

# Engineering a Paradox of Thrift Recession

Zhen Huo

University of Minnesota

José-Víctor Ríos-Rull

University of Minnesota

Federal Reserve Bank of Minneapolis

CAERP, CEPR, NBER

## Abstract

We build a variation of the neoclassical growth model where financial shocks to households or wealth shocks (in the sense of wealth destruction) generates a recessions. Two standard ingredients that are necessary are 1) the existence of adjustment costs that make the expansion of the tradable goods sector difficult and 2) the existence of some frictions in the labor market that prevent an enormous drop in real wages. We pose a new ingredient that greatly magnify the recession, which is that a reduction in consumption expenditures reduce measured productivity while technology is unchanged. Our model provides a novel, quantitative theory of the current recessions in Southern Europe.

PRELIMINARY - PLEASE DO NOT CITE OR DISTRIBUTE