ABSTRACT

In a model with collateralized debt, negative shocks to the value of the housing stock adversely affect the risk sharing technology. This mechanism sheds new light on the consumption correlation puzzle. We investigate risk-sharing patterns for the 30 largest US metropolitan areas and we find empirical support for the housing collateral channel. A decrease in the value of housing collateral endogenously increases the sensitivity of regional consumption growth to region-specific risk, as predicted by the model, and the effects are large. In times when housing collateral is very scarce, the dispersion of regional consumption growth relative to regional income growth is twice as high as when collateral is very abundant. Our structural estimation of the model’s consumption dynamics implies a time path for consumption growth dispersion that closely matches the one in the data. The housing collateral effect is the key element that enables this match. The implied cost of collateral variation is between .5 and 1.5 percent of regional consumption.

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