Financial Instability Hypothesis: a Stochastic Microfoundation

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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 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 the consequently different reactions to external shocks, impact on the macroeconomic dynamics. The solution of the model leads to a formally complete analytical description of long run dynamics and fluctuations of aggregate production.

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