Emerging Market Business Cycles with Heterogeneous Agents*

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Abstract

This paper makes the first attempt to study the emerging market business cycles in a heterogeneous-agent small open economy model with aggregate uncertainty. The model's two-asset environment over different degrees of liquidity is calibrated so that the marginal propensities to consume (MPC) are as high as empirical estimates from emerging market micro data, which are substantially greater than the U.S. MPC estimates. I then take the model to macro data through Bayesian estimation. I find that high-MPC households generate the stylized pattern of emerging economies that consumption is more volatile than output: this phenomenon disappears when households are counterfactually replaced with those exhibiting U.S. MPCs. High-MPC households contribute to the consumption volatility through i) their strong consumption response to resource fluctuations and ii) significantly enhanced precautionary saving when illiquid assets become more illiquid. The mechanisms of conventional theories are dampened in my model because households significantly deviate from the Permanent Income Hypothesis, which these mechanisms crucially depend on.

***JEL classification*:** E21, E32, F41, D31

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