

# Consumption-Led Growth

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Second Annual Conference on International Economics  
Federal Reserve Bank of Dallas University of Houston  
October 2017

# The question

- What is the impact of current account openness on growth? productivity? welfare?
- Very relevant question (Eurozone, China, resurgence of capital controls)
- Not fully settled theoretically (even abstracting from financial instability issues)

# Outline

- Brief overview of the issue
- Key insight of the paper
- The rise and fall of Southern Europe?

# Current account openness in a one-good world

- Consider a poor/impatient country
- Wants resources now (v/s tomorrow)
- **Open CA unambiguously help** (even if not that much, Gourinchas and Jeanne, 2006)
- Typically open CA yields faster growth, through more capital accumulation

## Current account openness in a multi-good world

- Consider again poor/impatient country
- With open CA inflow of resources change domestic prices (e.g. Tradable v/s non tradables, wages) relative to autarky
- Domestic agents react to these changes, affecting allocations (possibly reducing growth, Benigno Fornaro, 2013)
- If economy has other distortions (IM, labor rigidities), these price changes can make economy worst off (relative to autarky/capital controls)

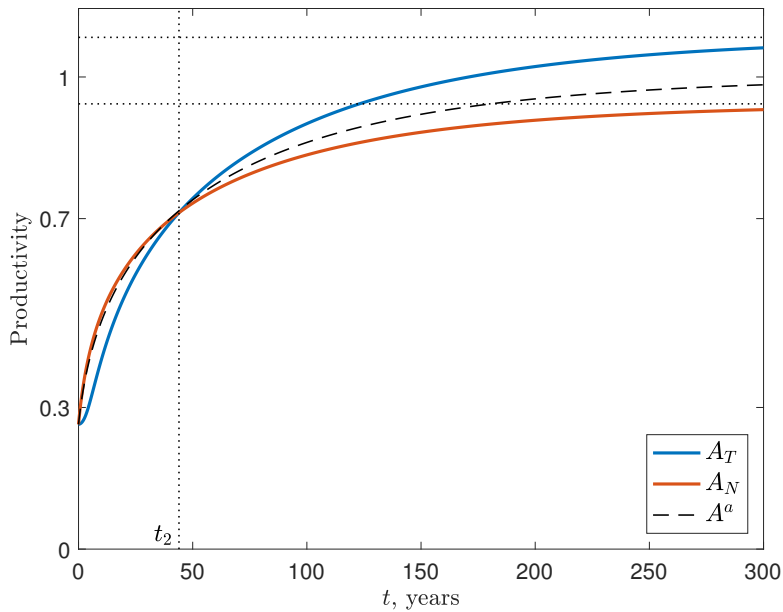
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- If economy has other distortions (IM, labor rigidities), these price changes can make economy worst off (relative to autarky/capital controls)
- Removing a distortion (closed CA) in a second best world not necessarily desirable
- Heathcote Perri (2016) show that if intl risk sharing is imperfect, shutting down CA can raise welfare, when price movements that result improve risk sharing.

# The BIG paper

- Consider a poor (low TFP) country, with  $T$  &  $NT$
- Capital openness affect  $\frac{P^N}{P^T}$
- Firms react to these price changes choosing to invest in innovation in  $T$  v/s  $NT$
- Clean analytical characterization of TFP path, for arbitrary CA paths
- Allow to assess how structural parameters (i.e. elasticity of substitution, initial conditions) affect changes in convergence path as CA is opened

# Productivity dynamics with open and close account



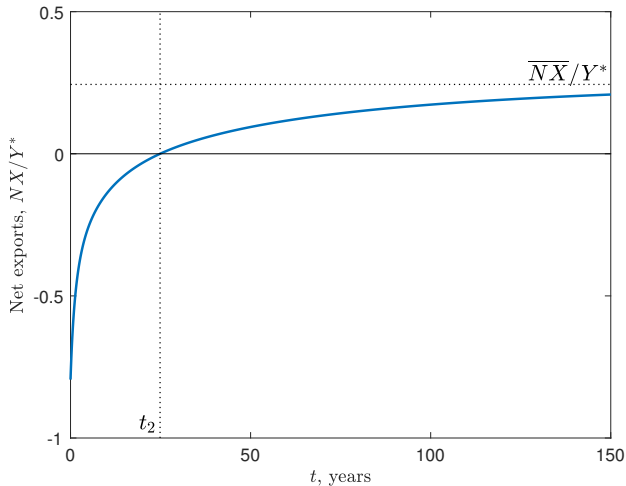


## Key insight of BIG, 1

- Open capital account generate stronger domestic demand in the short run (and weaker in the long run)

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## Key insight of BIG, 2

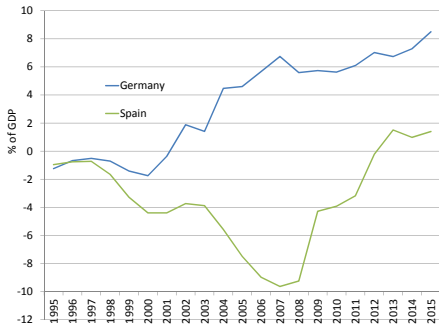
- Stronger domestic demand both toward  $T$  and  $NT$  but..

