SEARCH-BASED ENDOGENOUS ASSET LIQUIDITY AND THE MACROECONOMY

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Abstract
We develop a search-theory of asset liquidity which gives rise to endogenous financing constraints on investment in an otherwise standard dynamic general equilibrium model. Asset liquidity describes the ease of issuance and resaleability of private financial claims, which is the outcome of a costly search-and-matching process for such claims implemented by financial intermediaries. Limited liquidity of private claims creates a role for liquid assets, such as government bonds, to ease financing constraints. We show that endogenising liquidity is essential to generate positive co-movement between asset liquidity and asset prices. When the cost of intermediating funds to entrepreneurs rises, investment and output fall while the hedging value of liquid assets increases, driving up liquidity premia. In the U.S., such intermediation cost shocks can account for at least 37% of the variation in output, and more than 78% of the variation in liquidity premia. (JEL: E22; E44; G11)

The editor in charge of this paper was Dirk Krueger.

Acknowledgments: We thank the editor and four anonymous referees for their inputs that significantly improve the paper. We also benefited from discussions with Andrew Atkeson, Marco Bassetto, Tobias Broer, Mariacristina De Nardi, Frank Heinemann, Patrick Kehoe, Nobuhiro Kiyotaki, Ricardo Lagos, Iourii Manovskii, Guido Menzio, Guillermo Ordonez, Nicola Pavoni, Facundo Piguillem, Fabien Postel-Vinay, Morten Ravn, Victor Rios-Rull, Thomas Sargent, Robert Shimer, Shouyong Shi, Ted Temzelides, Pierre-Olivier Weill, Randall Wright, and Fabrizio Zilibotti, together with seminar participants at various institutions and conferences. We thank DIW Berlin and the Centre for Macroeconomics for providing financial support, and Jihyun Bae and Carlo Galli for excellent research assistance. This paper was written in Sören Radde's individual capacity and is not related to his role at Goldman Sachs. The analysis, content and conclusions set forth in this paper are those of the authors alone and not of Goldman Sachs & Co. or any of its affiliate companies. The authors alone are responsible for the content and all remaining errors.

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