Housing Market Frictions, Asset Prices, and the Amplification of Macroeconomic Shocks

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Abstract

This paper studies asset pricing and labor market dynamics when houses are modeled as a component of wealth and a consumption good. The discount factor depends on consumption of non durables and houses that cannot be adjusted costlessly. Housing liquidity frictions give rise to risk over the relative consumption ratio that drives asset prices. I study this idea quantitatively in a model that features a portfolio choice based on liquidity as well as risk. Following a TFP shock firms post fewer vacancies. Rising unemployment implies more aggregate and individual risk and therefore, more risk over the relative consumption ratio, leading to higher discounts and rising unemployment. This parsimonious mechanism accounts for both responsiveness of individual consumption to unemployment shocks and the countercyclical market price of risk and is quantitatively important. After calibrating the model to match the salient features of the wealth distribution I find that risk over the relative consumption ratio amplifies output fluctuations by 18% and unemployment volatility by 200%, while the welfare losses are mostly borne by the asset poor households.

Keywords: Search and Matching, Labor Income Risk, Portfolio Choice, Business Cycles.