

Theoretical Foundations of Buffer Stock Saving

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Abstract

This paper builds foundations for rigorous and intuitive understanding of ‘buffer stock’ saving models (Bewley (1977)-like models with a wealth target), pairing each theoretical result with quantitative illustrations. After describing conditions under which a consumption function exists, the paper articulates stricter ‘Growth Impatience’ conditions that guarantee alternative forms of stability — either at the population level, or for individual consumers. Together, the numerical tools and analytical results constitute a comprehensive toolkit for understanding buffer stock models.

Keywords Precautionary saving, buffer stock saving, marginal propensity to consume, permanent income hypothesis, income fluctuation problem

JEL codes D81, D91, E21

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1 Introduction

For consumers whose income is affected by realistic transitory and permanent shocks *a la* Friedman (1957) and Muth (1960), only one further ingredient is required to construct a microeconomically testable model of optimal consumption: A description of preferences. Zeldes (1989) was the first to calibrate a quantitatively plausible example, spawning a literature showing that such models' predictions can match household life cycle data reasonably well, whether or not explicit liquidity constraints are imposed.¹

¹See Carroll (1997) or Gourinchas and Parker (2002) for arguments that models with only 'natural' constraints (see below) match a wide variety of facts; for a model with explicit constraints that produces very similar results, see, e.g. Cagetti (2003).

Appendices

A c Functions Exist, are Concave, and Differentiable

To show that (??) defines a sequence of continuously differentiable strictly increasing concave functions $\{c_T, c_{T-1}, \dots, c_{T-k}\}$, we start with a definition. We will say that a function $n(z)$ is ‘nice’ if it satisfies

1. $n(z)$ is well-defined iff $z > 0$
2. $n(z)$ is strictly increasing
3. $n(z)$ is strictly concave
4. $n(z)$ is \mathbf{C}^3
5. $n(z) < 0$
6. $\lim_{z \downarrow 0} n(z) = -\infty$.

(Notice that an implication of niceness is that $\lim_{z \downarrow 0} n'(z) = \infty$.)

Assume that some v_{t+1} is nice. Our objective is to show that this implies v_t is also nice; this is sufficient to establish that v_{t-n} is nice by induction for all $n > 0$ because $v_T(m) = u(m)$ and $u(m) = m^{1-\rho}/(1-\rho)$ is nice by inspection.

Now define an end-of-period value function $v_t(a)$ as

$$v_t(a) = \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} v_{t+1}(\mathcal{R}_{t+1}a + \xi_{t+1})].$$

Since there is a positive probability that ξ_{t+1} will attain its minimum of zero and since $\mathcal{R}_{t+1} > 0$, it is clear that $\lim_{a \downarrow 0} v_t(a) = -\infty$ and $\lim_{a \downarrow 0} v'_t(a) = \infty$. So $v_t(a)$ is well-defined iff $a > 0$; it is similarly straightforward to show the other properties required for $v_t(a)$ to be nice. (See Hiraguchi (2003).)

Next define $\underline{v}_t(m, c)$ as

$$\underline{v}_t(m, c) = u(c) + v_t(m - c) \tag{1}$$

which is \mathbf{C}^3 since v_t and u are both \mathbf{C}^3 , and note that our problem’s value function defined in (??) can be written as

$$v_t(m) = \max_c \underline{v}_t(m, c). \tag{2}$$

\underline{v}_t is well-defined if and only if $0 < c < m$. Furthermore, $\lim_{c \downarrow 0} \underline{v}_t(m, c) = \lim_{c \uparrow m} \underline{v}_t(m, c) = -\infty$, $\frac{\partial^2 \underline{v}_t(m, c)}{\partial c^2} < 0$, $\lim_{c \downarrow 0} \frac{\partial \underline{v}_t(m, c)}{\partial c} = +\infty$, and $\lim_{c \uparrow m} \frac{\partial \underline{v}_t(m, c)}{\partial c} = -\infty$. It follows that the $c_t(m)$ defined by

$$c_t(m) = \arg \max_{0 < c < m} \underline{v}_t(m, c) \tag{3}$$

exists and is unique, and (??) has an internal solution that satisfies

$$u'(c_t(m)) = v'_t(m - c_t(m)). \tag{4}$$

Since both u and \mathbf{v}_t are strictly concave, both $c_t(m)$ and $a_t(m) = m - c_t(m)$ are strictly increasing. Since both u and \mathbf{v}_t are three times continuously differentiable, using (4) we can conclude that $c_t(m)$ is continuously differentiable and

$$c'_t(m) = \frac{\mathbf{v}_t''(a_t(m))}{u''(c_t(m)) + \mathbf{v}_t''(a_t(m))}. \quad (5)$$

Similarly we can easily show that $c_t(m)$ is twice continuously differentiable (as is $a_t(m)$) (See Appendix B.) This implies that $v_t(m)$ is nice, since $v_t(m) = u(c_t(m)) + \mathbf{v}_t(a_t(m))$.

B $c_t(m)$ is Twice Continuously Differentiable

First we show that $c_t(m)$ is \mathbf{C}^1 . Define y as $y \equiv m + dm$. Since $u'(c_t(y)) - u'(c_t(m)) = \mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))$ and $\frac{a_t(y) - a_t(m)}{dm} = 1 - \frac{c_t(y) - c_t(m)}{dm}$,

$$\frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)} = \left(\frac{u'(c_t(y)) - u'(c_t(m))}{c_t(y) - c_t(m)} + \frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)} \right) \frac{c_t(y) - c_t(m)}{dm}$$

Since c_t and a_t are continuous and increasing, $\lim_{dm \rightarrow +0} \frac{u'(c_t(y)) - u'(c_t(m))}{c_t(y) - c_t(m)} < 0$ and $\lim_{dm \rightarrow +0} \frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)} < 0$ are satisfied. Then $\frac{u'(c_t(y)) - u'(c_t(m))}{c_t(y) - c_t(m)} + \frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)} < 0$ for sufficiently small dm . Hence we obtain a well-defined equation:

$$\frac{c_t(y) - c_t(m)}{dm} = \frac{\frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)}}{\frac{u'(c_t(y)) - u'(c_t(m))}{c_t(y) - c_t(m)} + \frac{\mathbf{v}_t'(a_t(y)) - \mathbf{v}_t'(a_t(m))}{a_t(y) - a_t(m)}}.$$

This implies that the right-derivative, $c_t^+(m)$ is well-defined and

$$c_t^+(m) = \frac{\mathbf{v}_t''(a_t(m))}{u''(c_t(m)) + \mathbf{v}_t''(a_t(m))}.$$

Similarly we can show that $c_t^+(m) = c_t^-(m)$, which means $c'_t(m)$ exists. Since \mathbf{v}_t is \mathbf{C}^3 , $c'_t(m)$ exists and is continuous. $c'_t(m)$ is differentiable because \mathbf{v}_t'' is \mathbf{C}^1 , $c_t(m)$ is \mathbf{C}^1 and $u''(c_t(m)) + \mathbf{v}_t''(a_t(m)) < 0$. $c''_t(m)$ is given by

$$c''_t(m) = \frac{a'_t(m)\mathbf{v}_t'''(a_t) [u''(c_t) + \mathbf{v}_t''(a_t)] - \mathbf{v}_t''(a_t) [c'_t u'''(c_t) + a'_t \mathbf{v}_t'''(a_t)]}{[u''(c_t) + \mathbf{v}_t''(a_t)]^2}. \quad (6)$$

Since $\mathbf{v}_t''(a_t(m))$ is continuous, $c''_t(m)$ is also continuous.

C \mathcal{T} Is a Contraction Mapping

We must show that our operator \mathcal{T} satisfies all of Boyd's conditions.

Boyd's operator \mathcal{T} maps from $\mathcal{C}_F(\mathcal{A}, \mathcal{B})$ to $\mathcal{C}(\mathcal{A}, \mathcal{B})$. A preliminary requirement is therefore that $\{\mathcal{T}z\}$ be continuous for any F -bounded z , $\{\mathcal{T}z\} \in \mathcal{C}(\mathbb{R}_{++}, \mathbb{R})$. This is not difficult to show; see Hiraguchi (2003).

Consider condition (1). For this problem,

$$\begin{aligned}\{\mathcal{T}_x\}(m_t) & \text{ is } \max_{c_t \in [\underline{\kappa}m_t, \bar{\kappa}m_t]} \left\{ u(c_t) + \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} x(m_{t+1})] \right\} \\ \{\mathcal{T}_y\}(m_t) & \text{ is } \max_{c_t \in [\underline{\kappa}m_t, \bar{\kappa}m_t]} \left\{ u(c_t) + \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} y(m_{t+1})] \right\},\end{aligned}$$

so $x(\bullet) \leq y(\bullet)$ implies $\{\mathcal{T}_x\}(m_t) \leq \{\mathcal{T}_y\}(m_t)$ by inspection.²

Condition (2) requires that $\{\mathcal{T}_0\} \in \mathcal{C}_F(\mathcal{A}, \mathcal{B})$. By definition,

$$\{\mathcal{T}_0\}(m_t) = \max_{c_t \in [\underline{\kappa}m_t, \bar{\kappa}m_t]} \left\{ \left(\frac{c_t^{1-\rho}}{1-\rho} \right) + \beta 0 \right\}$$

the solution to which is patently $u(\bar{\kappa}m_t)$. Thus, condition (2) will hold if $(\bar{\kappa}m_t)^{1-\rho}$ is F -bounded, which it is if we use the bounding function

$$F(m) = \eta + m^{1-\rho}, \quad (7)$$

defined in the main text.

Finally, we turn to condition (3), $\{\mathcal{T}(z + \zeta F)\}(m_t) \leq \{\mathcal{T}z\}(m_t) + \zeta \alpha F(m_t)$. The proof will be more compact if we define \check{c} and \check{a} as the consumption and assets functions³ associated with $\mathcal{T}z$ and \hat{c} and \hat{a} as the functions associated with $\mathcal{T}(z + \zeta F)$; using this notation, condition (3) can be rewritten

$$u(\hat{c}) + \beta \{E(z + \zeta F)\}(\hat{a}) \leq u(\check{c}) + \beta \{Ez\}(\check{a}) + \zeta \alpha F.$$

Now note that if we force the \cup consumer to consume the amount that is optimal for the \wedge consumer, value for the \cup consumer must decline (at least weakly). That is,

$$u(\hat{c}) + \beta \{Ez\}(\hat{a}) \leq u(\check{c}) + \beta \{Ez\}(\check{a}).$$

Thus, condition (3) will certainly hold under the stronger condition

$$\begin{aligned}u(\hat{c}) + \beta \{E(z + \zeta F)\}(\hat{a}) & \leq u(\hat{c}) + \beta \{Ez\}(\hat{a}) + \zeta \alpha F \\ \beta \{E(z + \zeta F)\}(\hat{a}) & \leq \beta \{Ez\}(\hat{a}) + \zeta \alpha F \\ \beta \zeta \{EF\}(\hat{a}) & \leq \zeta \alpha F \\ \beta \{EF\}(\hat{a}) & \leq \alpha F \\ \beta \{EF\}(\hat{a}) & < F.\end{aligned}$$

where the last line follows because $0 < \alpha < 1$ by assumption.⁴

Using $F(m) = \eta + m^{1-\rho}$ and defining $\hat{a}_t = \hat{a}(m_t)$, this condition is

$$\beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} (\hat{a}_t \mathcal{R}_{t+1} + \xi_{t+1})^{1-\rho}] - m_t^{1-\rho} < \eta (1 - \underbrace{\beta \mathbb{E}_t \Phi_{t+1}^{1-\rho}}_{=\zeta})$$

²For a fixed m_t , recall that m_{t+1} is just a function of c_t and the stochastic shocks.

³Section ?? proves existence of a continuously differentiable consumption function, which implies the existence of a corresponding continuously differentiable assets function.

