Reading Notes: Consumption and Habits

This paper studies if households form habits when making consumption decisions. The author uses Marginal Rate of Substitution and the Euler equation to find intertemporal non-separability of preferences as evidence of consumption habit formation. They find that there is evidence of habit formation when control for the time invariant unobserved heterogeneity.

This paper uses consumption behavior model with liquidity constraint. The liquidity constraints for consumers will make the standard Euler equation invalid because it introduces consumption decisions to be dependent on consumers' information set. It is unsure this dependence comes from liquidity constraints or intertemporal non-separability (habit). To solve this problem of consumer behavior model, this paper studies three non-durable commodities: food, transport, and services.

The author imposes the assumption that consumers maximize their discounted lifetime utility subject to liquidity constraints and flow budget constraints. The first order conditions of the maximization of lifetime utility shows that marginal rate of substitution between two goods depends on the relative prices of two goods so they can identify MRS. Furthermore, MRS's time inseparability can serve as the evidence for consumption habit formation. When the liquidity constraints are not binding, the author can use Euler equation to study intertemporal substitution effects because Euler equation is not robust to the presence of liquidity constraints. The difference between the first order condition of MRS and Euler equation can help us separate liquidity constraints and intertemporal dependence in preferences(habit).

In the empirical analysis, the author controls for time invariant unobserved heterogeneity that causes the inconsistent estimates of the model: the expectational errors and the existence of preference shock. This paper adopts Generalized Method of Moments to estimate MRS and Euler Equation of food versus services and transport versus services.

This paper uses dataset of Spanish households' consumption decisions between 1985 and 1995 and estimates the marginal rate of substitution and the Euler equation of food versus services and transport versus services. When the author estimates the MRS and Euler equation without controlling for time invariant unobserved heterogeneity. They find that the preferences are intertemporally separable which means there is no evidence of habit formation. After the author controls for fixed effect, they find preferences are not intertemporally separable which means there is evidence for habit formation. These results show that it is necessary to account for time invariant unobserved heterogeneity when studying the habit formation of consumers.