Income-Induced Expenditure Switching

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Outline

The paper

- Focuses on the role of income effects in determining the switch from imported to domestic products during episodes of "sudden stop"
- Extraordinary micro dataset, masterly done empirical analysis on Latvia (descriptive and econometric)
- As Latvia has fixed exchange rates (now in the euro), supposedly the relative price change channel (real depreciation) is shut off, thus alternative mechanisms:
  - Income effect produces switch towards lower quality goods
  - Need preferences to be non-homothetic and imports assumed to be of higher quality
- Results very interesting and relevant: income effect seems to explain 1/3 of import contraction in Latvia (based on analysis of food and beverages)

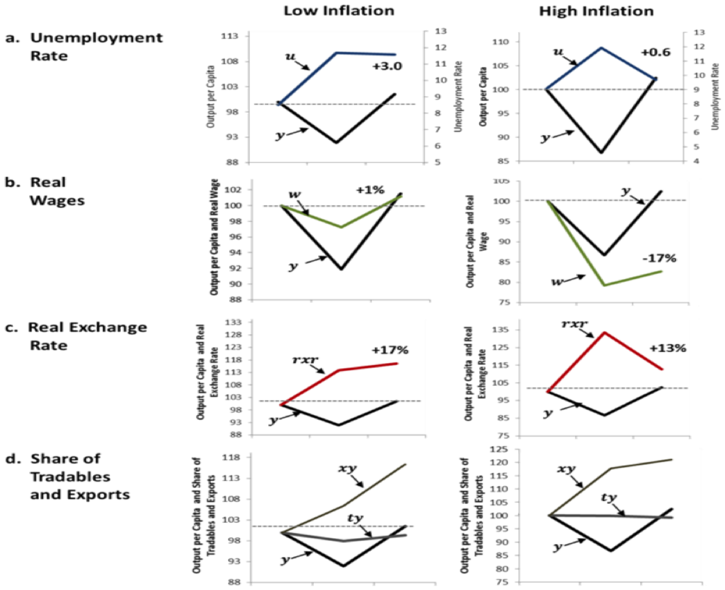
Conceptual framework

- Use preference specification (non-homothetic preferences) typical of lower frequency analyses: structural change, secular trends
- For a short run phenomenon: sudden stop
- Idea: size of drop in total income/consumption so large to trigger behavior typically observed in long-run horizons

Comments and questions

- Overall assessment of Latvian experience and how generalizable is the case study
- Some features of sudden stops: little reallocation from tradable to non-tradable
- Role of real exchange rate changes in that respect exaggerated
- Misleading looking only at export response

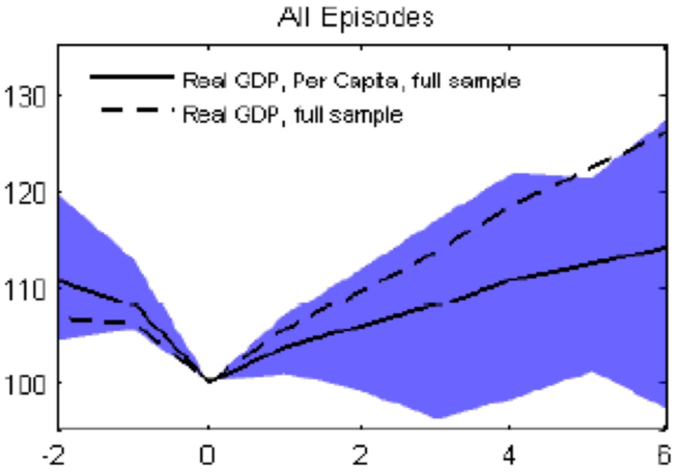
Sudden stops/financial crises



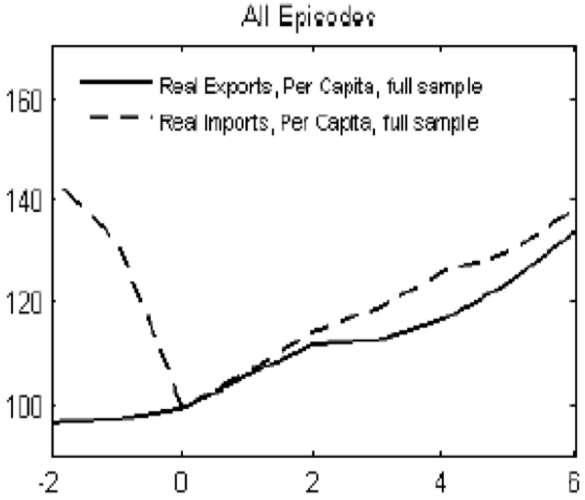
Latvia's sudden stop

- Adjustment of Latvia to the fall in GDP following the sudden stop not fast, relative to other experiences of sudden stop
- Export dynamics different: in Latvia exports drop during the toughest year of the crisis (due to global nature of crisis?)
- Given that domestic supply is equal to total output minus exports plus imports, the drop in exports in 2009 may explain a higher availability of goods in the domestic market (in contrast to typical sudden stop in which exports counteract the fall in domestic demand)
- At the same time supply of foreign goods might have declined due to credit constraints and supply shock at exporter country (more on this in the discussion of the econometric results)

