1: CiteSeerX â€" Precautionary Saving and Aggregate Demand Fluctuations Preliminary

Precautionary Saving and Consumption Fluctuations by Jonathan A. Parker and Bruce Preston. Published in volume 95, issue 4, pages of American Economic Review, September , Abstract: This paper uses the consumption Euler equation to derive a decomposition of consumption growth into four.

Consumption theory The rational optimization framework In their studies of consumption, economists generally draw upon a common theoretical framework by assuming that consumers base their expenditures on a rational and informed assessment of their current and future economic circumstances. For example, economists usually assume 1 that the urgency of consumption needs will decline as the level of consumption increases this is known as a declining marginal utility of consumption , 2 that people prefer to face less rather than more risk in their consumption people are risk-averse , and 3 that unavoidable uncertainty in future income generates some degree of precautionary saving. Within the rational optimization framework, there are two main approaches. The standard version of the life-cycle model also assumes that consumers would prefer to spend everything before they die i. Life-cycle models are most commonly employed by microeconomists modeling household-level data on consumption, income, or wealth. The permanent income hypothesis omits the detailed treatment of demographics and retirement encompassed in the life-cycle model, focusing instead on the aspects that matter most for macroeconomic analysis, such as predictions about the nature of the consumption function , which relates consumer spending to factors such as income, wealth, interest rates, and the like. Perhaps the most important feature of the consumption function for macroeconomics is what it has to say about the marginal propensity to consume MPC when there are changes in income. Economist John Maynard Keynes , who was the first to stress the importance of the MPC in The General Theory of Employment, Interest, and Money , believed that up to 90 percent of any increase in current income would translate into an immediate increase in consumption expenditure an MPC of 90 percent. Friedman asserted that on average only about one-third of any windfall a one-time unanticipated gain would be spent within a year. He further argued that a one-for-one correlation between increased income and increased spending would occur only when the income increase was perceived to reflect a permanent change in circumstances e. The modern mathematical versions of the life-cycle and permanent-income-hypothesis models used by most economists bring some plausible refinements to the original ideas. For example, the modern models imply that the marginal propensity to consume out of windfalls is much higher for poor than for rich households. This tendency makes it impossible to determine the impact of a tax cut or government program on consumption spending without knowing whether it is aimed primarily at low-wealth or high-wealth households. The theory further indicates that tax cuts or spending programs such as extended unemployment benefits aimed primarily at lower-income households should be considerably more effective at stimulating or maintaining aggregate spending than programs aimed at richer households. A linen shirtâ€¦is, strictly speaking, not a necessary of life. The Greeks and Romans lived, I suppose, very comfortably though they had no linen. But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt, the want of which would be supposed to denote [a] disgraceful degree of poverty. Smith clearly did not believe one of the baseline assumptions built into the standard models of consumption described above: Habit formation also implies a very different reaction to income shocks that reflects a gradual adaptation to new circumstances. The speed of adjustment depends on the strength of the habit. A considerable amount of evidence from macroeconomic data seems to suggest that consumption does indeed react sluggishly to macroeconomic shocks. A final modification commonly made to the baseline life-cycle model is the abandonment of the assumption that people accumulate wealth solely to finance their own future spending. The high saving rates of the richest few percent of households at least in the United States are hard to explain in such a framework. An alternative theory holds that some rich people gain satisfaction directly from the ownership of wealth, not merely from the happy contemplation of that wealth being spent by children, grandchildren, and so on. People might enjoy being wealthy for reasons of status, power, avarice , or other motivations that fall outside the traditional scope of economic analysis. Alternatives to fully informed

