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New Shocks under Financial Frictions

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Christoph Görtz[1,3], John D. Tsoukalas[4] and Francesco Zanetti[2,5]

[1]CAMA (ANU), [2]Centre For Macroeconomics, [3]University of Birmingham, [4]University of Glasgow, [5]University of Oxford

We examine the dynamic effects and empirical role of TFP news shocks in the con-text of frictions in financial markets. We document two new facts using VAR methods. First, a (positive) shock to future TFP generates a significant decline in various credit spread indicators considered in the macro-finance literature. The decline in the credit spread indicators is associated with a robust improvement in credit supply indicators, along with a broad based expansion in economic activity. Second, VAR methods also establish a tight link between TFP news shocks and shocks that explain the majority of un-forecastable movements in credit spread indicators. These two facts provide robust evidence on the importance of movements in credit spreads for the propagation of news shocks. A DSGE model enriched with a financial sector generates very similar quantitative dynamics and shows that strong linkages between leveraged equity and ex-cess premiums, which vary inversely with balance sheet conditions, are critical for the amplification of TFP news shocks. The consistent assessment from both methodologies provides support for the traditional news view' of aggregate fluctuations.