Propagation of Export Shocks: The Great Recession in Japan

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Background

- Japan experienced a significant decline in GDP during the Great Recession. Japan's real GDP fell by 8.8% from the first quarter of 2008 to the first quarter of 2009.
- During the same period, the real value of exports from Japan fell by 36.1%.
- Export finance does not seem to be a major factor in this episode (Amiti and Weinstein 2011).
- Decline in export demand seems to be a culprit as a major cause of the GDP decline.
- From the viewpoint of the business cycle theory, this instance is a rare event where we can trace the shocks and their propagation.

Question

- How much did the export demand shock contribute to Japan's GDP decline during the Great Recession?
- How did the shock propagate across sectors and regions?

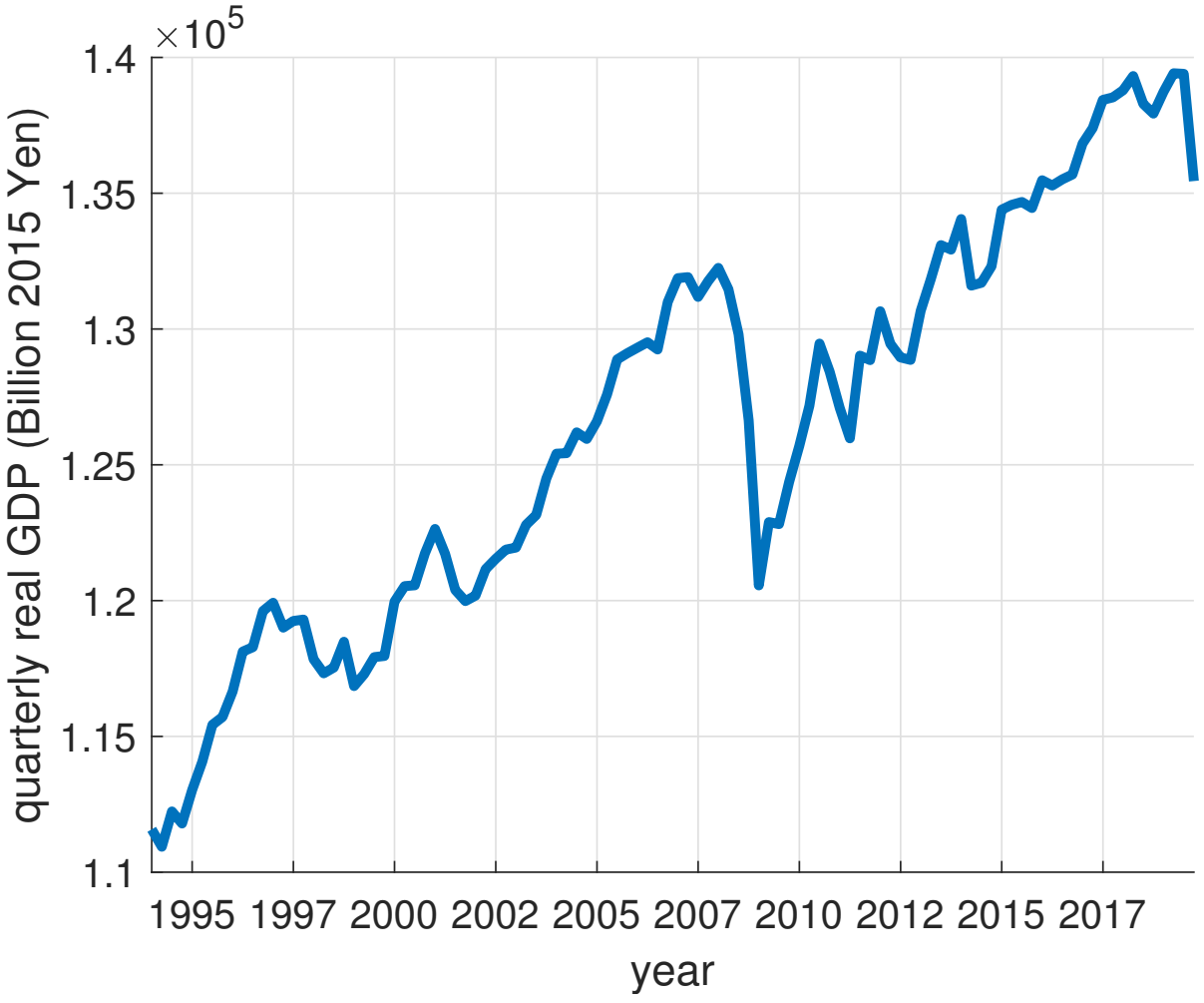
What we do

- Construct the export data, using the customs data, from each of the nine regions and industries.
- Using the inter-regional input-output table, construct a dynamic general equilibrium model to analyze the propagation of export shocks from one region to other regions.
  - The model provides an "RBC-like" framework that incorporates export demand shock.
  - We can keep track of the propagation process which is typically a "black box" in the RBC literature.
  - The monopolistic-competition-based model allows us to evaluate the effect of price stickiness.

Literature

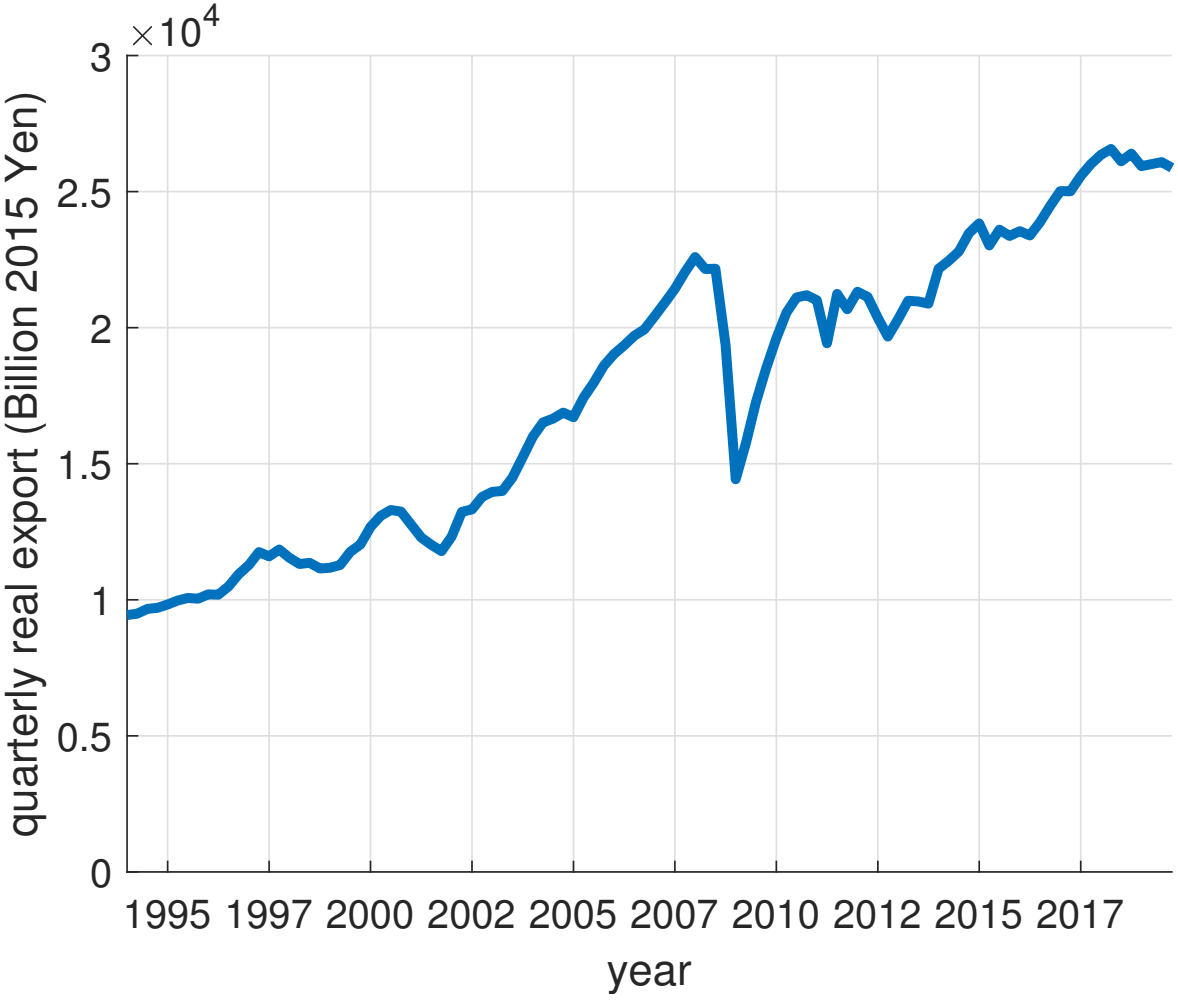
- Sectoral business cycles: Long and Plosser 1987 AER; Dupor 1999 JME; Horvath 2000 JME
- Production network model: Acemoglu et al. 2012 EMA; Baqaee and Farhi 2019 EMA
- Demand shocks in input-output network: Bartelsman et al. 1994 AER; Guiso et al. 2017 JER
- Great recession and trade: Alessandria et al. 2011; Eaton et al. 2016 AER
- Global propagation through input-output network: Ho et al. 2022; Huo et al. 2023; Boeckelmann et al. 2024
- Export shocks in firm-to-firm network: Huneeus 2020; Dhyne et al. 2022
- Regional propagation through input-output network: Caliendo et al. 2018 REStud

