How Financial Innovations and Accelerators Drive Booms and Busts in U.S. Consumption

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The recent US consumption boom, bust and recovery have been attributed to fluctuations in financial and housing wealth but these do not explain the longer term record. Coherent explanations highlight changes in the supply of credit and the liquidity of housing wealth, factors which are not directly observed. Our indexes of unsecured consumer credit availability and the liquidity of housing wealth address this gap, and yield a consumption function with far superior parameter stability and ability to account for U.S. consumption than models that omit these factors. The liquidity of housing wealth is estimated as a common unobservable state in a jointly estimated, non–linear state space model of consumption and mortgage refinancing. The resulting credit-augmented, life cycle model of consumption shows that financial innovations and frictions play critical roles in the booms and busts in U.S. consumption.