## Key insight of BIG, 2

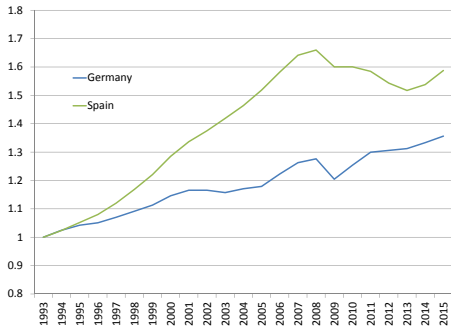
- Stronger domestic demand both toward  $T$  and  $NT$  but..
- $P^T$  moves less (**more substitutable with foreign goods**) than  $P^N$ , hence  $\frac{P^N}{P^T}$  raises
- Higher profit from investing in NT, stronger productivity growth in NT in the short run
- In the long run NX negative (country repays its borrowing), weaker absorption (relative to autarky), reverse effect

# The rise and fall of Southern Europe

## Current Account



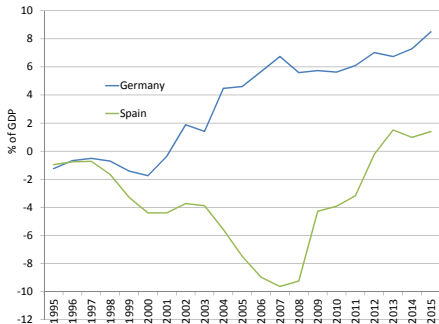
## GDP



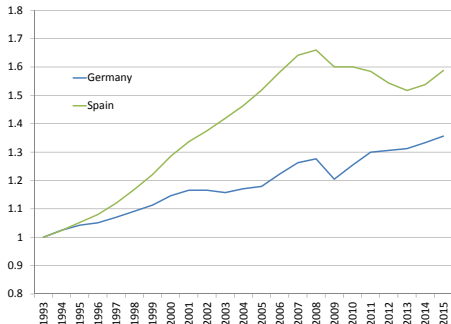
- Spain grows fast as CA open, collapse when CA reverts

# The rise and fall of Southern Europe

## Current Account

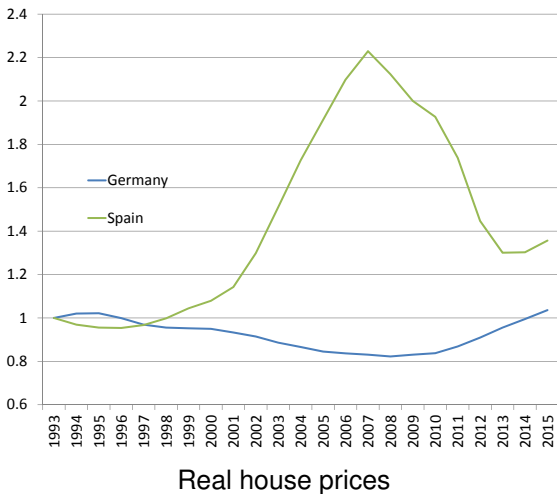


## GDP



- Spain grows fast as CA open, collapse when CA reverts
- Heathcote, Perri (2017): how much of the growth cycle can be explained by the CA path?
- Driver not the Euro but the CA liberalization, (MNS 2017 would suggest both)

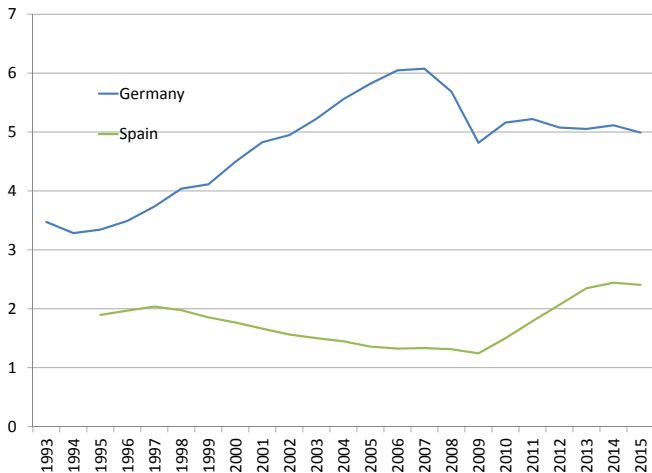
# Non Tradable/Tradable Prices



Real house prices

- Fast growth:  $\frac{P^N}{P^T} \uparrow$
- Growth collapse:  $\frac{P^N}{P^T} \downarrow$

