Falling Behind: Has Rising Inequality Fueled the American Debt Boom?

Moritz Drechsel-Grau Fabian Greimel
University of Mannheim

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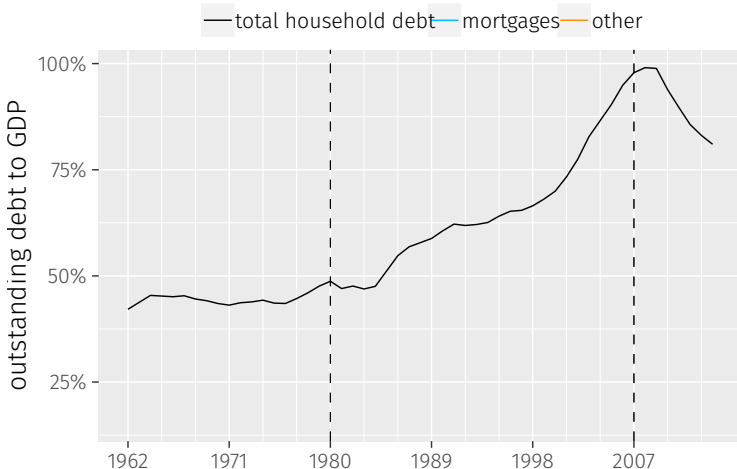
Outline

Facts I: US Household Debt Boom



Source: US Flow of funds

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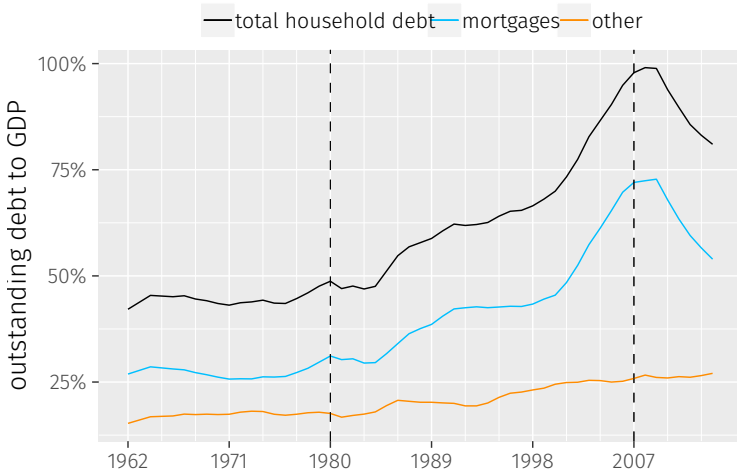

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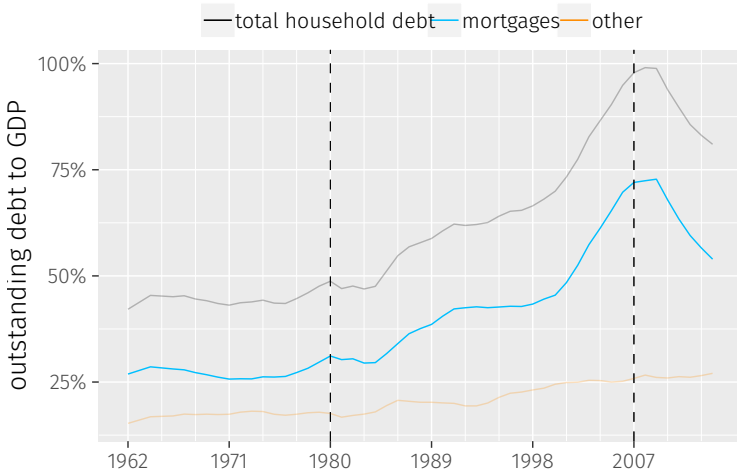

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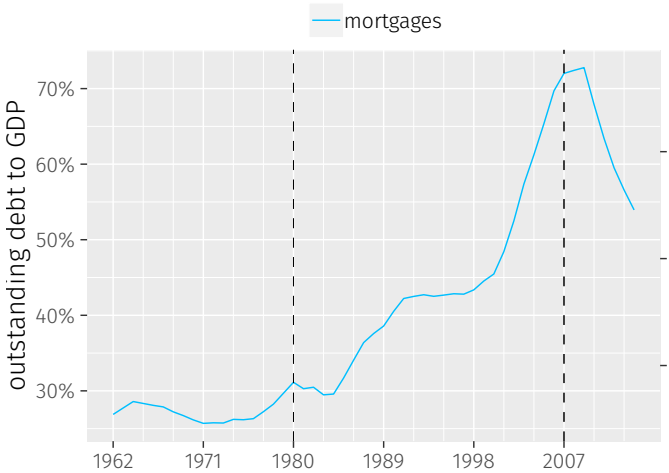

