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Financial Market Illiquidity Shocks and Macroeconomic Dynamics: Evidence from the UK

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Abstract

We examine the link between financial market illiquidity and macroeconomic dynamics by fitting a Bayesian time-varying parameter VAR with stochastic volatility to UK data from 1988Q1 to 2016Q4. We capture liquidity conditions in the stock market using a battery of illiquidity proxies. This paper departs from previous studies examining macro-financial linkages by using theoretically grounded sign restrictions, and conducting structural inference in a non-linear framework. We document both statistically significant differences in the transmission of these shocks, and substantial increases in the economic importance of these shocks during the 2008 recession.

Keywords: stock market illiquidity, time-varying parameter VAR, macro-financial linkages, sign restrictions

JEL Codes: E32, E44, E47, E52, E58

1. Introduction

The importance of adding financial channels to macroeconomic modelling has only recently received increasing attention. For instance, Federal Reserve Bank of Boston President Eric Rosengren (2010) argued that the seriousness of the recent financial crisis was underestimated by economic forecasters because the provision of liquidity to the real economy was “only crudely incorporated into most macroeconomic modeling” (p.221). Writing in *The Financial Times* in November 2012, former Bank of England (BoE) Monetary Policy Committee Member Deanne Julius (2012) flagged the importance of adding financial channels in the BoE’s econometric model. Both views were reinforced by the Head of the Monetary and Economic Department at the Bank of International Settlements Claudio Borio (2014) who noted that for most of the post-war period “financial factors in general progressively disappeared from macroeconomists’ radar screen”(p.182).

The main contribution of this paper is to assess the structural dynamics between financial market illiquidity shocks and macroeconomic fundamentals. We fit a time-varying parameter VAR (TVP VAR) with stochastic volatility to UK macroeconomic data, and two measures of stock market illiquidity, from 1988Q1 to 2016Q4. As noted by Granger (2008), TVP VARs are an attractive modelling strategy since they offer an approximation to any non-linear model. There are two novelties in our approach. First, we identify an illiquidity shock using theoretically grounded contemporaneous sign restrictions. Second, we conduct structural inference in a generalised framework. The above sets our paper aside from the existing literature exploring time-varying macro-financial linkages, such as Prieto et al. (2016) and Ellington et al. (2017). The importance of conducting structural inference in a manner consistent with the modelling strategy is twofold. First, structural analysis using linear techniques undermines imposing non-linear

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