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Introduction

Lucrezia Reichlin and Kenneth D. West

The International Seminar on Macroeconomics (ISOM) meets every June in a different European city, bringing together American and European economists to study a variety of topics under the very broadly-defined rubric of macroeconomics. The tradition started in 1978. During the first half of its life it was popularly known as the Gordon-deMenil seminar. Jeffrey Frankel is now codirector of ISOM, with Francesco Giavazzi as his European counterpart. Since 2004, NBER has been the sole sponsor of ISOM, and the proceedings are published as the *NBER International Seminar on Macroeconomics*. We continue to work with a local host in a different European country each summer, and to divide the authors and discussants equally between Americans and Europeans.

This volume contains a selection of the papers originally presented at the 29th International Seminar on Macroeconomics, which took place in Tallinn on June 16–17, 2006. The meeting was hosted by the Bank of Estonia and particularly by Mr. Marten Ross (Deputy Governor, Bank of Estonia). In 2006 the program was organized by Lucrezia Reichlin and Kenneth D. West. The decision regarding publication of each paper is made by a committee consisting of the six members of the ISOM board, with the advice of a referee when necessary. NBER ISOM 2006 is the third annual installment appearing as a companion volume to the *NBER Macroeconomics Annual*.

Overview of the Volume

The seven papers published in the 29th volume of ISOM cover quite a range of topics. While the subject matter of the papers ranges widely, one can weave some overarching themes. The seven chapters fall into three categories. Part I deals with labor markets, part II with productiv-

ity and international business cycles, part III with fiscal and monetary policy and stability.

Part I: Labor markets

The first section is on labor markets. Both papers study quantitative implications for the behavior of key labor market variables of different models at business cycle frequencies.

The first chapter in this section, by Morten Ravn, analyzes quantitatively the business cycle implications of the Mortenson and Pissarides (1994) and Pissarides (2000) style labor market matching model with endogenous labor market participation. Ravn models the participation choice as a tradeoff between foregoing expected benefits of actively searching and engaging in a costly labor market search. The focus on business cycles is novel in the literature and reveals two counterfactual implications of the model: low volatility of the vacancy-unemployment ratio and procyclical unemployment. These implications are derived from an analytical expression implied by the model in which labor market tightness is a linear function of consumption, which explains the title "the consumption-tightness puzzle". It remains to be seen if the counterfactual implications of the model can be corrected by modeling search differently, as claimed by Julio Rotemberg in his discussion, or whether they signal a more fundamental problem in that framework.

The second chapter in part I is "Cyclical Wages in a Search and Bargaining Model with Large Firms," by Julio Rotemberg. Rotemberg's study is motivated by the well-known fact that real wages are mildly procyclical. Models in which the business cycle is driven by technology shocks tend to predict that real wages will be strongly procyclical, at least when wages are set flexibly. As in some earlier literature, Rotemberg uses a search model to determine wages. He assumes that firms have market power, and in contrast to earlier literature he allows for exogenous variation in the elasticity of demand. Rotemberg considers various calibrations of his model. When the elasticity of demand is held constant, and technology shocks drive the cycle, the elasticity of the wage with respect to employment is implausibly high. But when shocks to the elasticity of demand drive the cycle, the elasticity of the wage with respect to employment is moderate.

Part II: Productivity and international business cycles

This part focuses on open economy issues. The chapter by Corsetti, Dedola, and Leduc is an empirical investigation of the effect of technological shocks on international variables such as the real exchange rate and the trade balance. The findings, based on a sample of five G7 countries, challenge common views in the literature that supply shocks deteriorate the terms of trade on impact. They suggest shocks that increase permanently domestic labor productivity in manufacturing relative to other G7 countries raise relative consumption, deteriorate net exports and raise the relative price of nontradables. The response of the real exchange rate differs across countries, with relative price depreciation in small open economies such as Italy and the United Kingdom, and appreciation in the largest economies, such as the United States and Japan. These findings not only challenge common views, but, if proved correct, would imply that the high productivity growth of the United States relative to other industrialized countries will be the cure for its trade deficit, thereby shedding new light on the debate on global imbalances.