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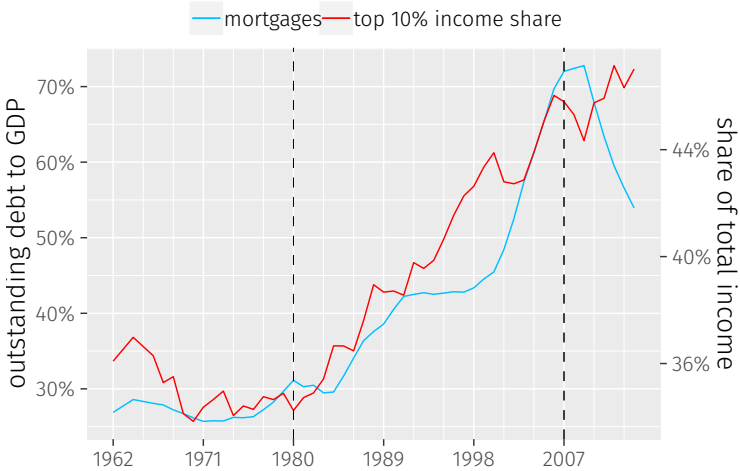
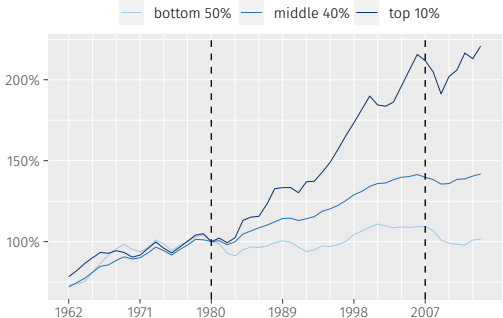
Facts I: US Household Debt Boom and Income Inequality



Source: US Flow of funds and World Inequality Database (Piketty et al.) ▸ alternative inequality measure

Facts II: Real Incomes Rise for Top 50%

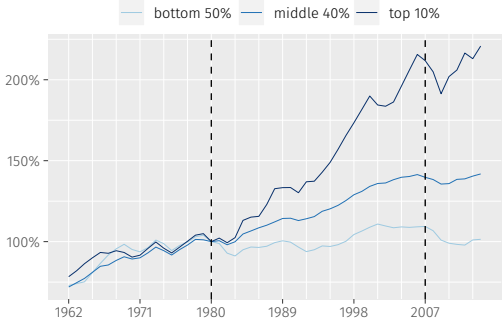
Income growth



Pre-tax incomes in the US. Base year: 1980. Based on Piketty et al. (2018).

Facts II: Real Incomes Rise for Top 50% – Mortgages Rise Across the Distribution

Income growth



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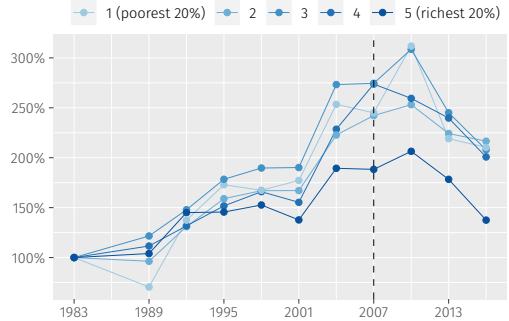
Mortgage debt growth



Mean mortgage debt as a fraction of mean income by income group in the US. Data from Surveys of Consumer Finances (Fed)

Research Question and Method

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Can rising income inequality account for (part of) the boom in mortgage debt and house prices?

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Mechanism

Keeping up with the Joneses

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General Equilibrium Model

- Heterogeneous agents (Bewley-Huggett-Aiyagari)
- durable housing and non-durable consumption, mortgages
- social comparisons
- state-of-the-art income process (Guvenen et al., 2019)

What We Do

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2. Main experiment: exogenously increase inequality in the permanent component of income to match observed increase (1980-2007)
3. Horse race: compare mechanisms with other suggested drivers of the mortgage and house price boom
   - exogenous net capital inflow, lower interest rates (Global Saving Glut)
   - looser collateral constraints (financial innovation/liberalization)

What We Find

1. Rising inequality and social comparisons generate about 50% of observed mortgage and house price booms
2. Saving glut does not generate strong house price boom

Analytical results

- that individual debt is increasing in the incomes of the reference group
- that aggregate debt-to-income ratio is increasing in top incomes when somebody cares about the rich

How Rising Income Inequality Leads to a Mortgage Boom

rising top inequality $\xrightarrow[\text{with the Joneses}]{\text{Keeping up}}$ mortgage boom

1. rich become richer (exogenously)
2. rich improve their houses, raise reference point
3. non-rich want to keep up with the richer Joneses
4. non-rich improve their houses using a mortage
5. higher debt-to-income ratios across the distribution

Note: non-rich $\approx$ bottom 90 % (almost everyone!)