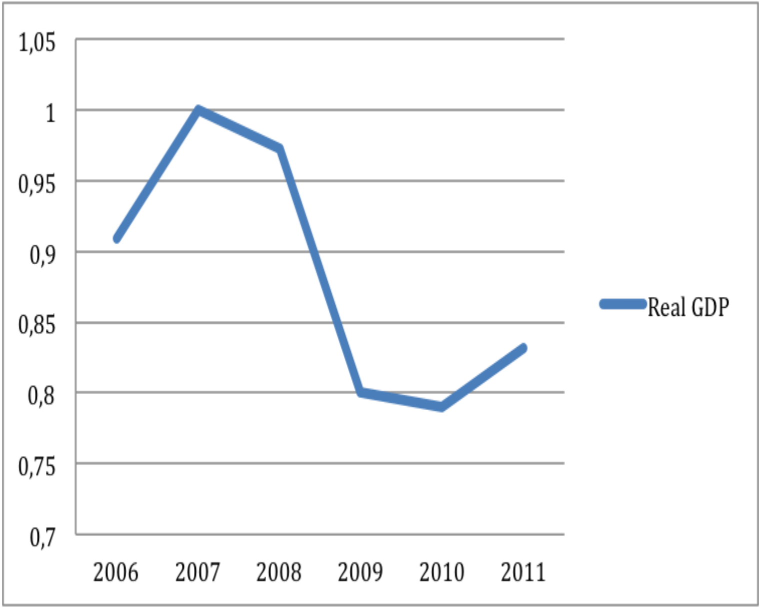
Sudden stop: Real GDP dynamics



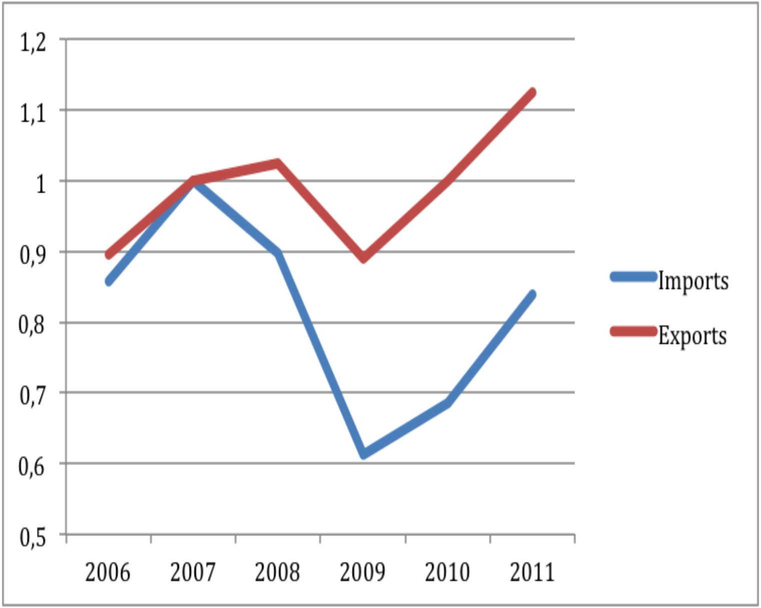
Sudden stop: Export and import dynamics



Latvia: Real GDP dynamics in sample period



Latvia: Export and import dynamics



Latvia: Large changes in relative prices across items)

2009/2008 (y-on-y December)

	Price change	foreign share
Meat and meat products	-5%	0,01
Milk, cheese, eggs	-10%	0,00 to 0,15
Hot drinks	9%	0,86
Alcoholic beverages	13%	0,65
Personal care	6%	0,98

Econometrics

- Estimation of the percentage change in the share of product i in group j
- In previous version of the paper estimation was done on levels, in the last version in growth rates
- Explained by convincing arguments on the virtue of the growth rate specification, however
  - Given that the analysis is based on quarterly data, one would expect some dynamic adjustment in the share. Is it acceptable to have a static version?
  - Potential "supply side" effects: due to lack of credit the super market buys less imported goods, which are likely to be bunched to reduce transportation costs and may require credit, vs local products that are delivered in smaller quantities and more often and thus may require less credit
  - Are we sure these effects are captured by group-time effects, as they may be item specific within groups?

Conclusions

- Really nice paper and extremely rich
- It could benefit from discussing more
  - The specific vs general features of the Latvian experience
  - The possible dynamic factors affecting the econometric specification