



Debt servicing, aggregate consumption, and growth



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ABSTRACT

We develop a neo-Kaleckian growth model that emphasizes the importance of consumption behavior. In our model, workers first make consumption decisions based on their gross income, and then treat debt servicing commitments as a substitute for saving. Workers' borrowing is induced by their desire to keep up with the consumption standard set by renters' consumption, reflecting an aspect of the relative income hypothesis. As a result of this consumption and debt servicing behavior, consumer debt accumulation and income distribution have effects on aggregate demand, profitability, and economic growth that differ from those found in existing models. We also investigate the financial sustainability of the Golden Age and Neoliberal growth regimes within our framework. It is shown that distributional changes between the Golden Age and the Neoliberal regimes, together with corresponding changes in consumption emulation behavior via expenditure cascades, suffice to make the Neoliberal growth regime unsustainable.

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1. Introduction

In a Kalecki–Keynes world, investment drives saving with an appropriately functioning financial market, rather than saving driving investment as in orthodox theory. Making the Keynes–Kalecki assumption that output is endogenous to investment, the output level becomes an adjusting variable for generating an appropriate (investment–expenditure–equalizing) level of savings. In other words, savings – and hence consumption – are largely passive/residual variables in the Kalecki–Keynes framework.

However, this neglects the point that consumption has become an important independent source of aggregate demand in the economy. The active role of consumption has been made possible by the increased availability of consumer credit in an increasingly consumer-friendly culture.¹ A well functioning financial sector is an important precondition for the independence of investment from saving in Kalecki and Keynes. In Joan Robinson's words, it is “the central thesis of the *General Theory* that firms are free, within limits, to accumulate as they please, and that the rate of saving of the economy as a whole accommodates itself to the rate of investment that they decree” (Robinson (1962, pp. 82–83) quoted in Asimakopulos (1983)). In more

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¹ For discussion of the non-economic factors associated with these developments, see Schor (1998), Cynamon and Fazzari (2008, 2013), and Wisman (2009, 2013).

recent times, characterized by easily accessible consumer credit, a rather crude but similar statement can now be made about aggregate consumption: “[households] are free, within wide limits, to [consume] as they please, and... the rate of saving of the economy as a whole accommodates itself to the rate of [consumption] that they decree.”

But if credit *facilitates* autonomous consumption, what actually *causes* household spending to become disconnected from household income? In keeping with the insights of the relative income hypothesis (Duesenberry, 1949), one source of this disconnect is the propensity of households to emulate contemporary standards of consumption established by others. Cynamon and Fazzari (2008, 2013), for example, provide a detailed explanation of this behavior based on the notion that consumer preferences endogenously evolve in a world of social cues. This gives rise to a situation in which households use credit and debt to consume in excess of what their current income and wealth allow, in the pursuit of consumption standards set by other (more affluent) households. In a decision-making environment of fundamental uncertainty, it is unlikely that households always fully understand the future consequences of this behavior.²

Inequality also affects consumption and household debt accumulation. According to Barba and Pivetti (2009), there have been substantial shifts in income away from low and middle-income classes in the US since the 1980s, accompanied by a large drop in the personal saving rate, massive increases in household liabilities, and large increases in the use of household debt to finance consumption in the bottom 80% of the income distribution. Barba and Pivetti (2009) argue that rising household debt has largely been caused by the efforts of low and middle-income households to maintain their relative standards of consumption in the face of persistent changes in the income distribution that have favored higher income households.³

In light of the preceding discussion, we believe it is important to reexamine the macroeconomic implications of consumption and saving decisions and household debt accumulation. Reflecting this concern, we propose a macroeconomic model that features not only an independent investment function, but also a consumption function in which explicitly modeled borrowing by some households, motivated by a desire to emulate the consumption standards of more affluent households, finances part of total household consumption expenditure. We are, of course, by no means the first to consider such extensions of the Keynes–Kalecki view (see, for example, Dutt (2005, 2006,

2008); Kim (2012)).⁴ But the analysis that follows makes three important contributions to the existing literature. First, building on the work of Kim et al. (2014), we show that the precise manner in which debtor households manage their debt servicing commitments (rather than simply whether or not debt servicing commitments exist and increase over time) affects the characteristics of the growth regime. Second, our analysis is motivated by the observation that there are numerous dimensions to the increases in income inequality that have been observed over the past thirty years, including a rise in the profit share, a larger managerial share of income, and increased inequality within the top 10% of the size distribution of income. By using numerical solution techniques, we are able to demonstrate the simultaneous impact of these various changes in inequality on the sustainability of the growth process. Finally, we demonstrate the important role that consumption emulation (“keeping up with the Joneses”) plays in making a growth regime unsustainable, by showing that it matters exactly *who* poorer households emulate (rather than simply whether or not emulation effects are present).

The remainder of the paper is organized as follows. In Section 2, we describe the accounting relationships between households, firms, and banks that make our model stock-flow consistent. Section 3 describes the behavior of firms and households, with a particular focus on the consumption, borrowing, and debt-servicing decisions of the latter. In Section 4 we discuss the comparative static properties of our model, while Section 5 focuses on the models’ debt dynamics and the implied (un)sustainability of growth regimes that differ with respect to the distribution of income. Section 6 offers some conclusions, chief among which is that over the last three decades, distributional changes between the Golden Age (1948–73) and Neoliberal (1980–2007) growth regimes in the presence of consumption emulation effects can be strongly associated with rendering the growth dynamics of advanced capitalist economies financially unsustainable.

2. Accounting

It is useful to begin by setting out some accounting relationships that show how the heterogeneous households whose behavior we model in the following sections are related to one another, and to the rest of the economy. We begin by writing:

$$Y = W_p N + W_r \alpha N + \Pi \quad (1)$$

where Y denotes real income, Π denotes total real profits, W_p is the real wage of production workers, W_r is the real

² Cynamon and Fazzari (2008, 2013) invoke Hyman Minsky’s financial instability hypothesis in their discussion of household debt and its implications for macroeconomic instability. Minsky’s thinking on the relationship between debt and macroeconomic instability is, of course, also germane to the analysis in this paper. Whereas Minsky’s concern was with qualitative change in financial postures in the course of debt accumulation, however, our focus is on consumption and saving behaviors and their effects on the sustainability of growth in the presence of changes in income inequality.

³ See also Foster and Magdoff (2009), Kumhof and Rancière (2010) and Setterfield (2013).

⁴ See also Palley (2009), who combines the relative income hypothesis with the permanent income hypothesis. The resulting relative permanent income theory of consumption explains various consumption-related empirical findings in the US economy. Zezza (2008), meanwhile, links income inequality, mortgage debt, and housing and equity markets within a post-Keynesian stock-flow consistent growth framework. He shows that when workers are more inclined to emulate capitalists’ consumption, this results in a positive demand-led growth effect coupled with rising mortgage debt.

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