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## Introduction

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In June 2007 the International Seminar on Macroeconomics (ISoM) met in Istanbul. The seminar convened—as it has done year after year since 1978—a group of about thirty European and American economists to study a variety of topics within macroeconomics, defined very broadly. As it has become customary, we have been hosted by a European central bank, this year the Central Bank of Turkey. Authors, discussants, and participants were equally divided between Americans and Europeans.

After a long association with the *European Economic Review* and the *Journal of the European Economic Association*, a selection of the papers presented in the past four seminars were published by MIT Press in three volumes entitled *NBER International Seminar on Macroeconomics*. Starting last year a selection of the ISoM papers was published by the University of Chicago Press. This volume is the second in the new series.

The volume contains a selection of the papers originally presented at the thirtieth ISoM meeting, which took place in Istanbul on June 15–16, 2007. We thank our hosts at the Central Bank of Turkey, and particularly Hakan Kara and the two deputy governors, Erdem Başçı and Mehmet Yorukoglu, who have also kindly accepted to serve as discussants. The program was organized by Richard Clarida and Francesco Giavazzi. 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.

### Overview of the Volume

The seven papers published in this volume cover quite a range of topics. While the subject matter of the chapters ranges widely, one can weave some overarching themes. The seven chapters fall into four categories.

Part I deals with optimal monetary policy, part II with the international transmission of disturbances, part III with capital account liberalization, and part IV with European financial integration.

### **PART I: Optimal Monetary Policy**

Central banks have become increasingly transparent, but just how transparent should they be? Some central banks (e.g., the Reserve Bank of New Zealand, the Riksbank, the Bank of Norway) strive to reveal just about everything that is relevant; others (e.g., the Bank of England) are more circumspect. Likewise, the academic literature is divided about the welfare case for full transparency. In "Interest Rate Signals and Central Bank Transparency" Charles Wyplosz, Pierre Gosselin, and Aileen Lotz analyze the signaling role of the interest rate and consider various degrees of transparency, ranging from full opacity, to just publishing the interest rate, to also revealing the signals and an estimate of their precision. The interest rate is a special signal because, unlike information about the state of the economy, it can be used by the central bank to affect market expectations. In other words, it is a manipulable signal. The authors push this logic to its end and assume that the interest rate is *only* a signaling device and that it does not play any direct macroeconomic role. If the interest rate allows the central bank to shape expectations, by optimally choosing the interest rate the central bank can deal with the unavoidable common knowledge effect in a way that is welfare enhancing. That tends to make partial transparency preferable to full transparency because in the latter case the interest rate does not convey any additional information and cannot be used by the central bank to shape private sector expectations. If, however, the central bank ignores the precision of private sector signals, its optimally chosen interest rate may do more harm than good. This tends to make full transparency the best regime choice. The chapter produced a lively discussion. Some participants questioned the assumption that the rate of interest is a signal but has otherwise no effect on the economy. Others observed that the chapter misses an important source of uncertainty: markets observe the same data as the central bank, where the relevant uncertainty lies in the way the central bank will interpret these data. While there is little the authors could do about the first criticism, the second observation is addressed in the version published in this volume.

## **PART II: International Transmission**

“The Simple Geometry of Transmission and Stabilization in Closed and Open Economies” by Paolo Pesenti and Giancarlo Corsetti provides a simple, but informative, framework for understanding monetary policy choices in an open economy. The framework features a two period, two country analysis and, as the title indicates, highlights the geometric intuition behind the results. The chapter compares and contrasts the cases of: (a) Closed and open economies, (b) Flexible and preset prices, (c) Producer and local currency pricing, (d) Nash and cooperative equilibria. The presentation at the conference generated a lively discussion about the generality of the two by two approach as well as the intuition behind some of the results. The chapter’s simple geometry was thought to be well-suited to provide insights into certain questions in particular, such as producer versus local currency pricing.

