

This PDF is a selection from a published volume from  
the National Bureau of Economic Research

Volume Title: NBER International Seminar on Macroeconomics  
2005

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Pissarides, editors

Volume Publisher: MIT Press

Volume ISBN: 0-262-06265-8, 978-0-262-06265-7

Volume URL: <http://www.nber.org/books/fran07-1>

Conference Date: June 17-18, 2005

Publication Date: May 2007

Title: Introduction to "NBER International Seminar  
on Macroeconomics 2005"

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URL: <http://www.nber.org/chapters/c11372>

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# Introduction

Jeffrey A. Frankel and Christopher A. Pissarides

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 within “macroeconomics,” defined very broadly. The tradition started in 1978, and during the first half of its life was popularly known as the “Gordon-deMenil seminar.” Jeffrey A. Frankel is now overall co-director of ISOM, with Francesco Giavazzi as his European counterpart.

This volume contains a selection of the papers originally presented at the 28<sup>th</sup> International Seminar on Macroeconomics, which took place in Budapest on June 17–18, 2005. The meeting was kindly hosted by the Magyar Nemzeti Bank—the Central Bank of Hungary—and in particular by its Deputy Governor, György Szapáry, who took an active role in the proceedings. In 2005 the program was organized by Jeffrey A. Frankel and Christopher A. Pissarides. The papers published here have gone through the usual refereeing process for NBER Conference volumes.

Geographically, ISOM has been venturing farther afield than its origins in the major countries of Western Europe. The 2005 meeting was the first held in Central or Eastern Europe, and the first held in any of the ten countries that had officially acceded to the European Union the year before, in 2004. Subsequent ISOM meetings will continue to extend our interest in the east.

## ISOM Tradition and Transition

From 1990 through 2003, the National Bureau of Economic Research organized ISOM jointly with the European Economic Association and a selection of the papers was published in the Association’s journal. One goal, originally, was to help narrow what was perceived to be a

gap between the two continents. European academic macroeconomists several decades ago were more insular than their American counterparts (notwithstanding that the United States may have been the more insular place, economically and politically). In any case, times have changed. Europe now turns out many fine macroeconomists, who are doing frontier research and are well-plugged in to what goes on outside the borders of the countries of their birth, in other European countries as well as across the oceans.

In 2004, both sponsoring parties decided that the collaboration had accomplished its mission. The NBER became the sole sponsor of ISOM. 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. But with the 27<sup>th</sup> annual ISOM proceedings, we inaugurated a new regime. Now the proceedings are published by MIT Press as the *NBER International Seminar on Macroeconomics*. The new proceedings, of which *NBER ISOM 2005* is the second annual installment, appear as a companion volume to the *NBER Macroeconomics Annual*. The *Macro Annual* has since its birth in 1986 established a genuinely unique reputation for must-read articles on a range of relevant macroeconomic topics, written by leaders of the field, mostly based in the United States. Thus both conference series have distinguished pedigrees, and the decision by MIT Press to bring the two together as parallel publications was inspired and auspicious.

## Overview of the Volume

The eight papers published in the 28<sup>th</sup> volume of ISOM, as usual, cover quite a range of topics. While the subject matter of the papers ranges widely, one can weave some overarching themes.

The eight chapters fall into two categories. **Part I** deals with **Macroeconomic Policy and Labor Markets**. The first four of this year's papers explore relationships among macroeconomic aggregates that are of universal interest among advanced countries, one of them on macro derivatives, one on the implications of globalization, and two specifically regarding labor markets. **Part II** considers **Implications of an Expanding Monetary Union**. The four papers here are more relevant specifically to some of the topical questions associated with the Eastward expansion of the EU and EMU. Two concern fiscal policy in a region that has unified economically. Two deal with aspects of the

mechanics of the process when a country such as Hungary joins the euro: the real exchange rate and the choice of invoice currency, respectively.

## **Part I: Macroeconomic Policy and Labor Markets**

We now summarize the chapters in greater detail.

