A Primer on IRBC Theory

(Complete Markets, Incomplete Markets and the role of Terms of Trade in business cycles)

Enrique G. Mendoza
University of Pennsylvania & NBER
Layout of the lecture

- Study complete & incomplete markets models of response of trade balance (TB) to terms-of-trade (TOT) shocks (Harberger-Laursen-Metzler, HLM, effect) and role of TOT in business cycles

1. General introduction to HLM literature

2. Backus’s complete markets RBC framework

3. Mendoza’s incomplete markets model
   1. Stylized facts on TOT, HLM and business cycles
   2. SOE multisector RBC model with Epstein-Uzawa preferences to pin down stochastic steady state
   3. RBC-style quantitative analysis
REVIEW OF THE EARLY HLM LITERATURE
Classic HLM Argument (1950)

- Keynesian import demand: positive but less-than-unitary marginal prop. to import (mpm)

- HLM effect: A worsening of TOT worsens the trade deficit: $\rho(TB, TOT) > 0$

- A fall in TOT causes a fall in disposable income in terms of imports, and since $0 < mpm < 1$, imports fall by less than disposable income and the value of exports $\rightarrow$ trade balance falls
Intertemporal models of the 1980s

- Obstfeld (1982), Svensson and Razin (1983) and a large collection of papers that followed them
- Deterministic intertemporal equilibrium models in the class of Workhorse Model No. 1
- Main prediction: Response of TB to TOT shocks depends on duration of TOT shocks
  - Transitory shocks yield HLM effects
  - As persistence increases, co-movement weakens
  - Permanent shocks have zero or even negative co-movement (depending on discount factor)
The OSR argument

\[ c_2 = p_2 Y_2 + (1 + r^*)(p_1 Y_1 - c_1) \]

\[ c^*_0 = E_0 \]

\[ c^*_0 = p^*_0 Y_2 \]

\[ c^*_0 = p^*_1 Y_1 \]

\[ -(1 + r^*) \]

Y_1,Y_2 exportable endowment

\( c_1,c_2 \) importable good
The OSR argument: transitory shock

\[ c_2 = p_2 Y_2 + (1 + r^*)(p_1 Y_1 - c_1) \]

\[ c_2^0 = p_2^0 Y_2 \]

\[ c_1^0 = p_1^0 Y_1 \]

\[ p_1^2 < p_1^0, p_2 \text{ fixed} \]

Trade deficit
The OSR argument: permanent shock

\[ c_2 = p_2 Y_2 + (1 + r^*)(p_1 Y_1 - c_1) \]

- \( c_0^0 = E_0 \)
- \( c_0^1 = E_1 \)
- \( p_2^1 < p_2^0, p_1^1 < p_1^0 \)
Formal derivation of the OSR results

• Rewrite Workhorse model No. 1 with two goods:

\[
\max \sum_{t=0}^{\infty} \beta^t u(c^m_t)
\]

s.t. \( c^m_t = p^x_t \bar{x} - b_{t+1} + b_t (1 + r^*) \)

\[
\lim_{t \to \infty} \frac{b_t}{(1 + r^*)^t} = 0
\]

\[
\beta(1 + r^*) = 1 \quad p^x_t = \overline{p^x}(1 \pm \epsilon_t)
\]

\[
u'(c^m_t) = \beta(1 + r^*)u'(c^m_t) \Rightarrow \overline{c^m} \quad \forall t
\]

\[
\overline{c^m} = (1 - \beta)\overline{p^x}\bar{x} \left( \sum_{t=0}^{\infty} \frac{(1 + \epsilon_t)}{(1 + r^*)^t} \right) + b_0 r^*
\]
The OSR results

• Permanent TOT fall: Largest cut in PV of income, makes imports fall as much as value of exports.

\[
\bar{c}^m = \frac{(1 - \beta)p^x \bar{x}(1 + \epsilon)}{(1 - \beta)} \Rightarrow \bar{c}^m = \downarrow p_t^x \bar{x}
\]

• Transitory TOT fall: Fall in PV of income is smaller than with permanent shock, hence imports fall less, and thus must fall less than value of exports at date t (consumption smoothing), so \(p_t^x \bar{x} - c_t^m\) falls

• Transitory fall in TOT reduces TB (HLM effect), permanent fall has no effect
THE RESPONSE OF TB TO TOT SHOCKS IN MODELS WITH UNCERTAINTY AND COMPLETE MARKETS
Backus’s Two Country Model

• The relationship between TOT and TB depends on source of TOT variations and structure of preferences

• It DOES NOT depend on persistence of TOT!