## Tradable/Non Tradable VA



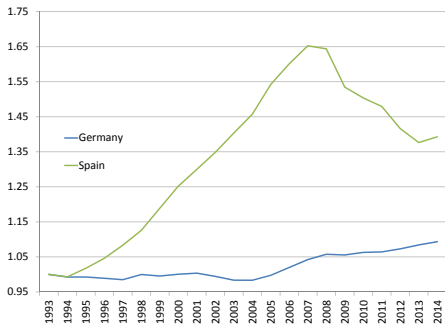
Ratio is value added in manufacturing to value added in construction

- Fast growth:  $\frac{VA^T}{VA^N} \downarrow$
- Growth collapse:  $\frac{VA^T}{VA^N} \uparrow$

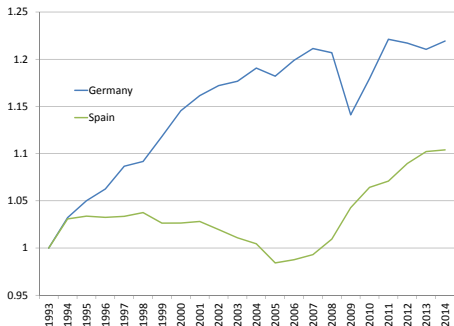


# Employment and LP dynamics

## Employment



## Labor Productivity

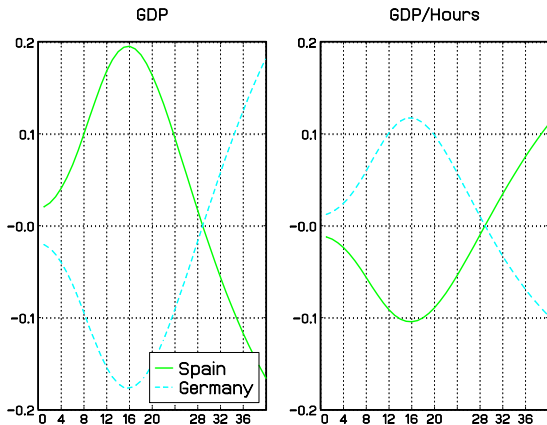


- Fast growth: Employment  $\uparrow$ , LP  $\downarrow$
- Growth collapse: Employment  $\downarrow$ , LP  $\uparrow$

## A model of southern Europe

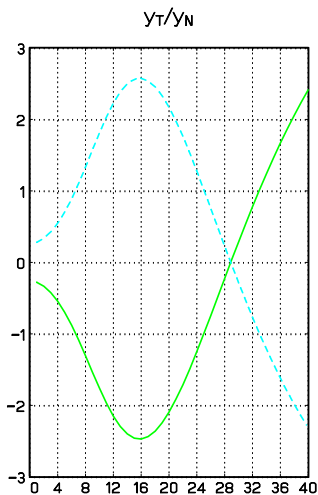
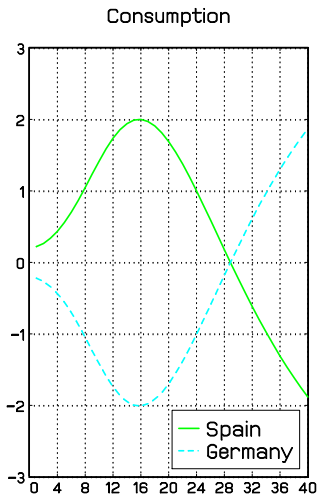
- South impatient, gradual opening up of CA, borrows initially and then CA reverses
- Key Ingredient: NT more labor intensive than T
- Otherwise standard RBC model

# The raise and fall of southern Europe



- Why GDP increases? ( $Y^T$  falls and  $Y^N$  rises)
- Because  $NT$  more labor intensive, higher aggregate labor demand necessary to produce the early increase in  $NT$

# Consumption-Led Growth!



# Efficiency?

- Issue is whether this boom bust cycle, driven by openness, is efficient. If no other friction, it is!
- in BIG fully open capital is suboptimal because it creates too much innovation in non tradables (competitive innovators do not internalize decreasing returns)
- Typically literature focuses on inefficiency stemming from downward sticky wages
- Wages increase in the upswing, do not fall in the downswing, no recovery of the tradables
- Little wage rigidity can easily wipe out the benefit of opening CA

# Conclusions

- BIG revisit an old but policy relevant issue
- Bring new insights regarding efficiency and sectoral productivity dynamics
- Important contribution in guiding the growth impact of CA policies