In "Production Sharing and Business Cycle Synchronization in the Accession Countries," the second paper in part II, Linda Tesar considers the role of trade in the transmission of business cycles between the accession countries and the more mature economies of Western Europe. Tesar begins by documenting the characteristics of trade between selected European countries. She notes (in particular) that the data, which unfortunately are not particularly detailed or comprehensive, suggest that a fair amount of East-West trade involves vertically integrated production chains, thus implying production sharing across countries. She develops a model that allows trade in intermediate goods that are complements (which she calls standard trade flow) and trade in intermediate goods that are substitutes (production sharing). In the model, productivity shocks are the source of business cycles. She calibrates the model and finds that if trade is standard there is little transmission of business cycles across Europe, whereas if there is production sharing there is substantial transmission with positive correlation. She notes that this result has implications for monetary policy, since positive cyclical correlations conventionally are thought to imply benefits to monetary policy coordination.

Part III: Fiscal and monetary policy and stability

This section addresses different issues in fiscal and monetary policy. The chapter by Bovenberg and Uhlig provides a quantitative characterization of optimal intergenerational risk sharing in a stochastic overlapping generation model. The analysis, carried out in a log-linear framework, makes it possible to understand the role of preferences and technology in the optimal policy mix. Bovenberg and Uhlig show three results. First, for reasonable parameter values, the old typically bear a larger burden of the risk of productivity shocks. Second, even when population grows, consumption of the old and the young move in the same direction. Third, the optimal response to persistent unexpected increases in longevity is to shift resources towards future consumption at the expense of current workers and current retirees. The response to an increase in longevity involves an increase in capital investment, a decline in worker consumption, and such a large decline in retiree consumption per unit of time that total retiree consumption declines. The negative effect on total retiree consumption contrasts to what was found in related work by Bohn (2001, 2005), who is one of the discussants and challenges the result and claims that this is the effect of an unrealistically high elasticity of intertemporal substitution.

In the second chapter in part III, Troy Davig and Eric Leeper allow monetary policy to switch endogenously between more and less aggressive stances, depending on the level of inflation. In "Endogenous Monetary Policy Regime Change," the authors begin with a conventional Taylor rule, in which the interest rate is set in response to the level of inflation and the output gap. In contrast with earlier literature, however, they allow the magnitude of response to the inflation and output gap to vary with the level of inflation and output gap. Importantly, and again in contrast to earlier literature, this variation is endogenous. In the simplest setup, policy is more aggressive when inflation is above a given threshold π^* than when inflation is below the threshold. The authors also consider richer models in which the output gap or expected inflation play a role in determining whether monetary policy switches. The authors calibrate various versions of their model and find that regime switching leads to qualitative changes that are quantitatively important. There is a preemption effect in the unaggressive regime, as the response to a positive demand shock is muted because private agents factor in the possibility that a rise in inflation will cause the monetary authority to switch to aggressive policy. Also, shocks have asymmetric effects, be-

cause some shocks bring the economy closer to a regime switch and some take the economy farther away.

The last chapter, by Giannitsarou and Scott, investigates three questions on the fiscal behavior of the United States, Japan, Germany, the United Kingdom, Italy, and Canada since 1960: (1) is current fiscal policy sustainable, (2) how have OECD governments achieved fiscal sustainability in the past decades, and (3) what are the implications for inflation of projected rising fiscal deficits? The analysis exploits implications of the intertemporal budget constraint of the government on the relation between a ratio of current liabilities to the primary deficit with future values of inflation, interest rates, GDP, narrow money growth, and changes in the primary deficit. The main finding is that fiscal imbalances are mainly removed through adjustments in the primary deficit with inflation playing a less important role. Overall the authors claim post-WWII evidence suggests that anticipated future increases in fiscal deficits need not necessarily have a substantial impact on inflation.