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*edited by Lucrezia Reichlin
and Kenneth D. West*

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on Macroeconomics 2006**

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**Edited by
Lucrezia Reichlin and Kenneth West**

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8. Unless otherwise determined by the Board or exempted by the terms of paragraphs 6 and 7, a copy of this resolution shall be printed in each NBER publication as described in paragraph 2 above.

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Abstracts

1. The Consumption-Tightness Puzzle

Morten O. Ravn

This chapter introduces a labor force participation choice into a labor market matching model embedded in a dynamic stochastic general equilibrium set-up with production and savings. The participation choice is modelled as a trade-off between foregoing the expected benefits of actively searching and engaging in a costly labor market search. The model introduces a symmetry in firms' and workers' search decision since both sides of the labor market vary search effort at the extensive margins. This set up is shown to be of considerable analytical convenience and gives rise to a linear relationship between labor market tightness and the marginal utility of consumption. We refer to the latter as the "consumption-tightness puzzle" because (1) it gives rise to a number of counterfactual implications, and (2) it is a robust implication of theory. Among the counterfactual implications are very low volatility of tightness, procyclical unemployment, and a positively sloped Beveridge curve. These implications all derive from procyclical variations in participation rates that follow from allowing for the extensive search margin.

2. Cyclical Wages in a Search-and-Bargaining Model with Large Firms

Julio J. Rotemberg

This chapter presents a complete general equilibrium model with flexible wages, where the degree to which wages and productivity change when cyclical employment changes is roughly consistent with postwar U.S. data. Firms with market power are assumed to bargain simulta-

neously with many employees, each of whom finds himself matched with a firm only after a process of search. When employment increases as a result of reductions in market power, the marginal product of labor falls. This fall tempers the bargaining power of workers and, thus, dampens the increase in their real wages. The procyclical movement of wages is dampened further if the posting of vacancies is subject to increasing returns.

3. Productivity, External Balance, and Exchange Rates: Evidence on the Transmission Mechanism among G7 Countries

Giancarlo Corsetti, Luca Dedola, and Sylvain Leduc

This chapter investigates the international transmission of productivity shocks in a sample of five G7 countries. For each country, using long-run restrictions, we identify shocks that permanently increase domestic labor productivity in manufacturing (our measure of tradables) relative to an aggregate of other industrial countries including the rest of the G7. We find that, consistent with standard theory, these shocks raise relative consumption, deteriorate net exports, and raise the relative price of non-tradables—in full accord with the Harrod-Balassa-Samuelson hypothesis. Moreover, the deterioration of the external account is fairly persistent, especially for the United States. The response of the real exchange rate and (our proxy for) the terms of trade differs across countries: while both relative prices depreciate in Italy and the United Kingdom (smaller and more open economies), they appreciate in the United States and Japan (the largest and least open economies in our sample); results are inconclusive for Germany. These findings question a common view in the literature: that a country's terms of trade fall when its output grows, thus providing a mechanism to contain differences in national wealth when productivity levels do not converge. They enhance our understanding of important episodes, such as the strong real appreciation of the dollar as the U.S. productivity growth accelerated in the second half of the 1990s. They also provide an empirical contribution to the current debate on the adjustment of the U.S. current account position. Contrary to widespread presumptions, productivity growth in the U.S. tradable sector does not necessarily improve the U.S. trade deficit, nor deteriorate the U.S. terms of trade, at least in the short and medium run.

4. Production Sharing and Business Cycle Synchronization in the Accession Countries

Linda L. Tesar

This chapter provides a quantitative assessment of the role of trade in the transmission of business cycles within and between the regions of Eastern and Western Europe. The model allows for trade in intermediate inputs that are substitutes in production and for nearshoring, in which intermediate inputs from the East and West are complements. The model is calibrated to data on aggregate and bilateral trade flow, relative country sizes, and the extent of nearshoring. The model suggests that expanded East-West trade will produce positive output comovements within Europe. However, the two types of trade also produce very different dynamics for consumption and labor supply. Thus, one's view of whether trade makes business cycles "more similar" across Europe or not depends both on the nature of trade and on the metric one uses to assess business cycle synchronization.

5. Pension Systems and the Allocation of Macroeconomic Risk

Lans Bovenberg and Harald Uhlig

This chapter explores the optimal risk sharing arrangement between generations in an overlapping generations model with endogenous growth. We allow for nonseparable preferences, paying particular attention to the risk aversion of the old as well as overall "life-cycle" risk aversion. We provide a fairly tractable model, which can serve as a starting point to explore these issues in models with a larger number of periods of life, and show how it can be solved. We provide a general risk sharing condition and discuss its implications. We also explore the properties of the model quantitatively. Among the key findings are the following. First, and for reasonable parameters, the old typically bear a larger burden of the risk in productivity surprises, if old-age risk aversion is smaller than life risk aversion, and vice versa. Thus, it is not necessarily the case that the young ensure smooth consumption of the old. Second, consumption of the young and the old always move in the same direction, even for population growth shocks. This result is in contrast to the result of a fully-funded decentralized system without risk sharing between generations. Third, persistent increases in longevity will lead to lower total consumption of the old (and thus certainly lower per-period consumption of the old) as well as the young and higher work

effort of the young. The additional resources are, instead, used to increase growth and future output, resulting in higher consumption of future generations.

6. Endogenous Monetary Policy Regime Change

Troy Davig and Eric M. Leeper

This chapter makes changes in monetary policy rules (or regimes) endogenous. Changes are triggered when certain endogenous variables cross specified thresholds. Rational expectations equilibria are examined in three models of threshold switching to illustrate that (1) expectations formation effects generated by the possibility of regime change can be quantitatively important, (2) symmetric shocks can have asymmetric effects, and (3) endogenous switching is a natural way to formally model preemptive policy actions. In a conventional calibrated model, preemptive policy shifts agents' expectations, enhancing the ability of policy to offset demand shocks; this yields a quantitatively significant "preemption dividend."

7. Inflation Implications of Rising Government Debt

Chryssi Giannitsarou and Andrew Scott

The intertemporal budget constraint of the government implies a relationship between a ratio of current liabilities to the primary deficit with future values of inflation, interest rates, GDP and narrow money growth, and changes in the primary deficit. This relationship defines a natural measure of fiscal balance, and can be used as an accounting identity to examine the channels through which governments achieve fiscal adjustment. We evaluate the ability of this framework to account for the fiscal behavior of six industrialized nations since 1960. We show how fiscal imbalances are mainly removed through adjustments in the primary deficit (80–100 percent), with less substantial roles being played by inflation (0–10 percent) and GDP growth (0–20 percent). Focusing on the relation between fiscal imbalances and inflation suggests extremely modest interactions. This post–World War II evidence suggests that widely anticipated future increases in fiscal deficits need not necessarily have a substantial impact on inflation.