Theoretical Foundations of Buffer Stock Saving

Chris Carroll

Johns Hopkins University

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A Small Open Buffer Stock Economy
Conclusions

Motivation

Drawbacks of Numerical Solutions

A Black Box

- Can Construct Solution to Model Without Really Understanding It
- Hard Even To Be Sure Your Numerical Solution Is *Right*
- Little Intuition for How Results Might Change With
    - Calibration
    - Structure
- *Very* Hard To Teach!

I Am A *Big* Fan Of Numerical Methods

- Have Done A Good Deal Of Work With Them Myself
- But As A Result, Have Felt All These Drawbacks Keenly

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The Gap This Paper Fills

Foundations For Microeconomic Household's Problem With

- Uncertain Labor Income

- No Liquidity Constraints

- CRRA Utility

- (Problem with Liquidity Constraints Is A Limiting Case)

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Key Result

Restrictions On Parameter Values Such That

- Problem Defines A Contraction Mapping
    - $\Rightarrow$ $\exists$ A Unique Consumption Function $c(m)$
- There Is A 'Target' Ratio Of Assets to Permanent Income
    - Requires A Key 'Impatience' Condition To Hold
    - Good News
        - Condition Is Weaker (Easier To Satisfy) Than Previous Papers Imposed

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The Perfect Foresight Problem
The Real Problem

Limit as horizon T goes to infinity of

$$\mathbf{v}_{T-n} = \max \; \mathbb{E}_t \left[\sum_{i=0}^{n} \beta^i u(\mathbf{c}_{t+i}) \right]$$

$$
\begin{aligned}
\mathbf{a}_t &= \mathbf{m}_t - \mathbf{c}_t \\
\mathbf{k}_{t+1} &= \mathbf{a}_t \\
\mathbf{b}_{t+1} &= \mathbf{k}_{t+1} R \\
\mathbf{p}_{t+1} &= \mathbf{p}_t \underbrace{\mathbf{\Phi \Psi}_{t+1}}_{\equiv \mathbf{\Phi}_{t+1}} \\
\mathbf{m}_{t+1} &= \mathbf{b}_{t+1} + \mathbf{p}_{t+1} \boldsymbol{\xi}_{t+1},
\end{aligned}
$$

$$
\boldsymbol{\xi}_{t+n} = \begin{cases} 0 & \text{with probability } \wp > 0 \\ \boldsymbol{\theta}_{t+n}/(1-\wp) & \text{with probability } (1-\wp) \end{cases} \quad (1)
$$

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Surely This Problem Has Been Solved?

No.

- Can't Use Stokey et. al. theorems because CRRA utility
- Lit thru Matkowski and Nowak (2011) Can't Handle Permanent Shocks
- Must Use Boyd's 'Weighted' Contraction Mapping Theorem
- Surprisingly Subtle

Fortunately, the Conclusions Are Simple!

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Benchmark: Perfect Foresight Model

Definitions:

Absolute Patience Factor	$Þ$	$= (R\beta)^{1/\rho}$
Return Patience Factor	$Þ_R$	$= Þ/R$
Perfect Foresight Growth Patience Factor	$Þ_\Phi$	$= Þ/\Phi$

Name	Condition		Implication
(AIC) Absolute Impatience Condition	$Þ$	$< \quad 1$	$c \downarrow$ over time
(RIC) Return Impatience Condition	$Þ_R$	$< \quad 1$	$c/a \downarrow$ over time
(GIC) Growth Impatience Condition	$Þ_\Phi$	$< \quad 1$	$c/p \downarrow$ over time

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When Does A Useful Limiting Solution Exist?

Finite Human Wealth (FHWC) condition:

$$\Phi \;\; < \;\; R \tag{2}$$

Return Impatience Condition:

$$\text{Þ}_R \;\; < \;\; R \tag{3}$$

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When Does A Useful Limiting Solution Exist?

Finite Human Wealth (FHWC) condition:

$$\mathbf{\Phi} \quad < \quad R \tag{2}$$

Return Impatience Condition:

$$\mathbf{P}_R \quad < \quad R \tag{3}$$

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What If There Are Liquidity Constraints?