⁴The remainder of the proof could be reformulated using the second-to-last line at a small cost to intuition.

which by imposing **PF-FVAC** (equation (??), which says $\underline{\mathfrak{I}} < 1$) can be rewritten as:

$$\eta > \frac{\beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} (\hat{a}_t \mathcal{R}_{t+1} + \underline{\xi}_{t+1})^{1-\rho}] - m_t^{1-\rho}}{1 - \underline{\mathfrak{I}}}. \quad (8)$$

But since η is an arbitrary constant that we can pick, the proof thus reduces to showing that the numerator of (8) is bounded from above:

$$\begin{aligned} & (1 - \wp) \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} (\hat{a}_t \mathcal{R}_{t+1} + \underline{\theta}_{t+1}/(1 - \wp))^{1-\rho}] + \wp \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} (\hat{a}_t \mathcal{R}_{t+1})^{1-\rho}] - m_t^{1-\rho} \\ & \leq (1 - \wp) \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} ((1 - \bar{\kappa}) m_t \mathcal{R}_{t+1} + \underline{\theta}_{t+1}/(1 - \wp))^{1-\rho}] \\ & \quad + \wp \beta R^{1-\rho} ((1 - \bar{\kappa}) m_t)^{1-\rho} - m_t^{1-\rho} \\ & = (1 - \wp) \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} ((1 - \bar{\kappa}) m_t \mathcal{R}_{t+1} + \underline{\theta}_{t+1}/(1 - \wp))^{1-\rho}] \\ & \quad + m_t^{1-\rho} \left(\wp \beta R^{1-\rho} \left(\wp^{1/\rho} \frac{(R\beta)^{1/\rho}}{R} \right)^{1-\rho} - 1 \right) \\ & = (1 - \wp) \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} ((1 - \bar{\kappa}) m_t \mathcal{R}_{t+1} + \underline{\theta}_{t+1}/(1 - \wp))^{1-\rho}] + m_t^{1-\rho} \left(\underbrace{\wp^{1/\rho} \frac{(R\beta)^{1/\rho}}{R}}_{<1 \text{ by WRIC}} - 1 \right) \\ & < (1 - \wp) \beta \mathbb{E}_t [\Phi_{t+1}^{1-\rho} (\underline{\theta}/(1 - \wp))^{1-\rho}] = \underline{\mathfrak{I}} (1 - \wp)^\rho \underline{\theta}^{1-\rho}. \end{aligned}$$

We can thus conclude that equation (8) will certainly hold for any:

$$\eta > \underline{\eta} = \frac{\underline{\mathfrak{I}} (1 - \wp)^\rho \underline{\theta}^{1-\rho}}{1 - \underline{\mathfrak{I}}} \quad (9)$$

which is a positive finite number under our assumptions.

The proof that \mathcal{T} defines a contraction mapping under the conditions (??) and (??) is now complete.

C.1 \mathcal{T} and v

In defining our operator \mathcal{T} we made the restriction $\underline{\kappa} m_t \leq c_t \leq \bar{\kappa} m_t$. However, in the discussion of the consumption function bounds, we showed only (in (??)) that $\underline{\kappa}_t m_t \leq c_t(m_t) \leq \bar{\kappa}_t m_t$. (The difference is in the presence or absence of time subscripts on the MPC's.) We have therefore not proven (yet) that the sequence of value functions (??) defines a contraction mapping.

Fortunately, the proof of that proposition is identical to the proof above, except that we must replace $\bar{\kappa}$ with $\bar{\kappa}_{T-1}$ and the **WRIC** must be replaced by a slightly stronger (but still quite weak) condition. The place where these conditions have force is in the step at (9). Consideration of the prior two equations reveals that a sufficient stronger condition is

$$\begin{aligned} & \wp \beta (R(1 - \bar{\kappa}_{T-1}))^{1-\rho} < 1 \\ & (\wp \beta)^{1/(1-\rho)} (1 - \bar{\kappa}_{T-1}) > 1 \end{aligned}$$

$$(\wp\beta)^{1/(1-\rho)}(1 - (1 + \wp^{1/\rho}\mathbf{P}_R)^{-1}) > 1$$

where we have used (??) for $\bar{\kappa}_{T-1}$ (and in the second step the reversal of the inequality occurs because we have assumed $\rho > 1$ so that we are exponentiating both sides by the negative number $1 - \rho$). To see that this is a weak condition, note that for small values of \wp this expression can be further simplified using $(1 + \wp^{1/\rho}\mathbf{P}_R)^{-1} \approx 1 - \wp^{1/\rho}\mathbf{P}_R$ so that it becomes

$$\begin{aligned} (\wp\beta)^{1/(1-\rho)}\wp^{1/\rho}\mathbf{P}_R &> 1 \\ (\wp\beta)\wp^{(1-\rho)/\rho}\mathbf{P}_R^{1-\rho} &< 1 \\ \beta\wp^{1/\rho}\mathbf{P}_R^{1-\rho} &< 1. \end{aligned}$$

Calling the weak return patience factor $\mathbf{P}_R^\wp = \wp^{1/\rho}\mathbf{P}_R$ and recalling that the **WRIC** was $\mathbf{P}_R^\wp < 1$, the expression on the LHS above is $\beta\mathbf{P}_R^{\wp^{-\rho}}$ times the **WRPF**. Since we usually assume β not far below 1 and parameter values such that $\mathbf{P}_R \approx 1$, this condition is clearly not very different from the **WRIC**.

The upshot is that under these slightly stronger conditions the value functions for the original problem define a contraction mapping in F -bounded space with a unique $v(m)$. But since $\lim_{n \rightarrow \infty} \underline{\kappa}_{T-n} = \underline{\kappa}$ and $\lim_{n \rightarrow \infty} \bar{\kappa}_{T-n} = \bar{\kappa}$, it must be the case that the $v(m)$ toward which these v_{T-n} 's are converging is the *same* $v(m)$ that was the endpoint of the contraction defined by our operator \mathcal{T} . Thus, under our slightly stronger (but still quite weak) conditions, not only do the value functions defined by (??) converge, they converge to the same unique v defined by \mathcal{T} .⁵

D Convergence in Euclidian Space

D.1 Convergence of v_t

Boyd's theorem shows that \mathcal{T} defines a contraction mapping in an F -bounded space. We now show that \mathcal{T} also defines a contraction mapping in Euclidian space.

Calling v^* the unique fixed point of the operator \mathcal{T} , since $v^*(m) = \mathcal{T}v^*(m)$,

$$\|v_{T-n+1} - v^*\|_F \leq \alpha^{n-1} \|v_T - v^*\|_F. \quad (10)$$

On the other hand, $v_T - v^* \in \mathcal{C}_F(\mathcal{A}, \mathcal{B})$ and $\kappa = \|v_T - v^*\|_F < \infty$ because v_T and v^* are in $\mathcal{C}_F(\mathcal{A}, \mathcal{B})$. It follows that

$$|v_{T-n+1}(m) - v^*(m)| \leq \kappa \alpha^{n-1} |F(m)|. \quad (11)$$

Then we obtain

$$\lim_{n \rightarrow \infty} v_{T-n+1}(m) = v^*(m). \quad (12)$$

⁵It seems likely that convergence of the value functions for the original problem could be proven even if only the **WRIC** were imposed; but that proof is not an essential part of the enterprise of this paper and is therefore left for future work.

Since $v_T(m) = \frac{m^{1-\rho}}{1-\rho}$, $v_{T-1}(m) \leq \frac{(\bar{\kappa}m)^{1-\rho}}{1-\rho} < v_T(m)$. On the other hand, $v_{T-1} \leq v_T$ means $\mathcal{I}v_{T-1} \leq \mathcal{I}v_T$, in other words, $v_{T-2}(m) \leq v_{T-1}(m)$. Inductively one gets $v_{T-n}(m) \geq v_{T-n-1}(m)$. This means that $\{v_{T-n+1}(m)\}_{n=1}^\infty$ is a decreasing sequence, bounded below by v^* .

D.2 Convergence of c_t

Given the proof that the value functions converge, we now show the pointwise convergence of consumption functions $\{c_{T-n+1}(m)\}_{n=1}^\infty$.

Consider any convergent subsequence $\{c_{T-n(i)}(m)\}$ of $\{c_{T-n+1}(m)\}_{n=1}^\infty$ converging to c^* . By the definition of $c_{T-n}(m)$, we have

$$\begin{aligned} u(c_{T-n(i)}(m)) + \beta \mathbb{E}_{T-n(i)}[\Phi_{T-n(i)+1}^{1-\rho} v_{T-n(i)+1}(m)] \\ \geq u(c_{T-n(i)}) + \beta \mathbb{E}_{T-n(i)}[\Phi_{T-n(i)+1}^{1-\rho} v_{T-n(i)+1}(m)], \end{aligned} \quad (13)$$

for any $c_{T-n(i)} \in [\underline{\kappa}m, \bar{\kappa}m]$. Now letting $n(i)$ go to infinity, it follows that the left hand side converges to $u(c^*) + \beta \mathbb{E}_t[\Phi_t^{1-\rho} v(m)]$, and the right hand side converges to $u(c_{T-n(i)}) + \beta \mathbb{E}_t[\Phi_t^{1-\rho} v(m)]$. So the limit of the preceding inequality as $n(i)$ approaches infinity implies

$$u(c^*) + \beta \mathbb{E}_t[\Phi_{t+1}^{1-\rho} v(m)] \geq u(c_{T-n(i)}) + \beta \mathbb{E}_t[\Phi_{t+1}^{1-\rho} v(m)]. \quad (14)$$

Hence, $c^* \in \arg \max_{c_{T-n(i)} \in [\underline{\kappa}m, \bar{\kappa}m]} \{u(c_{T-n(i)}) + \beta \mathbb{E}_t[\Phi_{t+1}^{1-\rho} v(m)]\}$. By the uniqueness of $c(m)$, $c^* = c(m)$.

E Perfect Foresight Liquidity Constrained Solution

Under perfect foresight in the presence of a liquidity constraint requiring $b \geq 0$, this appendix taxonomizes the varieties of the limiting consumption function $\hat{c}(m)$ that arise under various parametric conditions.

Results are summarized in table 1.

E.1 If GIC Fails

A consumer is ‘growth patient’ if the perfect foresight growth impatience condition fails ($\cancel{\text{GIC}}$, $1 < \mathbf{P}/\Phi$). Under $\cancel{\text{GIC}}$ the constraint does not bind at the lowest feasible value of $m_t = 1$ because $1 < (\mathbf{R}\beta)^{1/\rho}/\Phi$ implies that spending everything today (setting $c_t = m_t = 1$) produces lower marginal utility than is obtainable by reallocating a

marginal unit of resources to the next period at return R :⁶

$$\begin{aligned} 1 &< (R\beta)^{1/\rho} \Phi^{-1} \\ 1 &< R\beta \Phi^{-\rho} \\ u'(1) &< R\beta u'(\Phi). \end{aligned}$$

Similar logic shows that under these circumstances the constraint will never bind at $m = 1$ for a constrained consumer with a finite horizon of n periods, so for $m \geq 1$ such a consumer's consumption function will be the same as for the unconstrained case examined in the main text.

RIC fails, FHC holds. If the *RIC* fails ($1 < \mathbf{D}_R$) while the finite human wealth condition holds, the limiting value of this consumption function as $n \uparrow \infty$ is the degenerate function

$$\dot{c}_{T-n}(m) = 0(b_t + h). \quad (15)$$

(that is, consumption is zero for any level of human or nonhuman wealth).

