Financial Risk and Unemployment

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Abstract
There is a strong correlation between the corporate interest rate spread and the unemployment rate. We make two contributions to the literature based on this observation. First, we model the mechanisms by which these financial conditions can affect unemployment in a DMP model with capital. Second, we quantify these mechanisms, disciplining our model with US data. Financial conditions affect unemployment in four ways. First, high interest rates lower profits. Second, higher interest rates make vacancy posting more costly. Third, higher default rates lower the expected future profits of firm owners. Finally, default can lead directly to a separation between the worker and firm. We quantify these channels following various strategies outlined in the literature. Preliminary results suggest the model is able to produce quantitatively significant fluctuations under all calibration strategies.