



On the stock market liquidity and the business cycle: A multi country approach



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ABSTRACT

We provide original results on national and global stock market liquidity and its interaction with macroeconomic variables for six of the G7 economies, namely: Canada, France, Germany, Italy, Japan and UK, building on the methodology and on the US evidence by Naes et al. (2011). Using a number of additional tests, we find that different markets do not behave in a uniform manner. National liquidity has diminished ability in Granger causing macroeconomic variables for our sample countries, and in additional tests the same holds for an extended US sample, contrary to Naes et al. As regards global liquidity there is a two-way causality with macroeconomic indicators for the six nations in our sample while for the US there is no causality in either direction. We also show that there is no superior information in small firm liquidity in Granger causing macroeconomic variables even for the US in contrast to the sample period employed by Naes et al. implying an unstable relationship over time for the US.

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1. Introduction

Liquidity is linked to the state of the economy (Eisfeldt, 2004) and problems in financial markets can spread to the real economy. Naes, Skjeltorp, and Odegaard (2011) (henceforth NSO), show that at least since WWII, US market liquidity contains information about the real economy. However, Bernanke (2010) states that the understanding of this relationship is an incomplete chore for researchers, while NSO highlight the importance of looking at a larger cross-section of stock markets. We offer original evidence for six different countries namely: Canada, France, Germany, Italy, Japan and the UK. We are further motivated by the fact that this issue is ever more important following the recent financial crisis (Mclean & Zhao, 2014), thus we start below by verifying the relationship of liquidity and recessions for the above named markets in Fig. 1.

Fig. 1, exhibits time series for illiquidity (Roll's effective spread and the Amihud ratio²) in relation to periods where there is negative GDP growth

for two consecutive quarters. The figure shows that although there exists a relationship between liquidity and the business cycle for these markets as in NSO, it is only in Canada that liquidity variables consistently predict the onset of a recession, while for the rest of the economies this relationship is not to a single direction. For example, the national Amihud ratio (NAM henceforth) behaves as expected with regard to a recession except for Japan and Germany, where it exhibits the opposite and mixed behaviour respectively. The national Roll effective spread estimator (NRO henceforth) is not as consistent as it moves to different directions before different recessions for all countries in the sample except again for Canada.³

³ In Canada NRO and NAM increase before recessions consistent with NSO and with the existence of a relationship of market liquidity and the business cycle. In France NAM behaves as in NSO but NRO however offers less clear evidence. In Germany, NAM decreases (increases) before a recession and increases (decreases) during the recession of Q4 2002–Q2 2003 (Q2 08–Q1 09). NRO also behave inconsistently by increasing and decreasing respectively before the two aforementioned recessions. In the most recent recession Q4 12–Q1 13 NRO declines while NAM remains stable. In Italy, sometimes NRO behaves the same as NSO and sometimes it is inconsistent, while NAM is not behaving consistently. In the most recent recession Q3 11–Q4 13 both measures increase and decrease quite erratically. In Japan both measures exhibit consistent behaviour and decrease (increase) just before (during) recessions. Up to Q2 12, market liquidity variables have a contemporaneous relationship with the real economy rather than a leading one as NSO suggest. In the most recent recession though Q2 12–Q4 12, both variables increase. In the UK, NRO behaviour is inconsistent with NSO, while NAM increases before the recession, to reduce on the onset, and then repeats the same behaviour sequence.

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² Both capture illiquidity and are clearly explained in the next section. Note for now that we also split each of the two measures to 'national' relating only to the liquidity of the nation's firms and 'global' where liquidity is made up of international firms only, also explained analytically in the relevant section. The global factor is value weighted.