RIC fails, FHC fails. *FHC* implies that human wealth limits to $h = \infty$ so the consumption function limits to either $\dot{c}_{T-n}(m) = 0$ or $\dot{c}_{T-n}(m) = \infty$ depending on the relative speeds with which the MPC approaches zero and human wealth approaches ∞ .⁷

Thus, the requirement that the consumption function be nondegenerate implies that for a consumer satisfying *GHC* we must impose the *RIC* (and the *FHC* can be shown to be a consequence of *GHC* and *RIC*). In this case, the consumer's optimal behavior is easy to describe. We can calculate the point at which the unconstrained consumer would choose $c = m$ from Equation (??):

$$\begin{aligned} m_{\#} &= (m_{\#} - 1 + h)\underline{\kappa} \\ m_{\#}(1 - \underline{\kappa}) &= (h - 1)\underline{\kappa} \\ m_{\#} &= (h - 1) \left(\frac{\underline{\kappa}}{1 - \underline{\kappa}} \right) \end{aligned} \quad (16)$$

which (under these assumptions) satisfies $0 < m_{\#} < 1$.⁸ For $m < m_{\#}$ the unconstrained consumer would choose to consume more than m ; for such m , the constrained consumer is obliged to choose $\dot{c}(m) = m$.⁹ For any $m > m_{\#}$ the constraint will never bind and the consumer will choose to spend the same amount as the unconstrained consumer, $\bar{c}(m)$.

(Stachurski and Toda (2019) obtain a similar lower bound on consumption and use it to study the tail behavior of the wealth distribution.)

⁶The point at which the constraint would bind (if that point could be attained) is the $m = c$ for which $u'(c_{\#}) = R\beta u'(\Phi)$ which is $c_{\#} = \Phi/(R\beta)^{1/\rho}$ and the consumption function will be defined by $\dot{c}(m) = \min[m, c_{\#} + (m - c_{\#})\underline{\kappa}]$.

⁷The knife-edge case is where $\mathbf{D} = \Phi$, in which case the two quantities counterbalance and the limiting function is $\dot{c}(m) = \min[m, 1]$.

⁸Note that $0 < m_{\#}$ is implied by *RIC* and $m_{\#} < 1$ is implied by *GHC*.

⁹As an illustration, consider a consumer for whom $\mathbf{D} = 1$, $R = 1.01$ and $\Phi = 0.99$. This consumer will save the amount necessary to ensure that growth in market wealth exactly offsets the decline in human wealth represented by $\Phi < 1$; total wealth (and therefore total consumption) will remain constant, even as market wealth and human wealth trend in opposite directions.

E.2 If GIC Holds

Imposition of the **GIC** reverses the inequality in (15), and thus reverses the conclusion: A consumer who starts with $m_t = 1$ will desire to consume more than 1. Such a consumer will be constrained, not only in period t , but perpetually thereafter.

Now define $b_{\#}^n$ as the b_t such that an unconstrained consumer holding $b_t = b_{\#}^n$ would behave so as to arrive in period $t + n$ with $b_{t+n} = 0$ (with $b_{\#}^0$ trivially equal to 0); for example, a consumer with $b_{t-1} = b_{\#}^1$ was on the ‘cusp’ of being constrained in period $t - 1$: Had b_{t-1} been infinitesimally smaller, the constraint would have been binding (because the consumer would have desired, but been unable, to enter period t with negative, not zero, b). Given the **GIC**, the constraint certainly binds in period t (and thereafter) with resources of $m_t = m_{\#}^0 = 1 + b_{\#}^0 = 1$: The consumer cannot spend more (because constrained), and will not choose to spend less (because impatient), than $c_t = c_{\#}^0 = 1$.

We can construct the entire ‘prehistory’ of this consumer leading up to t as follows. Maintaining the assumption that the constraint has never bound in the past, c must have been growing according to \mathbf{P}_{Φ} , so consumption n periods in the past must have been

$$c_{\#}^n = \mathbf{P}_{\Phi}^{-n} c_t = \mathbf{P}_{\Phi}^{-n}. \quad (17)$$

The PDV of consumption from $t - n$ until t can thus be computed as

$$\begin{aligned} \mathbb{C}_{t-n}^t &= c_{t-n}(1 + \mathbf{P}/R + \cdots + (\mathbf{P}/R)^n) \\ &= c_{\#}^n(1 + \mathbf{P}_R + \cdots + \mathbf{P}_R^n) \\ &= \mathbf{P}_{\Phi}^{-n} \left(\frac{1 - \mathbf{P}_R^{n+1}}{1 - \mathbf{P}_R} \right) \\ &= \left(\frac{\mathbf{P}_{\Phi}^{-n} - \mathbf{P}_R}{1 - \mathbf{P}_R} \right) \end{aligned}$$

and note that the consumer’s human wealth between $t - n$ and t (the relevant time horizon, because from t onward the consumer will be constrained and unable to access post- t income) is

$$h_{\#}^n = 1 + \cdots + \mathcal{R}^{-n} \quad (18)$$

while the intertemporal budget constraint says

$$\mathbb{C}_{t-n}^t = b_{\#}^n + h_{\#}^n$$

from which we can solve for the $b_{\#}^n$ such that the consumer with $b_{t-n} = b_{\#}^n$ would unconstrainedly plan (in period $t - n$) to arrive in period t with $b_t = 0$:

$$b_{\#}^n = \mathbb{C}_{t-n}^t - \overbrace{\left(\frac{1 - \mathcal{R}^{-(n+1)}}{1 - \mathcal{R}^{-1}} \right)}^{h_{\#}^n}. \quad (19)$$

Defining $m_{\#}^n = b_{\#}^n + 1$, consider the function $\hat{c}(m)$ defined by linearly connecting the points $\{m_{\#}^n, c_{\#}^n\}$ for integer values of $n \geq 0$ (and setting $\hat{c}(m) = m$ for $m < 1$). This

function will return, for any value of m , the optimal value of c for a liquidity constrained consumer with an infinite horizon. The function is piecewise linear with ‘kink points’ where the slope discretely changes; for infinitesimal ϵ the MPC of a consumer with assets $m = m_{\#}^n - \epsilon$ is discretely higher than for a consumer with assets $m = m_{\#}^n + \epsilon$ because the latter consumer will spread a marginal dollar over more periods before exhausting it.

In order for a unique consumption function to be defined by this sequence (19) for the entire domain of positive real values of b , we need $b_{\#}^n$ to become arbitrarily large with n . That is, we need

$$\lim_{n \rightarrow \infty} b_{\#}^n = \infty. \quad (20)$$

E.2.1 If FHC Holds

The FHC requires $\mathcal{R}^{-1} < 1$, in which case the second term in (19) limits to a constant as $n \uparrow \infty$, and (20) reduces to a requirement that

$$\begin{aligned} \lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_{\Phi}^{-n} - (\mathbf{P}_R / \mathbf{P}_{\Phi})^n \mathbf{P}_R}{1 - \mathbf{P}_R} \right) &= \infty \\ \lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_{\Phi}^{-n} - \mathcal{R}^{-n} \mathbf{P}_R}{1 - \mathbf{P}_R} \right) &= \infty \\ \lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_{\Phi}^{-n}}{1 - \mathbf{P}_R} \right) &= \infty. \end{aligned}$$

Given the GIC $\mathbf{P}_{\Phi}^{-1} > 1$, this will hold iff the RIC holds, $\mathbf{P}_R < 1$. But given that the FHC $\mathcal{R} > \Phi$ holds, the GIC is stronger (harder to satisfy) than the RIC; thus, the FHC and the GIC together imply the RIC, and so a well-defined solution exists. Furthermore, in the limit as n approaches infinity, the difference between the limiting constrained consumption function and the unconstrained consumption function becomes vanishingly small, because the date at which the constraint binds becomes arbitrarily distant, so the effect of that constraint on current behavior shrinks to nothing. That is,

$$\lim_{m \rightarrow \infty} \dot{c}(m) - \bar{c}(m) = 0. \quad (21)$$

E.2.2 If FHC Fails

If the FHC fails, matters are a bit more complex.

Given failure of FHC, (20) requires

$$\begin{aligned} \lim_{n \rightarrow \infty} \left(\frac{\mathcal{R}^{-n} \mathbf{P}_R - \mathbf{P}_{\Phi}^{-n}}{\mathbf{P}_R - 1} \right) + \left(\frac{1 - \mathcal{R}^{-(n+1)}}{\mathcal{R}^{-1} - 1} \right) &= \infty \\ \lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_R}{\mathbf{P}_R - 1} - \frac{\mathcal{R}^{-1}}{\mathcal{R}^{-1} - 1} \right) \mathcal{R}^{-n} - \left(\frac{\mathbf{P}_{\Phi}^{-n}}{\mathbf{P}_R - 1} \right) &= \infty \end{aligned}$$

If RIC Holds. When the RIC holds, rearranging (22) gives

$$\lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_\Phi^{-n}}{1 - \mathbf{P}_R} \right) - \mathcal{R}^{-n} \left(\frac{\mathbf{P}_R}{1 - \mathbf{P}_R} + \frac{\mathcal{R}^{-1}}{\mathcal{R}^{-1} - 1} \right) = \infty$$

and for this to be true we need

$$\begin{aligned} \mathbf{P}_\Phi^{-1} &> \mathcal{R}^{-1} \\ \Phi/\mathbf{P} &> \Phi/R \\ 1 &> \mathbf{P}/R \end{aligned}$$

which is merely the RIC again. So the problem has a solution if the RIC holds. Indeed, we can even calculate the limiting MPC from

$$\lim_{n \rightarrow \infty} \kappa_{\#}^n = \lim_{n \rightarrow \infty} \left(\frac{c_{\#}^n}{b_{\#}^n} \right) \quad (22)$$

which with a bit of algebra¹⁰ can be shown to asymptote to the MPC in the perfect foresight model:¹¹

$$\lim_{m \rightarrow \infty} \kappa(m) = 1 - \mathbf{P}_R. \quad (24)$$

If RIC Fails. Consider now the ~~RIC~~ case, $\mathbf{P}_R > 1$. We can rearrange (22) as

$$\lim_{n \rightarrow \infty} \left(\frac{\mathbf{P}_R(\mathcal{R}^{-1} - 1)}{(\mathcal{R}^{-1} - 1)(\mathbf{P}_R - 1)} - \frac{\mathcal{R}^{-1}(\mathbf{P}_R - 1)}{(\mathcal{R}^{-1} - 1)(\mathbf{P}_R - 1)} \right) \mathcal{R}^{-n} - \left(\frac{\mathbf{P}_\Phi^{-n}}{\mathbf{P}_R - 1} \right) = \infty. \quad (25)$$

which makes clear that with ~~FHWC~~ $\Rightarrow \mathcal{R}^{-1} > 1$ and ~~RIC~~ $\Rightarrow \mathbf{P}_R > 1$ the numerators and denominators of both terms multiplying \mathcal{R}^{-n} can be seen transparently to be positive. So, the terms multiplying \mathcal{R}^{-n} in (22) will be positive if

$$\begin{aligned} \mathbf{P}_R \mathcal{R}^{-1} - \mathbf{P}_R &> \mathcal{R}^{-1} \mathbf{P}_R - \mathcal{R}^{-1} \\ \mathcal{R}^{-1} &> \mathbf{P}_R \\ \Phi &> \mathbf{P} \end{aligned}$$

which is merely the GIC which we are maintaining. So the first term's limit is $+\infty$. The combined limit will be $+\infty$ if the term involving \mathcal{R}^{-n} goes to $+\infty$ faster than the term involving $-\mathbf{P}_\Phi^{-n}$ goes to $-\infty$; that is, if

$$\begin{aligned} \mathcal{R}^{-1} &> \mathbf{P}_\Phi^{-1} \\ \Phi/R &> \Phi/\mathbf{P} \\ \mathbf{P}/R &> 1 \end{aligned}$$

¹⁰Calculate the limit of

$$\left(\frac{\mathbf{P}_\Phi^{-n}}{\mathbf{P}_\Phi^{-n}/(1 - \mathbf{P}_R) - (1 - \mathcal{R}^{-1}\mathcal{R}^{-n})/(1 - \mathcal{R}^{-1})} \right) = \left(\frac{1}{1/(1 - \mathbf{P}_R) + \mathcal{R}^{-n}\mathcal{R}^{-1}/(1 - \mathcal{R}^{-1})} \right) \quad (23)$$

¹¹For an example of this configuration of parameters, see the notebook `doApndxLiqConstr.nb` in the Mathematica software archive.

