The Time-Varying Volatility of Financial Shocks in Macroeconomic Fluctuations

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In order to investigate sources of the Great Recession (Dec. 2007 to Jun. 2009) of the US economy in the latter portion of the first decade of the 2000s, we modified the standard New Keynesian dynamic stochastic general equilibrium (DSGE) model by embedding financial frictions in both the banking and the corporate sectors. Furthermore, the structural shocks in the model are assumed to possess stochastic volatility (SV) with a leverage effect. Then, we estimated the model using a data-rich estimation method and utilized up to 40 macroeconomic time series in the estimation. In light of a DSGE model, we suggest the following three empirical evidences in the Great Recession: (1) the negative bank net-worth shock gradually spread before the corporate net worth shock burst ; (2) the data-rich approach and the structural shocks with SV found the contribution of the corporate net worth shock to a substantial portion of the macroeconomic fluctuations after the Great Recession, which is unlike the standard DSGE model; and (3) the Troubled Asset Relief Program (TARP) would work to bail out financial institutions, whereas balance sheets in the corporate sector would still not have stopped deteriorating.