Saving on a Rainy Day, Borrowing for a Rainy Day

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Key features of the paper

- Overall assessment: a highly competent paper on a topical issue with important implications for consumption/household finance theory and for policy
- Fact: Savings rates spiked during the last three recessions in UK, fell immediately afterwards, and did so across all age groups
- Question: Which aspects of a recession could generate this movement of savings rates?
- Key: Observe how the savings rates of different age groups respond to the recessions and use this pattern to pick the best model
- Ingredients:
  - UK data from FES 1976-2010, over three recessions, and five cohorts
  - Life-cycle model with two assets and three variants of recession features:
    - Negative income shock (in practice: permanent)
    - Negative income shock plus increase in variance of permanent shocks
    - Negative income shock plus ban on new borrowing during recession

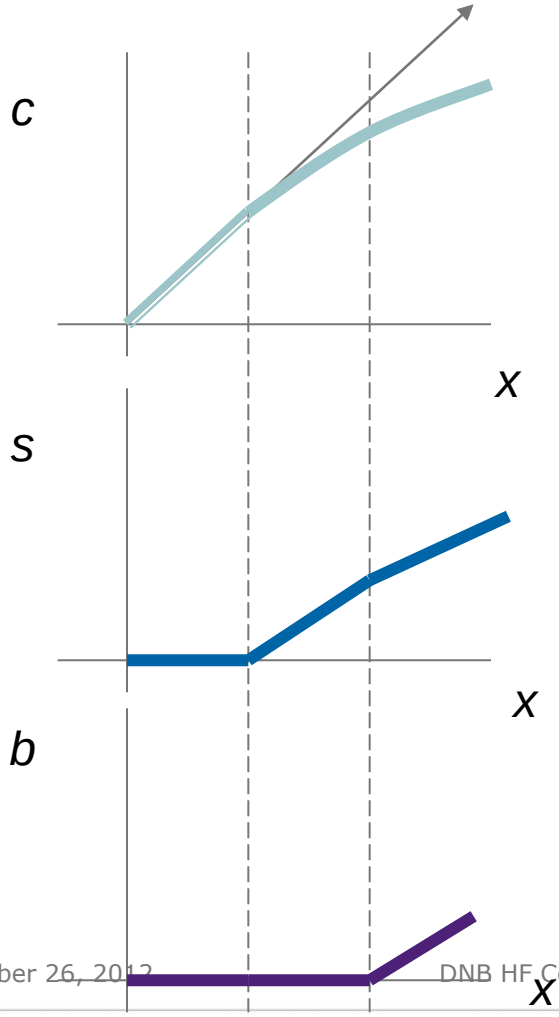
Key features of the paper

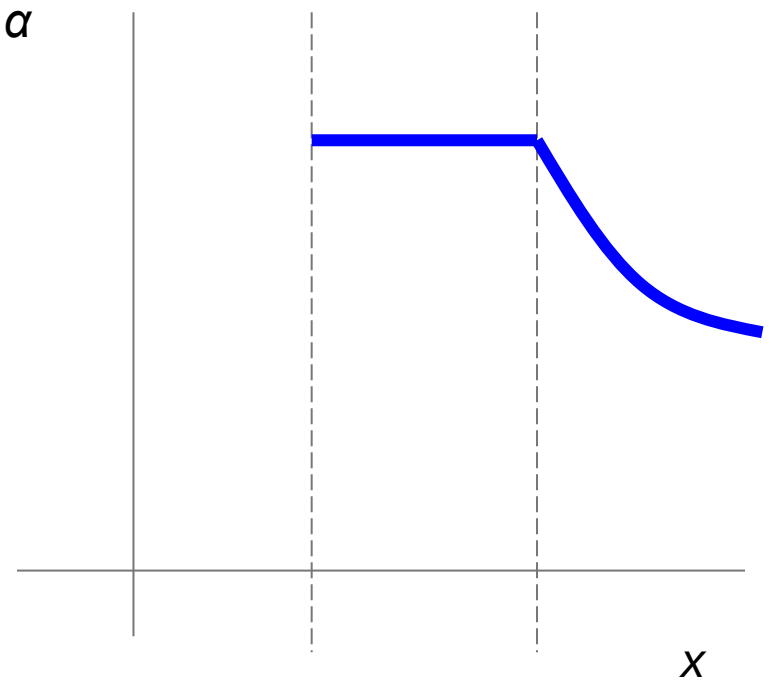
- Approach:
  - Estimate pattern of savings rates responses from the FES data
  - Run simulations of 10,000 HH
    - First, in variant 1 assuming they do not experience a recession
    - Then again, assuming they experience a variant 1 recession
    - Compute extra responses if recession is of variant 2
    - and then extra responses of variant 3 relative to variant 1
    - Consider also *realization* of stock market crashes; and of multiple recessions
- Result:
  - Key feature of recession that helps the model match the data:
    - Increased variance of permanent shocks
  - Quite good fit between chosen variables in the data and in the models in terms of matching responses of saving ratios of different age groups