- FHWC is *not* necessary for solution to exist
- Other Key Condition For Useful Solution is
  'Perfect Foresight Finite Value of Autarky Condition (PF-FVAC)':

$$\beta \Phi^{1-\rho} \ < \ 1 \qquad (4)$$

- Without RIC, Constraints Are Irrelevant
  - Because Wealth Always Wants To Rise, So Constraint Never Binds

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Liquidity Constraints and Uncertainty

- Introduce permanent shocks to income
- Finite Value of Autarky Condition Becomes

$$\text{FVAC:} \quad 0 < \overbrace{\beta\underline{\underline{\Phi}}^{1-\rho}}^{\equiv\underline{\underline{\beth}} \; = \; \text{VAF}} < 1 \tag{5}$$

$$0 < \beta < \underline{\underline{\Phi}}^{\rho-1},$$

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Contraction Mapping Requirements

Finite Value of Autarky Condition: Same As In Liq Constr Problem!

$$\text{FVAC: } 0 < \overbrace{\beta \underline{\underline{\Phi}}^{1-\rho}}^{\equiv \underline{\underline{\beth}} \, = \, \text{VAF}} < 1 \tag{6}$$
$$0 < \beta < \underline{\underline{\Phi}}^{\rho-1},$$

'Weak Return Impatience Condition' (WRIC)

$$0 \leq \quad \wp^{1/\rho} \pmb{Þ}_{\mathsf{R}} \quad < 1 \tag{7}$$

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Requirement For Existence Of A Target

Definitions: 'Uncertainty-Adjusted' Growth:

$$\underline{\boldsymbol{\Phi}} \equiv \boldsymbol{\Phi}\underline{\boldsymbol{\Psi}} < \boldsymbol{\Phi}$$

Adjusted Growth Patience Factor:

$$\text{GPF-Mod: } \boldsymbol{\Phi}_{\underline{\boldsymbol{\Phi}}} = \boldsymbol{\Phi}/\underline{\boldsymbol{\Phi}} = \mathbb{E}[\boldsymbol{\Phi}/(\boldsymbol{\Phi}\boldsymbol{\Psi})] \qquad (8)$$

Growth Impatience Condition:

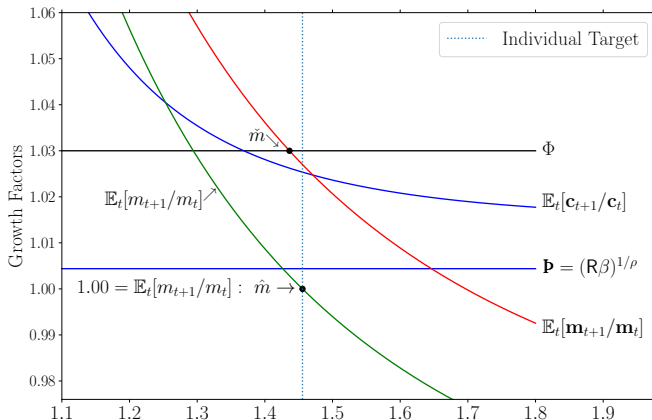$$\text{GIC-Mod: } \boldsymbol{\Phi}_{\underline{\boldsymbol{\Phi}}} < 1, \qquad (9)$$

Why? Because it can be shown that

$$\lim_{m_t \to \infty} \mathbb{E}_t\left[\frac{m_{t+1}}{m_t}\right] = \boldsymbol{\Phi}_{\underline{\boldsymbol{\Phi}}} \qquad (10)$$

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Five Propositions
The Target Saving Figure
Bounds On The Consumption Function
The Consumption Function and Target Wealth

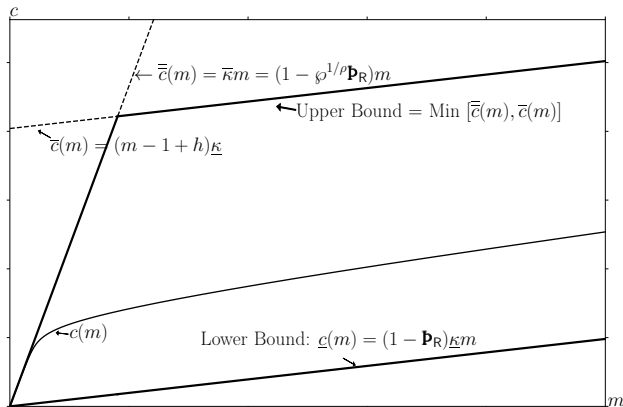# Five Propositions

1. $\lim_{m_t \to \infty} \mathbb{E}_t[\mathbf{c}_{t+1}/\mathbf{c}_t] = \mathbf{Þ}$