Outline

Relation to the Literature

- Macroeconomics with housing and mortgages, housing (debt) boom

  e.g. Kumhof et al. (2015, AER), Favilukis et al. (2017, JPE), Kaplan et al. (2019, JPE), Justiniano et al. (2019, JPE)

  $\rightsquigarrow$ new (demand-side) mechanism, extended time-horizon
- External habits (Keeping up with the Joneses)

  e.g. Abel (1990, AER P&P), Campbell and Cochrane (1999, JPE), Ljungqvist and Uhlig (2000, AER)

  $\rightsquigarrow$ heterogenous agent model, use micro-evidence for parameterization
- "Distributional macroeconomics"

  e.g. Kaplan and Violante (2014, Ecma), Kaplan et al. (2016, AER), Achdou et al. (2015)

  $\rightsquigarrow$ another reason why "inequality matters for macro"
- Empirical consumption externalities

  e.g. De Giorgi et al. (2019, REStud), Bertrand and Morse (2016, REStat), Bellet (2017)

  $\rightsquigarrow$ quantify effects on macroeconomic outcomes
- Network economics e.g. Ballester et al. (2006, Ecma), Ghiglino and Goyal (2010, JEEA)

  $\rightsquigarrow$ infinite-horizon network model

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Economic environment

Bewley-Huggett-Aiyagari heterogenous agents model with housing

1. continuum of households
   - ex-ante identical
   - heterogenous productivity (earnings)
   - constant mortality rate
   - *keeping up with the Joneses* motive
2. borrowing subject to collateral constraint
3. production of final good (linear technology)
4. construction sector

Households' problem

- constant mortality rate m
- risky endowment income y
- non-durable consumption c, durable housing h
- asset a (savings device and mortgage)
- social comparisons
  - housing status $s(h, \bar{h})$
  - reference measure $\bar{h}$
- house price p, interest rate r

Preferences

$$\mathbb{E}_0 \int_0^\infty e^{-(\rho+m)t} u(c_t, s(h_t, \bar{h}_t))$$

Endogenous States

$$\dot{a}_t = y_t + r_t a_t - c_t - p_t x_t$$
$$\dot{h}_t = -\delta h_t + x_t$$

Collateral constraint

$$-a_t \leq \omega p_t h_t$$

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Social comparisons

Status function $s(h, \bar{h})$

- ratio specification (as in Abel, 1990)

$$s(h, \bar{h}) = \frac{h}{\bar{h}^{\phi}}$$

- ϕ is the sensitivity w.r.t reference housing

$$\phi = -\frac{\text{elasticity of utility w.r.t } \bar{h}}{\text{elasticity of utility w.r.t } h}$$

- follow estimate by Bellet (2017):

$$\phi = 0.7$$

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Flow utility

$$\frac{\left((1-\xi)c^{\varepsilon} + \xi\left(\frac{h}{\bar{h}^{\phi}}\right)^{\varepsilon}\right)^{\frac{1-\gamma}{\varepsilon}}}{1-\gamma}$$

Production

Construction sector

(from Kaplan et al., 2019)

- inputs: labor N_h and land permits $\bar{L}$
- aggregate productivity Θ
- housing investment
  $I_h = (\Theta N_h)^{\alpha}(\bar{L})^{1-\alpha}$ with $\alpha \in (0,1)$
- $\max_{N_h} p_t I_h - w N_h$

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Consumption good

linear production: $Y_c = \Theta(1 - N_h)$

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Financial markets

- exogenous net supply of assets a^S
- borrowing subject to collateral constraint

Equilibrium

A stationary equilibrium is a joint distribution $\mu(a, h, y)$, policy functions $c(a, h, y, \bar{h})$, $h(a, h, y, \bar{h})$, $a(a, h, y, \bar{h})$, prices (p, r) and a reference measure $\bar{h}$ such that

- policy functions are consistent with agents' optimal choices $(c_t, h_t, a_t)_{t>0}$ given incomes $(y_t)_{t>0}$, prices p, r and reference measure $\bar{h}$
- markets clear
  - asset market: $\int a(a, h, y) d\mu = a^S$
  - housing investment equals housing production
- the reference measure is consistent with choices: $\bar{h} = \bar{h}(\mu)$

