

Discussion of “Income-Induced Expenditure Switching”

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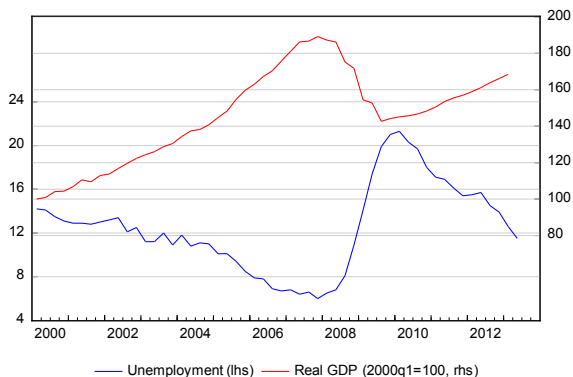
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1. Macroeconomic context

- ▶ 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%.

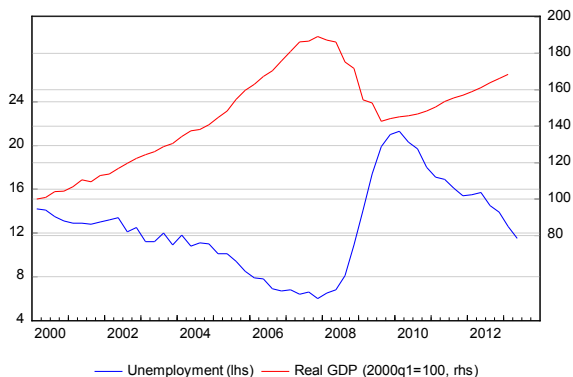
FIGURE 1: GDP and Unemployment in Latvia



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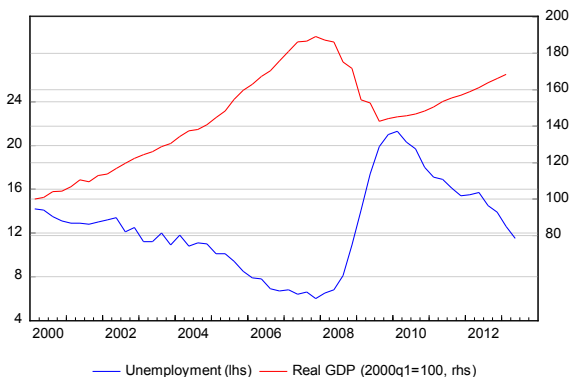
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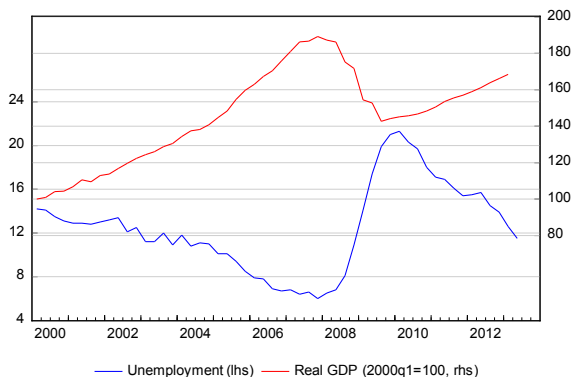
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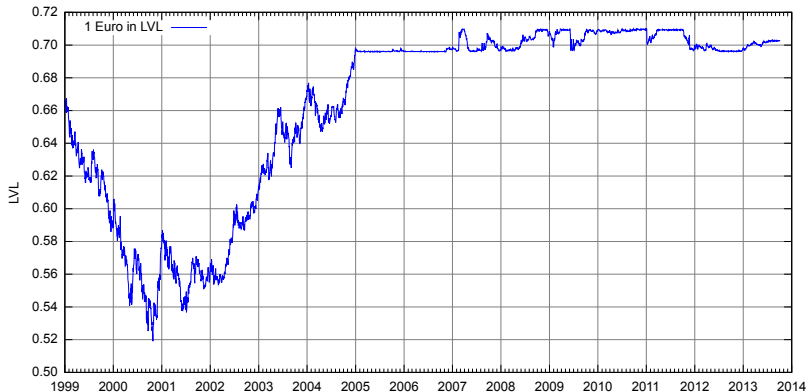
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1. Macroeconomic context

