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Status seeking in the small open economy

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Abstract

In our modified version of the small open economy Ramsey model, agents have preferences over consumption and status, the latter determined by relative wealth. Contrary to the standard model in which an impatient country asymptotically mortgages all of its capital and labor income, this extension potentially yields interior steady states. This results from the fact that the effective rate of return becomes a function of consumption and net assets. Notably, a permanent increase in government expenditure crowds out long-run consumption more than one-for-one. Similarly, the effects of improvements in productivity on long-run consumption are magnified by relative wealth preferences.

JEL classification: E21; F41

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1. Introduction

An individual's utility is usually stated in terms of the *absolute* levels of economic variables, such as consumption of goods and services, leisure, wealth, etc. This standard specification is intuitively appealing and adequate to study many economic problems. There is evidence, some of which is provided by Easterlin (1974, 1995), Clark and Oswald (1996), Oswald (1997), and Frank (1997), to indicate, however, that an individual's economic well-being depends crucially on his *relative* position, or status, in society. The idea that individuals are motivated by status considerations is a very old one in economics and can be traced back to thinkers such as Hume (1978) and Veblen (1899). After World War II interest in this idea and its potential policy implications was maintained by authors such as Duesenberry (1949), Scitovsky (1976), Hirsch (1976), Boskin and Sheshinski (1978), Layard (1980), and Frank (1985a,b). In the last decade, there are an increasing number of researchers who study the implications of status preference in a dynamic macroeconomic or endogenous growth context. In general, there are two alternative ways in which status is modeled in macroeconomic settings. The approach adopted by Galí (1994), Persson (1995), Harbaugh (1996), Rauscher (1997b), Grossmann (1998), Ljungqvist and Uhlig (2000), and Fisher and Hof (2000) specifies that status derives from relative consumption. In contrast, Corneo and Jeanne (1997, 2001a,b), Rauscher (1997a), Futagami and Shibata (1998), Fisher (2001), and Hof and Wirl (2003) consider that status arises from relative wealth.

To date, most of the macroeconomic research on status-preference has been restricted to the closed economy, Fisher (2001) and Hof and Wirl (2003) being an exception. Due to the increasing integration of the world economy and the greater role played by international assets in wealth accumulation, we believe additional work needs to be done in analyzing the role played by status-preference in the open economy context. In this paper, we will introduce relative wealth into an otherwise standard small open economy Ramsey model.[2]

It is well-known that the small open economy Ramsey model—under the assumption of perfect capital mobility—exhibits several problematic features if the domestic rate of time preference differs from the exogenous world interest rate. If, for example, the economy is ''relatively patient'' in the sense that its rate of time preference is less than the exogenous world interest rate, it then accumulates assets to such an extent that it eventually violates the small open economy assumption. On the other hand, if the domestic rate of time preference exceeds the world interest rate, in other words, if the economy is ''relatively impatient'', agents then over time mortgage all their

[2] Our work is related to the recent Spirit of Capitalism literature, which is exemplified by authors such as Cole et al. (1992), Zou (1994, 1998), and Bakshi and Chen (1996), who seek to explain growth, savings, and asset pricing behavior. This research views wealth accumulation as the means to achieving social status, which itself enables agents to acquire nonmarket goods that are regarded as ''prizes'' by society at large. As stressed by Cole et al. (1992), utility functions that include variables such as relative wealth can then be interpreted as reduced-form versions of preferences over ''deep'' variables in which different social organizations can lead to different reduced-form preferences.