2. $\lim_{m_t \to 0} \mathbb{E}_t[\mathbf{c}_{t+1}/\mathbf{c}_t] = \infty$

3. $\exists$ a unique target value of m, called $\check{m}$

4. $\mathbb{E}_t[\mathbf{c}_{t+1}/\mathbf{c}_t | m_t = \check{m}] = \mathbf{\Phi} - \epsilon$

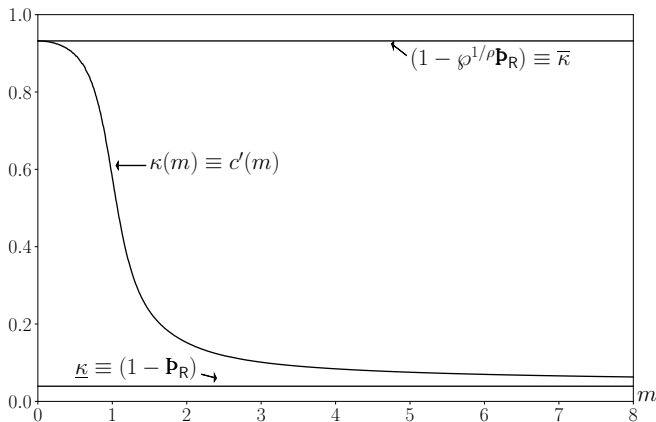5. $\left(\frac{d\mathbb{E}_t[\mathbf{c}_{t+1}/\mathbf{c}_t]}{dm_t} \right) < 0$

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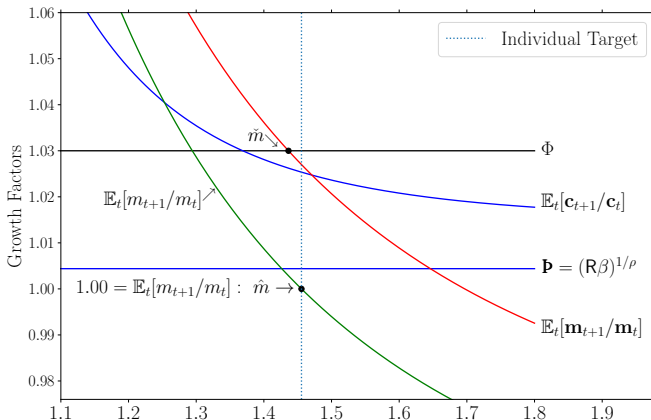The Problem
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The Target Saving Figure

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Bounds On the Consumption Function

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The Marginal Propensity to Consume

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The Invariant Distribution
Balanced Growth Equilbrium

Convergence To The Invariant Distribution

Szeidl (2013) Proves Existence of an Invariant Distribution of m, c, a, etc.

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The Invariant Distribution
Balanced Growth Equilbrium

Balanced Growth Equilibrium

Achieved When Cross Section Distribution Reaches Invariance

$$\mathbf{Y}_{t+1}/\mathbf{Y}_t = \mathbf{C}_{t+1}/\mathbf{C}_t = \mathbf{\Phi} \qquad (11)$$

Fisherian Separation Fails, Even Without Liquidity Constraints!

Insight:

- Precautionary Saving $\approx$ Liquidity Constraints
- If $\grave{c}(m)$ is solution for constrained consumer,

$$\lim_{\wp \downarrow 0} c(m; \wp) = \grave{c}(m) \qquad (12)$$

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The MPC Out Of Permanent Shocks

https://www.econ2.jhu.edu/people/ccarroll/papers/MPCPerm.pdf

Lots of Recent Papers Trying to Measure the MPCP

Paper Proves:

- MPCP < 1
- But not a lot less:
  - 0.75 to 0.95 (annual rate) for wide range of parameter values

- Defined Conditions Under Which Widely Used Problem Has Solution
  - Finite Value of Autarky Condition Guarantees Contraction (with WRIC)
  - Growth Impatience Condition Prevents $m \rightarrow \infty$
- Economy Of Buffer Stock Consumers Exhibits Balanced Growth
  - Even In Absence of General Equilibrium Adj of Interest Rate

MATKOWSKI, JANUSZ, AND ANDRZEJ S. NOWAK (2011): "On Discounted Dynamic Programming With Unbounded Returns," *Economic Theory*, 46, 455–474.

SZEIDL, ADAM (2013): "Stable Invariant Distribution in Buffer-Stock Saving and Stochastic Growth Models," *Manuscript, Central European University,* Available at http://www.personal.ceu.hu/staff/Adam_Szeidl/papers/invariant_revision.pdf.