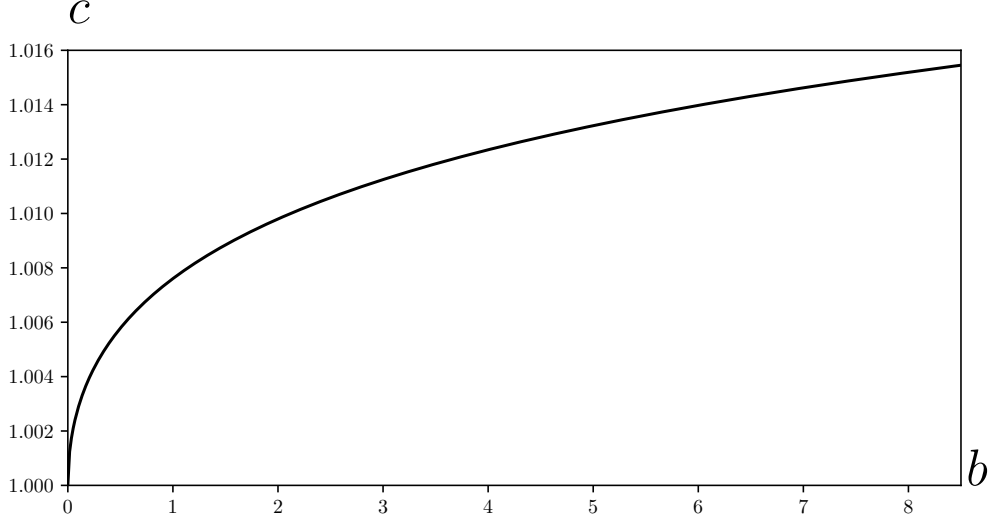


Figure 1 Appendix: Nondegenerate c Function with ~~FHWC~~ and ~~RIC~~

which merely confirms the starting assumption that the ~~RIC~~ fails.

What is happening here is that the $c_{\#}^n$ term is increasing backward in time at rate dominated in the limit by Φ/\mathfrak{D} while the $b_{\#}$ term is increasing at a rate dominated by Φ/R term and

$$\Phi/R > \Phi/\mathfrak{D} \quad (26)$$

because ~~RIC~~ $\Rightarrow \mathfrak{D} > R$.

Consequently, while $\lim_{n \uparrow \infty} b_{\#}^n = \infty$, the limit of the *ratio* $c_{\#}^n/b_{\#}^n$ in (22) is zero. Thus, surprisingly, the problem has a well defined solution with infinite human wealth if the ~~RIC~~ fails. It remains true that ~~RIC~~ implies a limiting MPC of zero,

$$\lim_{m \rightarrow \infty} \kappa(m) = 0, \quad (27)$$

but that limit is approached gradually, starting from a positive value, and consequently the consumption function is *not* the degenerate $\dot{c}(m) = 0$. (Figure 1 presents an example for $\rho = 2$, $R = 0.98$, $\beta = 1.00$, $\Phi = 0.99$; note that the horizontal axis is bank balances $b = m - 1$; the part of the consumption function below the depicted points is uninteresting — $c = m$ — so not worth plotting).

We can summarize as follows. Given that the ~~GIC~~ holds, the interesting question is whether the ~~FHWC~~ holds. If so, the ~~RIC~~ automatically holds, and the solution limits into the solution to the unconstrained problem as $m \uparrow \infty$. But even if the ~~FHWC~~ fails, the problem has a well-defined and nondegenerate solution, whether or not the ~~RIC~~ holds.

Although these results were derived for the perfect foresight case, we know from work elsewhere in this paper and in other places that the perfect foresight case is an upper bound for the case with uncertainty. If the upper bound of the MPC in the perfect foresight case is zero, it is not possible for the upper bound in the model with uncertainty to be greater than zero, because for any $\kappa > 0$ the level of consumption in the model

with uncertainty would eventually exceed the level of consumption in the absence of uncertainty.

Ma and Toda (2020) characterize the limits of the MPC in a more general framework that allows for capital and labor income risks in a Markovian setting with liquidity constraints, and find that in that much more general framework the limiting MPC is also zero.

F The Perfect Foresight Liquidity Constrained Solution as a Limit

Formally, suppose we change the description of the problem by making the following two assumptions:

$$\begin{aligned}\wp &= 0 \\ c_t &\leq m_t,\end{aligned}$$

and we designate the solution to this consumer's problem $\dot{c}_t(m)$. We will henceforth refer to this as the problem of the 'restrained' consumer (and, to avoid a common confusion, we will refer to the consumer as 'constrained' only in circumstances when the constraint is actually binding).

Redesignate the consumption function that emerges from our original problem for a given fixed \wp as $c_t(m; \wp)$ where we separate the arguments by a semicolon to distinguish between m , which is a state variable, and \wp , which is not. The proposition we wish to demonstrate is

$$\lim_{\wp \downarrow 0} c_t(m; \wp) = \dot{c}_t(m). \quad (28)$$

We will first examine the problem in period $T - 1$, then argue that the desired result propagates to earlier periods. For simplicity, suppose that the interest, growth, and time-preference factors are $\beta = R = \Phi = 1$, and there are no permanent shocks, $\Psi = 1$; the results below are easily generalized to the full-fledged version of the problem.

The solution to the restrained consumer's optimization problem can be obtained as follows. Assuming that the consumer's behavior in period T is given by $c_T(m)$ (in practice, this will be $c_T(m) = m$), consider the unrestrained optimization problem

$$\dot{a}_{T-1}^*(m) = \arg \max_a \left\{ u(m - a) + \int_{\underline{\theta}}^{\bar{\theta}} v_T(a + \theta) d\mathcal{F}_{\theta} \right\}. \quad (29)$$

As usual, the envelope theorem tells us that $v'_T(m) = u'(c_T(m))$ so the expected marginal value of ending period $T - 1$ with assets a can be defined as

$$\dot{v}'_{T-1}(a) \equiv \int_{\underline{\theta}}^{\bar{\theta}} u'(c_T(a + \theta)) d\mathcal{F}_{\theta},$$

and the solution to (29) will satisfy

$$u'(m - a) = \dot{v}'_{T-1}(a). \quad (30)$$

$\hat{a}_{T-1}^*(m)$ therefore answers the question “With what level of assets would the restrained consumer like to end period $T - 1$ if the constraint $c_{T-1} \leq m_{T-1}$ did not exist?” (Note that the restrained consumer’s income process remains different from the process for the unrestrained consumer so long as $\wp > 0$.) The restrained consumer’s actual asset position will be

$$\hat{a}_{T-1}(m) = \max[0, \hat{a}_{T-1}^*(m)],$$

reflecting the inability of the restrained consumer to spend more than current resources, and note (as pointed out by Deaton (1991)) that

$$m_{\#}^1 = (\mathfrak{v}'_{T-1}(0))^{-1/\rho}$$

is the cusp value of m at which the constraint makes the transition between binding and non-binding in period $T - 1$.

Analogously to (30), defining

$$\mathfrak{v}'_{T-1}(a; \wp) \equiv \left[\wp a^{-\rho} + (1 - \wp) \int_{\underline{\theta}}^{\bar{\theta}} (c_T(a + \theta/(1 - \wp)))^{-\rho} d\mathcal{F}_{\theta} \right], \quad (31)$$

the Euler equation for the original consumer’s problem implies

$$(m - a)^{-\rho} = \mathfrak{v}'_{T-1}(a; \wp) \quad (32)$$

with solution $\hat{a}_{T-1}^*(m; \wp)$. Now note that for any fixed $a > 0$, $\lim_{\wp \downarrow 0} \mathfrak{v}'_{T-1}(a; \wp) = \mathfrak{v}'_{T-1}(a)$. Since the LHS of (30) and (32) are identical, this means that $\lim_{\wp \downarrow 0} \hat{a}_{T-1}^*(m; \wp) = \hat{a}_{T-1}^*(m)$. That is, for any fixed value of $m > m_{\#}^1$ such that the consumer subject to the restraint would voluntarily choose to end the period with positive assets, the level of end-of-period assets for the unrestrained consumer approaches the level for the restrained consumer as $\wp \downarrow 0$. With the same a and the same m , the consumers must have the same c , so the consumption functions are identical in the limit.

Now consider values $m \leq m_{\#}^1$ for which the restrained consumer is constrained. It is obvious that the baseline consumer will never choose $a \leq 0$ because the first term in (31) is $\lim_{a \downarrow 0} \wp a^{-\rho} = \infty$, while $\lim_{a \downarrow 0} (m - a)^{-\rho}$ is finite (the marginal value of end-of-period assets approaches infinity as assets approach zero, but the marginal utility of consumption has a finite limit for $m > 0$). The subtler question is whether it is possible to rule out strictly positive a for the unrestrained consumer.

The answer is yes. Suppose, for some $m < m_{\#}^1$, that the unrestrained consumer is considering ending the period with any positive amount of assets $a = \delta > 0$. For any such δ we have that $\lim_{\wp \downarrow 0} \mathfrak{v}'_{T-1}(a; \wp) = \mathfrak{v}'_{T-1}(a)$. But by assumption we are considering a set of circumstances in which $\hat{a}_{T-1}^*(m) < 0$, and we showed earlier that $\lim_{\wp \downarrow 0} \hat{a}_{T-1}^*(m; \wp) = \hat{a}_{T-1}^*(m)$. So, having assumed $a = \delta > 0$, we have proven that the consumer would optimally choose $a < 0$, which is a contradiction. A similar argument holds for $m = m_{\#}^1$.

These arguments demonstrate that for any $m > 0$, $\lim_{\wp \downarrow 0} c_{T-1}(m; \wp) = \check{c}_{T-1}(m)$ which is the period $T - 1$ version of (28). But given equality of the period $T - 1$ consumption functions, backwards recursion of the same arguments demonstrates that the limiting consumption functions in previous periods are also identical to the constrained function.

Note finally that another intuitive confirmation of the equivalence between the two

problems is that our formula (34) for the maximal marginal propensity to consume satisfies

$$\lim_{\wp \downarrow 0} \bar{\kappa} = 1,$$

which makes sense because the marginal propensity to consume for a constrained restrained consumer is 1 by our definitions of ‘constrained’ and ‘restrained.’