• Argues that his results differ from OSR because of uncertainty, but it is really because of uncertainty AND complete markets!
Uncertainty setup

• Follows Lucas (1982, 1984) in setting recursive (Markov) structure of choice under uncertainty

• Two country, stochastic endowment economy

• Uncertainty is characterized by events $z_t$ drawn from finite set $Z_t$, so that at each date $t = 0, 1, \ldots, T$ the state of nature is described by
  
  – $z^t$: history of events $z^t \equiv (z_1, \ldots, z_t)$ with $z^t \in Z^t$
  
  – $z_0$, the initial event.
Markov endowments

• Two countries specialized by commodity Markov processes of endowments of diff. goods
  – \( \{x(z^t)\} \), country 1. \( \{y(z^t)\} \), country 2.

• \( z_t \) follows Markov process characterized by a time-invariant Markov chain:
  1. \( z_t \in Z_t \in \mathbb{R}^n \) for \( n \) events (realization vector)
  2. \( P \in \mathbb{R}^{n \times n} \) transition matrix
  3. \( \pi_0 \in \mathbb{R}^{1 \times n} \) initial prob. Vector for each \( z \in Z \)

• Markov property: Probability of state \( z^t \) conditional on \( z_0 \) is given by:

\[
\pi(z^t) = \pi(z_t|z_{t-1})\pi(z_{t-1}|z_{t-2}) \ldots \pi(z_1|z_0)
\]
Preferences

• Households in each country consume both goods and have CES expected utility:

\[
(I) \quad u_i = \sum_{t=0}^{T} \beta^t \sum_{z^t \in Z^t} \pi(z^t) \left[ \frac{a_i(z^t)^{1-\alpha} + b_i(z^t)^{1-\alpha}}{1-\alpha} \right]
\]

\[\alpha > 0 \quad i = 1,2\]

\[1/\alpha \equiv \text{Atemporal & intertemporal elasticity of substitution}\]
Complete Markets of Contingent Claims

- Assume complete markets in state-contingent (Arrow-Debreu) claims, which are secs. traded at date 0 promising to deliver goods at particular future dates and states.

- A-D markets pin down \textbf{date-0 prices} of home and foreign goods defined as $q(z^t)$ and $p(z^t)$.

- Agents maximize utility subject to date 0 budget constraints that incorporate all A-D trades.
Budget constraints with A-D claims

(IIa) Home \[ \sum_{t, z^t} \left[ p(z^t)a_1(z^t) + q(z^t)b_1(z^t) - p(z^t)x(z^t) \right] \leq 0 \]

(IIb) Foreign \[ \sum_{t, z^t} \left[ p(z^t)a_2(z^t) + q(z^t)b_2(z^t) - q(z^t)y(z^t) \right] \leq 0 \]

- Terms of trade \[ \rightarrow TOT(z^t) \equiv \frac{p(z^t)}{q(z^t)} \]
Competitive Equilibrium with A-D Claims

- \{p(z^t), q(z^t)\}_{t,z^t} \text{ and } \{a_1(z^t), a_2(z^t), b_1(z^t), b_2(z^t)\}_{t,z^t}
  such that
  - Households max (I) s.t. (IIa), (IIb)
  - Commodity markets clear in all states:

\begin{align*}
a_1(z^t) + a_2(z^t) &= x(z^t) \\
b_1(z^t) + b_2(z^t) &= y(z^t)
\end{align*}

\forall z^t \in Z^t

- In the absence of distortions, Mantel & Negishi showed that A-D equilibrium can be characterized as solution to a planner’s problem that chains “seemingly static” problems
Planner’s Problem

\[ \max \sum_{i} \lambda_i u_i = \sum_{i} \lambda_i \sum_{t=0}^{T} \beta^t \sum_{z^t \in Z^t} \pi(z^t)u(a_i(z^t), b_i(z^t)) \]

s.t.
\[ a_1(z^t) + a_2(z^t) \leq x(z^t) \]
\[ b_1(z^t) + b_2(z^t) \leq y(z^t) \quad \forall z^t \in Z^t \]

for some choice of \( \lambda_i \)'s

\( A(z^t) \) multiplier on \( x(z^t) \) constraint ( \( A(z^t) = p(z^t) \) )
\( B(z^t) \) multiplier on \( y(z^t) \) constraint ( \( B(z^t) = q(z^t) \) )
Planner’s First-Order Conditions

\[ a_1(z^t): \lambda_1 \beta^t \pi(z^t)u_1(a_1(z^t), b_1(z^t)) = A(z^t) \]

\[ b_1(z^t): \lambda_1 \beta^t \pi(z^t)u_2(a_1(z^t), b_1(z^t)) = B(z^t) \]

\[ a_2(z^t): \lambda_2 \beta^t \pi(z^t)u_1(a_2(z^t), b_2(z^t)) = A(z^t) \]

\[ b_2(z^t): \lambda_2 \beta^t \pi(z^t)u_2(a_2(z^t), b_2(z^t)) = B(z^t) \]

• Define **date-t, state-t prices** (Arrow secs prices)

\[
\frac{A(z^t)}{\beta^t \pi(z^t)} = P(z^t) \quad \frac{B(z^t)}{\beta^t \pi(z^t)} = Q(z^t)
\]
Sequential solution

• Identical prices and allocations follow from solving independent problems for each state $z^t$. (eq. allocations and prices are not history dependent!)

