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Testing the Predictability of Consumption Growth: Evidence from China

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Abstract

Chow (1985, 2010, 2011) reports indirect evidence in favor of the permanent income hypothesis using time series observations in China. We revisit this issue by evaluating direct measures of the predictability of consumption growth in China during the post-economic reform regime (1978-2009) as well as the postwar US data for comparison. Our in-sample analysis provides strong evidence against the PIH for both countries. Out-of-sample forecast exercises show that consumption changes are highly predictable, which sharply contrasts the implication of Chow (1985, 2010, 2011).

Keywords: Permanent Income Hypothesis; Consumption; Diebold-Mariano-West Statistic

JEL Classification: E21; E27

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1 Introduction

In his early study, Chow (1985) reported strong evidence in favor of the Permanent Income Hypothesis (PIH) using annual observations in China from 1953 to 1982. Later, Chow (2010) extended his previous model for the data from 1978 to 2006, then provided the same conclusion. Using updated data, Chow (2011) reported weaker but similar supporting evidence for the PIH in China.

We note that his empirical analysis focuses on the coefficient of lagged consumption in an autoregressive model for consumption. Finding that the confidence band of that coefficient includes 1, he suggested that the PIH is consistent with Chinese annual data. However, his statistical inference may not be valid when consumption obeys an integrated process, because the conventional t -test becomes invalid when consumption is an $I(1)$ process.¹ Further, his work evaluates the validity of the PIH without addressing the predictability of consumption growth.

This paper fills this gap by directly investigating the in-sample and the out-of-sample predictability of consumption changes in China as well as the postwar US data for comparison. Our findings suggest that consumption changes are highly predictable, which provides a clear contrast with findings in Chow (1985, 2010, 2011).

The rest of the paper is organized as follows. Section 2 provides a data description and preliminary test results. In Section 3, we provide our major findings. Section 4 concludes.

2 Data and Preliminary Analysis

We obtained per capita disposable income (y_t) and consumption expenditure (c_t) in China from China Statistical Yearbook (2012) following Chow (1985, 2010, 2011).

¹ One should not use the normal distribution-based confidence band when the data generating process is an integrated process. That is, Chow's analysis based on such confidence bands is invalid.

Observations are annual and span from 1978 to 2012. China began their major economic reforms since 1978, so observations prior to 1978 are not used. Following Chow, we deflated all observations using the GDP deflator. All data are log transformed.

The log real per capita disposable income and the log real consumption expenditures of nondurables and services in the US are from the Federal Reserve Bank of St. Louis (FRED). The data is quarterly and covers the period from 1952:Q1 to 2011:Q4.

We first implement the augmented Dickey-Fuller (ADF) test for these variables. See Table 1. The ADF test rejects the null of nonstationarity only for differenced series with an exception of y_t in China when time trend is present. Overall, our test results imply that consumption and income are integrated series, which is also consistent with Chow's work.

Table 1

3 Empirical Findings

3.1 In-Sample Analysis

Campbell and Mankiw (1990) test the empirical validity of the PIH in the US by empirically evaluating Hall's (1978) famous claim that consumption follows a random walk process under the PIH. They assume that a constant fraction of consumers (λ) does not obey the PIH, because they are liquidity constrained. Therefore, they are not capable of smoothing consumption over time. For these consumers, changes in consumption simply reflect income changes, that is, $\Delta C_t = \Delta Y_t$. The rest of consumers are assumed to obey the PIH, which implies $\Delta C_t = \varepsilon_t$, where ε_t is a white noise process. Aggregating consumptions yields the following estimable equation.

$$\Delta C_t = \lambda \Delta Y_t + u_t, \tag{1}$$

where $u_t = (1 - \lambda)\varepsilon_t$. Naturally, finding non-zero estimates for λ provides evidence against the PIH.²

We employ their specification for Chinese data with an improved econometric method.³ To deal with the Endogeneity bias, we use the iterative efficient Generalized Method of Moments (GMM) estimation method (Hansen, 1982) and report results in Table 2. Results from the US data are reported in Table 3.

