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The effect of housing and stock market wealth on consumption in emerging and developed countries

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This study examines the long- and short-run relationship between private consumption, housing wealth, stock market wealth and income. In order to asses this relationship empirically, we use pooled mean group estimators of dynamic heterogeneous panel data on a sample of 30 developed and emerging economies. The sample countries are segmented into three separate panels: a developed bank-based panel, a developed market-based panel, and an emerging bank-based panel. Empirical estimates support the existence of long- and short-run stock market wealth effects in both groups of developed countries, with the effect being particularly strong in the developed market-based countries. A moderate long-run housing wealth effect is confirmed only for the developed bank-based countries, while a very strong short-run housing wealth effect is present in the developed market-based countries. As far as the emerging countries are concerned, the evidence is somewhat inconclusive, but it does seem to suggest that both wealth effects are effective in the long run, with housing wealth being more dominant.

1. Introduction

Understanding the behaviour of private consumption decisions is very important for explaining and forecasting the fluctuations of economic activities in general and private aggregate consumption in

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particular. Conventional macroeconomic models of private consumption usually entail household wealth and income variables. This simple consumption function model with household income and wealth as endogenous variables is motivated by several well-known theories, including the permanent income theory (Friedman, 1957) and the life-cycle hypothesis (Ando and Modigliani, 1963).

The recent boom-bust behaviour of housing and equity markets underlined the importance of wealth in determining not only the behaviour of consumption, but also the behaviour of savings, and has consequently returned wealth effects back to the research agenda. Thereby, researchers started to pay more attention to differentiating between housing and financial assets (wealth) due to different preferences of the consumers and different asset liquidity.

Although many empirical studies exploring wealth effects have been published in recent decades, most of them refer to developed countries. Studies of post-transition European economies and emerging markets are surprisingly rare given the importance consumer expenditures exhibit in the overall GDP development. Therefore, the main goal of this study is to explore the main features of housing and financial (stock market) wealth effects in the emerging countries (focusing mostly on post-transition European countries) and to compare them to the developed countries. The comparison between developed and emerging countries is very important if we take into account the fact that in the last two decades both equity and housing price booms were more pronounced in many post-transition European countries when compared to developed European countries undergoing asset prices booms (Posedel and Vizek, 2009, 2011; Syriopoulos, 2006), but the effect of those booms and subsequent busts on personal consumption in the former group of countries is underexplored. In addition, it also has to be noted that asset markets in emerging countries are much less liquid and prone to higher transaction costs, which could in turn result in a smaller propensity to consume wealth when compared to developed countries even if wealth increases in the examined period have been extremely large. Thus, by using the same methodology and comparable datasets for developed and emerging countries, we intend to directly compare the main features of their respective wealth effects. To the best of our knowledge, this is the first paper that studies and directly compares the impact of housing and stock market wealth effects on personal consumption in emerging and developed countries. Furthermore, as the body of literature on the impact of wealth effects on private consumption in European post-transition countries is rather limited, this study also complements earlier findings for those countries. Unlike other studies on emerging markets, this study differentiates between short-run and long-run wealth effects, thereby including the latest asset price boom and bust cycle in the analysis.

Besides comparing emerging to developed countries, we also compare countries according to the structure of their financial system. Namely, while all emerging countries in our sample are bank-based countries, some developed countries we analyse are characterized as market-based while others are more bank-oriented. Since the structure of the financial system may play a crucial role for the transmission of changes in asset prices to consumption, controlling for it in an empirical setting could provide additional insights into wealth effect features. The market-based financial system prevalent in the USA and the Commonwealth countries is characterized by a larger, more liquid and more capitalized stock market when compared to the bank-based financial systems found in continental, central and south-eastern Europe. This suggests that the responsiveness of consumption to changes in stock wealth should be higher for the former group of countries.

The rest of paper is organized as follows. Section 2 summarises the existing empirical literature on the effect of different components of wealth on consumption. Section 3 presents research data, while Section 4 reviews research methods and estimation results. The final section provides an overview of the main findings of the study.

2. Literature review

The empirical studies on the impact of housing and financial wealth on private consumption are mainly focused on advanced economies. Poterba (2000) concentrates on papers assessing stock market wealth effects, while Paiella (2009) updates the existing literature investigating both housing and stock market wealth in developed countries. The overall conclusion is that both wealth components have relevant explanatory power relative to consumption. However, the estimates of