Charles Engel and Michael Devereux, in “Expectations, Monetary Policy, and the Misalignment of Traded Goods Prices,” develop a potentially important theme: that shocks to information about future fundamentals can cause excessive volatility in exchange rates in the presence of plausible market frictions. Nominal exchange rates are modeled as asset prices, the relative price of two moneys, and are determined largely by expected future macroeconomic conditions. When some goods prices are sticky in each currency, exchange rate changes also determine changes in the relative prices of goods. There is a sticky price distortion, since freely set relative goods prices do not in general act like the relative price of two moneys. Large nominal exchange rate swings, reflecting expectations of the future, can thus lead to substantial misalignments in prices, even flexible commodity prices. Engel and Devereux point out that even in their model, a fixed exchange rate is not the optimal policy, because flexibility helps to obtain the relative price adjustment needed in response to current shocks. But they also argue that neither is benign neglect the best policy.

## **PART III: Capital Account Liberalization**

After liberalizing the capital account, many countries experience large swings in asset prices, capital flows, and aggregate production. In “Capital Flows and Asset Prices,” Kosuke Aoki, Gianluca Benigno, and Nobuhiro Kiyotaki investigate how the adjustment to capital account

liberalization depends upon the development of the domestic financial system. They show that the less developed the domestic financial system the more the economy is vulnerable to domestic and foreign financial shocks. The mechanism that drives the result is the difficulty at enforcing contracts. In the small open economy model that they analyze, contracts can only be enforced if debts are secured by collateral. But the assets that can be used as collateral for international borrowing are more restricted than domestic borrowing. The chapter generated a lively discussion. The main objections were related to the “dum” character of the capital inflows considered in the model. Moreover, the distinction between productive and unproductive entrepreneurs is hardly exogenous since, as the Chinese case illustrates and some participants noted, Foreign Direct Investment (FDI) flows often come with built-in managerial skills that can raise a firm’s productivity.

Three facts characterize countries that have opened up their capital account: (a) portfolio holdings are biased towards local equity; (b) international portfolios are long in foreign currency assets and short in domestic currency assets; (c) the depreciation of a country’s exchange rate is associated with a net external capital gain (i.e., with a positive wealth transfer from the rest of the world). In “International Portfolios with Supply, Demand, and Redistributive Shocks,” Robert Kollmann, Nicolas Coeurdacier, and Philippe Martin analyze these facts in a two-country, two-good model with trade in stocks and bonds. The two countries are subject to three types of disturbances: shocks to endowments, to the relative demand for home versus foreign goods, and to the distribution of income between labor and capital. With these shocks, optimal international portfolios are shown to be consistent with the stylized facts.

Enrique Mendoza, Vincenzo Quadrini, and José-Víctor Ríos-Rull, in “On the Welfare Implications of Financial Globalization without Financial Development” use a rigorous multi-country model with noninsurable idiosyncratic risk to show that, if countries differ in the degree of asset market incompleteness, financial globalization can hurt the poor in countries with less developed financial markets. This is because in these countries liberalization leads to an increase in the cost of borrowing, which is harmful for the poor because they have larger liabilities relative to their stock of assets. The quantitative analysis shows that the welfare effects are sizable and can justify policy intervention. This is an important question, because market incompleteness does seem to be a major challenge for emerging markets. But the chapter also raises other ques-

tions. For example, a feature of the global economy at present is the huge flow of capital from poor emerging economies to rich emerged economies. This is not well captured by the model, and it led some in the audience to question the implications of the model for the present circumstances.

#### **PART IV: European Financial Integration**

“Financial Integration within EU Countries: The Role of Institutions, Confidence, and Trust” by Sebnem Kalemli-Özcan, Bent E. Sørensen, and Mehmet Fatih Ekinci is an ambitious empirical chapter that constructs two measures of *de facto* integration across European regions to capture two dimensions of global financial flows, those for diversification and for development. The chapter finds evidence that capital market integration within the European Union is less than what is implied by theoretical benchmarks and less than what is found for U.S. states. In the second part of the chapter, the authors use data from the World Value Surveys to investigate the effect of social capital on financial integration among European regions, controlling for the effect of country-level institutions. They report that regions where the level of confidence and trust is high are more financially integrated with each other. Thus, the authors argue that social capital is a potentially important factor encouraging capital inflows. While this is an intriguing hypothesis, it was questioned by some at the conference. For example, the evaluation of capital flows is relative to a very simple theoretical benchmark that omits variables that are in fact important. If this were the case, the effect of social capital could capture these omitted variables.