Discussion of "Income-Induced Expenditure Switching"

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Toulouse
School
of Economics

0. Roadmap

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1. Macroeconomic context

- Latvia went through a brutal boom-bust-recovery episode since 2000. (BLANCHARD, GRIFFITHS AND GRUSS)
  - × An increase in GDP of almost 90% from 2000Q1 to 2007Q4,
  - × a decrease of 25% from 2007Q4 to 2009Q3,
  - × A recovery, as of 2013Q1, of 18%.

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Unemployment (lhs) —— Real GDP (2000q1=100, rhs)

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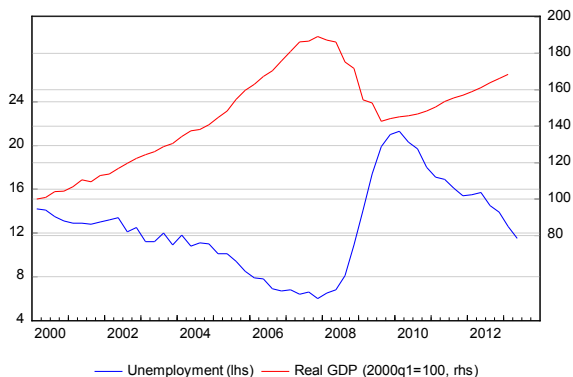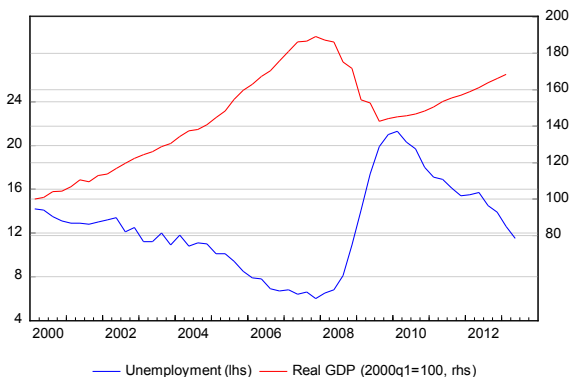 - × A recovery, as of 2013Q1, of 18%.

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▸ Since 2005, the Bank of Latvia is following a strict policy of pegging the lats to a basket composed of the US dollar, the euro, the pound sterling and the Japanese yen.

FIGURE 2: Euro-Lats exchange rate
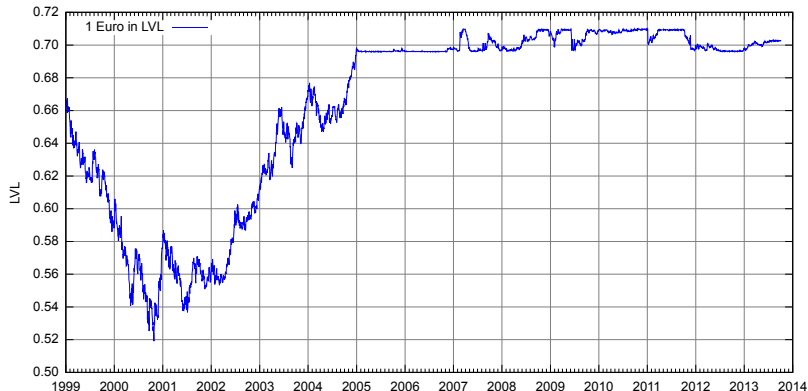
1. Macroeconomic context

- ► The recovery has been made possible by
  - × internal devaluation
  - × fiscal austerity

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FIGURE 3: Internal devaluation - Total economy (cumulative change)
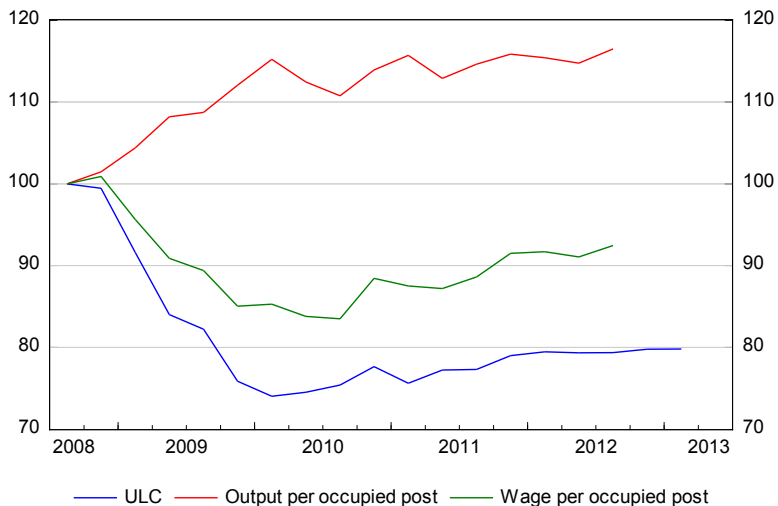
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FIGURE 4: Internal devaluation - Manufacturing (cumulative change)
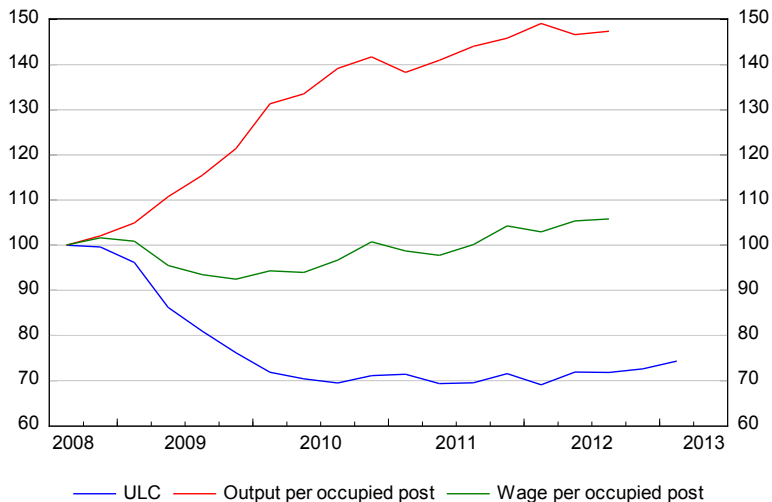
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FIGURE 5: Fiscal austerity