The first column provides instrumental variables used in each regression. The second column reports λ estimates along with their robust standard errors. The third column reports specification test (J -test) results, when applicable, along with corresponding p -values.

All λ estimates are positive and statistically significant at the 5% level, which provides strong empirical evidence against the PIH. Our model specification seems reasonable as the p -value of the J test statistics is greater than 0.05 in all regressions.

We also note that the λ estimates are substantially greater with Chinese data than those from the US. Estimates for λ vary from 0.835 to 0.872 in China, while it ranges from 0.287 to 0.769 in the US. This seems plausible because λ is a fraction of liquidity constrained consumers, and households in China are more likely to be such consumers relative to US counterparts.

Tables 2 and 3

3.2 Out-of-Sample Predictability

We next implement a more direct test for the PIH via out-of-sample forecast tests proposed by Diebold and Mariano (1995) and West (1996). We evaluate predictability of

² Campbell and Mankiw (1990) report significantly positive λ estimate using the US data for 1953 to 1986, which implies strong evidence against the PIH. Similarly strong evidence is also reported by Flavin (1981).

³ They use the two-stage instrumental variable estimator.

lagged variables for consumption changes relative to that of the random walk model, which is consistent with the PIH (Hall, 1978), serving as a benchmark.

The random walk model of C_t implies,

$$C_{t+1|t}^R = C_t, \quad (2)$$

where $C_{t+1|t}^R$ is the 1-step ahead consumption forecast by the random walk model given information set at time t . The competing model using a vector of lagged variables as the explanatory variables (X_t) is based on the following least squares regression,

$$\Delta C_{t+1} = \beta' \Delta X_t + u_t \quad (3)$$

Note that we use the difference filter for the consistency of the least squares estimator. Given the least squares coefficient estimate, we construct the 1-step ahead forecast by such an alternative model $C_{t+1|t}^A$ as follows.

$$C_{t+1|t}^A = \Delta \widehat{C}_{t+1|t} + C_t, \quad (4)$$

where $\Delta \widehat{C}_{t+1|t}$ is the fitted value from (3) and C_t is the actual realized observation at time t .

We define the following loss function differential variable,

$$d_t = L(\varepsilon_{t+1|t}^R) - L(\varepsilon_{t+1|t}^A),$$

where $L(\varepsilon_{t+k|t}^j)$, $j = R, A$ is a loss function and forecast errors are,⁴

$$\varepsilon_{t+1|t}^R = C_{t+1} - C_{t+1|t}^R, \quad \varepsilon_{t+1|t}^A = C_{t+1} - C_{t+1|t}^A$$

⁴ We use the conventional squared error loss function, $(\varepsilon_{t+1|t}^j)^2$, $j = R, A$.

The Diebold-Mariano-West statistic (*DMW*) with the null of equal predictive accuracy, $H_0: Ed_t = 0$, is given,

$$DMW = \frac{\bar{d}}{\sqrt{\widehat{Avar}(\bar{d})}} \quad (5)$$

where $\bar{d} = \frac{1}{T-T_0} \sum_{t=T_0+1}^T d_t$, and $\widehat{Avar}(\bar{d})$ is the asymptotic variance of \bar{d} , $\frac{1}{T-T_0} \sum_{j=-q}^q k(j, q) \hat{\Gamma}_j$, where $k(\cdot)$ denotes a kernel function where $k(\cdot) = 0, j > q$, and $\hat{\Gamma}_j$ is the j^{th} autocovariance function estimate.⁵

We carry out forecasting recursively by sequentially adding one additional observation from $P\%$ initial observations toward the end of observations. We re-estimate coefficients in the prediction model $\Delta c_{t+1} = \beta' \Delta x_t + u_t$ for each recursive sample, then re-formulate forecasts. The ratio of the root mean square prediction error (*RRMSPE*) is defined as the root mean square error of the random walk model relative to that of the competing model. Therefore, a greater value of *RRMSPE* than one implies some evidence against the PIH, because the explanatory variables have predictive power. Since the random walk model ($\beta = 0$) is nested by the alternative one, we evaluate the *DMW* statistics with McCracken's (2007) critical values to prevent size distortion problems, because the *DMW* statistic is severely under-sized with asymptotic critical values when competing models are nested.⁶

We report out-of-sample forecast exercise results in Tables 4 and 5 for China and the US, respectively. All *RRMSPE* values exceed one for both countries. Further, the *DMW* test rejects the null of equal predictability at any conventional significance level.

