The Effect of the Financial Crisis on Older Households in England

(James Banks, Rowena Crawford, Thomas Crossley and Carl Emmerson)

Discussion by
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The paper provides ..

- Detailed household level data on balance sheet older UK households
- Assessment of potential and actual wealth losses of financial crisis
- The impact of wealth losses for:
  - Spending on food (at home and outside); energy, clothing
  - Expected bequests
  - Probability of inadequate resources
- Innovative use of instruments

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Relevance

- Financial crisis has an impact on household wealth and expectations
- Trend of rising household wealth / consumption ratio’s
- Increasingly important to learn about the transmission of wealth shocks into the economy
- Wealth losses may have a larger impact on consumption than gains (Robert-Paul Berben, Kerstin Bernoth, Mauro Mastrogiacomo; 2006)

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Background

- Life cycle model (LCM): Households accumulate wealth during working life and decumulate wealth during retirement
- Without uncertainty and bequest motives: all wealth is consumed → unexpected wealth shocks lead to lower consumption
- In a world with uncertainty and bequest motives, wealth also serves as a financial buffer and for bequest motives → unexpected wealth shocks may be absorbed by lowering buffer or expected bequest
- Current paper: some effect on lower spending; hardly any for the two other dimensions

Questions on wealth data

- Pension wealth is calculated as the present discounted value of expected pension income streams from retirement to death
- How ‘safe’ is safe wealth in times of financial crisis, given that it mainly includes state and private pension wealth?
- What is the explanation for the rise in safe wealth/pension wealth for age 70+ respondents?

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Working versus retired

- Working and retired respondents may respond different to wealth losses
- Different benchmark for expectations (cf. LCM):
  - Working population expected to accumulate wealth
  - Retired expected to draw upon savings
- Working population have an additional margin for adjustment as they can postpone their age of retirement
- Suggestion: run separate spending regressions

Spending and wealth shocks

- Research question: What is the effect of unanticipated wealth shocks on spending?

- Difference in spending is regressed on reported wealth change

- Reported wealth increases for most households: reporting error, planned wealth changes, response to wealth shocks

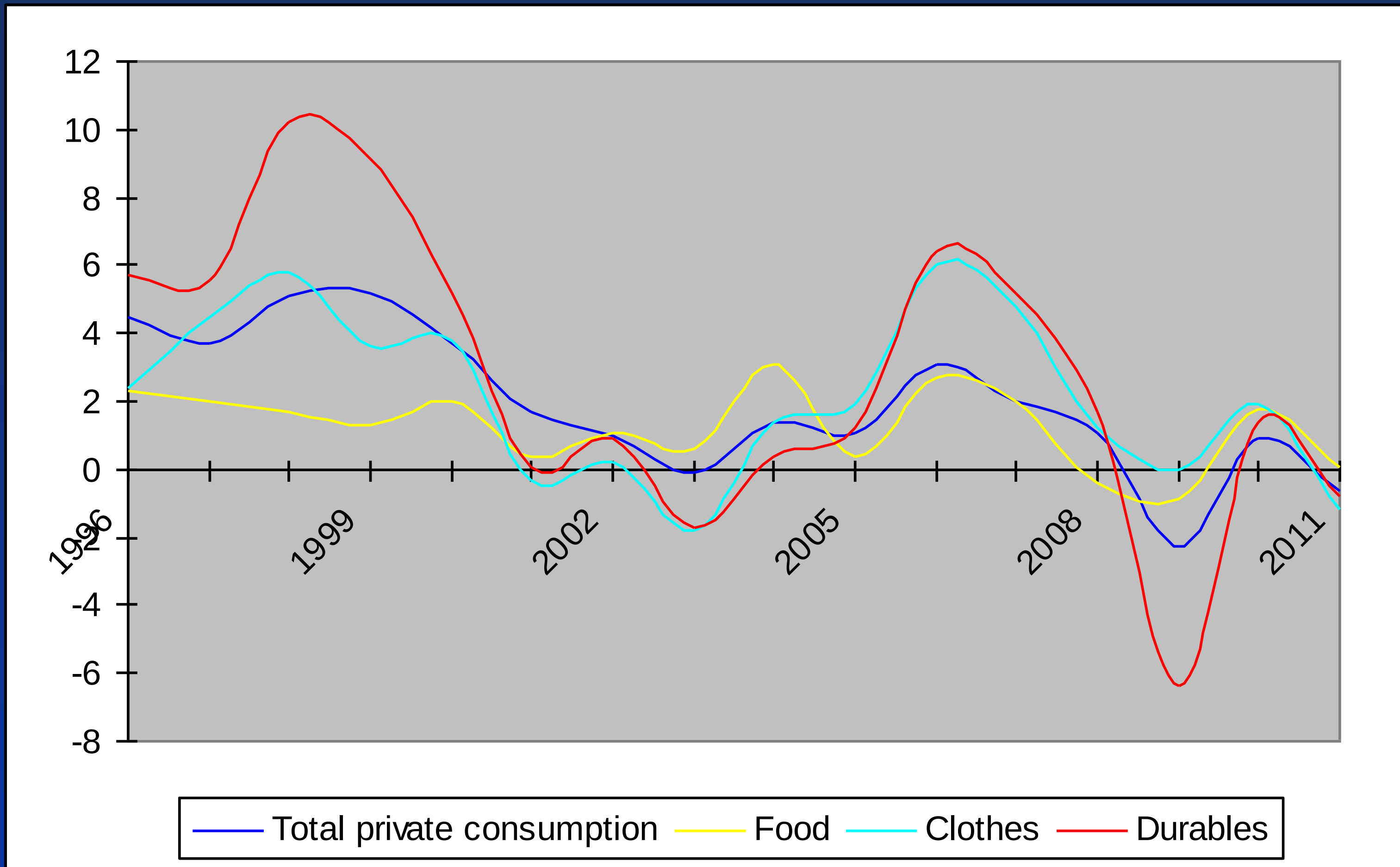
- Change in reported wealth is instrumented with the simulated shock in wealth. This addresses the issue of measurement error and endogeneity due to effect of spending cuts and other behavioural responses on wealth

