



Financial factors and the real economy

Introduction to policy discussion

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Effects of financial shocks on real economy

- Two papers studying the effects of financial shocks on the real economy.
- Both based on VAR models, one Bayesian VAR with sign restrictions, and one with Markov Switching and Cholesky decomposition.
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- Both papers suggest that financial shocks are important.
- Results rest on identification of shocks, standard is to use economic theory or intuition to give names to shocks (and to be able to interpret the shocks).
- What are these shocks affecting financial markets?

Shocks to financial markets

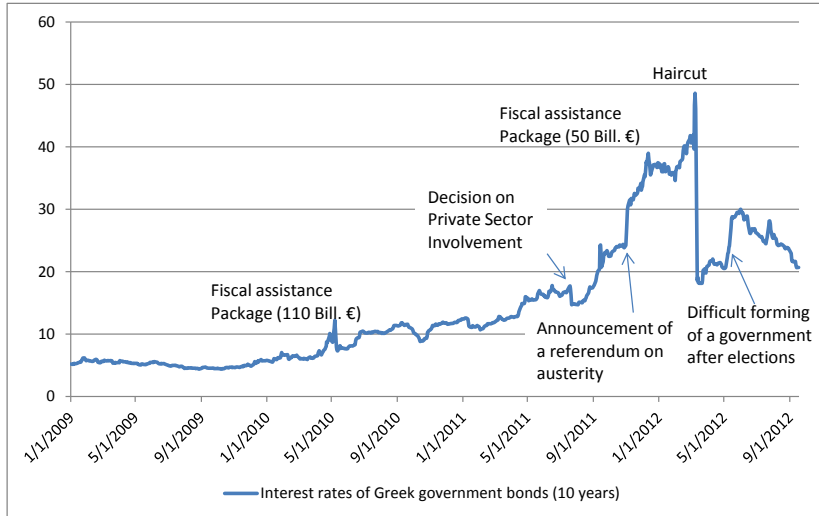
- We may distinguish between two different sources of shocks
 - Economic news (news on macroeconomic variables), and
 - political news (political decisions on budget consolidations, monetary policy decisions).
- General consensus that news announcements (unexpected component of these) can have substantial effects on pricing of financial assets. Microstructure of exchange rates: Evans and Lyons (2008).
- Empirical results suggest that news on policy actions also affect financial markets. Beetsma, Giuliodori, de Jong and Widijanto (2013): news announcements on Greek economy.

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- Asymmetric response to bad and good news, overreaction to bad news and underreaction to good news.

Example: Effects of political news

Figure 1: Greek government bonds interest rate 2009-2012.



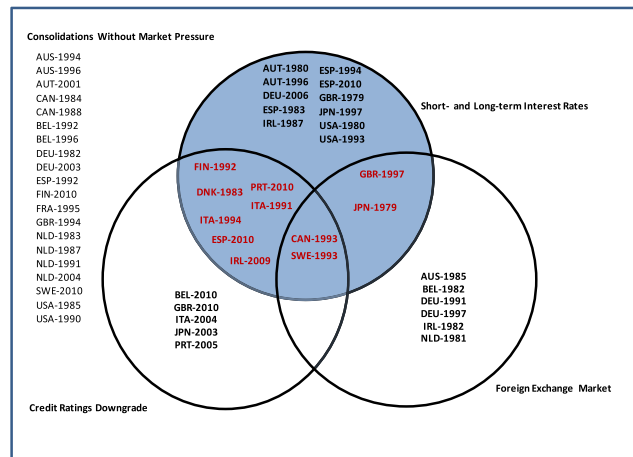
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- Periods of market pressure forces policymakers to react, an example is the implementation of budget consolidations.
- 41% of budget consolidations preceded by pressure on short- and long-term interest rates and 62% by some kind of market pressure.

Figure 2: Multiyear Fiscal Consolidation Episodes and Market Pressure 1/. 1/Each circle contains the episodes of multiyear fiscal consolidation that are preceded by market pressure. Consolidations in red font flag episodes that satisfy at least two market pressure indicators.



Sources: Dell' Erba, Mattina and Roitman (2015).

Lessons

- Important to study the effects of financial shocks on real economy.
- Also consider sources of shocks to financial markets. Improved identification and measurements.
- Linkages between financial markets and policymakers important.