An Assessment of Housing and Financial Wealth Effects in Spain: Aggregate Evidence on Durable and Non-durable Consumption

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Abstract Recent developments in housing and financial markets have led to fresh interest in the empirical evidence on wealth effects on consumption. This paper aims at providing up-to-date estimates of wealth effects by using a vector error correction model (VECM) approach to account for endogeneity and allow for the possibility of more than one variable equilibrating the system, in the same vein as previous work by Lettau and Ludvigson in the US. The breakdown of wealth into its housing and financial components leads to additional possibilities of adjustment to reach the long run equilibrium. In addition, the model accounts for potentially different values of the parameters linking consumption and wealth when distinguishing between durable and nondurable goods.

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1 Introduction

Recent developments in housing and financial markets have led to fresh interest in the empirical evidence on wealth effects on consumption. The varied and controversial results in the empirical literature, as well as the doubts on whether residential assets may really affect consumption in a similar way as financial wealth does, have maintained a debate over the actual magnitude of wealth effects and the relative size of its housing and financial components.

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This paper aims at providing up-to-date estimates of wealth effects in Spain by using a vector error correction model (VECM) approach to account for the endogeneity of several variables. This also makes it possible to incorporate not only a self-correction mechanism in consumption—as empirical consumption functions with an error correction term do—but also the possibility of other variables equilibrating the system, in the same vein as previous work by Lettau and Ludvigson in the US. The analysis follows the same approach of Sastre and Fernández-Sánchez (2005), who distinguished between durable and non-durable consumption to better describe aggregate consumption in Spain. In the current analysis a more recent sample and new definitions of some variables have been incorporated.

This paper is organized as follows. Section 2 describes some stylized facts about recent developments in Spanish private consumption and household savings rate. Section 3 provides the theoretical background which is the basis for using the cointegration analysis as our empirical approach. This methodology is briefly explained in section 4 together with a short description of the data set. The main empirical results are reported and interpreted in section 5 and the last section presents some brief conclusions.

2 Stylised facts of wealth effects in Spain

Up to 2008 the savings ratio of Spanish households fluctuated within a range of 10 to 15% of gross disposable income (Fig. 1). To a large extent, these fluctuations are associated to cyclical movements, which have an impact on income expectations and thereby on the propensity to save. Thus, in the crisis of the first half of the nineties the savings rate increased, although with an erratic pattern, and decreased during the booming period of the second half of that decade. In the mild downturn experienced in the early years of this century the ratio of savings to income increased slightly to drop again until 2007. In the last two years this ratio has risen again. This time in a very sharp way, as a consequence of the deterioration in economic perspectives and the increased uncertainty derived both from the financial crisis and the growth of unemployment.

Household net worth seems to have also contributed to these developments as it can be seen in Fig. 1. During the second half of the nineties the unprecedented fall in real interest rates experienced by the Spanish economy and the subsequent increase of financial wealth boosted household spending above income growth, thus pushing down the savings rate and raising the ratio of net financial wealth to consumption (Fig. 2). After the reversal of equity prices, financial wealth decelerated in the early years of this century, but total wealth still provided an important support for consumption due to the contribution of housing wealth.