

Accepted Manuscript

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PII: S1566-0141(17)30399-0
DOI: doi:[10.1016/j.ememar.2017.10.001](https://doi.org/10.1016/j.ememar.2017.10.001)
Reference: EMEMAR 524

To appear in: *Emerging Markets Review*

Received date: 6 October 2017
Accepted date: 11 October 2017



Please cite this article as: Chowdhury, Anup, Uddin, Moshfique, Anderson, Keith, Liquidity and Macroeconomic Management in Emerging Markets, *Emerging Markets Review* (2017), doi:[10.1016/j.ememar.2017.10.001](https://doi.org/10.1016/j.ememar.2017.10.001)

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Liquidity and Macroeconomic Management in Emerging Markets

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Abstract

Emerging markets have received considerable attention for foreign investment and international diversification due to the possibility of higher earnings and a low level of integration with global equity markets. These high returns often need to be balanced by the high liquidity costs of trading in illiquid emerging markets. Several studies have shown that central bank and government policies are significant determinants of market liquidity. We investigate the influence of monetary and fiscal policy variables on the market and firm level liquidity of eight emerging stock markets of Asia. Using four different (il)liquidity measures and nine macroeconomic variables, we find that changes in the money supply, government expenditure and private borrowing significantly affect stock market liquidity. Illiquidity is also strongly affected by the bank rate, short-term interest rate and government borrowing. We demonstrate that ‘crowding out’ and ‘cost of funds’ effects exist in these markets. Other major findings are that some markets are more sensitive to local macroeconomic news than world factors, the impact on size based portfolios largely depends on the instruments used by the central banks and government, the liquidity of the manufacturing sector is affected by changes in any policy variables, financial institutions are only influenced by monetary policy variables, and the service sector is least affected.

Keywords: Liquidity, Macroeconomics, Emerging markets, Central bank, SE Asia, crowding out

JEL classification: G15, G18, G28

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This paper was presented at the 2016 Cross Country Perspectives of Finance conferences held in Taiyuan and Pu'er, China.

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