Real GDP



- Source: FRED

Exports



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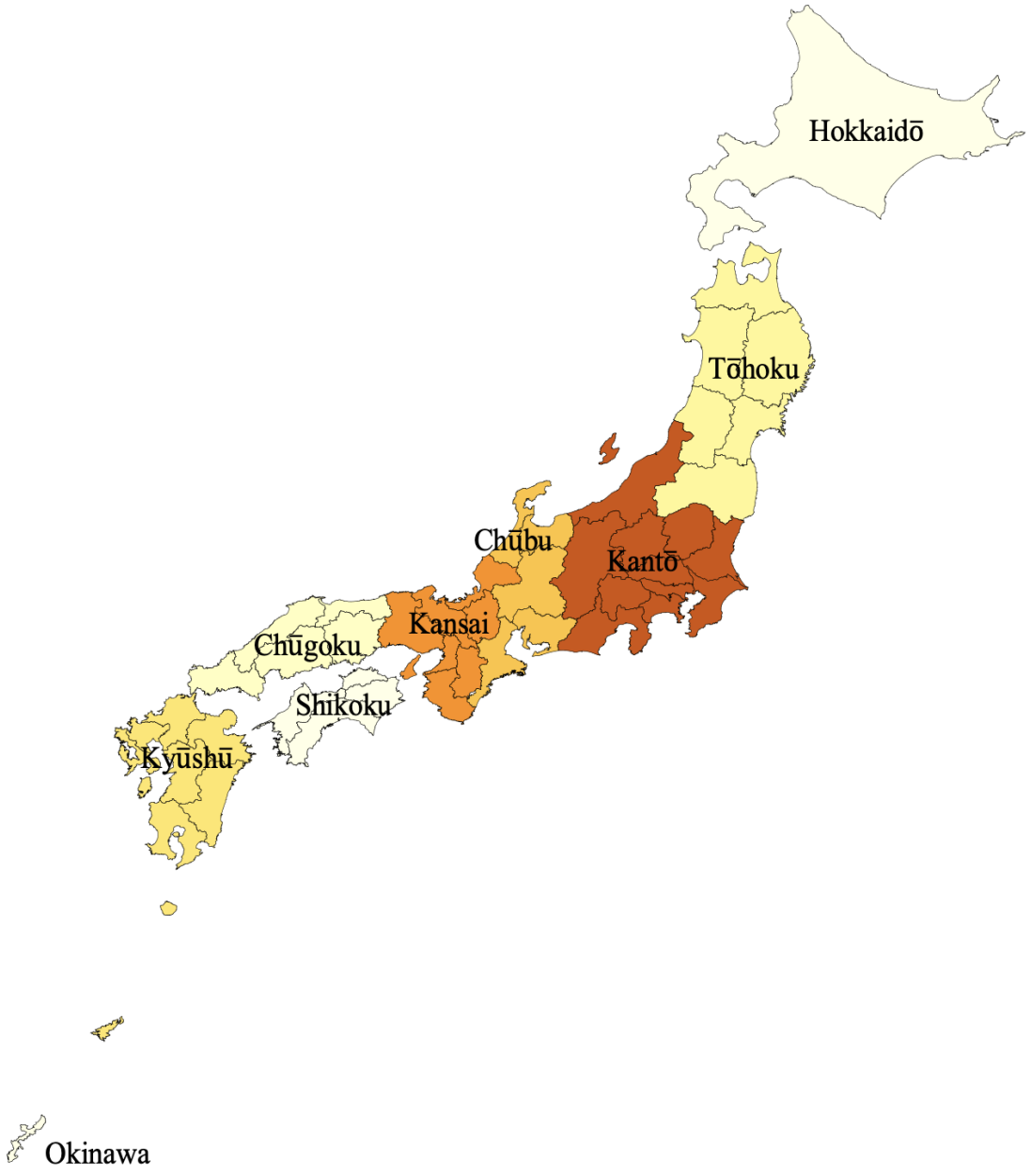