Outline

Calibration strategy

1. adapt estimated earnings process (Guvenen et al., 2019)
2. set 6 parameters externally to match 1980 target moments
3. calibrate two parameters internally to match 1980 target moments

Earnings process (1)

- Taken from Guvenen et al. (2019)
  - Captures both lifetime-inequality and income risk
  - estimated using administrative data from 1994–2013
- $y_{it} = (1 - \nu_{it}) \exp(\tilde{\alpha}_i + z_{it} + \epsilon_{it})$

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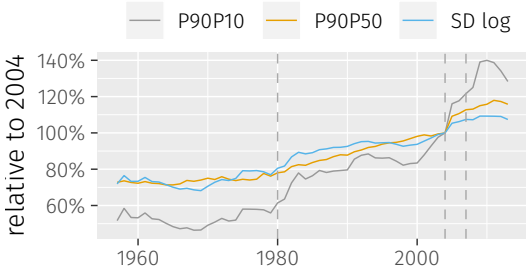
  - persistent component (think “AR(1)”)
  - transitory component (think “iid”)

Earnings process (2): Adjustments for 1980

- take into account changes in cross-sectional income distribution since 1980



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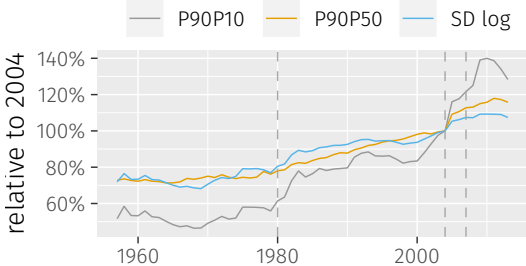

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- most of the increase in cross-sectional variation due to increase in permanent component (Kopczuk et al., 2010; Guvenen et al., 2014)
- adjust permanent component of incomes (σ_α^2) to match difference in P90/P50 ratio between 1980 and 2004

Parameterization

Parameter description		Source	Value
Preferences			
ϕ	strength of keeping up motive	Bellet (2017)	0.7
ρ	discount rate	internal	0.02
ξ	utility weight of housing	internal	0.277
$\frac{1}{1-\varepsilon}$	intra-temporal elasticity of substitution	Flavin and Nakagawa (2008, AER)	0.15
γ	inverse intertemporal elasticity of substitution	standard	1.5
$\frac{1}{m}$	constant mortality rate	45 years worklife	45.0
Housing and financial technogy			
$\frac{\alpha}{1-\alpha}$	price elasticity of housing supply	Saiz (2010, QJE)	1.5
δ	depreciation rate of housing	Bureau of Economic Analysis	0.021
ω	maximum loan-to-value ratio	P95 of LTV	0.85
$a^S/\bar{y}$	exogenous net asst supply	cum. current account	-0.01
Taxation and Unemployment Insurance			
τ_0	level of taxes	internal	0.932
τ_1	progressivity	Heathcote et al. (2017)	0.15
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Model fit: Targeted moments

moment	model	data (80/83)
aggregate loan-to-value	0.24	0.24
aggregate networth-to-income	4.63	4.6
tax-revenue-to-income	0.14	0.14

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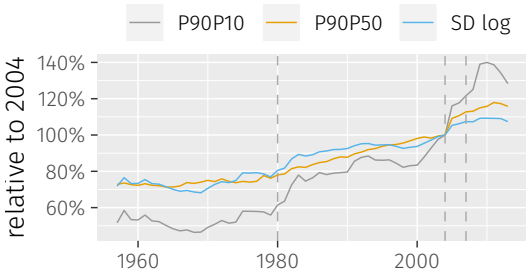
Rising inequality, mortgages and house prices 1980–2007 (1)

- inequality rises



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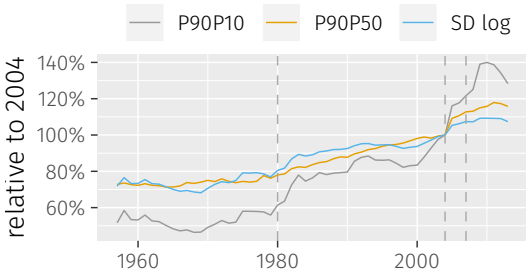
Rising inequality, mortgages and house prices 1980–2007 (1)

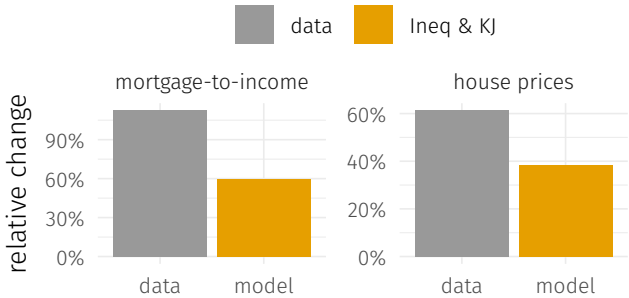
- inequality rises



Source: Guvenen et al. (2018)