• $P(z^t)$ and $Q(z^t)$ are Lagrange multipliers in these sequential Lagrangians for each $z^t$:

$$\mathcal{L} = \lambda_1 u(a_1(z^t), b_1(z^t)) + \lambda_2 u(a_2(z^t), b_2(z^t)) + P(z^t)[x(z^t) - a_1(z^t) - a_2(z^t)] + Q(z^t)[y(z^t) - b_1(z^t) - b_2(z^t)]$$
Sequential first-order conditions

\[ a_1(z^t): \lambda_1 u_1(.) = P(z^t) \]

\[ b_1(z^t): \lambda_1 u_2(.) = Q(z^t) \]

\[ a_2(z^t): \lambda_2 u_1(.) = P(z^t) \]

\[ b_2(z^t): \lambda_2 u_2(.) = Q(z^t) \]

\[ P(z^t): a_1(z^t) + a_2(z^t) \leq x(z^t) \]

\[ Q(z^t): b_1(z^t) + b_2(z^t) \leq y(z^t) \]
Closed-form solution of seq. problem

• Functional form: \[ u = \frac{a^{1-\alpha} + b^{1-\alpha}}{1 - \alpha} \]

• Eq. prices given welfare weights:
  \[ P(z^t) = \left[ \frac{\sum_i \lambda_i^\alpha}{x(z^t)} \right]^\alpha \]
  \[ Q(z^t) = \left[ \frac{\sum_i \lambda_i^\alpha}{y(z^t)} \right]^\alpha \]

• Eq. allocations given welfare weights:
  \[ a_1(z^t) = \lambda_1^* x(z^t), \quad a_2(z^t) = \lambda_2^* x(z^t), \]
  \[ b_1(z^t) = \lambda_1^* y(z^t), \quad b_2(z^t) = \lambda_2^* y(z^t) \]
  \[ \lambda_i^* \equiv \frac{\frac{1}{\lambda_i^\alpha}}{\sum_i \frac{1}{\lambda_i^\alpha}} \]
  \[ \lambda_1^* + \lambda_2^* = 1 \]
Closed form solution contn’d

• Eq. TOT:

\[
TOT(z^t) = \frac{p(z^t)}{q(z^t)} = \frac{P(z^t)}{Q(z^t)} = \left[\frac{y(z^t)}{x(z^t)}\right]^\alpha
\]

which are independent of welfare weights.

• To finish characterizing equil., we need to find particular weights \((\lambda_1^*, \lambda_2^*)\) that correspond to the CE for the endowment sequence \(\{x(z^t), y(z^t)\}\)

• This is done by identifying weights such that optimal quantities and prices satisfy each country’s budget constraint

• Weights are time and state invariant!
Equilibrium Welfare Weights

\[ \sum_{t,z^t} p(z^t)(x(z^t) - a_1(z^t)) = \sum_{t,z^t} q(z^t)b_1(z^t) \]

\[ \sum_{t,z^t} \beta^t \pi(z^t) \left[ \frac{\sum_i \lambda_i^{1-\alpha}}{x(z^t)} \right]^\alpha (x(z^t) - \lambda_1^* x(z^t)) = \sum_{t,z^t} \beta^t \pi(z^t) \left[ \frac{\sum_i \lambda_i^{1-\alpha}}{y(z^t)} \right]^\alpha \lambda_1^* y(z^t) \]

\[ \sum_{t,z^t} \beta^t \pi(z^t) x(z^t)^{1-\alpha} = \lambda_1^* \left[ \sum_{t,z^t} \beta^t \pi(z^t)(x(z^t)^{1-\alpha} + y(z^t)^{1-\alpha}) \right] \]

\[ \lambda_1^* = \frac{\sum_{t,z^t} \beta^t \pi(z^t) x(z^t)^{1-\alpha}}{\sum_{t,z^t} \beta^t \pi(z^t)(x(z^t)^{1-\alpha} + y(z^t)^{1-\alpha})} \]
Balance of trade

- Define trade balance in units of imported goods

\[ TB(z^t) = TOT(z^t)[x(z^t) - a_1(z^t)] - b_1(z^t) \]

- Equilibrium trade balance:

\[ TB(z^t) = \left[ \frac{y(z^t)}{x(z^t)} \right]^\alpha \left[ x(z^t) - \lambda^*_1 x(z^t) \right] - \lambda^*_1 y(z^t) \]

\[ TB(z^t) = y(z^t)^\alpha x(z^t)^{1-\alpha} (1 - \lambda^*_1) - \lambda^*_1 y(z^t) \]
The Relationship Between TB and TOT