G The Limiting MPC's

For $m_t > 0$ we can define $e_t(m_t) = c_t(m_t)/m_t$ and $a_t(m_t) = m_t - c_t(m_t)$ and the Euler equation (??) can be rewritten

$$\begin{aligned} e_t(m_t)^{-\rho} &= \beta R \mathbb{E}_t \left[\left(e_{t+1}(m_{t+1}) \left(\frac{\overbrace{Ra_t(m_t) + \Phi_{t+1}\xi_{t+1}}^{=m_{t+1}\Phi_{t+1}}}{m_t} \right) \right)^{-\rho} \right] \\ &= (1 - \wp) \beta R m_t^\rho \mathbb{E}_t \left[(e_{t+1}(m_{t+1}) m_{t+1} \Phi_{t+1})^{-\rho} \mid \xi_{t+1} > 0 \right] \\ &\quad + \wp \beta R^{1-\rho} \mathbb{E}_t \left[\left(e_{t+1}(\mathcal{R}_{t+1} a_t(m_t)) \frac{m_t - c_t(m_t)}{m_t} \right)^{-\rho} \mid \xi_{t+1} = 0 \right]. \end{aligned}$$

Consider the first conditional expectation in (??), recalling that if $\xi_{t+1} > 0$ then $\xi_{t+1} \equiv \theta_{t+1}/(1 - \wp)$. Since $\lim_{m \downarrow 0} a_t(m) = 0$, $\mathbb{E}_t[(e_{t+1}(m_{t+1}) m_{t+1} \Phi_{t+1})^{-\rho} \mid \xi_{t+1} > 0]$ is contained within bounds defined by $(e_{t+1}(\underline{\theta}/(1 - \wp)) \Phi \underline{\Psi} \underline{\theta}/(1 - \wp))^{-\rho}$ and $(e_{t+1}(\bar{\theta}/(1 - \wp)) \Phi \bar{\Psi} \bar{\theta}/(1 - \wp))^{-\rho}$ both of which are finite numbers, implying that the whole term multiplied by $(1 - \wp)$ goes to zero as m_t^ρ goes to zero. As $m_t \downarrow 0$ the expectation in the other term goes to $\bar{\kappa}_{t+1}^{-\rho} (1 - \bar{\kappa}_t)^{-\rho}$. (This follows from the strict concavity and differentiability of the consumption function.) It follows that the limiting $\bar{\kappa}_t$ satisfies $\bar{\kappa}_t^{-\rho} = \beta \wp R^{1-\rho} \bar{\kappa}_{t+1}^{-\rho} (1 - \bar{\kappa}_t)^{-\rho}$. Exponentiating by ρ , we can conclude that

$$\begin{aligned} \bar{\kappa}_t &= \wp^{-1/\rho} (\beta R)^{-1/\rho} R (1 - \bar{\kappa}_t) \bar{\kappa}_{t+1} \\ \underbrace{\wp^{1/\rho} R^{-1} (\beta R)^{1/\rho}}_{\equiv \wp^{1/\rho} \mathbf{P}_R} \bar{\kappa}_t &= (1 - \bar{\kappa}_t) \bar{\kappa}_{t+1} \end{aligned}$$

which yields a useful recursive formula for the maximal marginal propensity to consume:

$$\begin{aligned} (\wp^{1/\rho} \mathbf{P}_R \bar{\kappa}_t)^{-1} &= (1 - \bar{\kappa}_t)^{-1} \bar{\kappa}_{t+1}^{-1} \\ \bar{\kappa}_t^{-1} (1 - \bar{\kappa}_t) &= \wp^{1/\rho} \mathbf{P}_R \bar{\kappa}_{t+1}^{-1} \\ \bar{\kappa}_t^{-1} &= 1 + \wp^{1/\rho} \mathbf{P}_R \bar{\kappa}_{t+1}^{-1}. \end{aligned}$$

As noted in the main text, we need the **WRIC** (??) for this to be a convergent sequence:

$$0 \leq \wp^{1/\rho} \mathbf{P}_R < 1, \tag{33}$$

Since $\bar{\kappa}_T = 1$, iterating (33) backward to infinity (because we are interested in the limiting consumption function) we obtain:

$$\lim_{n \rightarrow \infty} \bar{\kappa}_{T-n} = \bar{\kappa} \equiv 1 - \wp^{1/\rho} \mathbf{P}_R \quad (34)$$

and we will therefore call $\bar{\kappa}$ the ‘limiting maximal MPC.’

The minimal MPC’s are obtained by considering the case where $m_t \uparrow \infty$. If the **FHWC** holds, then as $m_t \uparrow \infty$ the proportion of current and future consumption that will be financed out of capital approaches 1. Thus, the terms involving ξ_{t+1} in (33) can be neglected, leading to a revised limiting Euler equation

$$(m_t e_t(m_t))^{-\rho} = \beta R \mathbb{E}_t [(e_{t+1}(a_t(m_t) \mathcal{R}_{t+1}) (Ra_t(m_t)))^{-\rho}]$$

and using L’Hôpital’s rule $\lim_{m_t \rightarrow \infty} e_t(m_t) = \underline{\kappa}_t$, and $\lim_{m_t \rightarrow \infty} e_{t+1}(a_t(m_t) \mathcal{R}_{t+1}) = \underline{\kappa}_{t+1}$ so a further limit of the Euler equation is

$$\begin{aligned} (m_t \underline{\kappa}_t)^{-\rho} &= \beta R (\underline{\kappa}_{t+1} R (1 - \underline{\kappa}_t) m_t)^{-\rho} \\ \underbrace{R^{-1} \mathbf{P}}_{\equiv \mathbf{P}_R = (1 - \underline{\kappa})} \underline{\kappa}_t &= (1 - \underline{\kappa}_t) \underline{\kappa}_{t+1} \end{aligned}$$

and the same sequence of derivations used above yields the conclusion that if the **RIC** $0 \leq \mathbf{P}_R < 1$ holds, then a recursive formula for the minimal marginal propensity to consume is given by

$$\underline{\kappa}_t^{-1} = 1 + \underline{\kappa}_{t+1}^{-1} \mathbf{P}_R \quad (35)$$

so that $(\{\underline{\kappa}_{T-n}^{-1}\})_{n=0}^{\infty}$ is also an increasing convergent sequence, and we define

$$\underline{\kappa}^{-1} \equiv \lim_{n \uparrow \infty} \kappa_{T-n}^{-1} \quad (36)$$

as the limiting (inverse) marginal MPC. If the **RIC** does *not* hold, then $\lim_{n \rightarrow \infty} \underline{\kappa}_{T-n}^{-1} = \infty$ and so the limiting MPC is $\underline{\kappa} = 0$.

For the purpose of constructing the limiting perfect foresight consumption function, it is useful further to note that the PDV of consumption is given by

$$c_t \underbrace{(1 + \mathbf{P}_R + \mathbf{P}_R^2 + \cdots)}_{= 1 + \mathbf{P}_R(1 + \mathbf{P}_R \underline{\kappa}_{t+2}^{-1}) \dots} = c_t \underline{\kappa}_{T-n}^{-1}.$$

which, combined with the intertemporal budget constraint, yields the usual formula for the perfect foresight consumption function:

$$c_t = (b_t + h_t) \underline{\kappa}_t \quad (37)$$

H Unique and Stable Target and Steady State Points

This appendix proves Theorems 1-2 and:

Lemma 1. *If \check{m} and \hat{m} both exist, then $\check{m} \leq \hat{m}$.*

H.1 Proof of Theorem 1

Theorem 1. *For the nondegenerate solution to the problem defined in Section ?? when **FVAC**, **WRIC**, and **GIC-Mod** all hold, there exists a unique cash-on-hand-to-permanent-income ratio $\hat{m} > 0$ such that*

$$\mathbb{E}_t[m_{t+1}/m_t] = 1 \text{ if } m_t = \hat{m}. \quad (38)$$

Moreover, \hat{m} is a point of ‘stability’ in the sense that

$$\begin{aligned} \forall m_t \in (0, \hat{m}), \quad \mathbb{E}_t[m_{t+1}] &> m_t \\ \forall m_t \in (\hat{m}, \infty), \quad \mathbb{E}_t[m_{t+1}] &< m_t. \end{aligned} \quad (39)$$

The elements of the proof of Theorem 1 are:

- Existence and continuity of $\mathbb{E}_t[m_{t+1}/m_t]$
- Existence of a point where $\mathbb{E}_t[m_{t+1}/m_t] = 1$
- $\mathbb{E}_t[m_{t+1}] - m_t$ is monotonically decreasing

H.2 Existence and Continuity of $\mathbb{E}_t[m_{t+1}/m_t]$

The consumption function exists because we have imposed sufficient conditions (the **WRIC** and **FVAC**; Theorem ??).

Section ?? shows that for all t , $a_{t-1} = m_{t-1} - c_{t-1} > 0$. Since $m_t = a_{t-1}\mathcal{R}_t + \xi_t$, even if ξ_t takes on its minimum value of 0, $a_{t-1}\mathcal{R}_t > 0$, since both a_{t-1} and \mathcal{R}_t are strictly positive. With m_t and m_{t+1} both strictly positive, the ratio $\mathbb{E}_t[m_{t+1}/m_t]$ inherits continuity (and, for that matter, continuous differentiability) from the consumption function.

H.3 Existence of a point where $\mathbb{E}_t[m_{t+1}/m_t] = 1$.

This follows from:

1. Existence and continuity of $\mathbb{E}_t[m_{t+1}/m_t]$ (just proven)
2. Existence a point where $\mathbb{E}_t[m_{t+1}/m_t] < 1$
3. Existence a point where $\mathbb{E}_t[m_{t+1}/m_t] > 1$
4. The Intermediate Value Theorem

H.3.1 Existence of m where $\mathbb{E}_t[m_{t+1}/m_t] < 1$

If RIC holds. Logic exactly parallel to that of Section ?? leading to equation (??), but dropping the Φ_{t+1} from the RHS, establishes that

$$\begin{aligned} \lim_{m_t \uparrow \infty} \mathbb{E}_t[m_{t+1}/m_t] &= \lim_{m_t \uparrow \infty} \mathbb{E}_t \left[\frac{\mathcal{R}_{t+1}(m_t - c(m_t)) + \xi_{t+1}}{m_t} \right] \\ &= \mathbb{E}_t[(R/\Phi_{t+1})\mathbf{P}_R] \\ &= \mathbb{E}_t[\mathbf{P}/\Phi_{t+1}] \\ &< 1 \end{aligned} \tag{40}$$

where the inequality reflects imposition of the **GIC-Mod** (??).

If RIC fails. When the **RIC** fails, the fact that $\lim_{m \uparrow \infty} c'(m) = 0$ (see equation (??)) means that the limit of the RHS of (40) as $m \uparrow \infty$ is $\bar{\mathcal{R}} = \mathbb{E}_t[\mathcal{R}_{t+1}]$. In the next step of this proof, we will prove that the combination **GIC-Mod** and **RIC** implies $\bar{\mathcal{R}} < 1$.

So we have $\lim_{m_t \uparrow \infty} \mathbb{E}_t[m_{t+1}/m_t] < 1$ whether the **RIC** holds or fails.

H.3.2 Existence of $m > 1$ where $\mathbb{E}_t[m_{t+1}/m_t] > 1$

Paralleling the logic for c in Section ??: the ratio of $\mathbb{E}_t[m_{t+1}]$ to m_t is unbounded above as $m_t \downarrow 0$ because $\lim_{m_t \downarrow 0} \mathbb{E}_t[m_{t+1}] > 0$.

Intermediate Value Theorem. If $\mathbb{E}_t[m_{t+1}/m_t]$ is continuous, and takes on values above and below 1, there must be at least one point at which it is equal to one.

H.3.3 $\mathbb{E}_t[m_{t+1}] - m_t$ is monotonically decreasing.

Now define $\zeta(m_t) \equiv \mathbb{E}_t[m_{t+1}] - m_t$ and note that

$$\begin{aligned} \zeta(m_t) < 0 &\leftrightarrow \mathbb{E}_t[m_{t+1}/m_t] < 1 \\ \zeta(m_t) = 0 &\leftrightarrow \mathbb{E}_t[m_{t+1}/m_t] = 1 \\ \zeta(m_t) > 0 &\leftrightarrow \mathbb{E}_t[m_{t+1}/m_t] > 1, \end{aligned} \tag{41}$$

so that $\zeta(\hat{m}) = 0$. Our goal is to prove that $\zeta(\bullet)$ is strictly decreasing on $(0, \infty)$ using the fact that

$$\begin{aligned} \zeta'(m_t) &\equiv \left(\frac{d}{dm_t} \right) \zeta(m_t) = \mathbb{E}_t \left[\left(\frac{d}{dm_t} \right) (\mathcal{R}_{t+1}(m_t - c(m_t)) + \xi_{t+1} - m_t) \right] \\ &= \bar{\mathcal{R}}(1 - c'(m_t)) - 1. \end{aligned} \tag{42}$$

Now, we show that (given our other assumptions) $\zeta'(m)$ is decreasing (but for different reasons) whether the **RIC** holds or fails.