- ▶ 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

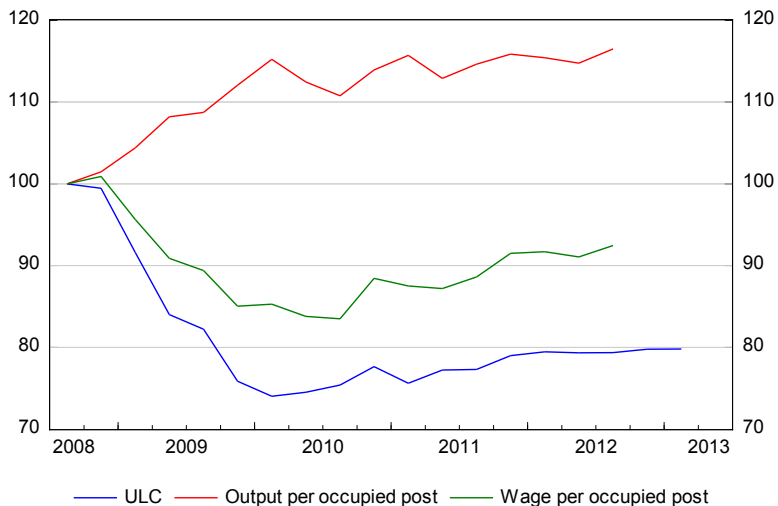


1. Macroeconomic context

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

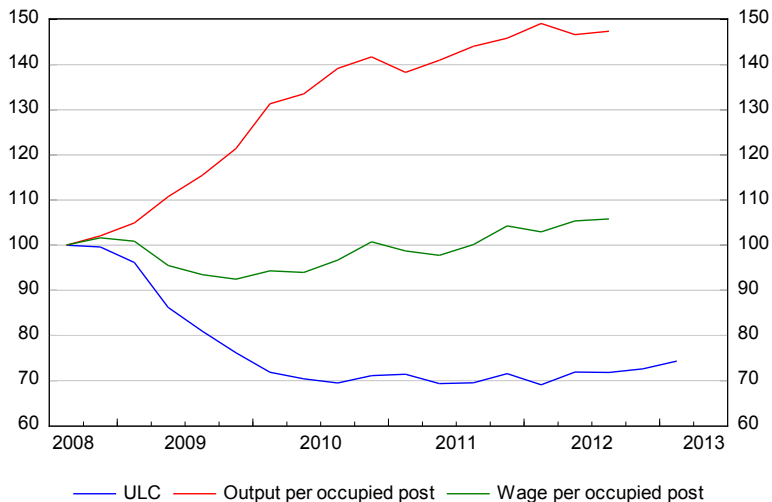
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FIGURE 3: Internal devaluation - Total economy (cumulative change)



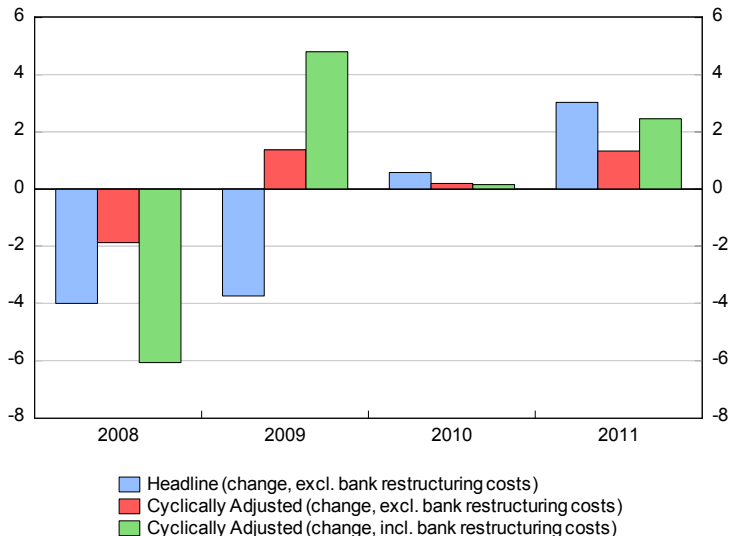
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FIGURE 4: Internal devaluation - Manufacturing (cumulative change)