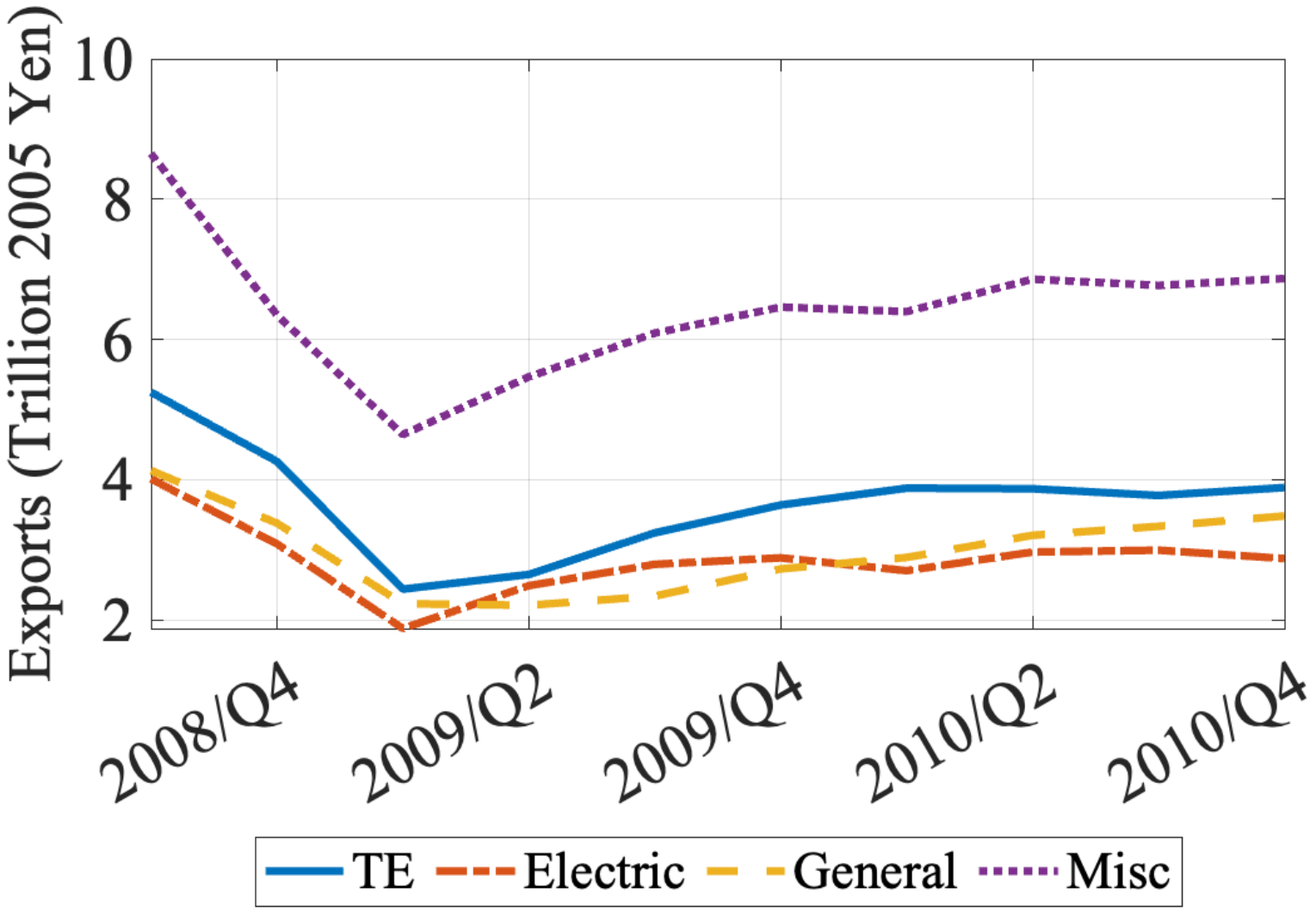
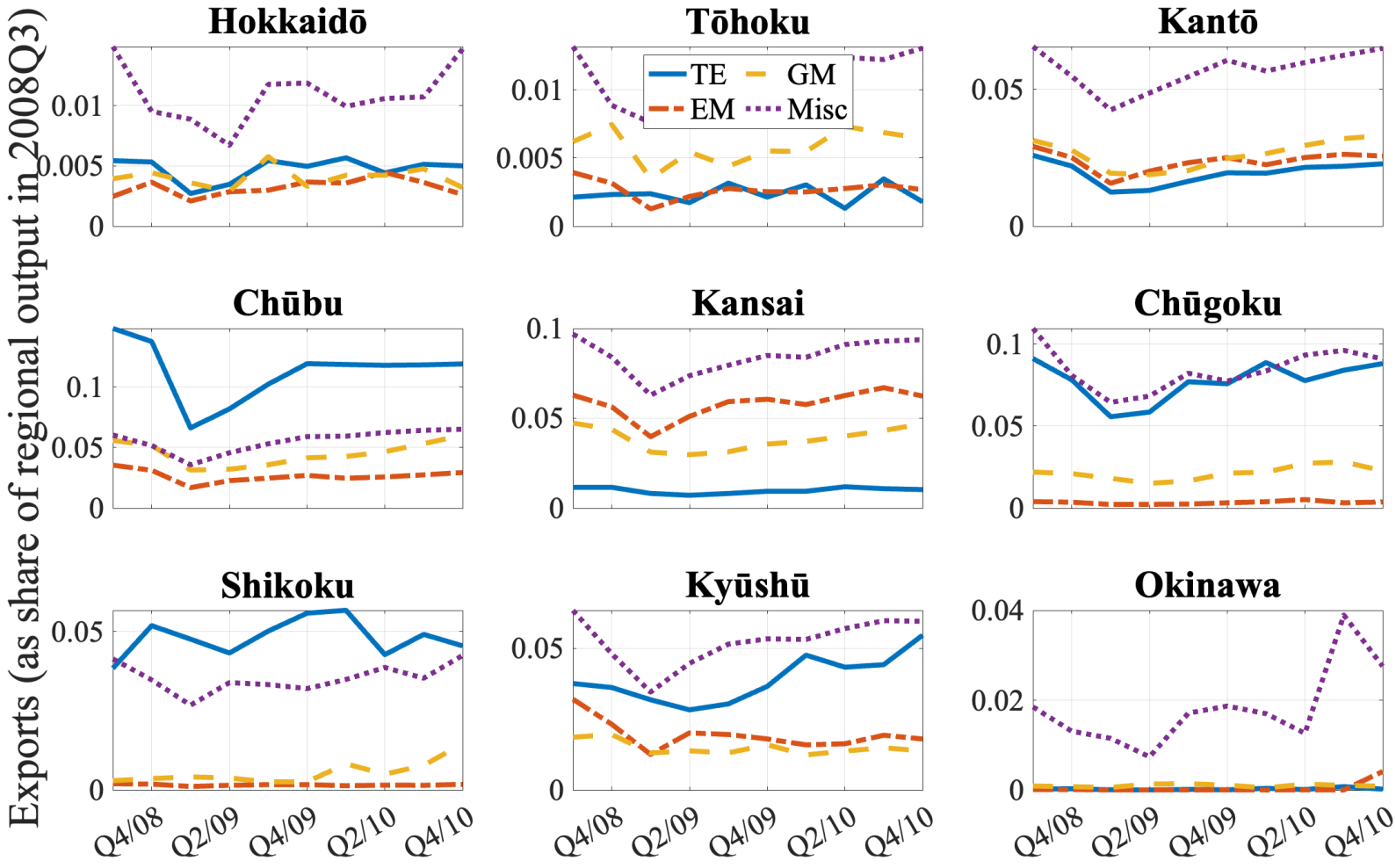
Nine regions