- adjust permanent component of incomes (σ_α^2) to match difference in P90/P50 ratio between 1980 and 2007
- all other parameters are kept constant

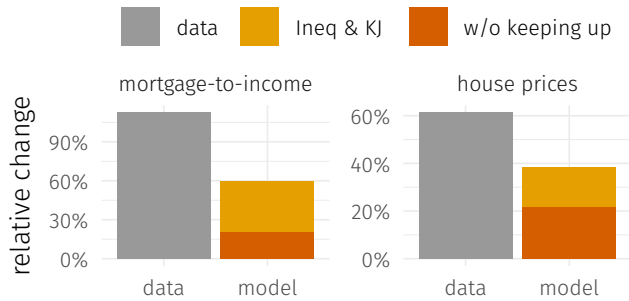
Rising inequality, mortgages and house prices 1980–2007 (2)



Take-away: Inequality & keeping up with the Joneses generate

- 40% of the observed mortgage boom
- 55% of the observed house price boom

Social Comparisons are an Important Amplifier — Rising Inequality is not Enough



Note: Keeping reference measure $\bar{h}$ constant at $\bar{h}_{1980}$.

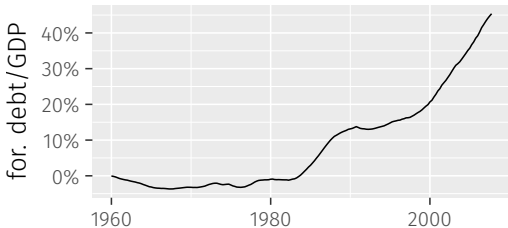
Take-away: Keeping up with the Joneses contributes 61% of the mortgage debt increase and 30% of the house price increase

Outline

Horse race against alternative mechanisms

Global Saving Glut

- cumulative current accout deficit $\approx$ net foreign debt position $= -a^S$
- exogenous rise in net supply of credit $-a^S$ (Justiniano et al., 2014)



Source: US BEA, FRED

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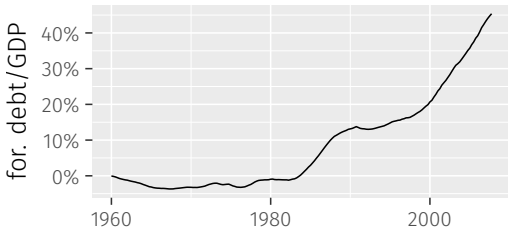
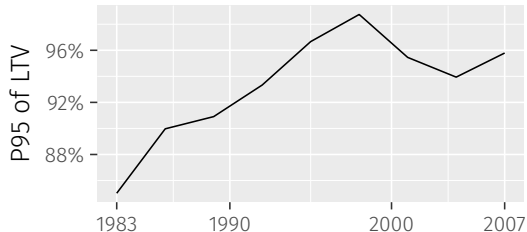


Source: US BEA, FRED

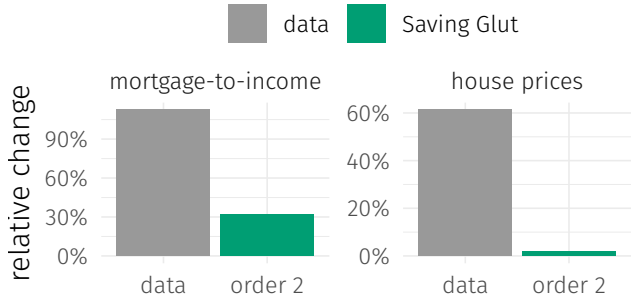
Looser borrowing standards

- loosening of collateral constraints
- result of financial liberalization (e.g. Favilukis et al., 2017)
- proxy ω with P95 of LTV distribution



Source: SCF

Decomposition of the three mechanisms



Take-away

1. Saving Glut generates stronger debt boom, but weaker house price boom

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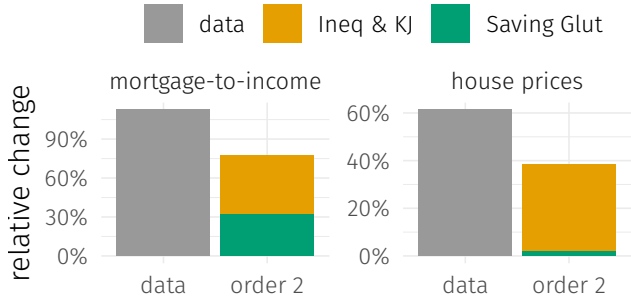

