

Cross Country Evidence on Consumption Persistence

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Abstract - The main focus of this article is the detection and measurement of the level of persistence in aggregate and disaggregate private consumption in Italy, Norway and the United Kingdom. Using a non-parametric methodology, we conclude that the presence of a significant degree of persistence in aggregate and disaggregate consumption in those three countries cannot be rejected.

These results are essential from a policy point of view. Persistence in consumption does exist and cannot be ignored, whether the goal is to stabilize the level of output via consumption or to boost output via long-lasting increases in consumption. One instrument that might be useful in addressing this issue is interest rates.

Keywords - Consumption, Persistence, Italy, Norway, the United Kingdom.

1. Introduction and Motivation

This paper addresses the issue of the degree of persistence in both aggregate and disaggregate private consumption and identifies its economic policy implications. Persistence can be thought of as a measure of the speed at which a variable returns to its baseline after a shock. In this sense, when the degree of persistence is small, a shock tends to have more temporary effects and conversely when the degree of persistence is high, a shock tends to have more long-lasting effects.

The recent world economic and financial crises are being mitigated by a massive fiscal countercyclical stimulus trend that mainly functions through private consumer spending. The economic rationale for this pattern is well known, as are the (macro-) economic reasons why some countries are recovering faster and better than others. However, these (macro) economic considerations are not the only (or the most important) factors in households' consumption behavior, even under the present economic circumstances. The

structure of preferences might be a factor, particularly if consumers have inter-temporally dependent preferences. Indeed, this might be a reason for consumption to display some sort of persistence or inertia.

The presence of inertia can substantially change the reaction of households to a policy shock or to innovations. This is particularly problematic for the formulation and the effectiveness of the present countercyclical policies that function through consumption. Persistence can reduce the incidence, length, and severity of shocks and changes in economic conditions. Furthermore, measuring the response of consumption to a shock is also important because it may show when it is more essential to act to overcome the harmful effect of a shock.

Traditionally, macroeconomic policies play the dominant role in smoothing the business cycle, but the effectiveness of those policies depends upon the economy's resilience. That is, the success of those policies depends upon the ability of the economic system to absorb the shock and to return to the baseline. Therefore, given the presence of persistence in consumption, the key question is whether it is viable and effective to design countercyclical policies that act through consumption expenditures, even if they are optimal.

The literature on the importance of persistence in macroeconomics is inexplicably insufficient. The first macroeconomic studies incorporating the issue of persistence appeared only in the early 1980s, and only recently did a factual interest, from an empirical point of view, in the phenomenon emerge. The importance and the need to (theoretically and empirically) study the phenomenon are further strengthened by the current economic and financial crisis, in which the persistence of the recession is a central issue. In addition, the literature on the persistence of