SEARCH-BASED ENDOGENOUS ASSET LIQUIDITY AND THE MACROECONOMY

Wei Cui  
University College London  

Sören Radde  
Goldman Sachs & Co.

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)

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E-mail: w.cui@ucl.ac.uk (Cui); soeren.radde@gmail.com (Radde)

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