

Comment on "The Household Channel of Monetary Policy in the Euro Area: A Back of the Envelope Calculation" by Jiri Slacalek, Oreste Tristani and Giovanni L. Violante

by Ralph Luetticke¹

Before discussing the contributions of this paper, let me elaborate on the broader context in which it is written. Over the past years, a growing number of studies have revisited the transmission channels of monetary policy in models with heterogeneous households that face idiosyncratic income risk, borrowing constraints, and portfolio choices. The introduction of borrowing constraints increases the relative importance of the budget constraint vis-a-vis inter-temporal substitution in the monetary transmission mechanism. In this environment, monetary transmission works to a larger extent through income and asset prices because the marginal propensity to consume out of transitory changes in cash-flows is higher than in models with a representative household. The strength of these channels depends on the distribution of wealth and household portfolio balances, which determines the fraction of constrained households.

Slacalek, Tristani and Violante quantify these channels for the Euro area. They do so by aggregating individual household responses using theory and data. This requires 3 steps: First, they theoretically derive the first-order change in household consumption to monetary shocks for three groups: poor hand-to-mouth, wealthy hand-to-mouth, and non hand-to-mouth households. Second, they estimate portfolio balances and the sensitivity of earnings to aggregate fluctuations for all three groups from EU micro data (HFCS and EU-LFS). Third, they estimate the aggregate response of the interest rate, income, and asset prices to monetary shocks using a SVAR approach with high-frequency monetary shocks as instruments. Finally, they combine all three elements to provide an estimate of the consumption response of each household group for Germany, Spain, France, and Italy.

Let me briefly present their main findings before going into the details of their procedure. They find substantial heterogeneity in monetary transmission across households and countries in the Euro area. The key drivers are differences in portfolio balances. Consumption by wealthy hand-to-mouth households responds

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the most to a monetary easing because they benefit from higher asset prices and lower debt burden. Transmission via asset prices and income is as important as transmission via interest rates in countries like Spain that have a large fraction of wealthy hand-to-mouth households. In Germany, by contrast, there are fewer wealthy hand-to-mouth households and transmission works to a larger extent via interest rates. This sheds new light on monetary transmission in the Euro area and provides guidance for future research.

To arrive at these results, the authors make non-trivial approximations at each step of their procedure. In this discussion, I will focus on the first step: The theoretical derivation of the first-order change in consumption. This derivation closely follows Auclert (2019). In particular, the derivation uses several simplifying assumptions. In the following, I will discuss three aspects of household portfolio balances that are key for monetary transmission, and highlight a number of assumptions that are quantitatively important in my view.

Housing

In the Euro area, wealthy hand-to-mouth households are typically homeowners with a mortgage. The reported differences in the monetary transmission between the three household groups (and hence between countries like Spain and Germany) crucially depend on the elasticity of consumption to house price changes. In their derivation of this elasticity, the authors assume a linear housing transaction cost and otherwise frictionless spot markets and divisibility of houses. As a consequence, all wealthy hand-to-mouth households consume a fraction of the gains in house prices within a year (the time period of analysis). This overestimates the consumption response because only a small fraction of households sells their house or re-mortgages to extract equity from the house. A quick fix would be to rescale the house price channel by the fraction of houses sold or re-mortgaged. This would decrease the importance of the asset price channel and make monetary transmission more similar across households and countries.

Two more issues pertain to the treatment of renters and potential house buyers. The current treatment of housing does not consider that some households might be worse off when house prices increase. The authors focus on non-durable consumption and leave out expenditures on rents and on new housing. Households

about to buy a house are obviously worse off, while renters might benefit from lower rents. Lower real rates most likely translate to a different degree into lower rents vs. higher house prices across countries (achieving the same adjustment in the rent-to-price ratio). This margin is a key determinant of the distributional consequences of monetary policy in the housing market; see e.g. Hintermaier and Koeniger (2018). These observations invite future research as differences in housing markets explain most of the heterogeneity in monetary transmission across the Euro area.

Debt

Portfolio balances also markedly differ across households in terms of debt holdings. Following Auclert (2019), the authors estimate the importance of the Fisher channel (real value of nominal debt) and unhedged interest rate exposure (real interest on net issuance of debt) for monetary transmission. These two channels are quantitatively most important for wealthy hand-to-mouth households, who benefit from a reduction in the real value of their mortgage debt. While borrowers like wealthy hand-to-mouth households gain, savers lose. Crucially, savers in nominal assets are mostly retired households. This age dimension of net nominal positions in the Euro area has been highlighted before (see Adam and Zhu (2015), Tzamourani (2019)), but is neglected in this study. The derivation of the consumption response assumes infinitely-lived households and constant labor supply. Retired households differ in at least two dimensions that are important for this study: 1) No labor supply (income depends on nominal pension benefits), 2) higher marginal propensity to consume toward the end of life. The first point implies that redistribution from retirees to workers has a negative effect on aggregate labor supply, because wealth effects only matter for labor supply of workers; see e.g. Doepke et al. (2015). The second point also dampens the aggregate effect of monetary policy because it weakens the correlation between redistribution and propensities to consume.

Premia

For the remuneration of portfolios after the monetary shock, the authors assume that all maturing assets are remunerated at the risk-free rate. This overestimates

the effects of monetary policy. There is incomplete pass-through of the policy rate to many assets; see e.g. Gertler and Karadi (2015). This is the case for mortgages which are the most important nominal assets for wealthy hand-to-mouth households. Other premia respond to monetary shocks as well. Using U.S. data, Luetticke (2018) documents incomplete pass-through of the policy rate to illiquid assets, like business capital or housing. Luetticke rationalizes this in a model with heterogeneity in household portfolios, in which capital including housing is illiquid. In this model, households do not only differ in marginal propensities to consume but also in marginal propensities to invest in capital. Importantly, propensities to consume and invest are negatively correlated, such that redistribution across households mainly affects the composition of aggregate expenditures in terms of consumption and investment. This points toward the importance of studying heterogeneity in investment decisions across households, which would complement this paper's focus on consumption.

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