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ScienceDirect
Journal of Policy Modeling 29 (2007) 609–622
Journal of Policy Modeling
www.elsevier.com/locate/jpm

The wealth effect: A contemporary update to the age of affluence

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Available online 7 May 2007

Abstract

At the end of World War II there was a great interest in estimation of reconversion prospects for the United States economy. A main question was: Would be the United States return to the conditions of the Great Depression of the 1930s or maintain a high level of employment and grow without inflation? Franco Modigliani and James Duesenberry independently proposed dynamic versions of the macroeconomic consumption function, and A.C. Pigou had recently suggested that the consumption function should include a term for real cash balances, a wealth effect which was relevant, given the accumulation of liquid assets during the austere consumer environment of the War. Also, from the original discussions of the mathematical models of the Keynesian system, there was consideration about the effects of the distribution of income on aggregate consumer spending. Those various lines of thought were discussed in a memorial conference for Franco Modigliani at the New School University in 2005. The present paper was on the memorial program, and examines the statistical content of the questions about reconversion prospects in the mid 1940s. It also extend the analysis through the rest of the 20th Century, with consideration of the macrodynamics of the early postwar period into the age of affluent consumer.

JEL classification: C22; C87; D31; E14; E22; E47

Keywords: Wealth effect; Income distribution; Savings function

1. Some background considerations

In April, 2005, meetings were held at the New School University, New York, in memory of Franco Modigliani, and the present paper was delivered on April 15th, with the main purpose

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0161-8938/$ – see front matter
doi:10.1016/j.jpolmod.2007.05.009

being to look at a savings (or consumption) function proposed by Professor Modigliani to address problems confronting the U.S. economy in the reconversion process, following the end of World War II.

Although the present assignment deals specifically with income and wealth distributions, that was only indirectly relevant for the meeting at the New School. In our paper, we take a retrospective look at the original proposal of a dynamic specification of the aggregate savings function by Franco Modigliani, and also, independently, by Duesenberry (1949) and Heller, Boddy, and Nelson (1953).

The economy has changed greatly since December, 1947, when the original paper was published by Franco Modigliani in Social Research. An extended version appeared in volume 11 of Studies in Income and Wealth for the National Bureau of Economic Research. In particular, it was often noted that the savings-income ratio appeared to have long-run stability, in the neighborhood of 10 percent, excluding, of course, the unusual years of the War. Today, however, the personal savings ratio is near zero, and sometimes negative; therefore the analysis of the savings function merits re-consideration, not particularly in terms of the original dynamic specification of Franco Modigliani, but in terms of modern economic lifestyles that were not considered in 1947.

At the time of the original publication of mathematical macromodels by John Hicks, Oscar Lange, and others, questions were raised about the relevance of income distribution (the subject of this collection of papers), demographics, dynamics, expectations, disaggregation by consumption type, inflation, and wealth variables.

In a much discussed paper by A.C. Pigou, a version of the wealth affect was about to take place in post-war planning and in Franco Modigliani's later separate discussion of the life-cycle effect. We shall refer to several of these specific points but focus mainly on income distribution, which was quickly aimed at Keynes' treatment of the propensity to consume, prior to the influence of the War.

Franco Modigliani in December, 1947, introduced a dynamic specification of the Keynesian savings (or consumption) function by adding a variable denoting the "highest previous income peak".[1] His specification became

$$\frac{S_t}{Y_t} = \alpha + \frac{\beta(Y_t - Y_t^0)}{Y_t}$$

or

$$\frac{C_t}{Y_t} = (1 - \alpha) - \frac{\beta(Y_t - Y_t^0)}{Y_t}$$

Y_t = real income per capita in year t, Y_t^0 = highest real income per capita in any year preceding t, S_t = saving per capita in year t, and C_t = consumption per capita in year t.

In one interpretation, this specification may be considered a dynamic form of the saving or consumption function. Franco Modigliani entitled his paper "Fluctuations in the Saving-Income Ratio: A Problem in Economic Forecasting". The function proposed by James Duesenberry was of the same general type.

[1] The extended paper appeared in volume 11 of *Studies in Income and Wealth* by the National Bureau of Economic Research. See, Modigliani (1949a, 1949b).