If RIC holds. Equation (??) indicates that if the **RIC** holds, then $\underline{\kappa} > 0$. We show at the bottom of Section ?? that if the **RIC** holds then $0 < \underline{\kappa} < c'(m_t) < 1$ so that

$$\bar{\mathcal{R}}(1 - c'(m_t)) - 1 < \bar{\mathcal{R}}(1 - \underbrace{(1 - \mathbf{P}_R)}_{\underline{\kappa}}) - 1$$

$$\begin{aligned}
&= \bar{\mathcal{R}} \mathbf{p}_R - 1 \\
&= \mathbb{E}_t \left[\frac{\mathbf{R}}{\Phi \Psi} \frac{\mathbf{p}}{\mathbf{R}} \right] - 1 \\
&= \underbrace{\mathbb{E}_t \left[\frac{\mathbf{p}}{\Phi \Psi} \right]}_{=\mathbf{p}_\Phi} - 1
\end{aligned}$$

which is negative because the **GIC-Mod** says $\mathbf{p}_\Phi < 1$.

If RIC fails. Under **RIC**, recall that $\lim_{m \uparrow \infty} c'(m) = 0$. Concavity of the consumption function means that c' is a decreasing function, so everywhere

$$\bar{\mathcal{R}} (1 - c'(m_t)) < \bar{\mathcal{R}}$$

which means that $\zeta'(m_t)$ from (42) is guaranteed to be negative if

$$\bar{\mathcal{R}} \equiv \mathbb{E}_t \left[\frac{\mathbf{R}}{\Phi \Psi} \right] < 1. \quad (43)$$

But the combination of the **GIC-Mod** holding and the **RIC** failing can be written:

$$\underbrace{\mathbb{E}_t \left[\frac{\mathbf{p}}{\Phi \Psi} \right]}_{\mathbf{p}_\Phi} < 1 < \underbrace{\frac{\mathbf{p}_R}{\mathbf{R}}}_{\mathbf{p}_R},$$

and multiplying all three elements by \mathbf{R}/\mathbf{p} gives

$$\mathbb{E}_t \left[\frac{\mathbf{R}}{\Phi \Psi} \right] < \mathbf{R}/\mathbf{p} < 1$$

which satisfies our requirement in (43).

H.4 Proof of Theorem 2

Theorem 2. *For the nondegenerate solution to the problem defined in Section ?? when **FVAC**, **WRIC**, and **GIC** all hold, there exists a unique pseudo-steady-state cash-on-hand-to-income ratio $\check{m} > 0$ such that*

$$\mathbb{E}_t[\Psi_{t+1} m_{t+1}/m_t] = 1 \text{ if } m_t = \check{m}. \quad (44)$$

Moreover, \check{m} is a point of stability in the sense that

$$\begin{aligned}
&\forall m_t \in (0, \check{m}), \quad \mathbb{E}_t[\mathbf{m}_{t+1}]/\mathbf{m}_t > \Phi \\
&\forall m_t \in (\check{m}, \infty), \quad \mathbb{E}_t[\mathbf{m}_{t+1}]/\mathbf{m}_t < \Phi.
\end{aligned} \quad (45)$$

The elements of the proof are:

- Existence and continuity of $\mathbb{E}_t[\Psi_{t+1} m_{t+1}/m_t]$
- Existence of a point where $\mathbb{E}_t[\Psi_{t+1} m_{t+1}/m_t] = 1$
- $\mathbb{E}_t[\Psi_{t+1} m_{t+1} - m_t]$ is monotonically decreasing

H.4.1 Existence and Continuity of the Ratio

Since by assumption $0 < \underline{\Psi} \leq \Psi_{t+1} \leq \bar{\Psi} < \infty$, our proof in H.2 that demonstrated existence and continuity of $\mathbb{E}_t[m_{t+1}/m_t]$ implies existence and continuity of $\mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t]$.

H.4.2 Existence of a stable point

Since by assumption $0 < \underline{\Psi} \leq \Psi_{t+1} \leq \bar{\Psi} < \infty$, our proof in Subsection H.2 that the ratio of $\mathbb{E}_t[m_{t+1}]$ to m_t is unbounded as $m_t \downarrow 0$ implies that the ratio $\mathbb{E}_t[\Psi_{t+1}m_{t+1}]$ to m_t is unbounded as $m_t \downarrow 0$.

The limit of the expected ratio as m_t goes to infinity is most easily calculated by modifying the steps for the prior theorem explicitly:

$$\begin{aligned}
 \lim_{m_t \uparrow \infty} \mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t] &= \lim_{m_t \uparrow \infty} \mathbb{E}_t \left[\frac{\Phi_{t+1} ((R/\Phi_{t+1})a(m_t) + \xi_{t+1}) / \Phi}{m_t} \right] \\
 &= \lim_{m_t \uparrow \infty} \mathbb{E}_t \left[\frac{(R/\Phi)a(m_t) + \Psi_{t+1}\xi_{t+1}}{m_t} \right] \\
 &= \lim_{m_t \uparrow \infty} \left[\frac{(R/\Phi)a(m_t) + 1}{m_t} \right] \\
 &= (R/\Phi)\mathbf{P}_R \\
 &= \mathbf{P}_\Phi \\
 &< 1
 \end{aligned} \tag{46}$$

where the last two lines are merely a restatement of the GIC (??).

The Intermediate Value Theorem says that if $\mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t]$ is continuous, and takes on values above and below 1, there must be at least one point at which it is equal to one.

H.4.3 $\mathbb{E}_t[\Psi_{t+1}m_{t+1}] - m_t$ is monotonically decreasing.

Define $\zeta(m_t) \equiv \mathbb{E}_t[\Psi_{t+1}m_{t+1}] - m_t$ and note that

$$\begin{aligned}
 \zeta(m_t) < 0 &\leftrightarrow \mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t] < 1 \\
 \zeta(m_t) = 0 &\leftrightarrow \mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t] = 1 \\
 \zeta(m_t) > 0 &\leftrightarrow \mathbb{E}_t[\Psi_{t+1}m_{t+1}/m_t] > 1,
 \end{aligned} \tag{47}$$

so that $\zeta(\hat{m}) = 0$. Our goal is to prove that $\zeta(\bullet)$ is strictly decreasing on $(0, \infty)$ using the fact that

$$\begin{aligned}
 \zeta'(m_t) &\equiv \left(\frac{d}{dm_t} \right) \zeta(m_t) = \mathbb{E}_t \left[\left(\frac{d}{dm_t} \right) (\mathcal{R}(m_t - c(m_t)) + \Psi_{t+1}\xi_{t+1} - m_t) \right] \\
 &= (R/\Phi)(1 - c'(m_t)) - 1.
 \end{aligned} \tag{48}$$

Now, we show that (given our other assumptions) $\zeta'(m)$ is decreasing (but for different reasons) whether the RIC holds or fails (RIC).

If RIC holds. Equation (??) indicates that if the RIC holds, then $\underline{\kappa} > 0$. We show at the bottom of Section ?? that if the RIC holds then $0 < \underline{\kappa} < c'(m_t) < 1$ so that

$$\begin{aligned} \mathcal{R}(1 - c'(m_t)) - 1 &< \mathcal{R}(1 - \underbrace{(1 - \mathbf{P}_R)}_{\underline{\kappa}}) - 1 \\ &= (\mathcal{R}/\Phi)\mathbf{P}_R - 1 \end{aligned}$$

which is negative because the GIC says $\mathbf{P}_\Phi < 1$.

If RIC fails. Under RIC, recall that $\lim_{m \uparrow \infty} c'(m) = 0$. Concavity of the consumption function means that c' is a decreasing function, so everywhere

$$\mathcal{R}(1 - c'(m_t)) < \mathcal{R}$$

which means that $\zeta'(m_t)$ from (48) is guaranteed to be negative if

$$\mathcal{R} \equiv (\mathcal{R}/\Phi) < 1. \quad (49)$$

But we showed in Section ?? that the only circumstances under which the problem has a nondegenerate solution while the RIC fails were ones where the FHCW also fails (that is, (49) holds).

H.5 A Third Measure

A footnote in Section ?? mentions reasons why it may be useful to calculate $\mathbb{E}_t[\log(\mathbf{m}_{t+1}/\log \mathbf{m}_t)]$. Here we show that one way of doing that is to calculate a nonlinear adjustment factor for the expectation of the growth factor.

$$\begin{aligned} \log(\mathbf{m}_{t+1}/\mathbf{m}_t) &= \log(\Phi\Psi_{t+1}m_{t+1}) - \log m_t \\ &= \log \Phi(a_t\mathcal{R} + \Psi_{t+1}\xi_{t+1}) - \log m_t \\ &= \log \Phi(a_t\mathcal{R} + 1 + (\Psi_{t+1}\xi_{t+1} - 1)) - \log m_t \end{aligned}$$

Now define $\check{m}_{t+1} = a_t\mathcal{R} + 1$, and compute the expectation:

$$\begin{aligned} \mathbb{E}_t[\log(\mathbf{m}_{t+1}/\mathbf{m}_t)] &= \mathbb{E}_t[\log \Phi(\check{m}_{t+1} + (\Psi_{t+1}\xi_{t+1} - 1))] - \log m_t \\ &= \log \Phi + \mathbb{E}_t[\log \check{m}_{t+1}(1 + (\Psi_{t+1}\xi_{t+1} - 1)\check{m}_{t+1}^{-1})] - \log m_t \\ &= \underbrace{\log \Phi + \log \check{m}_{t+1} - \log m_t}_{\equiv \log \mathbb{E}_t[\mathbf{m}_{t+1}/\mathbf{m}_t]} + \mathbb{E}_t[\log(1 + (\Psi_{t+1}\xi_{t+1} - 1)\check{m}_{t+1}^{-1})] \end{aligned}$$

and exponentiating tells us that

$$\exp(\mathbb{E}_t[\log \mathbf{m}_{t+1}/\mathbf{m}_t]) = \mathbb{E}_t[\mathbf{m}_{t+1}/\mathbf{m}_t] \exp(\mathbb{E}_t[\log(1 + (\Psi_{t+1}\xi_{t+1} - 1)\check{m}_{t+1}^{-1})]) \quad (50)$$

and this latter factor is a number that approaches 1 from below as m_t rises. Thus the expected growth rate of the log is smaller than the log of the growth rate of the expected growth factor. This implies that the m at which ‘balanced growth’ can be expected in the log, \check{m} , exceeds the corresponding point for the ratio, \check{m} .