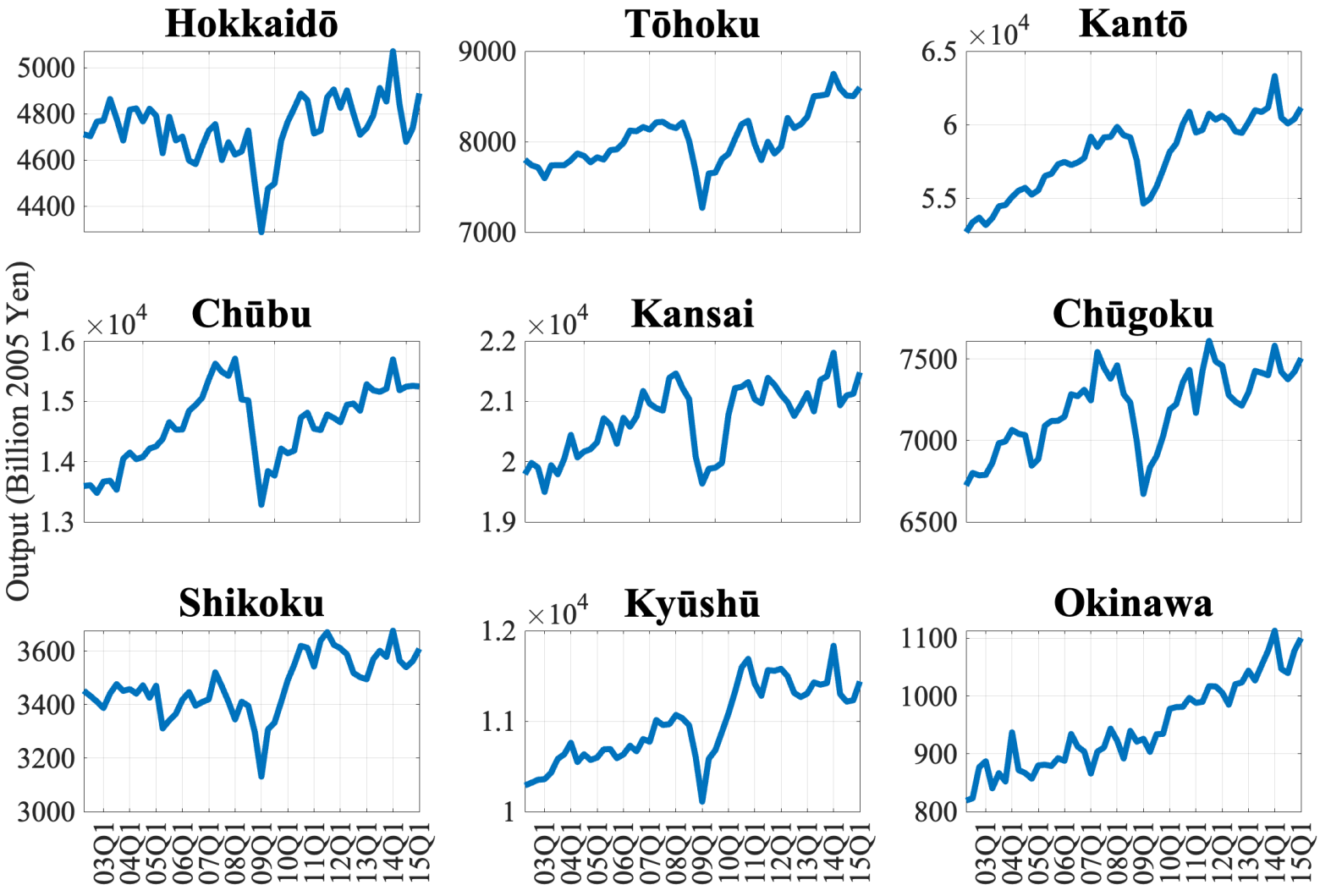
Exports


Exports (Trillion 2005 Yen)
10
8
6
4
2
2008/Q4
2009/Q2
2009/Q4
2010/Q2
2010/Q4
TE
Electric
General
Misc

Regional exports (scaled to regional GDP in the initial date)



Regional output



Model

- Dynamic input-output model with multiple regions.
- Representative consumer in each region.
- Monopolistic producer in each industry-region.
- Export (and import). The entire country is a small open economy.

Consumers

There are S products (industries) and I regions. The representative consumer (a price taker) at region i maximizes

$$\sum_{t=0}^{\infty} \frac{1}{(1+\rho)^t} \left[\frac{(C_{i,t})^{1-\sigma_c} - 1}{1-\sigma_c} - \chi \frac{(N_{i,t})^{1+\zeta}}{1+\zeta} \right]$$

subject to

$$P_{i,t}^c C_{i,t} + P_{i,t}^x X_{i,t} \leq \int_0^S w_{si,t} n_{si,t} ds + r_{i,t} K_{i,t} + \Pi_{i,t}$$

and

$$K_{i,t+1} = (1-\delta) K_{i,t} + X_{i,t}$$

(no inter-regional movements of capital, labor, and ownership).

Consumers

where

$$C_{i,t} = \left[\int_0^S \int_0^I (\xi^i_{sjc})^{\frac{1}{\sigma}} (c^i_{sj,t})^{\frac{\sigma-1}{\sigma}} dj ds + \int_0^Z (\xi^i_{zf})^{\frac{1}{\sigma}} (c^i_{zf,t})^{\frac{\sigma-1}{\sigma}} dz \right]^{\frac{\sigma}{\sigma-1}},$$

$$X_{i,t} = \left[\int_0^S \int_0^I (\xi^i_{sjx})^{\frac{1}{\sigma}} (x^i_{sj,t})^{\frac{\sigma-1}{\sigma}} dj ds \right]^{\frac{\sigma}{\sigma-1}},$$

and

$$N_{i,t} = \left[\int_0^S (n_{si,t})^{\frac{\tau+1}{\tau}} ds \right]^{\frac{\tau}{\tau+1}}.$$

Consumers

Solutions:

- Intertemporal optimization:

$$\left(\frac{C_{i,t}}{C_{i,t+1}}\right)^{-\sigma_c} = \frac{1}{1+\rho}\left(1+\frac{r_{i,t+1}}{P^x_{i,t+1}}-\delta\right)$$

- Labor supply:

$$\frac{w_{si,t}}{P^c_{i,t}} = \chi(C_{i,t})^{\sigma_c}(N_{i,t})^{\zeta}\left(\frac{n_{si,t}}{N_{i,t}}\right)^{\frac{1}{\tau}}.$$

Consumers

Solutions:

- Domestic goods demand:

$$c^i_{sj,t} = \left(\frac{p_{sj,t}}{P^c_{i,t}}\right)^{-\sigma} \xi^i_{sjc} C_{i,t}$$

- Foreign goods (import) demand:

$$c^i_{zf,t} = \left(\frac{p_{zf,t}}{P^c_{i,t}}\right)^{-\sigma} \xi^i_{zf} C_{i,t}$$

- Investment goods demand:

$$x^i_{sj,t} = \left(\frac{p_{sj,t}}{P^x_{i,t}}\right)^{-\sigma} \xi^i_{sjx} X_{i,t}$$

Consumers

Solutions:

- Price index for consumption:

$$P_{i,t}^{c} \equiv \left[\int_0^S \int_0^I \xi_{sjc}^{i} (p_{si,t})^{1-\sigma} di ds + \int_0^Z \xi_{zf}^{i} (p_{zf,t})^{1-\sigma} dz \right]^{\frac{1}{1-\sigma}}$$

- Price index for investment:

$$P_{i,t}^{x} \equiv \left[\int_0^S \int_0^I \xi_{sjx}^{i} (p_{sj,t})^{1-\sigma} dj ds \right]^{\frac{1}{1-\sigma}}$$

Production

- In region i, good h is produced by

$$y_{hi,t} = A_{hi}(M_{hi,t})^{\alpha}(N_{hi,t})^{\beta}(K_{hi,t})^{1-\alpha-\beta},$$

where

$$M_{hi,t} = \left[\int_0^S \int_0^I (\gamma_{sj}^{hi})^{\frac{1}{\sigma}} (m_{sj,t}^{hi})^{\frac{\sigma-1}{\sigma}} djds\right]^{\frac{\sigma}{\sigma-1}}.$$

m_{sj}^{hi} is the intermediate good s from region j used in production of good h in region i.

- Inverse demand for intermediate goods:

$$m_{sj,t}^{hi} = \left(\frac{p_{sj,t}}{P_{hi,t}^{m}}\right)^{-\sigma} \gamma_{sj}^{hi} M_{hi,t},$$

where

$$P_{hi,t}^{m} \equiv \left[\int_0^S \int_0^I \gamma_{sj}^{hi} (p_{sj,t})^{1-\sigma} djds\right]^{\frac{1}{1-\sigma}}.$$

Production

- The total demand for the good (s, j) is, by adding the consumption demand, investment demand, and the intermediate good demand,

$$y_{sj,t} = \int_0^I (c^i_{sj,t} + x^i_{sj,t})di + \int_0^S \int_0^I m^{hi}_{sj,t} didh + y^f_{sj,t}$$

  where $y^f_{sj,t}$ represents the foreign (export) demand.