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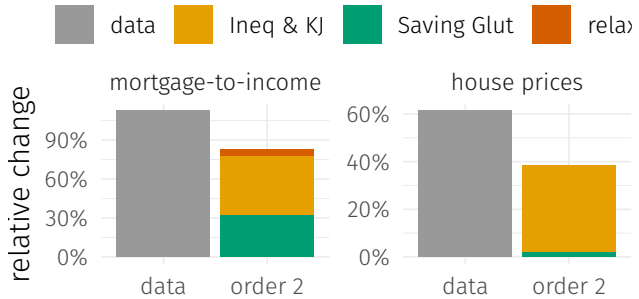

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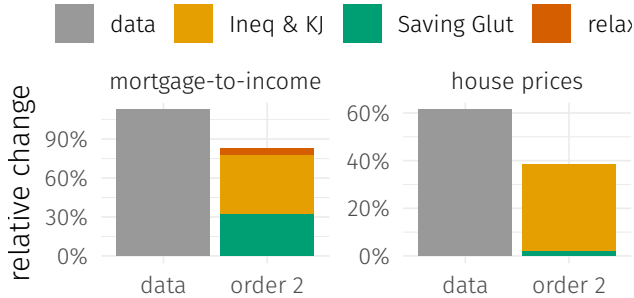
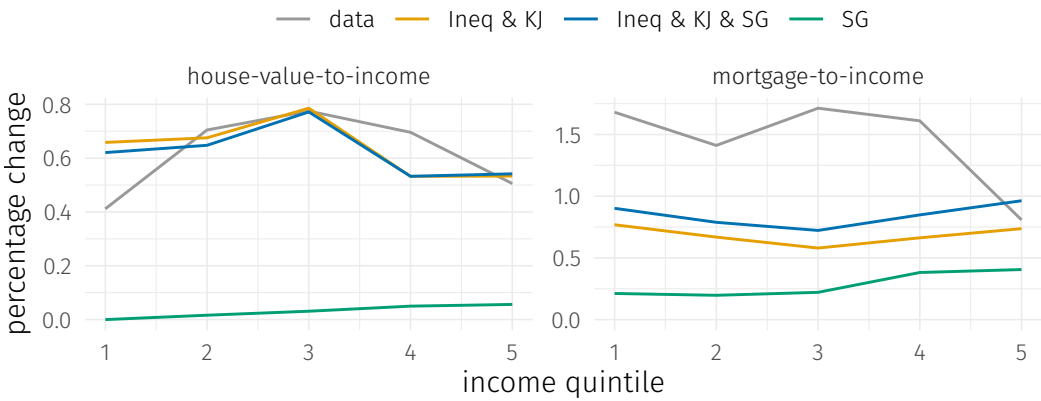


Take-away

1. Saving Glut generates stronger debt boom, but weaker house price boom
2. inequality and keeping up with the Joneses contributes about 50% to mortgages and 95% of to prices

Changes over the income distribution



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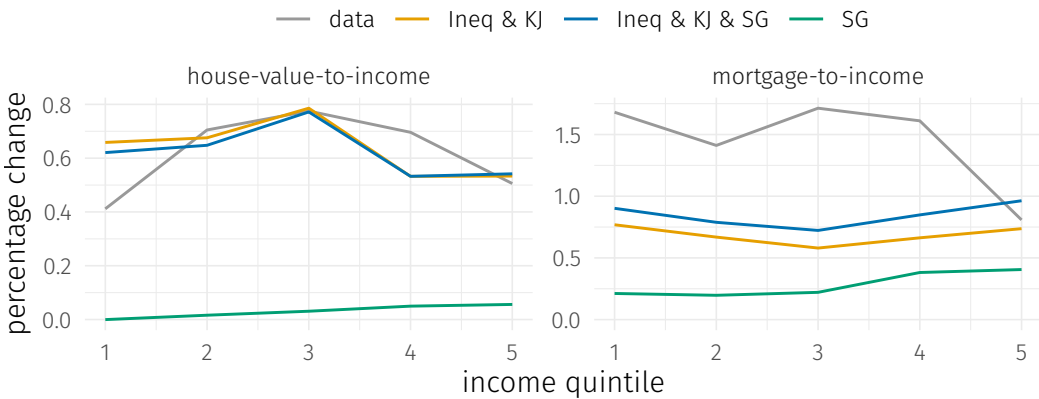

Take-away

Inequality and keeping up with the Joneses gets the inverse-U for house value

Outline

Conclusion

We formalize a causal link between rising top incomes and the debt boom based on “keeping up with the richer Joneses”

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Analytical results

- that individual debt is increasing in the incomes of the reference group
- that aggregate debt-to-income ratio is increasing in top incomes when somebody cares about the rich

Thank you!

