Household Risk Management

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Abstract

Household risk management, that is, households’ insurance against adverse shocks to income, assets, and financing needs, is limited and often completely absent, in particular for poor households. We explain this basic pattern in household insurance in an infinite horizon model in which households have access to complete markets subject to collateral constraints resulting in a trade-off between the financing needs for consumption and durable goods purchases and risk management concerns. We show that household risk management is monotone in household net worth and income, under quite general conditions, in economies with income risk, durable goods, and durable goods price risk. The limited participation in markets for claims which allow household risk management is a result of the financing risk management trade-off and should not be considered a puzzle.

JEL Classification: D91, E21, G22.

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