- Assume that the foreign demand takes the form

$$y^f_{sj,t} = \omega^f_{sj,t}(p_{sj,t})^{-\sigma}(\bar{P}_t)^{\sigma}.$$

  $\omega^f_{sj,t}$ is the parameter that governs the export shock and $\bar{P}_t$ is the price level in the foreign country.

Production

- The monopolist in (s, j) industry maximizes profit in two steps: (i) finding the right combination of intermediate goods, capital, and labor per unit of output; (ii) finding the right quantity to produce.
- The first step (competitive in factor markets):

$$\min_{M_{sj,t}, N_{sj,t}, K_{sj,t}} \quad P^m_{sj,t} M_{sj,t} + w_{sj,t} N_{sj,t} + r_{j,t} K_{sj,t}$$

subject to

$$1 = A_{sj} (M_{sj,t})^{\alpha} (N_{sj,t})^{\beta} (K_{sj,t})^{1-\alpha-\beta}.$$

The solution yields the unit cost λ^{sj}:

$$\lambda_{sj,t} = \frac{(P^m_{sj,t})^{\alpha} (w_{sj,t})^{\beta} (r_{j,t})^{1-\alpha-\beta}}{A_{sj} \alpha^{\alpha} \beta^{\beta} (1-\alpha-\beta)^{1-\alpha-\beta}}$$

Production

- Let

$$D_{sj,t} \equiv \left(\int_0^I \left((P_{i,t}^c)^\sigma \xi_{sjc}^i C_{i,t} + (P_{i,t}^x)^\sigma \xi_{sjx}^i X_{i,t} \right) di + \int_0^S \int_0^I (P_{hi,t}^m)^\sigma \gamma_{sj}^{hi} M_{hi,t} di dh \right) + y_{sj,t}^f$$

- The second step (monopolist in the product market):

$$\max_{p_{sj,t}} (p_{sj,t} - \lambda_{sj,t})(p_{sj,t})^{-\sigma} D_{sj,t}.$$

The result is the standard constant markup rule:

$$p_{sj,t} = \frac{\sigma}{\sigma - 1} \lambda_{sj,t}.$$

Thus the production of good (s, j) is

$$y_{sj,t} = \left(\frac{\sigma}{\sigma - 1} \lambda_{sj,t} \right)^{-\sigma} D_{sj,t}.$$

Trade balance

- We do not allow international borrowing and lending.
- We do not allow borrowing and lending across regions.
- The trade balance

$$\int_0^Z p_{zf,t} c^i_{zf,t} didz = \int_0^S p_{si,t} y^f_{si,t} dids$$

for each region i is automatically satisfied because of Walras's Law.

One-region static model

- Consider a static economy without capital (and the production is $y = AM^{\alpha}N^{1-\alpha}$).
- Assume $S = I = 1$ and all firms are symmetric (ξs are all 1).
- This model can be characterized analytically.

One-region static model

On the production side, the economy has the property

- M and N are linear in y.
- w/p is constant.

Note that from the definition of the price index

$$P = \left(p^{1-\sigma} + Z p_f^{1-\sigma} \right)^{\frac{1}{1-\sigma}},$$

we can write

$$\frac{p}{P} = \left(1 + Z \left(\frac{p}{p_f} \right)^{\sigma-1} \right)^{\frac{1}{\sigma-1}} = \Gamma(p),$$

where $\Gamma(p)$ is increasing in p. Given the imported goods price p_f, the increase in the domestic good price is translated to the discrepancy between PPI (p) and CPI (P).

One-region static model

- On the demand side, first note from the consumer's budget constraint,

$$C = \xi_c \frac{p}{P} y,$$

where $\xi_c \equiv (1 - \alpha(\sigma - 1)/\sigma)$. Here, C can change even when y is the same because of the relative price change.

- The demand equation

$$y = p^{-\sigma} \left(P^{\sigma} C + p^{\sigma} M + \omega^f \right)$$

can be rewritten as (replacing M and C)

$$p^{\sigma} \xi_c \left(1 - \Gamma(p)^{1-\sigma} \right) y = \omega^f.$$

The left-hand side is increasing in p, and thus, this equation can be drawn as a downward-sloping demand curve. More importantly, the demand curve shifts rightward with ω^f.

One-region static model

- On the supply side, starting from the labor supply equation:

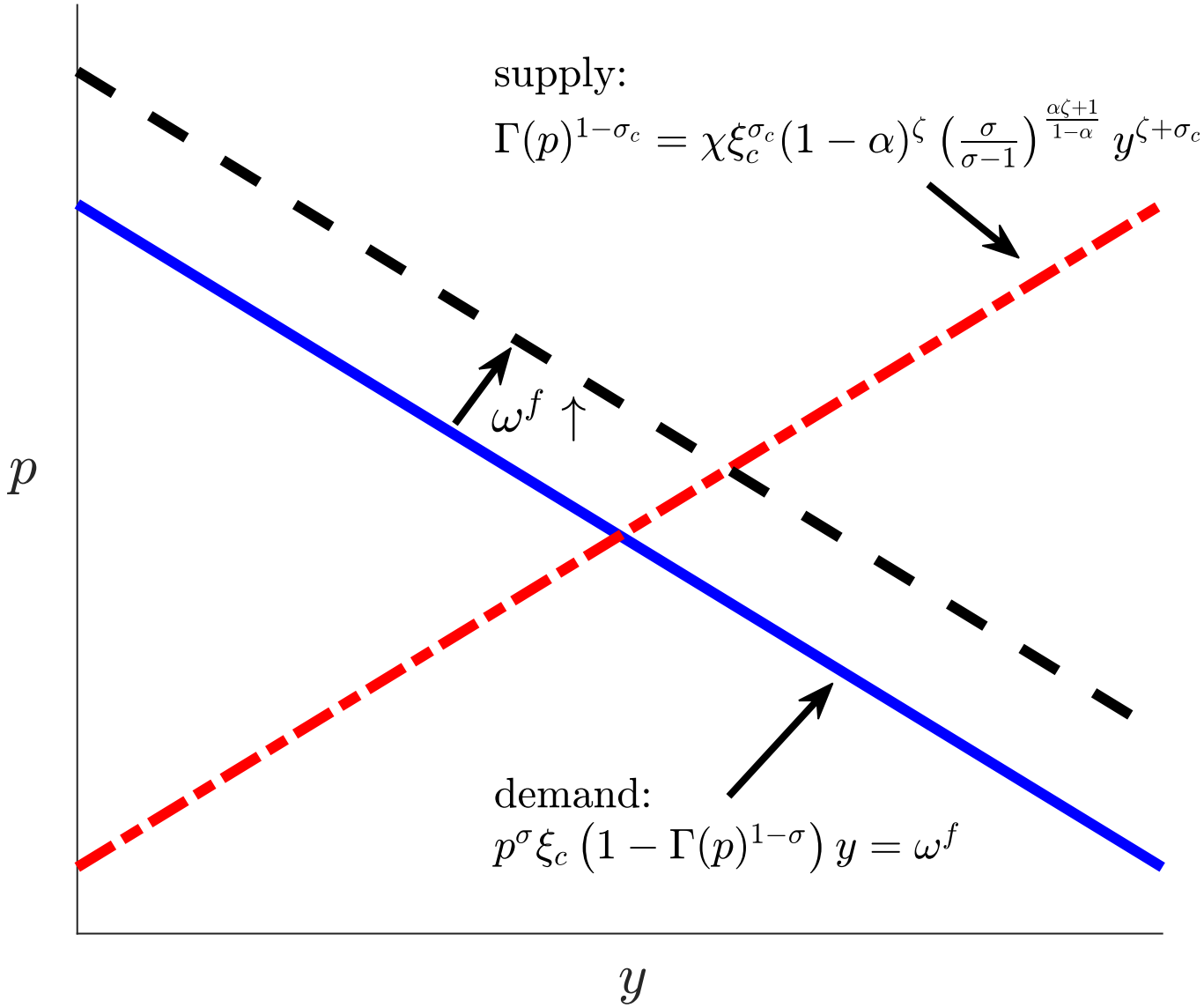
$$\frac{w}{P} = \chi C^{\sigma_c} N^{\zeta}.$$