rationality The modifications just described pose no challenge to the premise that consumers are fully informed rational optimizers. The popularity of this assumption reflects the fact that there is usually only one way to behave rationally, but there are a great many possible ways to behave stupidly. In the absence of a general theory of stupidity, economists have been unable to construct a unified, compelling alternative to the rational optimization framework. Nonetheless, a few specific deviations from fully informed rationality have been explored. Evidence from experimental psychology suggests that people have difficulty resisting the impulse for instant gratification, even when they agree at any time other than the exact moment of temptation that it would be rational to resist. Whether such self-control problems have large economic effects is unclear. It turns out that if such commitment strategies are available, they permit the consumer to achieve a lifetime consumption pattern very close to that predicted by the standard rational optimizing model, which makes no allowances for self-control problems or commitment mechanisms. Some distinctive implications , however, emerge in the model built on self-control problems. In particular, this model can explain seemingly illogical behaviour, such as holding a retirement savings account earning an interest rate of, say, 7 percent while simultaneously borrowing on credit cards and paying interest rates of up to 20 percent. Either the saving or the borrowing can be justified in the rational optimization framework if we assume that savers are rational and patient while borrowers are rational but impatient , but the simultaneous practice of saving at a low interest rate and borrowing at a high interest rate is virtually impossible to reconcile within the rationality framework. One other well-explored category of deviation from the standard framework simply drops the assumption that people are fully informed. Consumers who do not know whether a given shock to their incomes is transitory or permanent will tend to react as though there is some chance it is temporary and some chance that it is permanent. Alternatively, consumers who do not pay much attention to macroeconomic news may be slow to react when macroeconomic circumstances change e. This category of theories may provide an alternative to habit formation as a means of explaining the sluggish reaction of consumption spending to economic news. Consumption and the business cycle Private consumption expenditure accounts for about two-thirds of gross domestic product GDP in most developed countries, with the remaining one-third accounted for by business and government expenditures and net exports. A substantial portion of government expenditure e. In national income accounting , private consumption expenditure is divided into three broad categories: Durable goods are generally defined as those whose expected lifetime is greater than three years, and spending on durable goods is much more volatile than spending in the other two categories. Services include a broad range of items including telephone and utility service, legal and financial services, and travel and lodging services. The distinction between the flow of consumption as economists conceive it including the services of durable goods owned by households and consumption expenditure as measured in national income accounts is vital to understanding macroeconomic fluctuations. Producers and therefore employers make money only from the sale of a durable good, not from its continuing use after the sale. Therefore, it is the level of consumption expenditure â€"not the flow of consumption as defined aboveâ€"that determines short-term macroeconomic prosperity or otherwise. Both theory and evidence suggest roughly the following story. In an economic downturn, expenditures on durable goods such as automobiles generally plummet because many consumers who had been considering replacement of their durable goods decide to hold off either until the economy improves or until their need to replace the durable good becomes sufficiently urgent. The early phase of economic recoveries generally exhibits a surge in spending on durable goods as this process is reversed. More broadly, spending on durable goods tends to be much more volatile than spending on nondurables and services, because all that is needed to induce a surge in durables spending is something that pushes consumers from merely contemplating a purchase to actually making a purchase. This logic explains why spending on durables is much more sensitive to interest rates, rebates, and other economic stimuli than are other kinds of spending.

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Consumers are subject to idiosyncratic employment shocks against which they cannot insure directly. The labour market has a Diamond-Mortensen-Pissarides structure: Wages are determined through Nash bargaining. We also consider aggregate productivity shocks and a complete set of contingent claims conditional on this risk. We use the model to evaluate a tax-financed unemployment insurance scheme. We find that the latter effect is more potent for welfare outcomes; we tabulate the effects quantitatively for different kinds of consumers. We also demonstrate that productivity changes in the model—in steady state as well as stochastic ones—generate rather limited unemployment effects, unless workers are close to indifferent between working and not working; thus, recent findings are corroborated in our more general setting. The hope, of course, is that a more realistic microeconomic structure produces more reliable and robust macroeconomic implications. However, an arguably even more important value of the new models lies in their usefulness for analysing household welfare. That is, how do macroeconomic events, and aggregate policy, influence individuals and their welfare, and in particular to what extent are different households affected differently? For example, a series of papers shed light on how business cycles influence the cross-section of households and report a range of estimates for the potential gains, for different subgroups of consumers, from stabilizing the cycle; some of these estimates are orders of magnitude larger than the estimates that Lucas provided and that even put in question the relevance of analysing cycles at all. The model delivers a stationary distribution over households and their asset, consumption and income positions. Thus, risk plays a central role here, as does the idea that poorer consumers are less well insured and thus more vulnerable to adverse outcomes. In a typical BHA model, heterogeneity is in large part driven by exogenous employment shocks: The assumed exogeneity of these shocks is a potentially serious drawback as it implies that neither policy nor events, such as changes in productivity, will influence them. The model we develop can be productively used in a number of applications, and indeed a major motivation behind our work has been to provide the necessary tools allowing these applications to be undertaken. Here, we address two questions that have been central in the two separate literatures but so far have delivered only partial answers. Our first question regards the optimal level of government-provided unemployment insurance UI. Our framework, on the contrary, highlights the trade-off between insurance and job creation: As a result, less than perfect insurance is optimal even in the absence of moral hazard concerns. In our analysis, we assume that UI is financed by payroll taxes. In the BHA model, where markets for idiosyncratic risks are missing, such insurance would raise welfare; indeed the optimal level of insurance is full insurance. Indeed, provided the Hosios condition holds, steady-state output in the Pissarides model is maximized when there is no UI at all. Using a steady-state version of our model, we study the welfare effects of UI. Second, we ask how changes in productivity—permanent as well as temporary—influence labour-market outcomes. This is important not only as a background for analysing household insurance when there are aggregate shocks but also in itself. There is a sharp distinction between how productivity shocks operate in representative agent models of labour supply and in typical matching friction models. In the latter, where employment is constrained by frictions, both permanent and temporary productivity increases encourage vacancy creation and lead to lower unemployment, though a recent literature argues that these effects are much too small to explain the unemployment movements in the data. The precise value depends on what objective one uses, but as a rough approximation, no major change away from the zero replacement rate assumed in a standard BHA model is called for from the perspective of optimal policy. Thus, the labour-market inefficiencies that would result from raising benefits are rather strong quantitatively as compared with the benefits from insurance beyond self-insurance. Second, we solve the model with aggregate shocks and find that productivity shocks generate unemployment fluctuations in about the same way as in the model without risk-averse consumers. Thus, in a

