WHY IS CONSUMPTION MORE VOLATILE THAN OUTPUT IN EMERGING MARKETS?

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Abstract

Standard real business cycle theory predicts that consumption should be smoother than output, as observed in developed countries. In this paper we provide a novel explanation of the consumption volatility puzzle based on political factors. In our model groups that disagree on the size of government alternate in power and face aggregate uncertainty. While productivity shocks only affect consumption through responses to output, political shocks change the composition between private and public consumption for a given output size. As less stable governments and more polarized societies characterize emerging market economies the effects of political shocks are more pronounced. For a reasonable set of parameters we confirm the empirical relationship between political polarization and the ratio of consumption volatility to output volatility across countries.

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