The Macroeconomic implications of the covariance between income levels and risk

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Abstract

I argue that modern macroeconomic models with household heterogeneity should explicitly account for the well-known negative correlation between labor income levels and risk. I show that such correlation rationalizes the puzzling excess sensitivity of high-income households, thereby challenging the conventional transmission mechanisms of fiscal and monetary policy. In particular, given the same level of *positive* wealth, when income risk decreases over income level, high-income households rationally exhibit a higher Marginal Propensity to Consume (MPC) in response to transitory income shocks. This implies that within the wealth distribution, there are high-income, low-risk, and unconstrained households with high MPCs. To quantify the aggregate implications of this evidence, I build a Heterogeneous Agent New Keynesian (HANK) model augmented with ex-ante heterogeneity in the income processes. Two key facts emerge: (i) monetary shocks are magnified by the large elasticities of these *unconstrained* households; (ii) governments cannot use targeted transfers to simultaneously stimulate aggregate demand and provide insurance.

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Key words: Marginal Propensity to Consume, Income Risk, HANK, Fiscal Policy, Monetary Policy

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