Weakened Wealth Effect

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Abstract

Since life-cycle hypothesis was first introduced by Modigliani and Brumberg in 1954, wealth has been considered as one of major determinants of consumption. This is called wealth effect and it bridges asset market and real economy. However, what we observe recently is a severe discrepancy between asset market boom and real market stagnation, which implies the connection between asset market and real market became weak or broken. Employing permanent income hypothesis framework and using US Consumer and Expenditure data from 1995 to 2019, this paper explores the possibility of dwindling wealth effect and found the wealth effect has diminished over time. At individual level, decreasing interest rate can weaken wealth effect. At country level, by introducing heterogeneity in home owning status and age, this paper shows that increasing asset inequality and aging can weaken the wealth effect. The impact of asset inequality on wealth effect is especially important because it implies current expansionary monetary policy can harm the recovery of the economy in the long run.

Keywords: wealth effect, wealth, consumption, house price

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