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Financial shocks and the real economy in a nonlinear world: From theory to estimation

Andrea Silvestrini* & Andrea Zaghini†

Abstract

We examine the inter-linkages between financial factors and real economic activity. We review the main theoretical approaches that allow financial frictions to be embedded into general equilibrium models. We outline, from a policy perspective, the most recent empirical papers focusing on the propagation of exogenous shocks to the economy, with a particular emphasis on works dealing with time variation of parameters and other types of nonlinearities. We then present an application to the analysis of the changing transmission of financial shocks in the euro area. Results show that the effects of a financial shock are time-varying and contingent on the state of the economy. They are of negligible importance in normal times but they greatly matter in conditions of stress.

Keywords: financial crisis; nonlinearities; financial shocks

JEL classification: C32; E32; E44; E58

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