a point on the PO surface away from the CEs, We may imagine that at the termination all agents are required to return to the referee their initial endowment of money, but if they are unable to repay in full, the amount owed is deducted from the payoff. If a trader runs a surplus at the end the amount is added to the payoff.