⁵ Following Andrews and Monahan (1992), we use the quadratic spectral kernel with automatic bandwidth selection for our analysis.

⁶ Note that the alternative model nests the random walk model when β is a null vector.

Our results are quite robust to alternative initial split ratios.⁷ Again, we obtain strong empirical evidence against the PIH via more direct out-of-sample forecast analysis.

Tables 4 and 5

4 Concluding Remarks

This paper revisits the empirical inconsistency of the Permanent Income Hypothesis using household data in China along with the postwar US data as a benchmark.

We present strong evidence against the PIH in the sense that consumption growth is highly predictable, which is in contrast to the work by Chow (1985, 2010, 2011) who reported favorable indirect evidence using conventional but invalid normal approximation based tests.

Our in-sample analysis based on the specification of Campbell and Mankiw (1990) implies a lot weaker evidence of the PIH for Chinese data than the US data. The λ point estimates varied in the vicinity of 0.85 for China, while much smaller values were obtained when we use the US data, which seems reasonable because λ is a fraction of consumers who are liquidity constrained.

Our out-of-sample forecasting exercises directly address the predictability issue from the PIH. We obtain very strong results against the PIH for both countries in the sense that explanatory variables have substantial predictive contents for consumption growth, which is robust to the choice of sample split ratio.

⁷ The forecast performance may depend of the size of initial number of observations used in the estimation relative to the remaining observations for evaluations.

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Table 1. ADF Test Results

<i>China</i>		
Variable	ADF_c	ADF_t
c_t	-0.889	-2.693
y_t	0.044	-4.641*
Δc_t	-3.885*	-3.907 [†]
Δy_t	-4.263*	-4.163 [†]

<i>US</i>		
Variable	ADF_c	ADF_t
c_t	-1.839	-0.688
y_t	-2.093	-0.503
Δc_t	-4.966*	-5.280*
Δy_t	-9.416*	-14.62*

Note: ADF_c and ADF_t denote the ADF t -statistic with an intercept and with an intercept and time trend, respectively. We chose the number of lags by the Akaike Information Criteria with a maximum 8 lags for quarterly US data, while a maximum 2 lags were used for annual Chinese data.

Table 2. GMM Estimation Results: Chinese Data (Annual)

Instruments	λ (s.e)	J (p -value)
None (OLS)	0.872 (0.018)	<i>n.a</i>
Δy_{t-1}	0.864 (0.015)	<i>n.a</i>
Δc_{t-1}	0.868 (0.015)	<i>n.a</i>
$\Delta y_{t-1}, \Delta c_{t-1}$	0.835 (0.013)	3.637 (0.057)
$\Delta y_{t-1}, \Delta y_{t-2}$	0.862 (0.013)	1.619 (0.203)
$\Delta c_{t-1}, \Delta c_{t-2}$	0.868 (0.014)	0.081 (0.776)
$\Delta y_{t-1}, \Delta y_{t-2}, \Delta c_{t-1}, \Delta c_{t-2}$	0.844 (0.008)	4.836 (0.184)

Note: Annual observations span from 1978 to 2009. This table reports iterative efficient GMM estimates of $\Delta c_t = \lambda y_t + u_t$, using an array of instrumental variables. Numbers in parentheses in column 2 are standard errors for the λ estimate. p -values for the J -test statistic are from the chi-square distribution.