Refet S. Gürkaynak and Justin Wolfers lead off with “Macroeconomic Derivatives: An Initial Analysis of Market-Based Macro Forecasts, Uncertainty, and Risk.” In September 2002, a new market in “Economic Derivatives” was launched allowing traders to take positions on future values of non-farm payroll employment, initial jobless claims, retail sales, and ISM business sentiment. The authors provide an initial analysis of these data (predictions regarding 153 data releases over the first 2½ years of the futures market). Previous researchers have used survey data to measure market expectations of official economic statistics. But economic derivatives have several major advantages over surveys in that they provide market-implied probabilities of specific outcomes, and they predict somewhat more accurately and less biasedly market reactions to new data releases. They also allow a measure of uncertainty in investors’ forecasts, which is quite a different thing—both in principle and in practice—from the dispersion of views across market participants. Finally, the authors find no evidence of a risk premium, suggesting that the derivative prices can be used as a good measure of market expectations. Announcements of the payroll employment numbers—measured as deviations from the expectations embodied in the derivatives, are the ones that have the greatest impact, particularly on the stock and bond markets. Evidently a strong labor market is one of the best indicators of a strong overall economy.

Which leads us to the subject of the labor market. In “The Roots of Low European Employment: Family Culture?” Yann Algan and Pierre Cahuc take a fresh look at the cross-country differences in employment rates across advanced countries. As is well known, the biggest differences in employment rates across OECD countries are due mainly to female employment rates and to the employment of older men and women. Southern European countries have much lower employment rates than Scandinavian or Anglo-Saxon countries, essentially because fewer women come out to seek employment and more men retire early. The authors investigate the extent to which these differences are the

result of cultural differences rooted in religion and in beliefs about the role of the individual in the family. They make use of international data sets on social attitudes and find strong evidence in favor of their hypothesis that in European countries there are beliefs about the role of the family that are instrumental in the explanation of cross-country employment differences.

In "Shadow Sorting," Tito Boeri and Pietro Garibaldi take a close look at the unreported activity in labor markets. A variety of taxes and regulations on labor market activity push many workers to the underground economy, foregoing some of the benefits of a legally registered and more secure job for a job that pays no taxes and minimizes paperwork. The authors look at evidence on the shadow economy drawn from Italy and Brazil and conclude that there are close substitutions between shadow activity and unemployment. Employers choose whether to offer legally registered jobs or unreported jobs by weighing the benefits of avoiding tax on the latter, against the bigger security of employment of the former. Workers weigh up a similar trade-off and sort themselves according to their skill. More skilled workers seek jobs in the legal economy whereas less skilled ones may consider taking an unregistered job rather than face the risk of more unemployment. As a result, there is a close relation between the shadow employment rate and unemployment. Governments avoid monitoring more closely unreported jobs and closing them down, because this can increase unemployment. The authors find indirect evidence consistent with this hypothesis from their two countries.

In "Globalization and Equilibrium Inflation-Output Tradeoffs," Assaf Razin and Prakash Loungani examine the implications of increased international economic integration, both with respect to trade and capital flows, for the way the monetary authorities manage the long-run inflation rate. In an open economy, the representative consumer's payoff to unanticipated monetary expansion, in terms of higher output for a given increase in inflation, is likely to be less than in a closed economy. The authors demonstrate theoretically that international integration reduces the relative weight of output in the utility-based objective function. Instead, people should and do put relatively more weight on price stability. The authors bring some evidence on the inflation-output tradeoffs that supports the claim that globalization increases the relative weight of inflation in the monetary authority's objective function. This helps explain why central bankers around the world have delivered lower levels of inflation over the last decade than in the preceding

several decades (which supports arguments of David Romer and Ken Rogoff, among others).

## **Part II: Implications of an Expanding Monetary Union**

Economists have for some time tried to figure out what was the rationale behind the original Maastricht criteria that required new aspirants to EMU first to reduce their budget deficits below 3 percent of GDP, as well as the Stability and Growth Pact (SGP), which required that EMU members keep the deficits there. After all, this sort of fiscal convergence was not on the list of the various textbook criteria that have long been thought to qualify countries to give up their individual monetary policies and join a currency union. A typical example of such a criterion, rather, is synchronization of their business cycles (known as the pattern of "symmetric shocks"), because it reduces the need for individual monetary policies at the national level. To the contrary, one might think that when giving up the instrument of an independent monetary policy, it is all the more important for a country to retain the instrument of an independent fiscal policy, so as to be able to respond to idiosyncratic shocks.