• TOT gain caused by \((\downarrow x, \bar{y})\) or \((\uparrow y, \bar{x})\)

• First case: \((\downarrow x, \bar{y})\), compare TB before and after

\[
x^{1-\alpha} \bar{y}^\alpha (1 - \lambda_1^*) - \lambda_1^* \bar{y} \leq \bar{x}^{1-\alpha} \bar{y}^\alpha (1 - \lambda_1^*) - \lambda_1^* \bar{y}
\]

\[
x^{1-\alpha} \leq \bar{x}^{1-\alpha}
\]

\[
\left(\frac{x}{\bar{x}}\right)^{1-\alpha} \leq 1 \Rightarrow \begin{cases} 
\alpha < 1 \Rightarrow \left(\frac{x}{\bar{x}}\right)^{1-\alpha} < 1 \\
\alpha = 1 \Rightarrow \left(\frac{x}{\bar{x}}\right)^{1-\alpha} = 1 \\
\alpha > 1 \Rightarrow \left(\frac{x}{\bar{x}}\right)^{1-\alpha} > 1 
\end{cases}
\]

\[
\rho(TOT, TB) \leq 0 \iff \alpha \leq 1
\]
The Relationship Between TB and TOT

• Second case: \((\uparrow y, \bar{x})\)

\[
TB(y) \leq TB(\bar{y})
\]

\[
(1 - \lambda_1^*) x^{1-\alpha} (y^\alpha - \bar{y}^\alpha) \leq \lambda_1^* (y - \bar{y})
\]

\[
\alpha \to 0 \Rightarrow \uparrow y \Rightarrow (\uparrow TOT, \downarrow TB)
\]

\[
\alpha \text{ large} \Rightarrow \uparrow y \Rightarrow (\uparrow TOT, \uparrow TB)
\]
Main result

• The relationship between TOT and TB in a complete-markets setup depends on
  – Nature of the shock driving the two variables (x or y)
  – Preference parameters
  – Not on duration of shocks

• HLM effect requires “relatively” low atemporal & intertemporal elasticities of substitution
Why is this different from OSR?

- TOT shock is a shock incorporated into $Z^t$ given $Z^0$. In this sense, it is somewhat “anticipated” (realization of a random process with known support).
- We can show that for an “unanticipated” or “parametric”, change in sequence of endowments not included in $Z^t$ the results are similar to OSR (no effect on TB).
An “unexpected permanent shock”

• Consider a permanent endowment shock in perfect foresight.

• Initial equilibrium: \( x_t = y_t = 1 \quad \forall \ t \)

\[ \lambda_1^* = \lambda_2^* = 1/2 \]

\[ p_t = q_t = \beta^t \quad \text{TOT}=1 \]

\[ a_{1t} = a_{2t} = b_{1t} = b_{2t} = 1/2 \quad \forall \ t \]

\[ TB_t = [x_t - a_{1t}] - b_{1t} = 0 \]
Effects of “unexpected permanent shock”

- At $t = \tau$, $y_1 < 1 \quad \forall \ t \geq \tau$

$$TOT_t = y_1^\alpha \quad \forall \ t \geq \tau$$

$$TB_t = y_1^\alpha(1 - \lambda_1^*) - \lambda_1^* y_1$$

$$= y_1^\alpha - \frac{y_1^\alpha}{1 + y_1^{1-\alpha}} - \frac{y_1}{1 + y_1^{1-\alpha}}$$

$$= \frac{y_1^\alpha(1 + y_1^{1-\alpha}) - (y_1^\alpha + y_1)}{1 + y_1^{1-\alpha}} = 0$$
Why are predictions different under complete markets?

• Adding uncertainty without AD claims to OSR setup implies assuming incomplete markets

• $b$ is the only financial asset, and does not allow state-contingent trading
  – Adds potentially powerful wealth effects of nondiversified shocks (and prec. savings)

• In last example, $\lambda^*_1$ changes from $\frac{1}{2}$ to $\frac{1}{1 + y_1^{1-\alpha}}$
  – Reflects wealth effect.

• Incomplete markets limit agent’s ability to adjust behavior to “possibility of change”
What if we try solving the incomplete markets case?

• Backus shows that in the bond economy case:

\[ TB(z^t) = TOT(z^t)[x(z^t) - \lambda^*_1(z^t)x(z^t)] - \lambda^*_1(z^t)y(z^t) \]

where \( \lambda^*_1(z^t) \) is the state-contingent welfare weight that captures wealth effect (without a closed-form solution for \( \lambda^*_1(z^t) \))

• HLM effect of the OSR setup in a stochastic model requires incomplete markets

• This is necessary, but is it sufficient?