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Model

- durable houses h, non-durable consumption c
- asset a (mortgage if $a < 0$)
- Keeping up with the Joneses
  - reference measure $\bar{h}$
  - status function $s(h, \bar{h})$
- house price p, interest rate r

Preferences

$$\mathbb{E}_0 \int_0^\infty e^{-(\rho+m)t} u(c, s(h, \bar{h}))\, dt$$

Endogenous States

- $\dot{a}_t = y_t + r_t a_t - c_t - p_t x_t$
- $\dot{h}_t = -\delta h_t + x_t$
- a_0, h_0 given.

Model — Tractable Version

- durable houses h, non-durable consumption c
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For now:

- finite number of types j
- constant incomes y^j
- life-time borrowing constraint
- $r = \rho$, $\delta = m = 0$

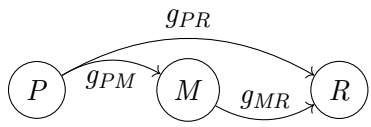
Modelling Keeping up with the Joneses: Example with three income types

$$u(c, s(h, \bar{h})) = \frac{\left(c_t^{1-\xi}\left(h_t - \phi \bar{h}_t^j\right)^{\xi}\right)^{1-\gamma}}{1-\gamma}$$

(a) Preferences

$$\begin{pmatrix} \bar{h}_P \\ \bar{h}_M \\ \bar{h}_R \end{pmatrix} = \underbrace{\begin{pmatrix} 0 & g_{PM} & g_{PR} \\ 0 & 0 & g_{MR} \\ 0 & 0 & 0 \end{pmatrix}}_{G \text{ (adjacency matrix)}} \begin{pmatrix} h_P \\ h_M \\ h_R \end{pmatrix}$$

(b) Reference consumption



(c) Corresponding graph

Result: Debt Is Increasing in Others' Incomes

(Individually) optimal debt (given p, r, $\bar{h}$) is

$$-\begin{pmatrix} a_P \\ a_M \\ a_R \end{pmatrix} = \pi_1 \begin{pmatrix} y_P \\ y_M \\ y_R \end{pmatrix} + \pi_2 \phi \begin{pmatrix} 0 & \tilde{\phi} \cdot g_{PM} & \tilde{\phi} \cdot g_{PR} + \tilde{\phi}^2 \cdot g_{PM} \cdot g_{MR} \\ 0 & 0 & \tilde{\phi} \cdot g_{MR} \\ 0 & 0 & 0 \end{pmatrix} \begin{pmatrix} y_P \\ y_M \\ y_R \end{pmatrix}$$

where $\pi_1, \pi_2 > 0$ depend on prices and parameters. Sketch of proof

- Results hold more generally: debt is increasing in incomes of all (directly and indirectly) linked agents
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$\rightsquigarrow$ Households need not be directly linked! (effects trickle-down)

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1. others' houses (and $\bar{h}$)
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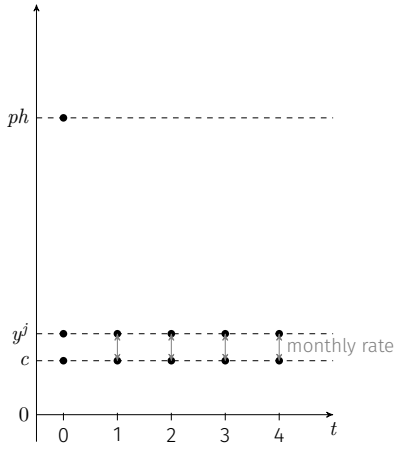
$$h = c\left(\frac{\xi}{(1-\xi)rp}\right)^{\frac{1}{1-\varepsilon}} + \phi\bar{h}$$

Why Is Debt Increasing in Others' Incomes?