Legend:
- Headline (change, excl. bank restructuring costs)
- Cyclically Adjusted (change, excl. bank restructuring costs)
- Cyclically Adjusted (change, incl. bank restructuring costs)
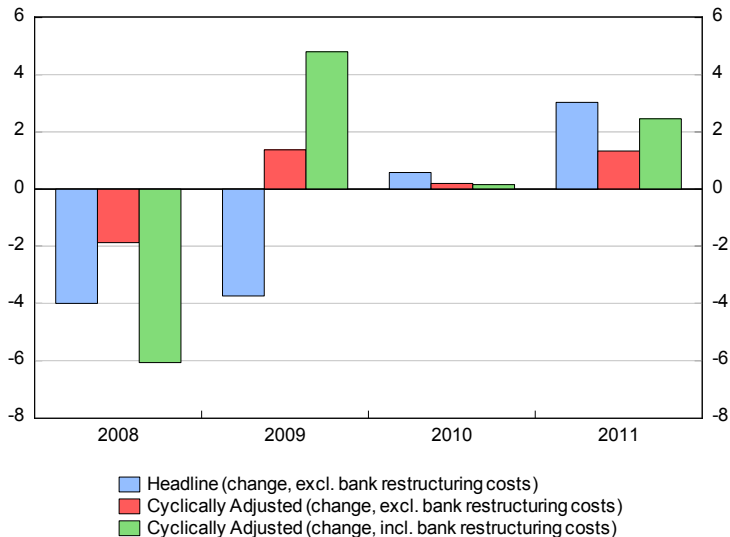
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▶ After years of large trade deficit, the recession has been accompanied by a sharp trade balance recovery

FIGURE 6: Trade balance

2. The puzzle

▶ In open macroeconomics, an improvement of the trade balance in recessions is typically a consequence of

  × a decrease in imports caused but the decrease of absorption during the recession

  × an expenditure switching (demand shifts from foreign goods to domestic ones) that is caused by a depreciation of the exchange rate.

▶ The expenditure switching channel should not be seen in the Latvian context as

  × There was no external devaluation

  × The internal devaluation *was only partly transmitted to prices, leading more to an increase in margins for firms.* (quoting Blanchard et al.)

▶ Why was the current account improvement then so large ?

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▶ Assume that consumption of domestic and foreign products are given by

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C^d &= Y^{\varepsilon_y^d} \left(\frac{eP^\star}{P} \right)^{\varepsilon_e^d} \\
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\end{aligned}
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with all elasticities being positive.

▶ Hometheticity of preferences implies

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\varepsilon_y^d = \varepsilon_y^f
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▶ so that

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\frac{C^d}{C^f} = \left(\frac{eP^\star}{P} \right)^{\varepsilon_e^d + \varepsilon_e^d}
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▶ With homothetic preferences, there is no expenditure switching absent of variations in the real exchange rate.

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▶ Assume that domestic goods are "inferior compared to the foreign ones"

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4. Empirical analysis

▶ Rudolfs and Julian do an amazing analysis of scanner-level data for food and beverages and find :

   ✕ imports contraction is by 1/3 accounted for by expenditure switching accounting, while the relative price of foreign goods increased by 4.4% only.

   ✕ switching took place within narrowly defined product groups, while the relative price adjustment was across product groups.

   ✕ Within a category, unit values of domestic goods were on average lower than those of comparable foreign ones.

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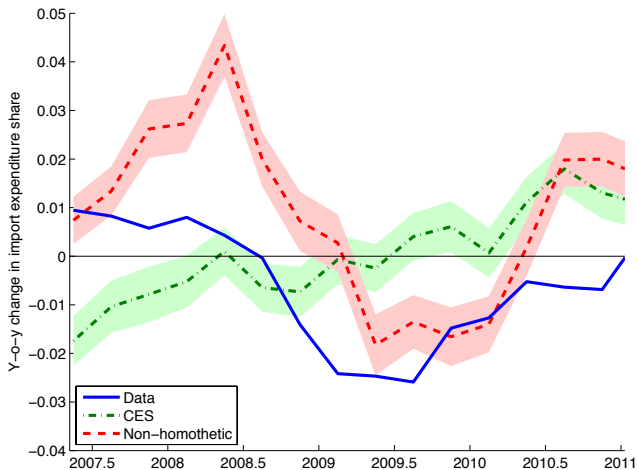
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5. In a nutshell

▶ The model success in one graph

FIGURE 7: Actual and estimated growth on the share of foreign goods in expenditures

6. Where to go now ?

- ▶ It is inter temporal wealth more than income that matters fro demand :
  - × asset prices went down
  - × future income growth was revised downwards

- ▶ Permanent income might have fallen more than current income, which would reinforce the expenditure switch.

- ▶ The credit crunch in from 2008 to 2011 has also increased the shadow value of one spent lats – or decreased income deflated by the full value of a lats.

- ▶ Commentators also mention an increases in perceived uncertainty (? ? ?). If so, this also reduces the share of income devoted to consumption.

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