  Note that $w/P = (w/p)\Gamma(p)$ (where w/p is constant) increases with p, which has a positive effect on labor supply N (substitution effect), whereas a high C has a negative effect on labor supply (wealth effect).
- Using the linear relationship between N and y, the relationship between C and y, and w/p being constant, we can derive the supply curve

$$\Gamma(p)^{1-\sigma_c} = \chi \xi_c^{\sigma_c} (1-\alpha)^{\zeta} \left(\frac{\sigma}{\sigma-1}\right)^{\frac{\alpha\zeta+1}{1-\alpha}} y^{\zeta+\sigma_c}.$$

  This relationship is upward sloping if the wealth effect is not too strong, that is, $\sigma_c < 1$.

Comparative statics



Comparative statics

- Suppose that the supply curve is upward sloping (i.e., $\sigma_c < 1$).
- When ω^f goes up, only the demand curve shifts, and in the new equilibrium, both y and p go up.
- p going up means both P and p/P go up. w/P goes up.
- y going up means M, N, and C all go up. C goes up because of both (i) y going up (more production) and (ii) p/P going up (terms of trade improvement).

Main mechanism

- Export demand parameter ω_f goes up $\rightarrow$
- The price of domestic goods, relative to the price of import goods, goes up $\rightarrow$
- The consumer's income (and real wages) goes up (acts similarly to productivity shock) $\rightarrow$
- Depending on substitution effect and wealth effect, labor supply may go up or down $\rightarrow$
- Depending on whether labor supply goes up or down, domestic production may go up or down $\rightarrow$
- Import always goes up (both substitution effect and income effect) and trade balances. If labor supply goes up, all Y, C, and N move together with the export shock. (We will use $\sigma_c = 1$ in the quantitative model.)

Calibration

- Calibrate the baseline economy in 2008Q3, that is, just before the export shock hits.
- The consumption share and the investment share, which dictate $\{\xi^i_{sjc}\}_{i,sj}$ and $\{\xi^i_{sjx}\}_{i,sj}$, is taken from the inter-regional input-output table in 2005 (IRIO2005).
- The cost share of each intermediate good (s,j) for the producer of good h at region i is governed by $\{\gamma^{hi}_{sj}\}_{hi,sj}$; this also follows IRIO2005.
- $\{\omega^f_{sj}\}_{sj}$ (export demand parameters) are set so that the GDP share of export goods (s,j) matches IRIO2005.
- Productivity $A_{sj} = A_s \times A_j$, A_s is from the JIP database (also the cost share parameter $\{\alpha_s\}$). A_j is from the wage data in Monthly Labor Force Survey.
- Disutility of labor, χ_i, is calibrated to replicate the regional variation of the employed population in 2008Q3.

Experiment

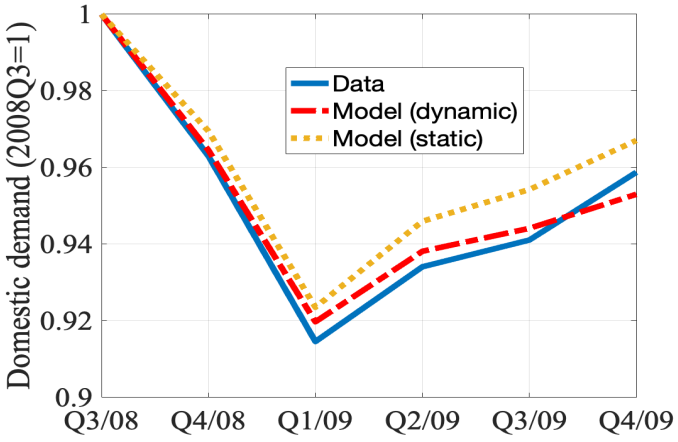
- Determine $\omega^f_{si,t}$ so that

$$\frac{p_{si,t}y^f_{si,t}}{p_{si,t=0}y^f_{si,t=0}} = \frac{\text{export value of } si \text{ in } t \text{ in data}}{\text{export value of } si \text{ in } t = 0 \text{ in data}}.$$

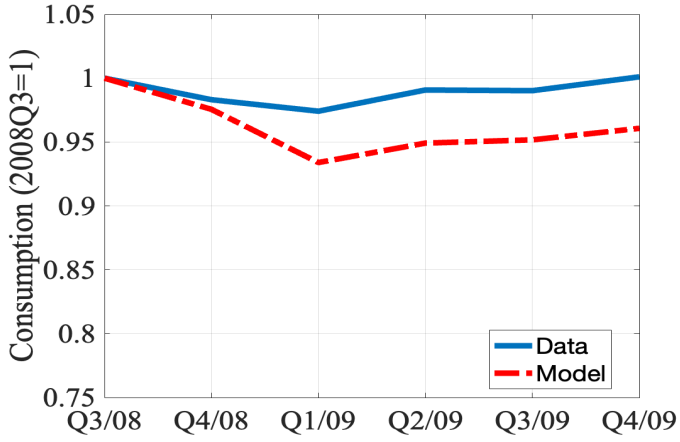
($t = 0$ means 2008Q3)

