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journal homepage: www.elsevier.com/locate/jcePolitical uncertainty and household savings[☆]Rolf Aaberge^{a,b}, Kai Liu^{a,c,d,*}, Yu Zhu^e^a Research Department, Statistics Norway, Norway^b ESOP, University of Oslo, Norway^c Faculty of Economics, University of Cambridge, United Kingdom^d IZA, Germany^e Economic Studies, University of Dundee, United Kingdom

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ABSTRACT

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Despite macroeconomic evidence pointing to a negative aggregate consumption response due to political uncertainty, few papers have used microeconomic panel data to analyze how households adjust their consumption after an uncertainty shock. We study household savings and expenditure adjustment from an unexpected, large-scale and rapidly evolving political shock that occurred largely in May 1989 in Beijing, China. Using monthly micro-panel data, we present evidence that a surge in political uncertainty resulted in significant temporary increases in savings among urban households in China. Households responded mainly by reducing semi-durable expenditure and frequency of major durable adjustment. The uncertainty effect is more pronounced among older, wealthier, and more socially advantaged households. We interpret our findings using existing models of precautionary behavior. By focusing on time variation in uncertainty, our identification strategy avoids many of the potential problems in empirical studies of precautionary savings such as self-selection and life-cycle effects. *Journal of Comparative Economics* 000 () (2016) 1–17. Research Department, Statistics Norway, Norway; ESOP, University of Oslo, Norway; Faculty of Economics, University of Cambridge, United Kingdom; IZA, Germany; Economic Studies, University of Dundee, United Kingdom.

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1. Introduction

Major political events, such as the US presidential election in 2000, the 9/11 terrorist attack, and the more recent Arab Spring, can have profound impacts on household consumption. For example, retail sales in the United States dropped by over 2.5% in September 2001, the month when the terrorist attack took place. These political shocks are often accompanied by an increase in policy uncertainty, where a growing literature shows that uncertainty shocks can have substantial economic impacts.¹

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¹ See Bloom (2013) for a review of this literature. Empirical evidence suggests that uncertainty shocks have negative effects on growth (Ramey and Ramey, 1995), consumer spending (Romer, 1990), and investment and hiring (Bloom, 2009).

Despite the macroeconomic evidence pointing to a negative aggregate consumption response due to political uncertainty, very few papers have used microeconomic panel data to analyze how households adjust their consumption after an uncertainty shock. Detailed household consumption panel data are essential both to understand the channel through which households adjust their consumption and of the variation of the adjustments across different types of households. However, most microeconomic data of consumer expenditure are collected at low frequency and have a long recall period.² Since uncertainty shocks are usually short-lived, the initial impact on household consumption often differs from the impact on future consumption when households gradually adjust to a new steady state. Without high-frequency consumption panels at household level, it is difficult to identify the size of the initial impact of an uncertainty shock and the path of dynamic adjustments afterwards.

Our first contribution is to analyzing household consumption around a time of escalating political uncertainty, using household panel data collected at monthly frequency from China. We exploit an unexpected, large-scale and rapidly evolving political shock that occurred largely in May 1989 in Beijing, China. The event, also known as the Tian'anmen Square Movement, was triggered by the unexpected death of a former leader in mid-April 1989, culminated in May, and faded after the Chinese government took action on June 4 in the same year. The event resulted in a change in political leadership and is widely regarded to mark the end of a period of rapid reform in China. Following Baker et al. (2012) and Bloom (2013), we present two descriptive measures showing increased policy uncertainty associated with the political event.

Our empirical analysis is conducted using monthly micro-panel data from a sample of the Urban Household Survey in China. The monthly expenditure is based on detailed daily diary entries covering all types of household expenditures. Our empirical approach is simple: we compare the mean household savings in April, the month immediately before the rise in political uncertainty, and in May of 1989, when the uncertainty shock took place. Differences in savings between these months could still be due to seasonality of consumption and/or income. For the comparison group, we use data from April and May of 1990 to estimate the difference in outcomes and subtract it from the estimate of the effect obtained from the 1989 data (a difference-in-difference estimator). One main advantage of using household panel data is that we are able to document the heterogeneity in the effects of uncertainty shock for different types of households and for different types of consumer expenditure. The micro data also allows us to control for household composition and demographic changes that may contaminate our results.

After adjusting for seasonality, we find that the saving rate increased by 18 percentage points in the month when the uncertainty shock culminated. The increase in savings was larger for households that had older heads, that were wealthier prior to the shock, and that were more socially advantaged. The results are robust to the inclusion of a set of household characteristics and to using household balance sheets as an alternative definition of savings. We are able to rule out any shocks to household resources from the political uncertainty, as there is no evidence of changes in average household income or wealth. We also do not find any significant change in idiosyncratic income uncertainty identified from realized income streams – neither the variance of permanent shocks nor the variance of transitory shocks change before and after the shock that took place in May 1989. Interestingly, the increase in savings is entirely due to a sizable reduction in semi-durable consumption (i.e. clothing and footwear) and frequency of major durable adjustment. Non-durable consumption is not affected by the uncertainty shock. Our estimates survive a range of robustness and placebo tests. To the extent that pessimism is concerned with longer term prospects than those arising from short-term uncertainties, the estimated short-run effects are more likely due to changes in political uncertainty rather than pessimism per se.

We interpret our findings using existing models of precautionary behavior. Unlike many other uncertainty shocks (such as the Great Recession) which may also affect the balance sheet of households either directly (through a wealth or income shock) or indirectly (through a credit crunch), we show that the uncertainty shock we study has no direct or indirect impact on household balance sheets. Although our empirical specification is limited in further distinguishing between alternative channels that are associated with the political event (such as pessimism or disruption in daily activity), our estimates suggest that uncertainty is the most plausible channel driving our results (see Section 5.5 for a discussion). Our estimates on household savings therefore shed new light on the strength of the precautionary saving motive, where empirical estimates using microeconomic data have not yet converged.³ Existing empirical tests on precautionary savings behavior almost all rely on cross-section differences in risk within the sample. The key identifying assumption is that the measure of risk must be exogenous; that is, it has to be uncorrelated with any other unobservables that might also determine consumer behavior.⁴ However, cross-sectional differences in risks may be correlated with unobservable (and likely heterogeneous) characteristics of the household, such as risk aversion and prudence, which would affect consumption choices directly. Fuchs-Schündeln and Schündeln (2005) show that correcting for self-selection into occupations decreases precautionary savings significantly.

² The Consumer Expenditure Survey, the most commonly used household consumption data in the United States, reports quarterly expenditure from the interview sample. The interview sample follows survey households for a maximum of five quarters. The Panel Study of Income Dynamics collects data on food consumption based on the amount spent on food in an average week. Since interviews are usually conducted around March each year, it has been argued that people report their food expenditure for an average week around that period.

³ Existing estimates range from close to zero precautionary savings (e.g. Skinner 1988; Guiso et al., 1992; Dynan 1993) to significant precautionary savings accounting for substantial fraction of wealth accumulation (e.g. Carroll and Samwick, 1997, 1998; Fuchs-Schündeln and Schündeln 2005). Browning and Lusardi (1996) contain an excellent review of this literature.

⁴ The usual empirical test is to correlate consumption or savings with some measure of risk. Researchers have used cross-sectional variations either in realized income risk across occupations (Skinner 1988; Carroll and Samwick, 1997, 1998) or geographic regions (Carroll et al., 2003) or in subjective risk expectations (Guiso et al., 1992; Lusardi 1997).

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