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Imperfect Risk-Sharing and the Business Cycle

(co-authored with David Berger and Luigi Bocola)

Abstract

Is imperfect risk-sharing across households important for aggregate fluctuations? This paper develops a framework to answer this question. We first propose an accounting procedure for households-level data on consumption, wages and hours worked. In our prototype model with complete financial markets, households' choices regarding labor supply and assets' holdings are distorted by individual-specific wedges. We measure the wedges using micro data and show how to combine them with a class of heterogeneous agents New Keynesian models. The models in this class have an equivalent representation featuring a stand-in household with state-dependent preferences. We derive a mapping between these "preference shocks" and the micro wedges, and use this equivalent representative-agent economy to perform counterfactuals. We find that deviations from perfect risk-sharing was an important determinant of aggregate demand during the U.S. Great Recession.