

Core Macroeconomics

Hillary Term 2008

Week 5: Consumption

Reading

This topic is a good example of the way that macroeconomic thinking has changed since the late 1970s. Until then, the life-cycle hypothesis and permanent-income hypothesis were dominant. After the inflationary shocks of the 1970s, Hall (1978) applied the theory of rational expectations to consumption, and produced the Rational Expectations Permanent Income Hypothesis (REPIH). However, this theory suffers from a number of empirical problems (notably, excess smoothness and excess sensitivity, as discussed in Deaton (1992)** chapters 1–2 and 6). Romer (1996)** chapter 7 presents a readable introduction to this topic, see also Burda & Wyplosz (2005) chapter 6 and Mankiw (2005) chapter 16 for background material. Muellbauer (1994)** and Aron, Muellbauer & Murphy (2007) are excellent sources for this topic, as is Attanasio & Weber (1994)** and Attanasio, Blow, Hamilton & Leicester (2005). Attfield, Demery & Duck (1985) chapter 9 and Begg (1982) chapter 7 look at the impact of rational expectations on consumption. You may also wish to look at the articles in the *Oxford Review of Economic Policy* issue of Summer 1994.

(Treasury 2003a)

Take notes on:

1. The Life-Cycle Hypothesis and the Permanent-Income Hypothesis
2. Consumption under uncertainty and the REPIH
3. The Euler Equation with Quadratic Preferences
4. Excess smoothness and excess sensitivity
5. The interest rate and saving
6. The effect on consumption of precautionary saving, credit constraints and asset prices
7. The UK saving rate in the 1980s.

Essay

A: “Aggregate consumption varies less than GDP, while aggregate investment varies more than GDP. Is this consistent with the assumption that consumption and investment decisions result from rational choices made by forward-looking agents?” (1999)

B: “Economic theory implies that aggregate consumption follows a random walk.” Discuss. (2006)

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