National level responses

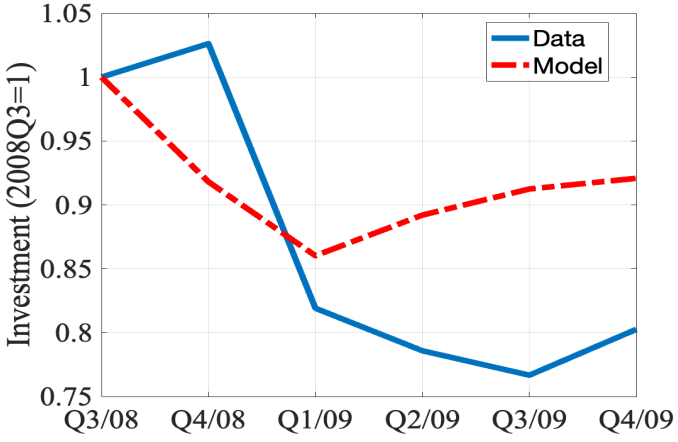
(a) Output



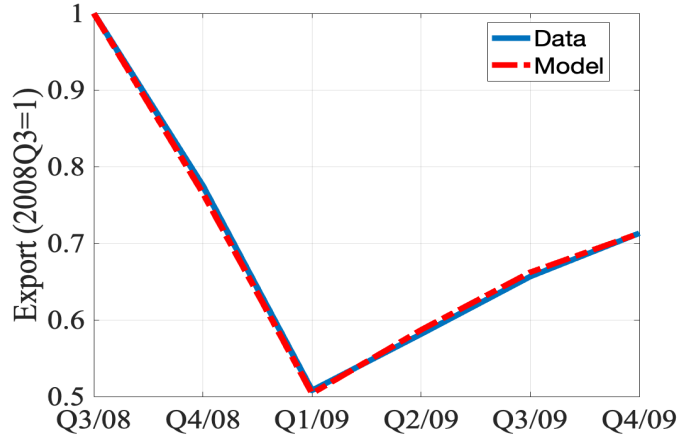
(b) Consumption



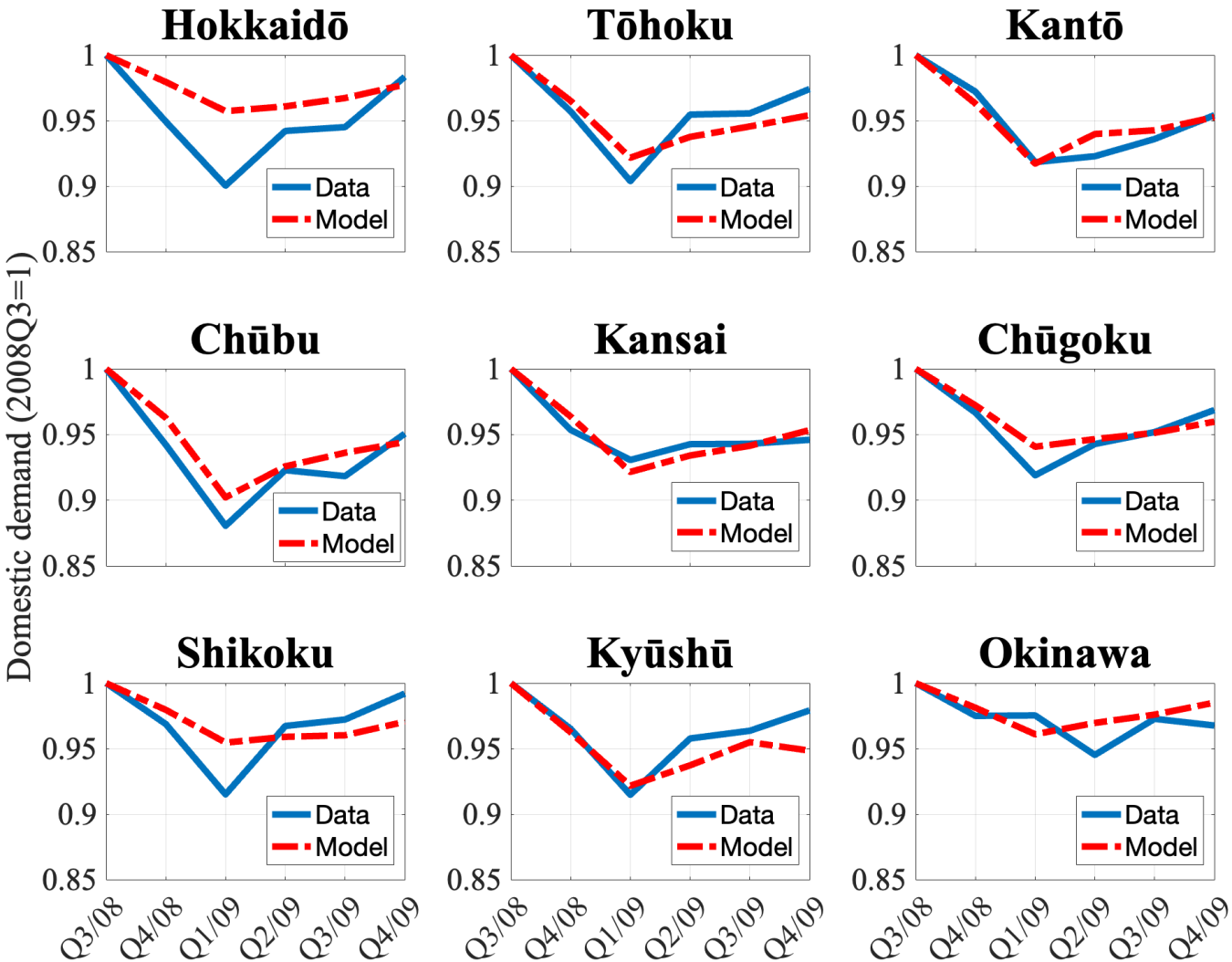
(c) Investment



(d) Export



Regional responses



Decomposition

- How do export shocks propagate across regions?
- We consider a counterfactual experiment where we feed the export shock to just one sector in one region. Then we decompose the output change in each region to different channels.

Procedure

- Three demand factors: domestic consumption demand, domestic intermediate demand, and foreign demand.

$$y_{sj} = \int_0^I c_{sj}^i di + \int_0^S \int_0^I m_{sj}^{hi} didh + y_{sj}^f$$

- Domestic consumption demand:

$$c_{sj}^i = \xi_{sj}^i \left(\frac{p_{sj}}{P^i} \right)^{-\sigma} C^i$$

- Domestic intermediate demand (from (h, i)):

$$m_{sj}^{hi} = \gamma_{sj}^{hi} \left(\frac{p_{sj}}{P^{hi}} \right)^{-\sigma} M^{hi}$$

- Foreign demand:

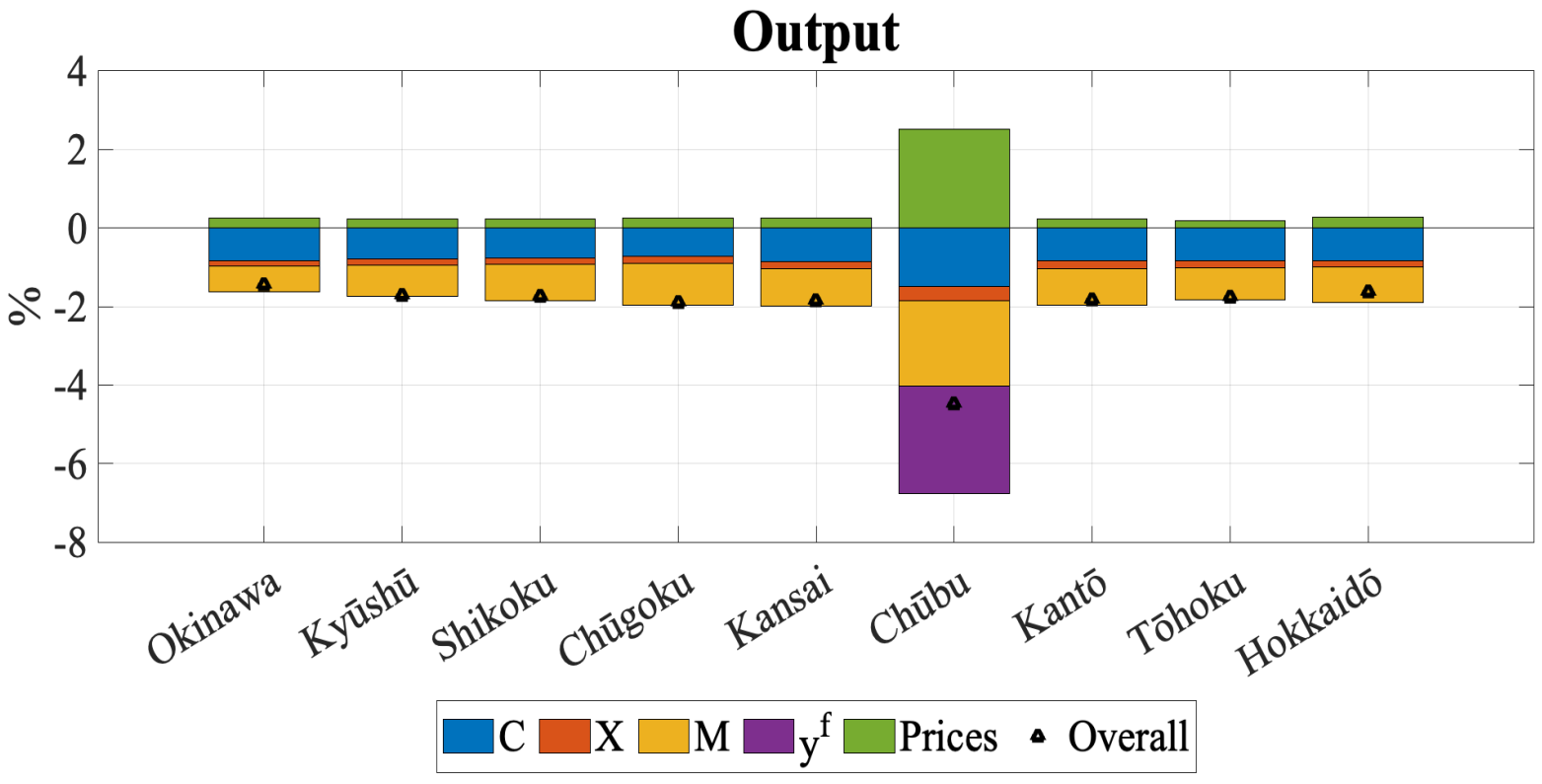
$$y_{sj}^f = \omega_{sj} \left(\frac{p_{sj}}{\bar{P}} \right)^{-\sigma}$$

