

(13) Lettau, Martin, Ludvigson, Sydney. "Understanding Trend and Cycle in Asset Values: Reevaluating the Wealth Effect on Consumption." NBER Working Paper 9848, 2003.

The authors argue that the consumption wealth linkage can not be understood without determining whether there exists important movements in asset values that are not associated with changes in consumption. They reevaluate the empirical foundation for the estimates of the consumption wealth link by using techniques that allow them to identify the permanent and transitory elements or the trend and cycle of net worth, and examine how these elements are related to consumer spending.

Estimating a vector error correction model, they find that although there is some short run predictability in the growth of consumption and labor income, it is wealth growth that exhibits error correction behavior and therefore predictability over long horizons. As wealth plays an important role in the error correction required to restore the variables to their common trend, it has a small weight in the permanent innovations and a large in the transitory, while consumption and labor income have a large weight in the permanent innovations and a small in the transitory.

They also find that the vast majority of variability in consumption, driven by permanent shocks is disassociated with the vast majority of variability in wealth driven by transitory shocks. This does not mean however that wealth has no impact on consumption, but rather that only permanent changes in wealth are related to consumer spending. They also find that transitory innovations have long lasting effects on wealth exhibiting a half life of a little over two years.

An implication of these findings is that conventional estimates of the wealth effect greatly overstate the response of consumption to a change in wealth, as most of these estimates are based on parameters of the shared trend in consumption, labor income, and wealth, but if most of the changes in wealth are not trend movements, but transitory that are unrelated to consumption, such estimates will significantly exaggerate the true correlation between consumption and wealth.