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Paradox of Thrift Recessions

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We build a variation of the neoclassical growth model in which both wealth shocks (in the sense of wealth destruction) and financial shocks to households generate recessions. The model features three mild departures from the standard model: (1) adjustment costs make it difficult to expand the tradable goods sector by reallocating factors of production from nontradables to tradables; (2) there is a mild form of labor market frictions (Nash bargaining wage setting with Mortensen-Pissarides labor markets); (3) goods markets for nontradables require active search from households wherein increases in consumption expenditures increase measured productivity. These departures provide a novel quantitative theory to explain recessions like those in southern Europe without relying on technology shocks.

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