Procedure

Steps:

1. Compute two economies. (1) baseline (2008Q3) (2) the economy with export shock at 2009Q1, but only one industry and one region (let's say TE industry in Chubu).
2. Consider five factors separately (only change these, keeping the rest as in the baseline):
   - Prices p_{sj} (except for the foreign demand), P^i, and P^{hi} ($\bar{P}$ is fixed because of the small open economy assumption.)
   - Consumption C
   - Investment X
   - Intermediate good M
   - Export y^f

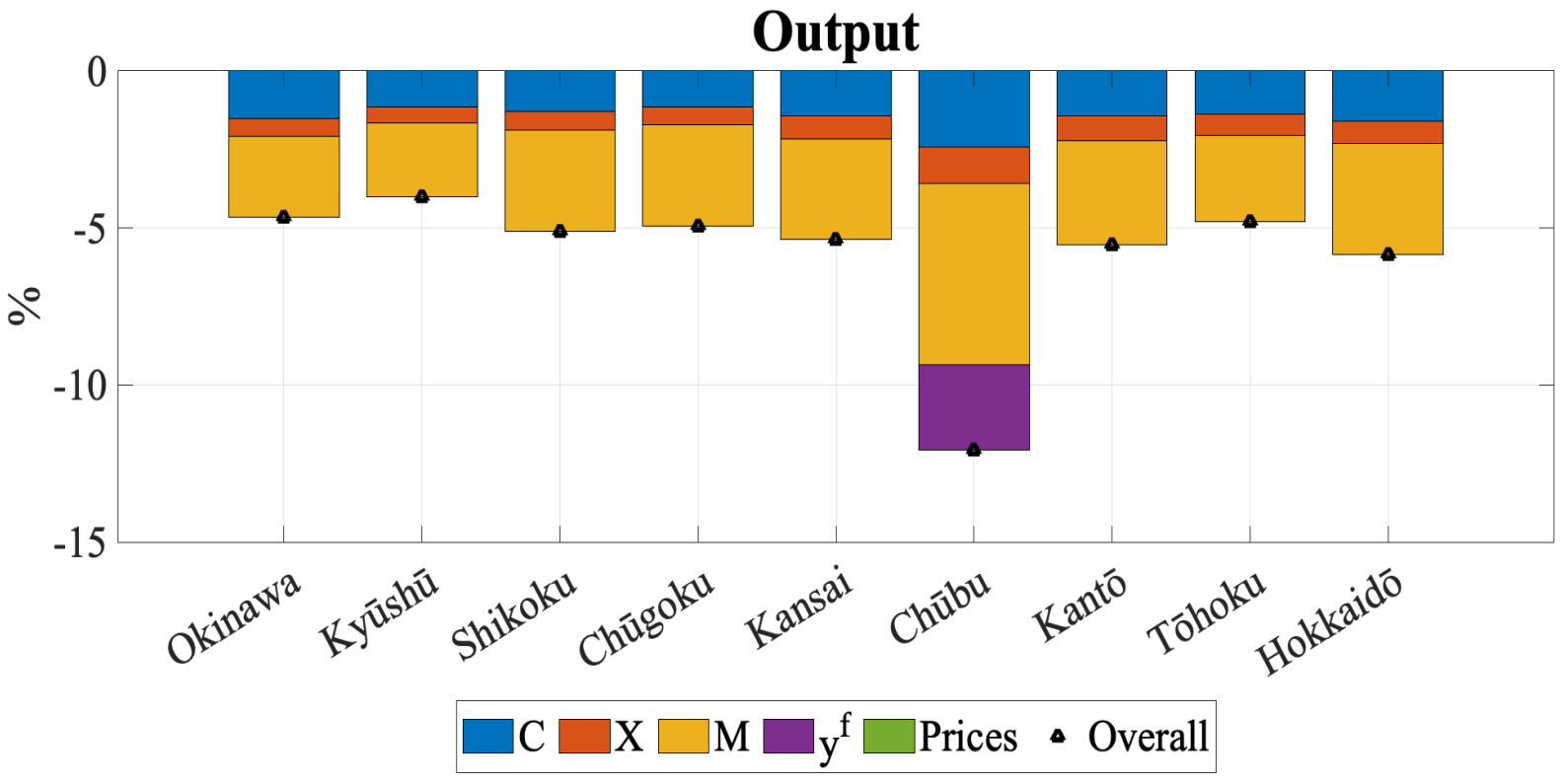
Outcome


Output
4
2
0
-2
-4
-6
-8
%
Okinawa
Kyūshū
Shikoku
Chūgoku
Kansai
Chūbu
Kantō
Tōhoku
Hokkaidō
C
X
M
y^f
Prices
Overall

Highlight of the propagation mechanism

- In Chubu, export, M, X, and C all had a negative impact on GDP. Price changes counteract (because the Chubu goods become cheaper).
- The decline in demand from Chubu causes M, X, and C in other regions to fall. The price change counteracts.
- Overall, there is a large propagation to other regions.
- For propagation, both consumption and intermediate-good demand are important (from Chubu and also the region itself).

The role of fixed prices



The outcome from the fixed-price model

- Suppose that the prices of all goods are fixed at the 2008Q3 level.
- With fixed prices, there are no counteracting price effects.
- The magnitude is quite large; "completely fixed prices" is an extreme assumption.

Conclusion

- We constructed a small open economy with (i) input-output linkage, (ii) inter-regional linkage, and (iii) export demand shocks.
- We quantify the model to Japan during the Great Recession, using the customs data and inter-regional input-output table.
- The model can replicate a substantial decline in output due to the export demand shock.
- For across-regional propagation, both consumption and intermediate-good demand play an important role.
- Price stickiness is quantitatively important.