Point 1
Borrowing constraints

- Standard borrowing constraint:
  - Quantity constraint on borrowing; recession: reduction in limit
- Complaint: Not many loan recalls during the recent recessions
- Innovation here:
  - Constraint preventing any NEW borrowing for duration of recession
  - Combined with some 'natural' constraint plus a limit of 3 times labor income
    - Note: This also presupposes loan recall
  - This creates a "precautionary borrowing" motive (borrow now in order to secure a higher borrowing limit later)
- Recent recession/crash: liquidity dried up (unexpectedly?)
  - Are all recessions similar? Debt versus asset recessions?
  - Key to precautionary borrowing: know that, if recession, no new loan
  - Was anything new in 3rd recession or were people anticipating this all along?
- Robustness/exploration
  - How would results change if people were not anticipating this constraint?
  - Or if prob of constraint were not equal to the probability of recession?
  - Or if the limit on new loans were random (encompassing)?

Point 2
Borrowing that increases with cash on hand?
Standard model (Cocco et al, 2005; Haliassos, Michaelides, 2003)





Point 2
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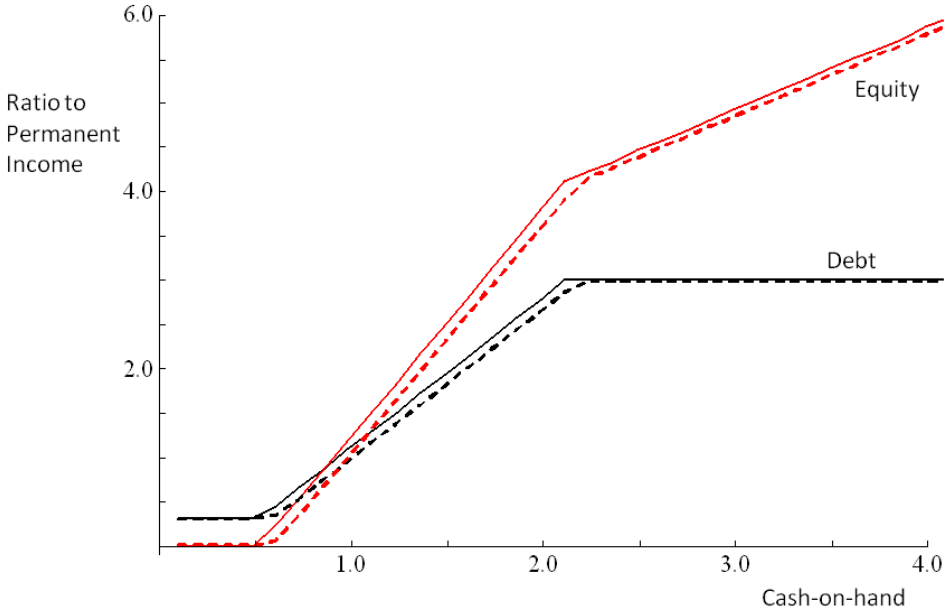

- The slope gets reversed!
- Are we desperate to borrow to invest?
- Stocks and DC lumped with housing
- Mortgages are the negative of the riskless asset
- Equity is 6/7 housing and 1/7 stocks
  - Return less volatile but still equity premium
- Could it be that these people are up against the 3Y borrowing constraint?

Point 3
Scattered Points

- Why test saving response only with respect to age?
  - Could be different with respect to occupation, education, wealth/income, etc.
- Can you exploit heterogeneity of responses or do you rely on averaging?

- Flow constraint on borrowing: is this a supply shock?
  - The demand curve shifts, too, in view of future anticipations.

- Stocks and housing: are we masking response issues by lumping together?
  - 6 to 1 housing in composite risky asset
  - people don't usually borrow to buy stocks
  - they don't hold stocks but no safe asset
  - Housing is liquid here: continuously and costlessly variable
    - yet, getting a house or a mortgage entails costs; so does paying off
  - Stock ownership versus homeownership: much less non-participation
    - disaster probabilities versus fixed costs