

Accepted Manuscript

Title: Liquidity and default in an exchange economy

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PII: S1572-3089(16)30134-6

DOI: <http://dx.doi.org/doi:10.1016/j.jfs.2016.10.010>

Reference: JFS 495

To appear in: *Journal of Financial Stability*

Received date: 19-1-2016

Revised date: 5-7-2016

Accepted date: 26-10-2016



Please cite this article as: S. Juan Francisco Martinez, Dimitrios P. Tsomocos, Liquidity and default in an exchange economy, *Journal of Financial Stability* (2016), <http://dx.doi.org/10.1016/j.jfs.2016.10.010>

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Liquidity and default in an exchange economy

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July 5, 2016‡

Abstract

This paper analyzes various channels of shock transmission in an economy subject to financial frictions, by incorporating liquidity and default effects on asset prices. We develop a framework in which we can assess financial stability policy by introducing a simplified model of exchange and financial intermediation that captures the effects of shocks on financial and real sectors of the economy. The model allows us to explain essential mechanisms and interactions of financial and real economic variables in a comprehensive, yet intuitive fashion. Our results suggest that liquidity and default in the credit markets should be analyzed contemporaneously when financial, monetary and productivity shocks affect financial stability as well as the real economy.

Keywords: Default, DSGE, financial stability, liquidity.

JEL Classification codes: D51, D52, E43, E44, E58.

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‡A preliminary version of this paper appeared in 2011 and was entitled “Liquidity effects on asset prices, financial stability and economic resilience.” We thank Dimitris Papadimitriou-Doukas and Luis Cabezas for excellent research assistance. We are indebted to CAE Goodhart, Tryphon Kollintzas and Oren Sussman for valuable advice. We also thank Kwangwon Ahn, Raphael Espinoza, Akshay Kotak, Li Lin, Joao and Carlos Madeira, Nuwat Nookhwun, Udara Peiris, Alexandros Vardoulakis and Ji Yan for their helpful comments and suggestions. We are grateful for the discussions at the *SAET conference* (2011), at Ancao, Faro, Portugal; the *Macro Prudential Seminar Series* at the Bank of England (2011); *The VI Seminar on Risk, Financial Stability and Banking* of the Banco Central do Brasil (2011); the *Meeting of the Chilean Economists Society* at Vina del Mar, Chile, (2011); the *ASSA annual meeting* at Chicago, US, (2012); the *Annual Meeting of the Society for Economic Dynamics* at Limassol, Cyprus, (2012); LACEA at Sao Paulo, Brazil, (2014); and the SIIP at the Central Bank of Chile, (2014). However, all remaining errors are ours.

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