Table 3. GMM Estimation: US Data (Quarterly)

Instruments	λ (s.e.)	J (p -value)
None (OLS)	0.287 (0.045)	<i>n.a</i>
$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}$	0.769 (0.282)	1.240 (0.538)
$\Delta y_{t-2}, \dots, \Delta y_{t-6}$	0.447 (0.157)	4.989 (0.288)
$\Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	0.628 (0.137)	5.885 (0.053)
$\Delta c_{t-2}, \dots, \Delta c_{t-6}$	0.664 (0.132)	8.291 (0.082)
$\Delta y_{t-2}, \dots, \Delta y_{t-4}, \Delta c_{t-2}, \dots, \Delta c_{t-4}$	0.487 (0.112)	9.902 (0.078)
$\Delta y_{t-2}, \dots, \Delta y_{t-6}, \Delta c_{t-2}, \dots, \Delta c_{t-6}$	0.505 (0.094)	13.06 (0.160)

Note: Following Campbell and Mankiw (1990), we use consumption expenditures for nondurable goods and services, and we excluded the first lagged variables from the set of instruments. Observations are quarterly and span from 1952:Q1 to 2011:Q4. This table reports iterative efficient GMM estimates of $\Delta c_t = \lambda y_t + u_t$, using an array of instrumental variables. Numbers in parentheses in column 2 are standard errors for the λ estimate. p -values for the J -test statistic are from the chi-square distribution.

Table 4. Out-of-Sample Forecast: China

Split Ratio	Explanatory Variables	<i>RRMSPE</i>	<i>DMW</i>
0.51	Δy_t	3.5999	6.6756*
	$\Delta y_{t-1}, \Delta y_{t-2}$	3.4202	7.3507*
	$\Delta c_{t-1}, \Delta c_{t-2}$	3.3188	7.2628*
	$\Delta y_{t-1}, \Delta y_{t-2}, \Delta c_{t-1}, \Delta c_{t-2}$	3.3204	7.1548*
0.66	Δy_t	3.6606	6.8638*
	$\Delta y_{t-1}, \Delta y_{t-2}$	3.3623	7.6711*
	$\Delta c_{t-1}, \Delta c_{t-2}$	3.7080	8.3429*
	$\Delta y_{t-1}, \Delta y_{t-2}, \Delta c_{t-1}, \Delta c_{t-2}$	3.6638	8.5777*
0.81	Δy_t	4.1636	5.0213*
	$\Delta y_{t-1}, \Delta y_{t-2}$	5.3395	6.0435*
	$\Delta c_{t-1}, \Delta c_{t-2}$	7.0499	6.5777*
	$\Delta y_{t-1}, \Delta y_{t-2}, \Delta c_{t-1}, \Delta c_{t-2}$	5.5285	6.5049*

Note: Out-of-sample forecasting was recursively implemented by sequentially adding one additional observation from $P\%$ initial observations toward the end of observations. Split ratio denotes the number for P . *RRMSPE* denotes the ratio of the root mean squared prediction error of the random walk hypothesis to the competing model. *DMW* denotes the test statistics of Diebold and Mariano (1995) and West (1996). * denotes rejection of the null hypothesis of equal predictability at the 1% significance levels.

Table 5. Out-of-Sample Forecast Analysis: US

Split Ratio	Explanatory Variables	<i>RRMSPE</i>	<i>DMW</i>
0.50	Δy_t	1.8411	10.322*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}$	1.9177	10.602*
	$\Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	2.0158	10.806*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}, \Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	2.0068	10.642*
0.65	Δy_t	1.7986	9.8501*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}$	1.8993	9.9372*
	$\Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	2.0615	10.660*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}, \Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	2.0824	10.892*
0.81	Δy_t	1.4856	5.4806*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}$	1.5825	5.9971*
	$\Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	1.7480	6.9882*
	$\Delta y_{t-2}, \Delta y_{t-3}, \Delta y_{t-4}, \Delta c_{t-2}, \Delta c_{t-3}, \Delta c_{t-4}$	1.7572	7.1435*

Note: Out-of-sample forecasting was recursively implemented by sequentially adding one additional observation from $P\%$ initial observations toward the end of observations. Split ratio denotes the number for P . *RRMSPE* denotes the ratio of the root mean squared prediction error of the random walk hypothesis to the competing model. *DMW* denotes the test statistics of Diebold and Mariano (1995) and West (1996). * denotes rejection of the null hypothesis of equal predictability at the 1% significance levels.