calibration like that in Shimer , unemployment fluctuations are small, and in one like that in Hagedorn and Manovskii HM , they are large. In Section 2 , we discuss some important background literature. The basic BHA dynamic general equilibrium model without aggregate fluctuations is then set up in Section 3 and analysed in Section 4. In Section 5 , we extend our model to incorporate aggregate uncertainty. Section 6 concludes and discusses the robustness of our results, especially as regards the finding that the insurance value of UI is quite low in the presence of self-insurance, as well as relevant extensions. First, there is a non-trivial and evolving distribution of wealth among consumers, which influences prices and aggregate quantities; and second, unlike in the one-firm neoclassical model, there is a distribution of wage outcomes influencing worker and firm decisions. We deal with each of these issues directly. Second, we consider complete markets with respect to aggregate risk, which means that all agents who hold equityâ€"i. Quantitative studies of the DMP matching model with risk-averse workers and savings are rare in the literature. These papers vary considerably in the ways they deal with the aforementioned challenges, but none of the papers nests both the DMP and BHA settings as we do here we obtain the DMP setting if we simply set risk aversion to zero, and the BHA setting if the matching probability is constant. This is clearly an important omission, because we believe that also the extensive margin is active for many households. However, we make the omission with a clear conscience, as we think that the model development we have offered in the present paper is a necessary first step; moreover, we have already begun researching, so far in the context of no aggregate shocks, the case with an active extensive margin. Using the model, we then evaluate tax-financed UI. There is a measure 1 of consumers in the economy; a consumer is either employed or unemployed. Output is either consumed or invested or, as we shall see below, used for vacancy creation. The remainder of the model description focuses on the decentralized equilibrium. Because of symmetry, in equilibrium the same amount of k is employed at each filled job. Vacant jobs and unemployed workers are randomly matched each period according to an aggregate matching function. The consumers can hold only two kinds of asset: The total value of the firms is represented by p. It is assumed that the consumers are not allowed to hold the claims to the profit of individual jobsâ€"they can only hold the claim to aggregate profits. We normalize the total amount of equity to one. The equity price p has to satisfy the following equation: We use q to denote the inverse of the gross real interest rate:

3: EconPapers: Precautionary Saving and Consumption Fluctuations

The economic importance of precautionary saving rivals that of the real interest rate, but the relative importance of each source of movement in the volatility of consumption is not precisely.