Furthermore, in the limit as \mathbf{m}_t gets arbitrarily large, if the RIC holds and thus $\underline{\kappa} > 0$, a_{t+1} rises without bound, as does $\check{m}_{t+1} = a_{t+1}\mathcal{R} + 1$, so the approximation $\log(1 + \epsilon) \approx \epsilon$ becomes arbitrarily good. Consequently, the last term on the RHS of (50)

can be approximated as

$$\begin{aligned}\mathbb{E}_t [\log(1 + (\Psi_{t+1}\xi_{t+1} - 1)\check{m}_{t+1}^{-1})] &\approx \mathbb{E}_t [(\Psi_{t+1}\xi_{t+1} - 1)\check{m}_{t+1}^{-1}] \\ &= 0\end{aligned}$$

This demonstrates that

$$\lim_{\mathbf{m}_t \uparrow \infty} \exp(\mathbb{E}_t[\log \mathbf{m}_{t+1}/\mathbf{m}_t]) = \mathbb{E}_t[\mathbf{m}_{t+1}/\mathbf{m}_t] \quad (51)$$

H.6 Proof of Lemma

H.6.1 Pseudo-Steady-State m Is Smaller than Target m

Designate

$$\begin{aligned}\check{m}_{t+1}(a) &= 1 + a\mathcal{R} \\ \hat{m}_{t+1}(a) &= 1 + a \underbrace{\mathcal{R}/\underline{\Psi}}_{\bar{\mathcal{R}} > \mathcal{R}}\end{aligned} \quad (52)$$

so that we can implicitly define the target and pseudo-steady-state points as

$$\begin{aligned}\hat{m} &= \hat{m}_{t+1}(\hat{m} - c(\hat{m})) \\ \check{m} &= \check{m}_{t+1}(\check{m} - c(\check{m}))\end{aligned} \quad (53)$$

Then subtract:

$$\begin{aligned}\hat{m} - \check{m} &= (\hat{a}\underline{\Psi}^{-1} - \check{a})\mathcal{R} \\ &= (a(\hat{m})\underline{\Psi}^{-1} - a(\check{m}))\mathcal{R} \\ &= (a(\hat{m})\underline{\Psi}^{-1} - (a(\hat{m} + \check{m} - \hat{m})))\mathcal{R} \\ &\approx (a(\hat{m})\underline{\Psi}^{-1} - (a(\hat{m}) + (\check{m} - \hat{m})a'(\hat{m})))\mathcal{R} \\ (\hat{m} - \check{m})(1 - \underbrace{a'(\hat{m})\mathcal{R}}_{< \mathbf{P}_{\Phi} < 1}) &= (\underline{\Psi}^{-1} - 1)\hat{a}\mathcal{R}\end{aligned} \quad (54)$$

The RHS of this equation is strictly positive because $\underline{\Psi}^{-1} > 1$ and both \hat{a} and \mathcal{R} are positive; while on the LHS, $(1 - \mathcal{R}a') > 0$. So the equation can only hold if $\hat{m} - \check{m} > 0$. That is, the target ratio exceeds the pseudo-steady-state ratio.¹²

¹²The use of the first order Taylor approximation could be substituted, clumsily, with the average of a' over the interval to remove the approximation in the derivations above.

H.6.2 The m Achieving Individual Expected-Log-Balanced-Growth Is Smaller than the Individual Pseudo-Steady-State m

Expected log balanced growth occurs when

$$\begin{aligned}
 \mathbb{E}_t[\log \mathbf{m}_{t+1}] &= \log \Phi \mathbf{m}_t \\
 \mathbb{E}_t[\log \mathbf{p}_{t+1} m_{t+1}] &= \log \Phi \mathbf{p}_t m_t \\
 \mathbb{E}_t[\log \Psi_{t+1} m_{t+1}] &= \log \Phi m_t \\
 \mathbb{E}_t[\log (a(m_t) \mathbf{R} + \Psi_{t+1} \xi_{t+1} \Phi)] &= \log \Phi m_t \\
 \mathbb{E}_t[\log (a(m_t) \mathcal{R} + \Psi_{t+1} \xi_{t+1})] &= \log m_t
 \end{aligned} \tag{55}$$

and we call the m that satisfies this equation \tilde{m} .

Subtract the definition of \tilde{m} from that of \tilde{m} :

$$\exp(\mathbb{E}_t[\log (a(\tilde{m}) \mathcal{R} + \Psi_{t+1} \xi_{t+1})]) - (a(\tilde{m}) \mathcal{R} + 1) = \tilde{m} - \check{m} \tag{56}$$

Now we use the fact that the expectation of the log is less than the log of the expectation,

$$\exp(\mathbb{E}_t[\log (a(\tilde{m}) \mathcal{R} + \Psi_{t+1} \xi_{t+1})]) < (a(\tilde{m}) \mathcal{R} + 1) \tag{57}$$

so

$$\begin{aligned}
 \exp(\mathbb{E}_t[\log (a(\tilde{m}) \mathcal{R} + 1)]) - (a(\tilde{m}) \mathcal{R} + 1) &< \tilde{m} - \check{m} \\
 (a(\tilde{m}) \mathcal{R} + 1) - (a(\tilde{m}) \mathcal{R} + 1) &< \tilde{m} - \check{m} \\
 (a(\tilde{m}) - a(\tilde{m} + \check{m} - \tilde{m})) \mathcal{R} &< \tilde{m} - \check{m} \\
 (a(\tilde{m}) - (a(\tilde{m}) + (\check{m} - \tilde{m}) \bar{a}')) \mathcal{R} &< \tilde{m} - \check{m} \\
 (\tilde{m} - \check{m}) \bar{a}' \mathcal{R} &< \tilde{m} - \check{m} \\
 \underbrace{\bar{a}' \mathcal{R}}_{< \mathbf{P}_\Phi} &< 1
 \end{aligned} \tag{58}$$

where we are interpreting \bar{a}' as the mean of the value of a' over the interval between \tilde{m} and \check{m} .

I Relational Diagrams for the Inequality Conditions

This appendix explains in detail the paper's ‘inequalities’ diagrams (Figures ??, ??).

I.1 The Unconstrained Perfect Foresight Model

A simple illustration is presented in Figure 2, whose three nodes represent values of the absolute patience factor \mathbf{P} , the permanent-income growth factor Φ , and the riskfree interest factor \mathbf{R} . The arrows represent imposition of the labeled inequality condition (like, the uppermost arrow, pointing from \mathbf{P} to Φ , reflects imposition of the **GIC** condition (clicking **GIC** should take you to its definition; definitions of other conditions are also

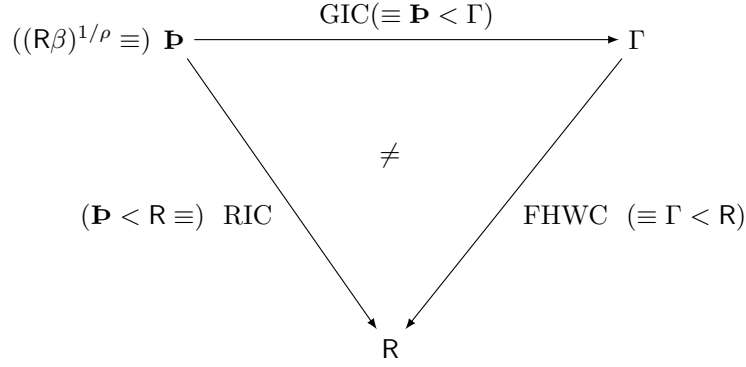


Figure 2 Appendix: Inequality Conditions for Perfect Foresight Model
(Start at a node and follow arrows)

linked below)).¹³ Annotations inside parenthetical expressions containing \equiv are there to make the diagram readable for someone who may not immediately remember terms and definitions from the main text. (Such a reader might also want to be reminded that R, β , and Γ are all in \mathbb{R}_{++} , and that $\rho > 1$).

Navigation of the diagram is simple: Start at any node, and deduce a chain of inequalities by following any arrow that exits that node, and any arrows that exit from successive nodes. Traversal must stop upon arrival at a node with no exiting arrows. So, for example, we can start at the \mathfrak{P} node and impose the **GIC** and then the **FHCW**, and see that imposition of these conditions allows us to conclude that $\mathfrak{P} < R$.

One could also impose $\mathfrak{P} < R$ directly (without imposing **GIC** and **FHCW**) by following the downward-sloping diagonal arrow exiting \mathfrak{P} . Although alternate routes from one node to another all justify the same core conclusion ($\mathfrak{P} < R$, in this case), \neq symbol in the center is meant to convey that these routes are not identical in other respects. This notational convention is used in **category theory diagrams**,¹⁴ to indicate that the diagram is not **commutative**.¹⁵

Negation of a condition is indicated by the reversal of the corresponding arrow. For example, negation of the **RIC**, **RIC** $\equiv \mathfrak{P} > R$, would be represented by moving the arrowhead from the bottom right to the top left of the line segment connecting \mathfrak{P} and R .

If we were to start at R and then impose **FHCW**, that would reverse the arrow connecting R and Φ , but the Φ node would then have no exiting arrows so no further deductions could be made. However, if we *also* reversed **GIC** (that is, if we imposed **GIC**), that would take us to the \mathfrak{P} node, and we could deduce $R > \mathfrak{P}$. However, we would have to stop traversing the diagram at this point, because the arrow exiting from the \mathfrak{P} node points back to our starting point, which (if valid) would lead us to the conclusion

¹³For convenience, the equivalent (\equiv) mathematical statement of each condition is expressed nearby in parentheses.

¹⁴For a popular introduction to category theory, see Riehl (2017).

¹⁵But the rest of our notation does not necessarily abide by the other conventions of category theory diagrams.

that $R > R$. Thus, the reversal of the two earlier conditions (imposition of ~~FHWC~~ and ~~GIC~~) requires us also to reverse the final condition, giving us ~~RIC~~.¹⁶

Under these conventions, Figure ?? in the main text presents a modified version of the diagram extended to incorporate the PF-FVAC (reproduced here for convenient reference).

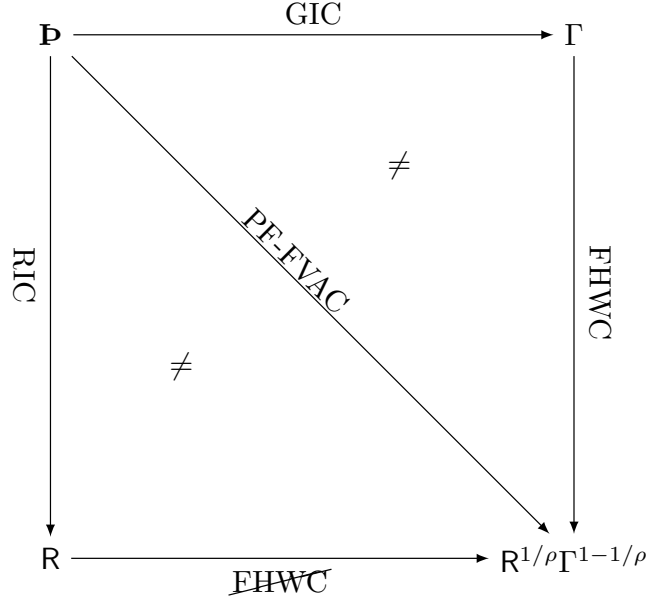


Figure 3 Appendix: Relation of GIC, FHWC, RIC, and PFVAC

An arrowhead points to the larger of the two quantities being compared. For example, the diagonal arrow indicates that $\mathfrak{D} < R^{1/\rho}\Phi^{1-1/\rho}$, which is an alternative way of writing the ~~PF-FVAC~~, (??)

