The 2018 CEPR European Conference on Household Finance

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The 2018 edition of the CEPR European Conference on Household Finance, held with the support of the Think Forward Initiative, took place on 5 and 6 October in Siracusa, Sicily. This summary describes the main themes emerging from the papers presented at the conference.

On 5-6 October 2018, Ortygia Business School hosted the 2018 edition of the European Conference on Household Finance. It was organised by The CEPR Network on Household Finance, Einaudi Institute for Economics and Finance, NUS Business School, Center for Studies in Economics and Finance, EDHEC Business School, and the Think Forward Initiative.

The Network runs the European Conference on Household Finance in the autumn of each year since 2015, alongside a Workshop in spring since 2016. The typical volume of submissions to the main event is about 175 papers, with an acceptance rate of 6%. Preceding each year's conference and workshop, the Think Forward Initiative and CEPR organise a discussion around issues of topical interest and this year's event discussed the promises and risks of "Robo-advisors and Consumer Finance". The summary of the most recent discussion can be found here. This column presents the main themes that emerged from papers presented at the conference.

1. Understanding the drivers of wealth accumulation is crucial

The new reality in many countries is that certain groups of people feel left behind in the process of economic well-being and of wealth accumulation. Household finance, with its emphasis on micro-data and careful modelling of heterogeneity in individual behaviour, can be a central tool for researchers, policy makers, and decision makers at large.

Understanding how much people save, as well as how much they earn on their savings is pivotal. Bach, Calvet and Sodini (2018) study the channels through which saving flows affect the dynamics of wealth inequality. Using administrative data from Sweden, the authors document that saving from labour income as a fraction of net worth is a decreasing function of net worth and is very heterogeneous within net worth brackets. The authors argue that such a saving rate heterogeneity has a strong impact on social mobility, but only a weak impact on the distribution of net worth. They also document that heterogeneity in wealth returns is the main driver of increases in top wealth shares in Sweden.

Adequacy of saving for retirement can be crucial in determining well-being at an age where borrowing or labour supply adjustments are either impossible or very costly. Beshears, Choi, Laibson, Madrian, Skimmyhorn and Zeldes (2018) study the relationship between human capital and rollovers into Individual Retirement Accounts (IRAs) in the United States and ask whether educational attainment has any relationship with retirement account fees paid by individuals. The authors find no economically meaningful association between the two and show that this is robust with other measures of human capital.

that participate in financial markets.

Behavioural biases have been demonstrated to influence adversely wealth accumulation. In studying the well-documented phenomenon of the disposition effect, Engelberg, Henriksson and Williams (2018) find that this effect exists for a stock only when the remainder of the investors' portfolio is at a loss. In an attempt to explain this phenomenon, the authors suggest that investors' utility comes from not just paper gains and losses, but also realized gains and losses. When an investor's portfolio has paper losses, the authors argue that they compensate it by realising gains.

2. Subjective expectations matter for financial behaviour and policy outcomes

A number of conference papers took up the issue of how subjective expectations are formed and what implications this has for individual and policy outcomes. Individual outcomes included consumption, financial asset behaviour, and indebtedness, and a major implication of the research is that expectations are heterogeneous, even in the face of a common environment, and important for outcomes. Heterogeneity may be induced, for example, by differential cognitive abilities, signals, or degrees of optimism.

D'Acunto, Hoang, Paloviita and Weber (2018) use high-quality data from Finland to document that only men with high cognitive abilities adjust their consumption propensities in response to changes in inflation expectations, even though everybody faces the same nominal interest rate. Thus, cognitive abilities are important human frictions to the effectiveness of policy instruments, controlling for other factors, such as income, education, borrowing constraints and other expectations.

Roth and Wohlfart (2018) conduct an information experiment to study how households' expectations about aggregate economic growth causally affect their expectations about their personal economic circumstances and behaviour. They provide respondents to an online survey of US individuals with heterogeneous (though valid) professional forecasts, and they show that respondents update their aggregate economic outlook, and extrapolate to their personal economic prospects, revising their consumption and financial investment behaviour.

Angelico (2018) provides robust empirical evidence that expectations have a strong predictive power for the dynamics of household debt: Optimism about future income increases debt, in line with the permanent income hypothesis. By setting up a consumption-savings model with natural expectations, the paper documents that consumers fail to forecast long-run income, resulting in over-indebtedness.

3. The supply side is pivotal for the opportunities faced by households

In a world with considerable financial innovation, financial illiteracy, and strong competition among suppliers, financial advice and default options matter for the choices made by households, their wealth accumulation, and their economic well being. Competition, incentive structure, and product design have very important, but not yet adequately understood implications for household financial behaviour.

Bhutta, Fuster and Hizmo (2018) study dispersion in prices paid for mortgages in the US and find that the gap between the 10th and the 90th percentile interest rate is over 50 basis points. Much of this dispersion occurs within lenders, suggesting an important role for price discrimination and negotiation in mortgage pricing. Interestingly, they also find that many borrowers end up with rates

facilitating entry of new, low cost lenders. Using a theoretical model, the paper shows that an unintended consequence of banning commissions is a 25% fall in consumer welfare due to a reduction in competitiveness in the mortgage market.

Gomes, Michaelides and Zhang (2018) argued that the welfare gains target date funds, which automatically reduce exposure to risky assets as the holder ages, can be significantly improved if they are modified to take advantage of predictability in excess returns. They demonstrate that taking into account predictability driven by the variance risk premium is welfare improving, as it is not correlated with individual household risk and thus places households in an advantageous position to exploit the equity premium.

4. Household debt matters, but not necessarily for consumption smoothing

Consumer debt, and in particular credit card debt, is considered a powerful agent in smoothing consumption when faced with income shocks. Olafsson, Pagel and Hundtofte (2018) use unique longitudinal data from Iceland and data for a representative sample of U.S. credit card holders. They find that households smooth their debt balances, rather than using high-interest, unsecured short-term borrowing to smooth consumption. They show that unemployment shocks do not induce a large borrowing response, thus presenting evidence contradicting traditional theories of consumption smoothing that suggest a counter-cyclical household demand for credit.

Credit is important in alleviating mobility constraints and labour market outcomes. Gomes, Schoenherr, Skrastins and Van Doorink (2018) exploit random time-series variation in the allocation of motorcycles in Brazil and show that credit to purchase a motorcycle improves employment, earnings and the willingness to commute further for a job than before.

Household leverage is correlated with the tendency to default but understanding what underlies this correlation is important for policy and regulation. Gupta and Hansman (2018) ask whether the correlation between mortgage leverage and default is due to moral hazard or adverse selection. Using a natural experiment in the US, the authors show that moral hazard is responsible for between 60-70% of the correlation, while adverse selection explains the rest.

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