July 18, 2008

For NBER Reporter 2008, No. 3

31st International Seminar on Macroeconomics

NBER's 31st International Seminar on Macroeconomics (ISOM) took place on June 20 and 21. (This was the 30th anniversary of the first ISOM meeting in Paris, one of the innovations made by Martin Feldstein when he became President of the NBER.) ISOM Chair Jeffrey Frankel of Harvard University and Christopher Pissarides, London School of Economics, organized this year's program. The location this year was Ljubljana, Slovenia, hosted by the central bank. Slovenia is the first of the transition economies to have achieved access to the euro. After opening remarks by the host, Dr. Marko Kranjec, Governor of the Bank of Slovenia, these papers were presented and discussed:

Matthieu Chemin, University of Quebec at Montreal, and **Etienne Wasmer**, Sciences Po Paris, "A Note on the Employment Effects of the 35_Hour Workweek Regulation in France"
Discussants: John Abowd, Cornell University and NBER, and Christopher Pissarides

Richard Baldwin, Graduate Institute, Geneva and NBER, and **Virginia Di Nino**, Bank of Italy, "Trade Pricing Effects of the Euro"
Discussants: Philippe Bacchetta, University of Lausanne, and Jose Manuel Campa, IESE Business School and NBER

Dalia Marin, University of Munich, "The New Corporation in Europe"
Discussants: Josef Brada, Arizona State University, and Polona Domadenik, University of Ljubljana

Laura Alfaro, Harvard University and NBER; **Andrew Charlton**, London School of Economics; and **Fabio Kanczuk**, Universidade de Sao Paulo, "Firm_Size Distribution and Cross_Country Income Differences"
Discussants: Jeffrey Frankel, Harvard University and NBER, and John Haltiwanger, University of Maryland and NBER

Paul R. Bergin, University of California, Davis and NBER, and **Ching_Yi Lin**, University of California, Davis, "Exchange Rate Regimes and the Extensive Margin of Trade"
Discussants: George von Furstenberg, National Science Foundation, and Stephen Redding, London School of Economics

Mark P. Taylor and **Hyeyoen Kim**, University of Warwick, "Real Variables, Nonlinearity, and European Real Exchange Rates"

Discussants: Charles Engel and Kenneth West, University of Wisconsin and NBER

Stephanie E. Curcuru and **Charles P. Thomas**, Board of Governors of the Federal Reserve System, and **Francis E. Warnock**, University of Virginia and NBER, "Current Account Sustainability and the Relative Reliability of the International Accounts"
Discussants: Michael Dooley, University of California, Santa Cruz and NBER, and Daniel Gros, Centre for European Policy Studies

Carmen M. Reinhart, University of Maryland and NBER, and **Vincent R. Reinhart**, American Enterprise Institute, "Capital Flow Bonanzas: An Encompassing View of the Past and Present"
Discussants: Francesco Giavazzi, MIT and NBER, and Sebnem Kalemli_Ozcan, University of Houston and NBER

Richard H. Clarida, Columbia University and NBER, "Reflections on Monetary Policy in the Open Economy"
Discussants: Paolo Pesenti, Federal Reserve Bank of New York and NBER, and Frank Smets, European Central Bank

France's 1998 implementation of the 35-hour workweek has been one of the greatest regulatory shocks on labor markets. Few studies evaluate the impact of this regulation because of a lack of identification strategies. **Chemin** and **Wasmer** find that for historical reasons, because of the way Alsace-Moselle was returned to France in 1918, the implementation of France's 35-hour workweek was less stringent in that region than in the rest of the country. Yet they find no significant difference in employment with the rest of France, which casts serious doubt on the effectiveness of this regulation in raising employment.

Baldwin and **Di Nino** investigate whether the euro boosted Eurozone integration by impeding pricing to market behavior. They study the pricing strategies of exporters from 20 countries (Eurozone and non Eurozone) to identify variations in the average cost mark-up and exchange rate pass through. Their preliminary findings suggest that the euro has not accelerated the speed of convergence of export prices within the area but rather has brought about a one time jump in convergence around the date of its adoption. Pricing-to-market estimations reveal no changes in the average mark-up nor in the exchange rate pass through elasticity. Overall, they find that the euro's introduction has had little impact on trade pricing behavior.

In the last 15 years the nature of the corporation has been changing. This has involved a change in management style to more decentralized and less hierarchical decisionmaking, a

stronger focus on “core competences”, the emergence of talent as the “new stakeholder” in the firm, and the organization of the corporation in an international value chain in which different stages of production are taking place in different countries. At the same time, the firm boundaries have been shifting, leading to outsourcing of firm activities on the one hand and merger activities on the other. **Marin** explores the role of international trade and foreign direct investment and the opening up to the former communist countries as the driving forces behind the emergence of the “new corporation” in Europe. She also examines the challenges these changes in corporate organization may pose, in particular in the areas of trade policy and human resource policies.

Using firm-level data for 79 developed and developing countries, **Alfaro** and her co-authors investigate whether differences in the allocation of resources across plants that are heterogeneous in size are a significant determinant of cross-country differences in income per worker. The researchers use a standard version of the neoclassical growth model augmented to incorporate monopolistic competition among heterogeneous firms. For their preferred calibration, the model explains 58 percent of the log variance of income per worker, as compared to the 42 percent success rate of the usual model.