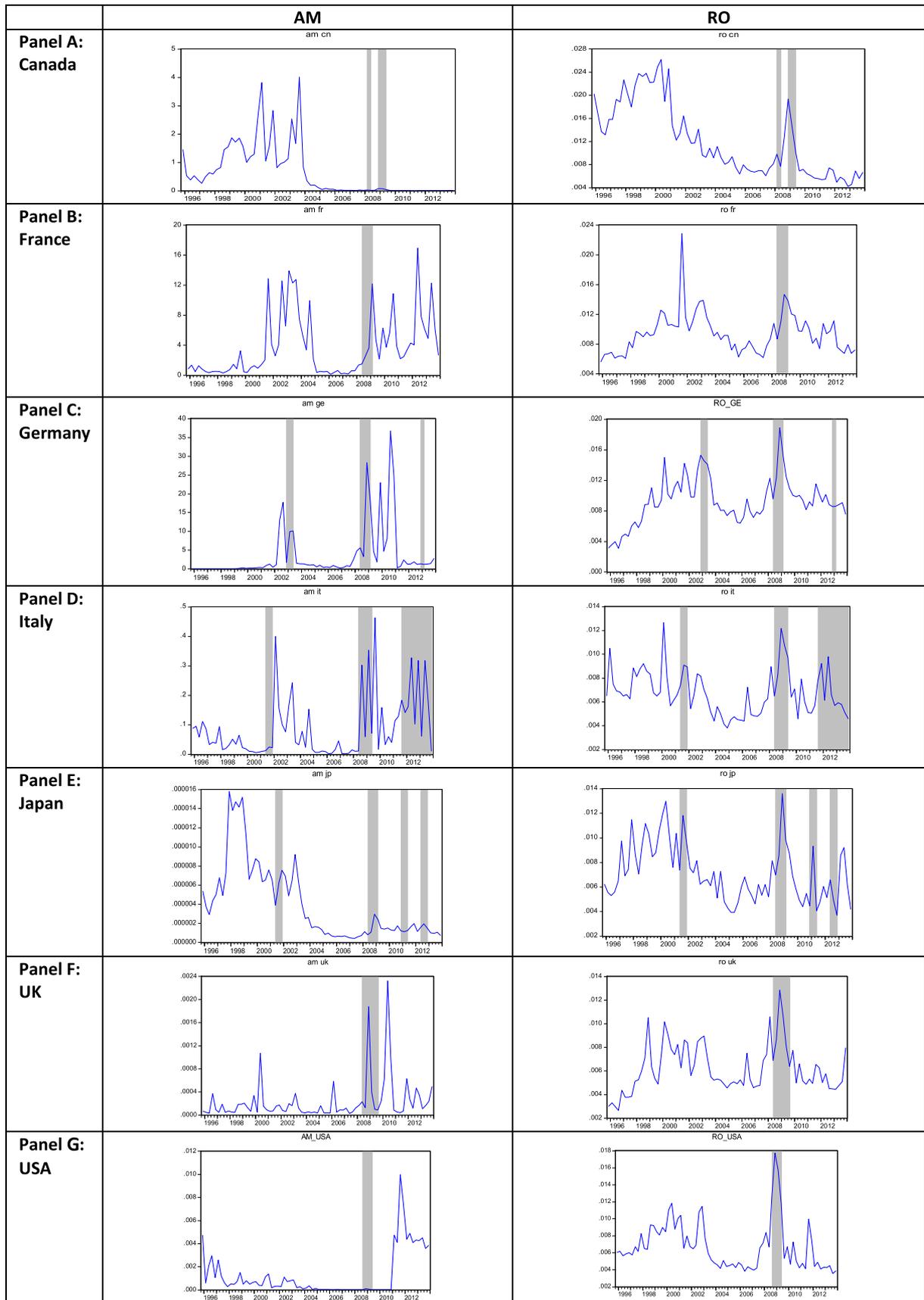


Fig. 1. Liquidity and the business cycle. The figure shows time series plots of the Amihud ratio (AM) and the effective Roll estimator (RO) for all countries in our sample. The grey lines are recession periods. A recession period is identified as a period for which there is negative GDP growth for two consecutive terms. Sample range Q4 1995–Q4 2013, 73 quarterly observations.

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