



# The spirit of capitalism, asset pricing and growth in a small open economy

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## Abstract

Conventional models of economic behavior have failed to account for a number of observed empirical regularities in macroeconomics and international economics. This may be due to preference specifications in conventional models. In this paper, we consider preferences with the “spirit of capitalism” (the desire to accumulate wealth as a way of acquiring status). We analyze a number of potential effects of international catching-up and the spirit of capitalism on savings, growth, portfolio allocation and asset pricing. Moreover, we obtain a multi-factor Capital Asset Pricing Model (CAPM). Our results show that status concerns have non-trivial effects on savings, growth, portfolio allocation, asset prices and the foreign exchange risk premium.

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## 1. Introduction

Conventional models of economic behavior assume that a person’s well-being depends on the absolute quantities of various goods and services he consumes and not on how these quantities compare with those consumed by others. Yet, from Max Weber’s pursuit of wealth as an

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end in itself (spirit of capitalism) to Duesenberry's "demonstration effect" in consumption, there is a long tradition in sociology and economics which acknowledges that people are concerned with their relative standing in society and individuals' consumption decisions are influenced by others (Duesenberry, 1949).

There is a growing recognition that modeling preferences to accommodate such elements enhance our understanding of saving-consumption, asset pricing, and economic growth. For example, several authors have recently shown that the spirit of capitalism has non-trivial consumption-saving, portfolio allocation, asset pricing and growth effects. Bakshi and Chen (1996a) develop a model where relative wealth status leads to a two factor Capital Asset Pricing Model (CAPM). Smith (2001) extends the model to recursive preferences and obtains a three factor CAPM. In another paper, Smith (1999) examines growth effects. In a series of papers, Gong and Zou examine long run growth, saving, policy effectiveness, and monetary issues in a cash-advance setting under the spirit of capitalism (Zou, 1994, 1995; Gong and Zou, 2001, 2002). Following Bakshi and Chen (1996a) and others, Carroll (2002) presents a model where wealth enters consumers' utility functions directly and shows that the model yields results consistent with the available data on the saving behavior of the wealthy.

Frank (1985) and others have shown that an individual's well-being depends significantly on his relative standing in a society whereas Greenfeld (2001) makes a compelling case that a country's global standing and international catching-up has played a dominant role in the history of modern economic growth. According to Greenfeld, while the spirit of capitalism defined the historically exceptional inclination for the pursuit of material gain, it was competitive nationalism and not Protestantism that provided the collective consciousness and a new set of moral values for modern economic growth. Being a member of a nation confers prestige upon an individual; as such, each individual invests in the dignity and prestige of the nation which is "necessarily assessed in relation to the status of other nations." Therefore nationalism implies international competition, and "makes competitiveness a measure of success in every sphere which a nation defines as significant for its self-image, and commits societies which define themselves as nations to a race with a relative and therefore forever receding finishing line" (Greenfeld, 2001, p. 23). The sense of being a nation started in Britain by the beginning of the 17th century and stimulated nationalism elsewhere.

In this paper, we incorporate elements of "spirit of capitalism" à la Greenfeld whereby the representative individual cares about his standing in the global wealth hierarchy and we use "international catching-up" to describe concerns about fluctuations in individual wealth relative to international wealth standards. When individuals care about relative status and the associated risks of falling out of status, they will hedge against these risks. This can have potentially important portfolio allocation, consumption-saving and growth effects. Using the "international catching-up" feature, we analyze consumption, growth, international portfolio allocation, and asset pricing in a dynamic stochastic general equilibrium setting. Our model builds on the rich equilibrium framework of Grinols and Turnovsky (1994) and well known to be capable of addressing a number of interesting issues (such as how means and variances of domestic government policy impact on the economy and isolating determinants of the real foreign exchange rate premium). Even though the capitalist spirit model of Bakshi and Chen (1996a) captures the main features of the catching-up with the Joneses features of Abel (1990), the idea has not been modeled in a stochastic general equilibrium setup in an *open* economy.

There are several distinctive features of the model developed here (the first two are familiar from Grinols and Turnovsky, 1994): First, the equilibrium involves the joint determination of the means and variances of the relevant economic variables (in terms of the first two moments

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