



## Wealth effects in emerging market economies

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### ABSTRACT

We build a panel of 14 emerging economies to estimate the magnitude of wealth effects on consumption. Using modern econometric techniques and quarterly data, we show that: (i) wealth effects are statistically significant and relatively large in magnitude; (ii) stock market and housing wealth effects are, generally, smaller for Latin American emerging markets; and (iii) housing wealth effects have substantially increased for Asian emerging economies in recent years. Additionally, while housing wealth effects are more important in countries with low level of financial development or low income level, financial wealth effects are stronger for countries with high stock market capitalization.

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## 1. Introduction

Household consumption is affected not only by income (Mallick, 2008), but also by wealth such as real estate and stock ownership (Sousa, 2010a). When real estate or stock prices rise, the wealth of homeowners or shareholders increases and household consumption can rise even when labor income remains constant. Such rise in consumption due to the increase in real estate prices is called housing wealth effect, whereas the rise in consumption that is due to the increase in stock market prices is called stock market wealth effect.

There is a large body of literature that studies the effect of asset price fluctuations on private consumption and authors have used different econometric techniques (such as panel versus single equation models) and databases (like micro panel data and aggregate time series) to address the issue. More recently, interest in the topic has regained ground against the background of the strong linkages between the macroeconomy (in particular, private consumption) and the wealth dynamics, which has led to concerns by numerous academics, central banks and governments about the potential implications of downturns in housing and equity prices (Sousa, 2010b).

Despite the wide range of studies, most of the empirical evidence refers to advanced economies and mostly to the United States, where data is more readily available. Extending the existing literature to assess the macroeconomic impact of asset price fluctuations in emerging markets may, therefore, be important as these economies are becoming a key engine of growth

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in the world economy and may play an important role in the resolution of global imbalances. In addition, since an increasingly large number of emerging market economies is becoming financially developed, their access to financial assets and the possibility to extract equity from them has also risen, hence, amplifying the potential macroeconomic impact of domestic asset price movements.<sup>1</sup> This may, in turn, generate a de-synchronization of the business cycle (Rafiq and Mallick, 2008; Mallick and Mohsin, 2010) or negatively impinge on the nexus between monetary stability and financial stability (Granville and Mallick, 2009; Sousa, 2010c; Castro, 2011).

The importance of financial assets in emerging economies is *inter alia* reflected both in the rise in stock market capitalization which currently represents more than 20% of the world's stock market capitalization,<sup>2</sup> and as a share of its domestic size which is in many cases higher than for developed economies. For real estate assets, emerging markets have been recording an important rise in homeownership rates, which are now estimated to be around 62% for Latin America and 55% for Emerging Asian urban areas.

In this paper, we intend to quantify the wealth effects in emerging markets. Using a panel of 14 emerging economies, we show that wealth effects are statistically significant and relatively large: a 10% rise in housing prices leads to an increase in private consumption of between 0.28% and 0.5%; an increase of 10% in stock prices is associated with a 0.26% to 0.30% increase in consumption; and when money wealth rises by 10%, consumption increases by 0.43% to 0.54%. Additionally, the empirical findings suggest that: (i) stock market wealth and housing wealth effects are, in general, smaller for Latin American emerging markets; and (ii) housing wealth effects have substantially increased in recent years for emerging Asian economies. Among Asian countries, stock market wealth effects tend to be larger in the most developed financial markets (for instance, Singapore) while housing wealth effects are only statistically significant in the cases of Taiwan and Thailand. Finally, the results suggest that consumption growth exhibits a substantial persistence and responds sluggishly to shocks. This may be an important reason for concern – particularly, in the case of a negative downturn – taking into account that these economies have often witnessed episodes of economic, financial and currency crises.

Additionally, we show that, while housing wealth effects are typically stronger for countries with low level of financial development, stock market and money wealth effects are larger in the case of countries with high stock market capitalization. Similarly, housing market wealth effects seem to be quantitatively more important for countries with low income level.

All in all, these features highlight the relative importance of housing assets for households in countries with low level of financial development or low income level and the sensitivity of consumption to financial wealth for countries with high stock market capitalization.

The rest of the paper is organized as follows. Section 2 reviews the existing literature of wealth effects on consumption. Section 3 presents the estimation methodology. Section 4 describes the data. Section 5 discusses the results. Section 6 provides the sensitivity analysis. Finally, Section 7 concludes with the main findings and policy implications.

## 2. A brief review of the existing literature

An extensive empirical literature has tried to estimate the magnitude of the wealth effects on consumption. For the US, commonly cited estimates of the marginal propensity to consume out of wealth are typically in the range of 4 to 7 cents increased consumer spending from a dollar increase in aggregate wealth (Gale and Sabelhaus, 1999). Mankiw and Zeldes (1991) show that the consumption of stockholders is more volatile and more strongly correlated with stock market returns than for non-stockholders. Ludvigson and Steindel (1999) also identify a wealth effect on consumption but show that the effect is unstable over time.

Other studies find modest wealth effects. Cochrane (1994), Mayer and Simons (1994) and Lettau and Ludvigson (2001) show that the overall impact on consumption is small and mainly transitory. Otoo (1999) shows that the correlation between stock prices and the consumer confidence level (either for stockholders or non-stockholders) does not change with the property of stocks, that is, consumers use stocks mainly as a leading indicator of real economic activity. Poterba (2000) points out that the concentrated nature of wealth, the desire to leave bequests, and precautionary motives in the consumer's behavior are important determinants of the modest wealth effects. Caporale and Williams (2001) suggest a small marginal propensity to consume out of wealth, but emphasize that the processes of financial liberalization/deregulation have strengthened wealth effects. Starr-McCluer (2002) suggests that concerns relative to trend inversions in stock prices can lead stockholders not to spend realized gains.

At the international level, the evidence is also quite diversified. In Japan, Horioka (1996) and Ogawa et al. (1996) suggest estimates for the marginal propensity to consume out of wealth of around between 1% and 4%, varying, considerably, with the definitions of wealth and income. In Canada, Boone et al. (2001) suggest the existence of a wealth effect of the order of 3% to 8%. In Australia, Tan and Voss (2003) estimate the marginal propensity to consume out of wealth in the range of 2, 4 and 5 cents, respectively. For the UK, Fernandez-Corugedo et al. (2007) quantify the marginal propensity to consume out of wealth at 5%.

<sup>1</sup> For a revision of China's financial research, see, for instance, Chan et al. (2007). Similarly, Ergungor (2008) investigates the relationship between economic growth and the development of the structure of the financial system. In addition, Marques and Mallick (2010) look at the role played by exchange rate fluctuations and, in particular, Pan et al. (2007) and Lin (2012) assess their linkages with stock markets.

<sup>2</sup> The stock market capitalization of the 14 emerging market economies studied in this paper accounted for 19.2% of the world's total stock market capitalization in September 2008. Only three years ago, their share of the world stock market capitalization was 12.3%. Harvey (1995) analyses the risk exposure of equity investments in emerging markets.

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