Job Uncertainty and Deep Recessions

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We study a model in which households are subject to uninsurable idiosyncratic employment shocks, firms set prices subject to nominal rigidities, and the labor market is characterized by matching frictions and by downward inflexible wages. We introduce heterogeneity in search efficiency that arises either upon job loss or during an unemployment spell. Higher risk of job loss and worsening job finding prospects during unemployment depress goods demand because of a precautionary savings motive amongst employed households. Lower goods demand produces a decline in job vacancies and the ensuing drop in the job finding rate in turn triggers higher precautionary saving setting in motion an amplification mechanism. The amplification mechanism is absent from standard macroeconomic models and depends on the combination of incomplete financial markets and frictional goods and labor markets. The model can account for key features of the Great Recession in response to the observed changes in the job separation rate and an increase in search efficiency heterogeneity estimated from the matching function.