

(23) Lettau, Martin, Ludvigson, Sydney, and Nathan Barczi. "A Primer on the Economics and Time Series Econometrics of Wealth Effects: A Comment." Federal Reserve Bank of New York, 2001.

The authors criticize the econometric methods used in (Davis & Palumbo, 2001) to address the question of how quickly the consumption adjust to changes in income and wealth, claiming that an alternative methodology is required to answer this question, and once it is employed, the resulting evidence weigh considerably against their interpretation of the data.

They claim that the first problem is the assumption that consumption does all of the adjustment ignoring the empirical evidence that it is wealth rather than consumption that does most of the error correction subsequent to a shock that causes consumption, wealth and labor income to deviate from their long run equilibrium relation. To deal with this problem, and in order to make inferences about adjustment time, it is necessary to use a vector error correction specification to take into account the adjustment of all the variables in the cointegrated system. To investigate which variable in a cointegrated system participate in the error correction subsequent to an equilibrium distorting shock, they consider the long horizon forecastable power of the cointegrating residual for the growth rates in each variable of the system, and find that their results suggest that the cointegrating residual has no forecasting power for consumption growth at any future horizon, but instead has strong forecasting power for the future growth in asset values, and accordingly deviations from the common trend in the three variables appear to be eliminated by subsequent movements in asset values not consumption.

They also claim that the estimates of the adjustment parameter in (Davis & Palumbo, 2001) are incorrect, because they are obtained by altering a single equation error correction representation for consumption to include conditioning variables that are not weakly exogenous for the parameter they seek to estimate. They use another specification to avoid this problem, and find that their results provide no support for the conclusion that aggregate consumer spending adjusts only gradually to movements in income or wealth. Instead, the adjustment parameter for consumption growth appears to be about zero indicating that spending typically adapts within the span of roughly one quarter to fluctuations in income and wealth. Since consumption does not participate in the error correction, and since lagged values of wealth growth have little impact on consumption growth, movements in wealth can have important implications for consumption contemporaneously, but they bear little relation to future consumption spending. This does not imply that wealth has no impact on aggregate consumption, but that permanent movements in wealth must influence spending, however, not all movements in wealth appear to be permanent, and the data suggest that transitory changes in wealth have little influence on consumer spending.