Basic concept[edit] Economists have realized significance of precautionary saving long ago. Historically, the precautionary motive for saving has been recognized by economists since before the time of John Maynard Keynes. The impact of the precautionary saving is realized through its impact on current consumption, as individuals defer their current consumption to be able to maintain the utility level of consumption in the future if income drops. Saving is a flow variable quantity, measured in units of currency per unit of time such as dollars per year. Conversely, the savings denotes the accumulated stock of funds that is present at a single point of time. This was realized by Friedman , [5] and later by Ando and Modigliani [6] and Bewley [7] in their seminal work on the permanent income hypothesis PIH. The relevance of the life-cycle framework, therefore, builds on intertemporal allocation of resources between the present and an uncertain future with the goal of maximizing utility. Analytical findings confirmed the presence of a precautionary saving motive, with precautionary saving positively correlated with income risk. Leland proved that, even for small variations of future income, the precautionary demand for saving exists. It was only recently that economists confirmed the early findings of Leland. Lusardi confirmed that intuitions derived from economic models without a precautionary motive could be seriously misleading, even with small uncertainty. Increased savings in the current period raises the expected value of future consumption. Hence the consumer reacts to increased income riskiness by raising level of saving. Yet increases in saving will also increase the variability variance of future consumption. This in turn gives rise to two conflicting tendencies of income and substitution effects. This is met with an opposite force, as higher riskiness makes it necessary to save more in order to protect oneself against very low levels of future consumption. This explains the negative income effect on consumption. A step forward was led by Kimball who defined the characteristic of "prudence". U is a utility function. The prudence index measures the intensity of the precautionary motive just as risk aversion measures the intensity of the desire for insurance. Numerical simulations suggested the possibility precautionary saving, ranging from 20 to 60 percent of all saving. A significant empirical contribution by Brumberg , showed that savings in the current period were seen statistically significant to bridge the gap between current income and the highest previously earned income. Hence, saving was considered a significant hedge against the income fluctuations. Insurance market incompleteness was introduced by assuming a large number of individuals who receive idiosyncratic labor income shocks that are uninsured. Findings of the model showed that lower variability of earnings led to a lower saving rate. The analysis also accounted for the case where market interest rate was higher than the subjective rate of time preference, and provided evidence that individuals will postpone consumption and save by accumulating large stocks of assets. When both rates were equal, given an anticipated shock to the labor income, a rational individual would hold a large stock of assets to hedge for the income risk. The paper also shows analytically that when the interest rate is lower than the time preference rate, individuals would accumulate savings. Browning and Lusardi concluded based on the empirical literature that while the precautionary motive is important for some people at some times, it is unlikely to be so for most people. This was conducted for households who did not or could not obtain complete insurance coverage against workplace accident risk, covering Industrial workers at the time significantly reduced their saving and insurance consumption by approximately 25 percent when their expected post accident benefits increased. The findings support modest precautionary saving, which is particularly relevant for self-employed. If the self-employed faced the same wage risk as the civil servants, their hours of work would be reduced by 4. More recent work focused on the importance of the time dimension. This in turn justifies the notion that precautionary saving may be part of the explanation of why large consumption falls anticipate large increases in unemployment in response to exogenous shocks to the economy. When employed workers are imperfectly insured against the occurrence of such spells, they hoard assets for self-insurance purposes. Moreover, during times of recession the precautionary motive for holding wealth is strengthened, causing aggregate saving to

rise and aggregate consumption to fall, which in turn affects the propagation of shocks in the economy. Carroll and Jeanne developed a model to test the relationship between economic development, the stock of savings and capital flows. Aggregate Implications and Tests. Consumption Puzzles and Precautionary Savings. Journal of Monetary Economics 25, Carroll, Christopher, and Kimball, Miles Return migration, uncertainty and precautionary savings. Development Journal of Development Economics, 52,

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Get this from a library! Precautionary saving and consumption fluctuations. [Jonathan A Parker; Bruce Preston; National Bureau of Economic Research.] -- Abstract: This paper uses data on the expenditures of households to explain movements in the average growth rate of consumption in the U.S. from the beginning of to the end of

5: Precautionary savings - Wikipedia

Precautionary Saving and Consumption Fluctuations âˆ— Jonathan A. Parker Princeton University and NBER Bruce Preston Columbia University March Abstract.

6: Precautionary Saving and Consumption Fluctuations

Precautionary Saving and Consumption Fluctuations By JONATHAN A. PARKER AND BRUCE PRESTON* This paper uses the consumption Euler equation to derive a decomposition of.

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