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# Liquidity Shocks, Business Cycles and Asset Prices \*

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## Abstract

In the aftermath of the Great Recession, macro models that feature financing constraints have attracted increasing attention. Among these, [Kiyotaki and Moore \(2012\)](#) is a prominent example. In this paper, we investigate whether the liquidity shocks and financial frictions proposed by [Kiyotaki and Moore \(2012\)](#) can improve the asset pricing predictions of the frictionless RBC model. We study the quantitative business cycle and asset pricing properties in an economy in which agents feature recursive preferences, are subject to a liquidity constraint, and suffer liquidity shocks. We find that the model predicts highly nonlinear time variation and levels of risk premia, which are driven by endogenous fluctuations in equity prices. However, the model fails to account for a basic fact: Periods of scarce liquidity are associated with high asset prices and low expected returns.

**JEL classification:** E22, E32, E44, G12

**Keywords:** Business Cycles, Investment, Asset Prices, Liquidity.

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