Research Working Papers

Ignorance, Pervasive Uncertainty, and Household Finance

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The interaction between two kinds of uncertainty explains household decisions on consumption, portfolio choices, and precautionary savings.

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This paper studies how two types of uncertainty due to ignorance interact to affect households' strategic decisions on their consumption, investment, and precautionary savings. Specifically, we construct a recursive utility version of a canonical Merton (1971) model with uninsurable labor income and unknown income growth. After solving the model explicitly, we theoretically and quantitatively explore how these ignorance-induced uncertainties interact with intertemporal substitution, risk aversion, and the correlation between the equity return and labor income, as well as how they jointly affect strategic asset allocation, precautionary savings, and the equilibrium asset returns. Next, we use data to test our model's predictions on the relationship between ignorance and asset allocation and quantitatively show that the interaction between the two types of uncertainty is the key to explaining the data. Finally, we find that the welfare costs of ignorance can be very large.

JEL Classification: C61, D81, E21

Article Citations

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Related Research

- Luo, Yulei, Jun Nie, Gaowang Wang, and Eric R. Young. Forthcoming. "Rational Inattention and the Dynamics of Consumption and Wealth in General Equilibrium." Journal of Economic Theory.
- Hansen, Lars Peter, and Thomas J. Sargent. 2015. "Four Types of Ignorance." Journal of Monetary Economics, vol. 69, iss. C, pp. 97-113.