Asset Prices and Business Cycles with Liquidity Shocks

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November 5, 2021

Abstract

We develop a production based asset pricing model with financially constrained firms to explain the observed high equity premium and low risk-free rate volatility. Investment opportunities are scarce and firms face productivity and liquidity shocks. A negative liquidity shock forces firms to liquidate a fraction of their assets. We calibrate the model to U.S. data and find that it generates an equity premium and a level and volatility of risk-free rate comparable to those observed in the data. The model also fits key aspects of the behavior of aggregate quantities, in particular, the volatility of aggregate consumption and investment.

JEL Codes: E20, E32, G12

Keywords: General Equilibrium, Business Cycles, Production Based Asset Pricing, Equity Premium and Risk-Free Rate Puzzles

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