- Suggestions:
  - Regress the spending change directly on the simulated wealth shock
  - Calculate simulated wealth shock with respect to a baseline path including ‘average’ price changes for a more accurate estimate of the unanticipated wealth shock

Spending consequences: large of small?

- Loss of wealth of 100 reduces spending by 0.7 for the total of the four spending items (with a share of about a third in total spending)
- This total spending-wealth elasticity seems more plausible than the elasticities for the in the four separate spending items
- The effect of 0.7 is due to the result of spending on <u>clothes</u>. This is quite high as clothes probably have a low share in spending (4% in Dutch data)
- The effect of <u>fuel spending</u> (including gas, electricity, coal, ..) has the wrong sign. Perhaps a spurious correlation due to the exclusion of temperature information, as wealth is correlated with the size of the house and thereby with gas consumption?

Dutch real expenditures: annual percent changes



After financial crisis: Spending cuts in clothes but even more in durables

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Empirical findings and explanations

- Some wealth effects on spending, but relatively small;
- Hardly any effect for expected bequests; if any it comes from housing wealth;
- No effect on the probability of financial problems;
- Explanations?

Asset price expectations?

- Dimitris Christelis, Dimitris Georgarakos and Tullio Jappelli (2011): consumption effects are stronger when consumers perceive stock price changes as permanent and not temporary

- If many households believe asset price changes are temporary, then wealth effects will be modest

- Jeff Dominitz and Charles Manski (2011): consumers can be split in three groups with different types of stock market expectation formation
  - Random walk type (27%)
  - Persistence (41%)
  - Mean reverting (32%)

Other savings motives than only retirement

- If savings are accumulated to have a buffer to absorb shocks, there is no need for a large response when the shock materializes
- Housing wealth may serve other purposes than saving for retirement
- Surveys show that households do not plan to run down housing wealth
- Home ownership primarily for consuming housing services
- Housing wealth may be part of bequest strategy (consistent with findings paper)

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Housing value and retirement saving in the Netherlands

- What are the chances that you will sell your house to finance retirement?

Chances (out of 100)	Percentage of home owners
- Between 0 and 25	52
- Between 25 and 50	20
- Between 50 and 75	11
- Between 75 and 100	9
- Do not know	8

- What are the chances that you will borrow against your house to finance your retirement?

Chances (out of 100)	Percentage of home owners
- Between 0 and 25	72
- Between 25 and 50	12
- Between 50 and 75	4
- Between 75 and 100	4
- Do not know	8

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