In "Fiscal Externalities and Optimal Taxation in an Economic Community," Marianne Baxter and Robert G. King examine a set of relevant issues. The fiscal policies of members of an economic union such as the EU create externalities for each other. A common rationale for the Maastricht criteria or SGP is that countries that get into trouble through large budget deficits could force the European Central Bank to bail them out. Baxter and King, however, emphasize in their model a different kind of externality in the setting of tax rates. They conclude that the trade deficit is a better indicator of the fiscal costs imposed on others than the fiscal deficit which is the traditional focus.

In "Fiscal Divergence and Business Cycle Synchronization: Irresponsibility is Idiosyncratic," Zsolt Darvas, Andrew K. Rose, and György Szapáry perform for fiscal links an exercise that had been formerly performed for trade links: to see if business cycle synchronization is endogenous with respect to convergence. Their empirical finding is that fiscal convergence, defined as persistently similar ratios of government deficit to GDP, is indeed systematically associated with more synchronized budget cycles. Synchronized budget cycles imply less need for separate monetary policies, so this finding supports the SGP. To understand the authors' rationale for this finding, forget the idea that governments use

discretionary fiscal policy to respond intelligently and benevolently to shocks in such a way as to stabilize the economy. Rather, governments are instead sometimes irresponsible, using fiscal policy to maximize their own objectives, such as winning elections, or are incompetent, such as responding to a downturn after it is too late, or otherwise producing fiscal policies that are as likely to be procyclical as countercyclical. As a result, independent fiscal policies are perfectly capable of exacerbating cyclical fluctuations rather than dampening them. The question then becomes whether they do so in a way that is correlated across EMU members, so that they can be partially offset with a common monetary policy, or whether they instead vary independently from country to country. The authors' answer is "yes:" preventing countries from following idiosyncratic fiscal policies raises the cyclical correlation, and thereby makes EMU more workable. Some may wish to interpret this result as a rationale for the SGP.

Countries that aspire to join the euro, such as the ten new EU members, must worry about more than the inability to use monetary policy to respond to future shocks. They must also worry about going in at an exchange rate that leaves their currency neither overvalued nor undervalued. This can be tricky in a rapidly growing economy that has non-traded goods, due to the Balassa-Samuelson effect. In "Dual Inflation and the Real Exchange Rate in New Open Economy Macroeconomics," Balázs Világi shows that the outcome of different productivity growth rates in traded and non-traded goods sectors depends on both market structure and market frictions, such as nominal rigidities. He argues that the Balassa-Samuelson effect is consistent with the modern modeling approach in open economy macroeconomics, which assumes rigid prices, if firms price to the market. But if this is the case then small open economies such as the emerging economies of central and Eastern Europe will experience different inflation rates in tradable and non-tradable goods and an appreciating currency. This naturally has implications for the timing of entry into the euro and the need to have consistent price-setting mechanisms across the eurozone countries, since entering the eurozone binds the exchange rate against the main trading partners and requires the satisfaction of inflation targets.

In "Trade Invoicing in the Accession Countries: Are They Suited to the Euro?" Linda S. Goldberg investigates the extent to which the ten accession countries (plus Bulgaria, whose accession date is 2007) are adopting the euro as the currency in which they invoice their exports. She finds that they adopted the use of euros at a rapid rate, but have

perhaps gone too far. Whereas Asian countries invoice in dollars to an extent that exceeds their trade with the U.S. and other trade transactions in homogeneous commodities, Eastern European countries do the reverse, making too little use of the dollar and too much of the euro, relative to their trade with the euro countries. Theory predicts that optimal invoicing choices depend on the composition of goods in exports and imports and on the macroeconomic fluctuations of trade partners. These considerations yield country-specific estimates of the desired degree of euro-denominated invoicing among the accession countries, which the actual degree of euro invoicing apparently exceeds.

But perhaps the explanation is that the newly acceding EU members have had their sights firmly fixed on a future of increased integration with the West.





## **Part I: Macroeconomic Policy and Labor Markets**

