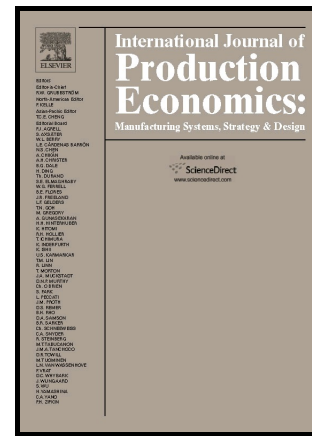


Author's Accepted Manuscript

Risk, Risk Aversion, and A Finance-Augmented Neoclassical Economic Model of Production

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www.elsevier.com/locate/ijpe

PII: S0925-5273(16)30009-3
DOI: <http://dx.doi.org/10.1016/j.ijpe.2016.03.009>
Reference: PROECO6366

To appear in: *Intern. Journal of Production Economics*

Received date: 8 January 2015
Revised date: 29 January 2016
Accepted date: 15 March 2016

Cite this article as: Yi Jin and Zhixiong Zeng, Risk, Risk Aversion, and A Finance-Augmented Neoclassical Economic Model of Production, *Intern. Journal of Production Economics*, <http://dx.doi.org/10.1016/j.ijpe.2016.03.009>

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January 2016

Abstract

We analyze the financial and macroeconomic environment within which production activity is embedded, and study the effects on equilibrium production of shocks to banking risk and to investor risk aversion in a general equilibrium setting. Given investor risk aversion, the total effect of a banking risk shock is decomposed into a bankruptcy effect and a risk-aversion effect. Allowing for changes in investor risk aversion, an accounting framework is developed to quantify the contributions of various shocks. When calibrated to financial data during the Global Financial Crisis, the risk-risk attitude shocks *interact* to generate large declines in employment and output.

JEL Classification: E44, G32, D86.

Keywords: Financial frictions; bankruptcy; risk aversion; financial crisis.

*We thank three anonymous referees for helpful comments and suggestions.

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