1. others' houses (and $\bar{h}$) increase in others' incomes
2. own house increases with others' houses
3. bigger house means more debt
   - use debt to smooth payments



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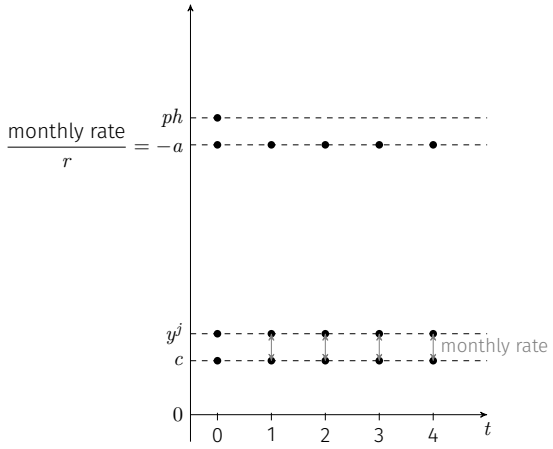

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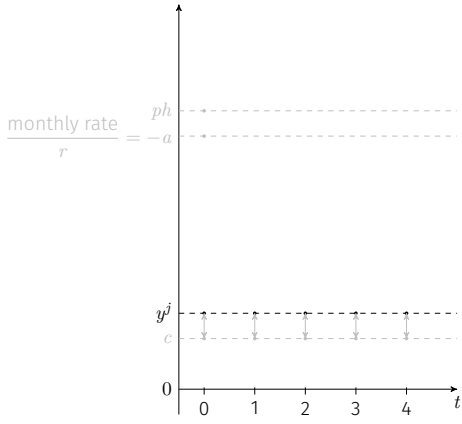

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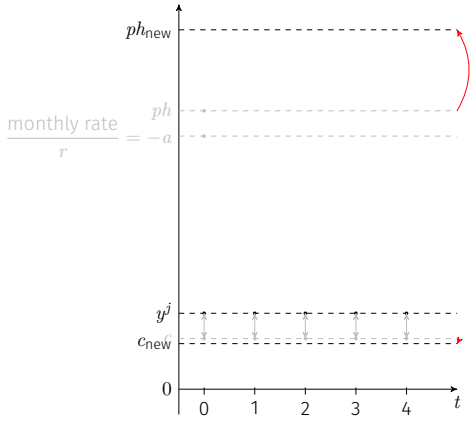

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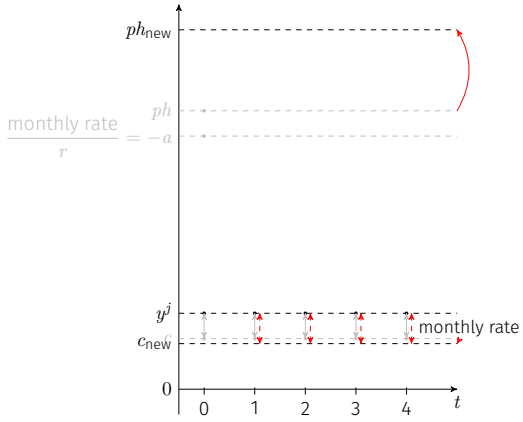

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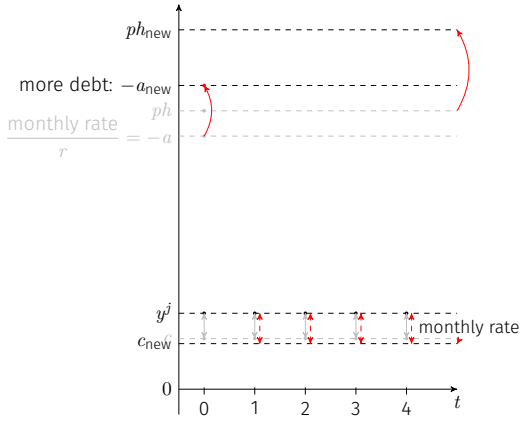

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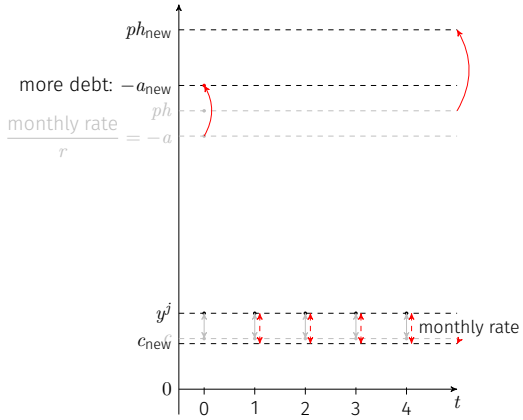

$\rightsquigarrow$ Own credit demand is increasing in others' income!

Tractable version of the model: Summary

Lemma
If initial endowments are sufficiently low (e.g. $a_0 = 0$), households optimally choose to be indebted.

Lemma
If households substitute houses for consumption, they optimally increase their debt.

Proposition
Optimal debt is increasing in the incomes of one's reference group (and the incomes of the reference group of the reference group, etc.)

Proposition
If social comparisons are upward-looking, total demand for debt is increasing in top incomes.

Results also hold with housing market clearing

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