High-MPC Households and Emerging Market Business Cycles∗

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Abstract

Micro data suggest that households in emerging economies exhibit substantially higher marginal propensity to consume (MPC) than those in developed economies. This paper evaluates the role of high-MPC households on the stylized patterns of emerging market business cycles. To this end, this paper makes the first attempt to study the emerging market business cycles through the lens of a heterogeneous-agent small open economy (HASOE) model. Specifically, I discipline the model using MPC estimates from the micro data and take the model to macro data through Bayesian estimation. When households are counterfactually replaced with those exhibiting U.S. MPCs, consumption volatility drops by 30 percent, and emerging economies’ stylized pattern that consumption is more volatile than output disappears. High-MPC households contribute to the consumption volatility through two main channels: strong consumption response to individual resource fluctuations and significant disruption in consumption smoothing when illiquid assets become more illiquid. The driving mechanisms of conventional theories such as consumption response to trend shocks or intertemporal substitution caused by interest rate variations do not drive the business cycles in my model because high-MPC households cannot accommodate them.

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