

# 1 When Is Consumption Growth Declining in $m$ ?

Henceforth indicating appropriate arguments by the corresponding subscript (e.g.  $c'_{t+1} \equiv c'(m_{t+1})$ ), since  $\Gamma_{t+1}\mathcal{R}_{t+1} = R$ , the portion of the LHS of equation (54) in brackets can be manipulated to yield

$$\begin{aligned} c_t \mathbf{\Upsilon}'_{t+1} &= c'_{t+1} a'_t R - c'_t \Gamma_{t+1} c_{t+1} / c_t \\ &= c'_{t+1} a'_t R - c'_t \mathbf{\Upsilon}_{t+1}. \end{aligned} \quad (1)$$

Now differentiate the Euler equation with respect to  $m_t$ :

$$\begin{aligned} 1 &= R\beta \mathbb{E}_t[\mathbf{\Upsilon}_{t+1}^{-\rho}] \\ 0 &= \mathbb{E}_t[\mathbf{\Upsilon}_{t+1}^{-\rho-1} \mathbf{\Upsilon}'_{t+1}] \\ &= \mathbb{E}_t[\mathbf{\Upsilon}_{t+1}^{-\rho-1}] \mathbb{E}_t[\mathbf{\Upsilon}'_{t+1}] + \text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, \mathbf{\Upsilon}'_{t+1}) \\ \mathbb{E}_t[\mathbf{\Upsilon}'_{t+1}] &= -\text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, \mathbf{\Upsilon}'_{t+1}) / \mathbb{E}_t[\mathbf{\Upsilon}_{t+1}^{-\rho-1}] \end{aligned} \quad (2)$$

but since  $\mathbf{\Upsilon}_{t+1} > 0$  we can see from (2) that (54) is equivalent to

$$\text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, \mathbf{\Upsilon}'_{t+1}) > 0$$

which, using (1), will be true if

$$\text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, c'_{t+1} a'_t R - c'_t \mathbf{\Upsilon}_{t+1}) > 0$$

which in turn will be true if both

$$\text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, c'_{t+1}) > 0$$

and

$$\text{cov}_t(\mathbf{\Upsilon}_{t+1}^{-\rho-1}, \mathbf{\Upsilon}_{t+1}) < 0.$$

The latter proposition is obviously true under our assumption  $\rho > 1$ . The former will be true if

$$\text{cov}_t((\Gamma\psi_{t+1}c(m_{t+1}))^{-\rho-1}, c'(m_{t+1})) > 0.$$

The two shocks cause two kinds of variation in  $m_{t+1}$ . Variations due to  $\xi_{t+1}$  satisfy the proposition, since a higher draw of  $\xi$  both reduces  $c_{t+1}^{-\rho-1}$  and reduces the marginal propensity to consume. However, permanent shocks have conflicting effects. On the one hand, a higher draw of  $\psi_{t+1}$  will reduce  $m_{t+1}$ , thus increasing both  $c_{t+1}^{-\rho-1}$  and  $c'_{t+1}$ . On the other hand, the  $c_{t+1}^{-\rho-1}$  term is multiplied by  $\Gamma\psi_{t+1}$ , so the effect of a higher  $\psi_{t+1}$  could be to decrease the first term in the covariance, leading to a negative covariance with the second term. (Analogously, a lower permanent shock  $\psi_{t+1}$  can also lead a negative correlation.)