

Reconsidering the Marginal Propensity to Consume Under Persistent Liquidity Constraints: Precautionary Saving Motives and the Erosion of the Permanent Income Hypothesis in Emerging Market Economies

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Abstract. The Permanent Income Hypothesis (PIH) has long served as the cornerstone of consumption-smoothing theory, yet its empirical validity within emerging market economies remains contested, particularly under conditions of sustained liquidity constraints and macrofinancial volatility. This paper re-examines the marginal propensity to consume (MPC) using household-level panel data from six middle-income economies spanning 2010–2023, employing a two-stage instrumental variable estimator augmented with time-varying precautionary saving controls. Our findings reveal statistically significant deviations from PIH predictions, with estimated MPCs systematically exceeding life-cycle benchmarks among liquidity-constrained quintiles. These results challenge the structural robustness of the PIH in non-OECD contexts and carry substantial implications for fiscal multiplier calibration, targeted transfer policy design, and macroprudential regulatory frameworks.

Keywords: permanent income hypothesis, marginal propensity to consume, liquidity constraints, precautionary saving, fiscal multiplier, household panel data, emerging market economies, consumption-smoothing theory, instrumental variable estimation

Introduction

The Permanent Income Hypothesis, originally formalized by Friedman (1957) and subsequently integrated into the life-cycle framework by Modigliani and Brumberg (1954), posits that rational households base current consumption decisions not on transitory income fluctuations but on expectations of lifetime wealth. For decades, this theoretical scaffold has underpinned the construction of dynamic stochastic general equilibrium (DSGE) models, informed the calibration of fiscal multipliers, and shaped the design of transfer

payment mechanisms across both advanced and developing economies. Yet, as macroeconomic conditions in the post-pandemic era (2022–2026) grow increasingly characterized by persistent inflationary pressures, tightening credit markets, and widening wealth inequality, the empirical foundations of the PIH have come under renewed and intensified scrutiny. In emerging market economies specifically, where formal credit infrastructure remains underdeveloped, collateral requirements are prohibitively stringent, and income streams are disproportionately volatile, the behavioral assumptions embedded in the PIH appear particularly ill-suited to observed household consumption dynamics. A growing body of microeconomic evidence — drawing on nationally representative household expenditure surveys and administrative tax records — documents MPC estimates substantially above the 0.0–0.05 range implied by full consumption-smoothing models, clustering instead in the 0.25–0.60 range for low- and middle-income quintiles. These empirical anomalies are not adequately reconciled by augmented buffer-stock saving models alone; they suggest a deeper structural misalignment between the theoretical architecture of the PIH and the financial realities confronting a majority of the global population. This misalignment carries non-trivial policy consequences. If household consumption responses to transitory income shocks are systematically underestimated by policymakers relying on PIH-consistent models, the calibration of automatic stabilizers, discretionary fiscal interventions, and social protection transfers will be correspondingly miscalibrated — potentially amplifying macroeconomic instability rather than attenuating it. The stakes are particularly acute in the context of current global fiscal consolidation debates and the reallocation of development finance resources post-COVID-19. The present paper contributes to this literature along three principal dimensions. First, we provide updated, cross-country MPC estimates for six representative middle-income economies using harmonized household panel data and a rigorous two-stage instrumental variable (2SIV) identification strategy. Second, we decompose the aggregate MPC into its precautionary and liquidity-driven components, enabling a more granular assessment of the mechanisms through which the PIH breaks down. Third, we assess the implications of our findings for fiscal multiplier heterogeneity and targeted transfer policy efficacy across income quintiles. The remainder of this paper is structured as follows. Section 2 reviews the theoretical and empirical literature on the PIH and its critiques. Section 3 describes the data sources, harmonization protocols, and econometric methodology. Section 4 presents the main empirical results and robustness checks. Section 5 discusses the policy implications for fiscal design and macroprudential regulation. Section 6 concludes with directions for future research.

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