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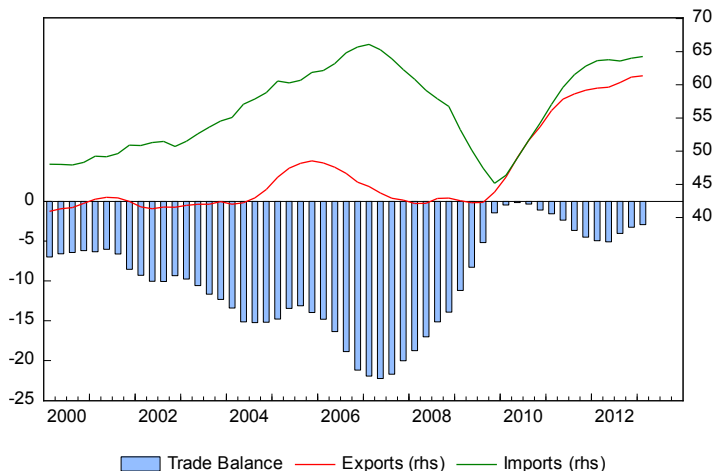
FIGURE 5: Fiscal austerity



1. Macroeconomic context

- ▶ 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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3. Income driven expenditure switching

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

$$C^d = Y^{\varepsilon_y^d} \left(\frac{eP^*}{P} \right)^{\varepsilon_e^d}$$
$$C^f = Y^{\varepsilon_y^f} \left(\frac{eP^*}{P} \right)^{-\varepsilon_e^f}$$

with all elasticities being positive.

- ▶ Homotheticity of preferences implies

$$\varepsilon_y^d = \varepsilon_y^f$$

- ▶ so that

$$\frac{C^d}{C^f} = \left(\frac{eP^*}{P} \right)^{\varepsilon_e^d + \varepsilon_e^f}$$

- ▶ *With homothetic preferences, there is no expenditure switching absent of variations in the real exchange rate.*

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- ▶ Rudolfs and Julian find a substantial amount of expenditure switching.
- ▶ This is possible with non homothetic preferences
- ▶ Assume that domestic goods are “inferior compared to the foreign ones”

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- ▶ then

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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.
- ▶ They estimate a demand system with possible non homotheticity and found that there is indeed an “relative inferiority” of domestic goods.

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5. In a nutshell

- ▶ Consider the (fictious) product group *“alcoholic beverage with bubbles”*
- ▶ Pre-crisis basket :

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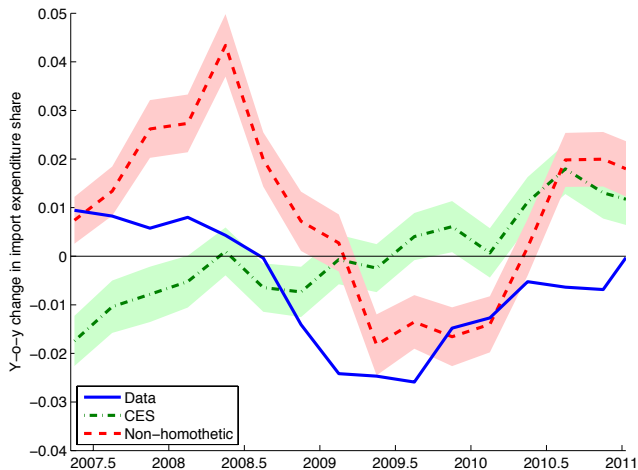
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5. In a nutshell

- ▶ 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 for 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.
- ▶ Those different effects call for a permanent income model in which credit constraints and expectations would have an important quantitative role.

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