

Hand-to-Mouth Households, Price Stickiness, and Consumption Volatility*

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Abstract

We introduce hand-to-mouth households and price stickiness into an otherwise standard small open economy model to replicate the well-known excess consumption volatility in emerging countries. Using aggregate data, we first empirically show that the share of hand-to-mouth households is significantly higher in emerging countries than in advanced countries. We then show that the model with only stationary productivity shocks generates the excess volatility of consumption, as long as the share of hand-to-mouth households and prices are sufficiently high and sticky. In general, because hand-to-mouth households do not have access to asset markets, their consumption is much more volatile than the consumption of savers with access to asset markets. Nevertheless, when prices are flexible, the model cannot generate excess consumption volatility because the consumption volatility of hand-to-mouth households is not large enough. However, when prices are sticky, hand-to-mouth consumption volatility is large enough for the model to generate excess consumption volatility. We also add various shocks, including trend productivity shocks and interest-rate shocks, to the model and estimate it to assess the contribution of each shock in explaining excess consumption volatility.

JEL Classification: E21, E32, F44

Keywords: hand-to-mouth households; price stickiness; consumption volatility

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