Bergin and **Lin** find that currency unions and direct exchange rate pegs raise trade through distinct channels. Panel data analysis of the period 1973-2000 indicates that currency unions have raised trade predominantly at the extensive margin, the entry of new firms or products. In contrast, direct pegs have worked almost entirely at the intensive margin, increased trade of existing products. The authors develop a stochastic general equilibrium model, featuring price stickiness and firm entry under uncertainty, to understand this result. Because both regimes tend to reliably provide exchange rate stability over the horizon of a year or so, which is the horizon of price setting, both lead to lower export prices and greater demand for exports. But because currency unions historically are more durable than pegs over a longer horizon, they encourage firms to make the longer-term investment needed to enter a new market. The model predicts that whenever exchange rate uncertainty is completely and permanently eliminated, all of the adjustment in trade occurs at the extensive margin.

Taylor and **Kim** carry out an analysis of European real exchange rate behavior before and after the implementation of Economic and Monetary Union (EMU). In particular, in an explicitly nonlinear framework, they model real exchange rates for a number of EMU and non-EMU countries against Germany, and they allow for variation in the equilibrium level of the

long-run equilibrium real exchange rate using either relative productivities or real diffusion indexes. The estimated models show that real variables are a significant determinant of long-run real exchange rates when incorporated into a nonlinear framework. The researchers also find that the speed of adjustment is generally faster after the implementation of EMU.

Curcuru, Thomas and Warnock provide a brief but relatively complete survey of various theories that have been offered regarding the sustainability of the U.S. current account deficit. They focus on the data these theories rely on, provide an evaluation of the relative reliability of data on various subcomponents of the international accounts, and through this analysis weigh in on which theories are better supported by the data. Their analysis of the dark matter theory from a relative data reliability perspective is that it fails because it is built on the assumption that an item that is largely unmeasured is the most accurate component of the entire set of international accounts. Their analysis of the exorbitant privilege theory requires much more depth, as they must first construct estimates of adjustments for known shortcomings in the accounts. After plugging various holes in the accounts, they find that the positive returns differential the United States earns on its net international investment position is much smaller than implied by the exorbitant privilege theory.

A considerable literature has examined the causes, consequences, and policy responses to surges in international capital flows. A related strand of papers has attempted to catalog systematically current account reversals and capital account "sudden stops." **Reinhart** and **Reinhart** offer an encompassing approach with an algorithm cataloging capital inflow bonanzas in both advanced and emerging economies during 1980-2007 for 181 countries and 1960-2007 for a subset of 66 economies from all regions. In line with earlier studies, this study shows that global factors -- such as commodity prices, international interest rates, and growth in the world's largest economies -- have a systematic effect on the global capital flow cycle. Bonanzas are no blessing for advanced or emerging market economies. In the case of the latter, capital inflow bonanzas are associated with a higher likelihood of economic crises (debt defaults, banking, inflation, and currency crashes). Bonanzas in developing countries are associated with procyclical fiscal policies and attempts to curb or avoid an exchange rate appreciation – very likely contributing to economic vulnerability. For the advanced economies, the results are not as stark, but bonanzas are associated with more volatile macroeconomic outcomes for GDP growth, inflation, and the external accounts, lower growth, and sustained declines in equity and housing

prices will follow at the end of the inflow episode.

Clarida's paper provides some intuition and quantitative insight into monetary policy choices faced in the open economy. The theoretical sections of the paper focus on three main building blocks: the "open economy" IS curve, the open economy Phillips curve, and the open economy Taylor rule. The following results are based upon a benchmark specification of the model, which assumes that the elasticity of substitution in consumption is less than 1: first, in general there will be a spillover from foreign output to potential domestic output -- potential output in the open economy is not a closed-economy construct and cannot be defined without reference to global developments. Second, in general there will be a spillover from foreign output growth to the domestic neutral real interest rate -- again the "domestic" neutral real interest rate cannot be defined without reference to global developments. Third, a more open economy may be expected to have a flatter Phillips curve. Finally, Clarida reviews a novel empirical implication of a version of this model, one that is supported in the data: that bad news about inflation will be good news for the exchange rate under a version of inflation targeting, notwithstanding an assumption that PPP (purchasing power parity) holds in the long run. He also introduces a new way to calibrate forward looking central bank policy rules using financial market data on real interest rates on inflation indexed bonds and break-even inflation rates instead of the instrumental variable, GMM approach introduced in his earlier work. He applies this approach to the Fed and ECB (European Central Bank) reaction functions since 2000 and finds that it accounts well for policy with much less emphasis on interest rate smoothing than in prior work. According to this analysis, variations in the neutral real interest rate, perhaps caused by the "global saving glut" and enhanced financial integration in a world of inflation targeting central banks, have played an important role in Fed policy this decade. For the ECB, the results are less clear cut because of the limited issuance of inflation indexed bonds during much of the sample, but are nonetheless encouraging.

A selection of these papers will appear in an NBER volume published by the University of Chicago Journals Division. They will also be available at "Books in Progress" on the NBER's website.