The Financial Instability Hypothesis: 
a Stochastic Microfoundation Framework

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Abstract

This paper examines the dynamics of financial distress and in particular the mechanism of transmission of shocks from the financial sector to the real economy. The analysis is performed by modelling the linkages between microeconomic financial variables and the aggregate performance of the economy by means of a new stochastic aggregation framework. This methodology overcomes some of the restrictions of the representative agent hypothesis which seems to be unsuitable for a context where different financial conditions of firms, and consequently different reactions to external shocks, impact on the macroeconomic dynamics. The model is solved both numerically and analytically, by means of a stochastic approximation that is able to replicate the numerical solution.

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