Research Working Papers

The Effects of Macroeconomic Shocks: Household Financial Distress Matters

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

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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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Note: Previous versions of this RWP from September 2020 and October 2021 were titled "Household Financial Distress and the Burden of "Aggregate" Shocks" and "Financial Distress and Macroeconomic Risks".

Related Research

- Athreya, Kartik, Ryan A. Mather, José Mustre-del-Río, and Juan M. Sánchez. 2019. "Consumption in the Great Recession: The Financial Distress Channel." Federal Reserve Bank of Kansas City, Research Working Paper no. 19-06, October. Available at https://doi.org/10.18651/RWP2019-06
- Athreya, Kartik, José Mustre-del-Río, and Juan M. Sánchez. 2019. "The Persistence of Financial Distress." Review of Financial Studies, vol. 32, no. 10, pp. 3851–3883. Available at https://doi.org/10.1093/rfs/hhz009
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