Accounting for household financial distress helps explain large regional differences in spending responses during recessions.

This paper investigates how, and how much, household financial distress (FD), arising from allowing debts to go unpaid, matters for the aggregate and cross-sectional consumption responses to macroeconomic risk. Through a battery of structural models, we show that FD can affect consumption responses through three channels: (1) as another margin of adjustment to shocks (direct channel); (2) because its persistence implies a significant degree of preference heterogeneity (indirect channel); and (3) because it can exacerbate macroeconomic risks whenever it is more severe in the hardest-hit regions, as evinced by the last two recessions (correlation channel). We find that all channels shape cross-sectional differences in the response of consumption to shocks. However, only the direct and indirect channels matter in the aggregate.

JEL Classification: D31, D58, E21, E44, G11, G12, G21

Article Citations


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Related Research


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