This diagram can be interpreted, for example, as saying that, starting at the \mathfrak{D} node, it is possible to derive the ~~PF-FVAC~~¹⁷ by imposing both the ~~GIC~~ and the ~~FHWC~~; or by imposing ~~RIC~~ and ~~FHWC~~. Or, starting at the Φ node, we can follow the imposition of the ~~FHWC~~ (twice — reversing the arrow labeled ~~FHWC~~) and then ~~RIC~~ to reach the conclusion that $\mathfrak{D} < \Phi$. Algebraically,

$$\begin{aligned} \del{FHWC} : \quad & \Phi < R \\ \del{RIC} : \quad & R < \mathfrak{D} \\ & \Phi < \mathfrak{D} \end{aligned} \tag{59}$$

which leads to the negation of both of the conditions leading into \mathfrak{D} . ~~GIC~~ is obtained directly as the last line in (59) and ~~PF-FVAC~~ follows if we start by multiplying the

¹⁶The corresponding algebra is

$$\begin{aligned} \del{FHWC} : \quad & R < \Phi \\ \del{GIC} : \quad & \Phi < \mathfrak{D} \\ \Rightarrow \del{RIC} : \quad & R < \mathfrak{D}, \end{aligned}$$

¹⁷in the form $\mathfrak{D} < (R/\Phi)^{1/\rho}\Phi$

Return Patience Factor ($\mathbf{RPF}=\mathbf{D}/\mathbf{R}$) by the \mathbf{FHWF} ($=\mathbf{\Phi}/\mathbf{R}$) raised to the power $1/\rho-1$, which is negative since we imposed $\rho > 1$. \mathbf{FHC} implies $\mathbf{FHWF} < 1$ so when \mathbf{FHWF} is raised to a negative power the result is greater than one. Multiplying the \mathbf{RPF} (which exceeds 1 because \mathbf{RIC}) by another number greater than one yields a product that must be greater than one:

$$1 < \overbrace{\left(\frac{(\mathbf{R}\beta)^{1/\rho}}{\mathbf{R}} \right)}^{>1 \text{ from } \mathbf{RIC}} \overbrace{(\mathbf{\Phi}/\mathbf{R})^{1/\rho-1}}^{>1 \text{ from } \mathbf{FHC}}$$

$$1 < \left(\frac{(\mathbf{R}\beta)^{1/\rho}}{(\mathbf{R}/\mathbf{\Phi})^{1/\rho} \mathbf{R} \mathbf{\Phi}/\mathbf{R}} \right)$$

$$\mathbf{R}^{1/\rho} \mathbf{\Phi}^{1-1/\rho} = (\mathbf{R}/\mathbf{\Phi})^{1/\rho} \mathbf{\Phi} < \mathbf{D}$$

which is one way of writing $\mathbf{PF-FVAC}$.

The complexity of this algebraic calculation illustrates the usefulness of the diagram, in which one merely needs to follow arrows to reach the same result.

After the warmup of constructing these conditions for the perfect foresight case, we can represent the relationships between all the conditions in both the perfect foresight case and the case with uncertainty as shown in Figure ?? in the paper (reproduced here).

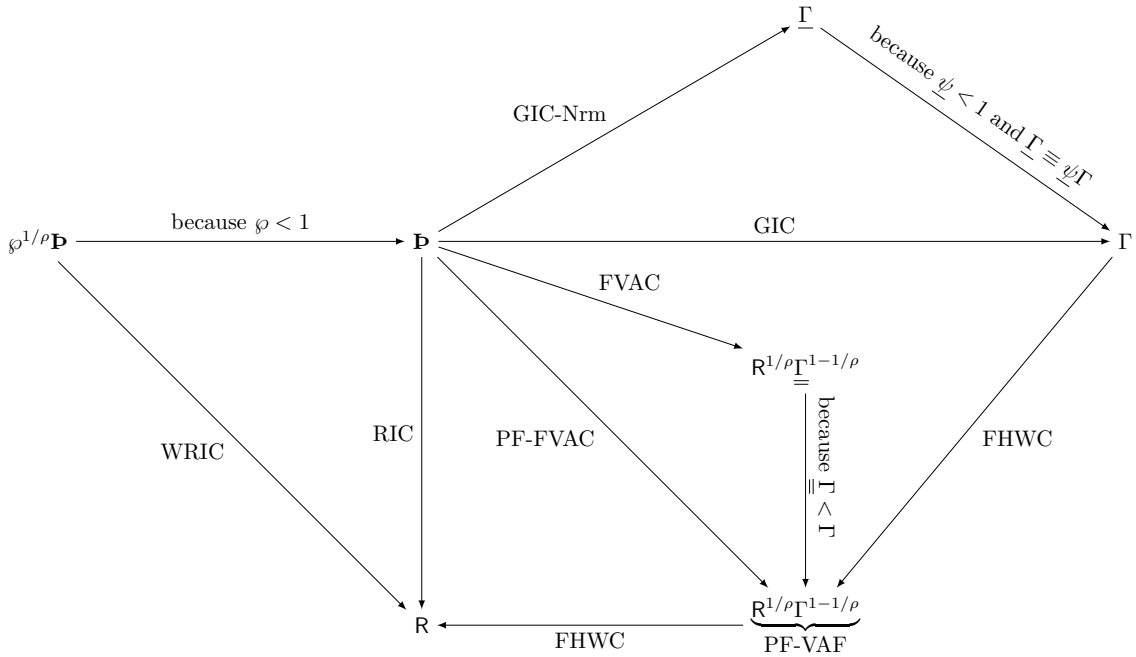


Figure 4 Appendix: Relation of All Inequality Conditions

Finally, the next diagram substitutes the values of the various objects in the diagram under the baseline parameter values and verifies that all of the asserted inequality conditions hold true.

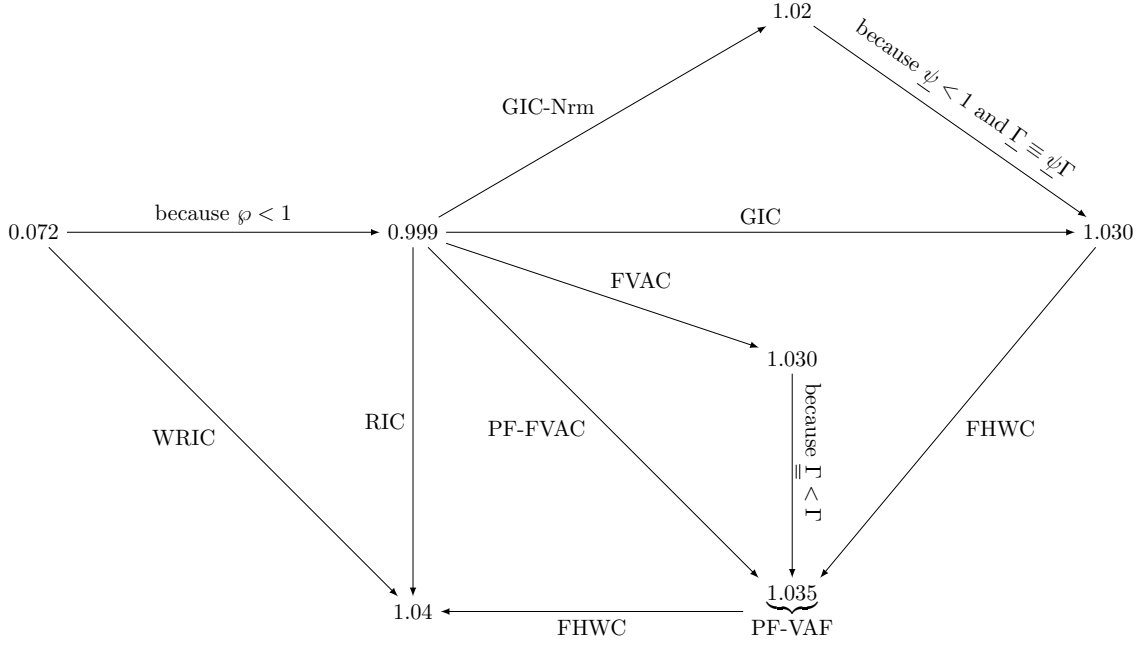


Figure 5 Appendix: Numerical Relation of All Inequality Conditions

J Apparent Balanced Growth in \mathfrak{c} and $\text{cov}(c, \mathbf{p})$

Section ?? demonstrates some propositions under the assumption that, when an economy satisfies the **GIC**, there will be constant growth factors $\Omega_{\mathfrak{c}}$ and Ω_{cov} respectively for \mathfrak{c} (the average value of the consumption ratio) and $\text{cov}(c, \mathbf{p})$. In the case of a Szeidl-invariant economy, the main text shows that these are $\Omega_{\mathfrak{c}} = 1$ and $\Omega_{\text{cov}} = \Phi$. If the economy is Harmenberg- but not Szeidl-invariant, no proof is offered that these growth factors will be constant.

J.1 $\log c$ and $\log(\text{cov}(c, \mathbf{p}))$ Grow Linearly

Figures 6 and 7 plot the results of simulations of an economy that satisfies Harmenberg- but not Szeidl-invariance with a population of 4 million agents over the last 1000 periods (of a 2000 period simulation).¹⁸ The first figure shows that $\log \mathfrak{c}$ increases apparently linearly. The second figure shows that $\log(-\text{cov}(c, \mathbf{p}))$ also increases apparently linearly. (These results are produced by the notebook `ApndxBalancedGrowthcNrmAndCov.ipynb`).

¹⁸For an exposition of our implementation of Harmenberg's method, see [this supplemental appendix](#).

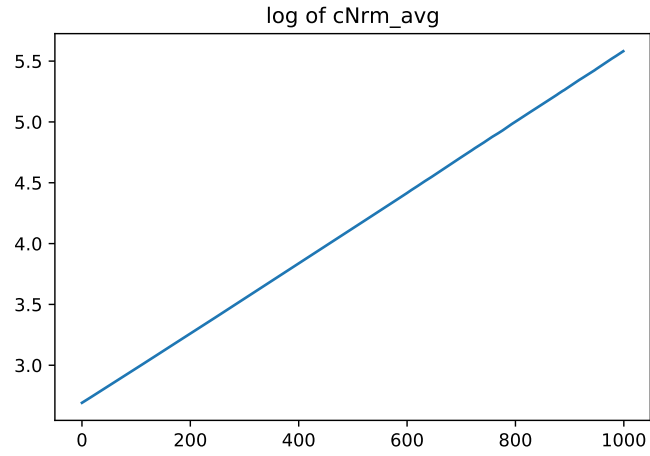


Figure 6 Appendix: $\log \mathfrak{c}$ Appears to Grow Linearly

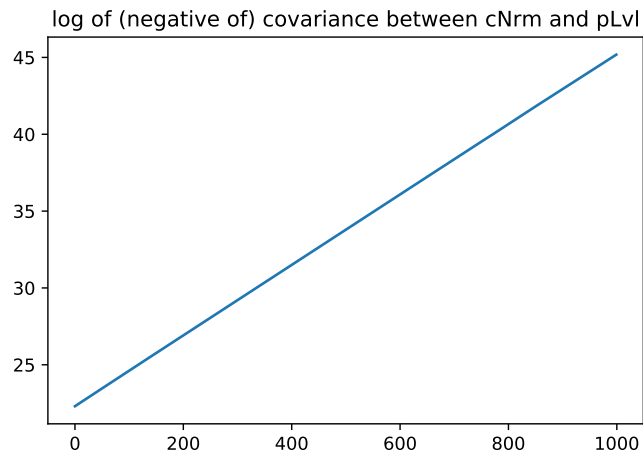


Figure 7 Appendix: $\log (-\text{cov}(c, \mathbf{p}))$ Appears to Grow Linearly

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Table 1 Appendix: Perfect Foresight Liquidity Constrained Taxonomy

For constrained \dot{c} and unconstrained \bar{c} consumption functions

Main Condition Subcondition	Math	Outcome, Comments or Results
GIC and RIC	$1 < \mathbf{P}/\Phi$ $\mathbf{P}/R < 1$	Constraint never binds for $m \geq 1$ FHWC holds ($R > \Phi$); $\dot{c}(m) = \bar{c}(m)$ for $m \geq 1$
and RIC GIC and RIC	$1 < \mathbf{P}/R$ $\mathbf{P}/\Phi < 1$ $\mathbf{P}/R < 1$	$\dot{c}(m)$ is degenerate: $\dot{c}(m) = 0$ Constraint binds in finite time $\forall m$ FHWC may or may not hold $\lim_{m \uparrow \infty} \bar{c}(m) - \dot{c}(m) = 0$ $\lim_{m \uparrow \infty} \dot{\kappa}(m) = \underline{\kappa}$
and RIC	$1 < \mathbf{P}/R$	FHWC $\lim_{m \uparrow \infty} \dot{\kappa}(m) = 0$

Conditions are applied from left to right; for example, the second row indicates conclusions in the case where ~~GIC~~ and RIC both hold, while the third row indicates that when the **GIC** and the ~~RIC~~ both fail, the consumption function is degenerate; the next row indicates that whenever the **GIC** holds, the constraint will bind in finite time.