



[Financial Market Imperfections and Labour Market Outcomes](#)

CFM-DP2016-24

Alireza Sepahsalari

Centre For Macroeconomics and University College London

This paper investigates the importance of credit market frictions on labour market outcomes. I build a tractable search and matching model of the labour market with firm dynamics and heterogeneity in productivity and size. Firms produce output using labour, which they hire in a frictional market modelled by a directed search approach, and capital which they rent period-by-period. First, I show that the interaction of search and financial frictions slows down the reallocation of labour and capital from low productivity to high productivity firms and therefore prolongs the recession following a financial shock. Second, I find that the credit tightening reduces the net employment of large and productive firms more than small and unproductive firms, consistent with recent empirical findings. Third, I find that the introduction of financial frictions enhances the ability of the model to explain the fluctuation and persistence observed in output and labour market flows during the great recession. In fact, the model can account for 50% of the increase in unemployment during the 2008-2010 recession.