

This research project is about understanding how banks and financial institutions affect the economy. Macroeconomists use multiple complicated theories to describe the financial sector and it is often hard to see whether these theories share common features and predictions. This is problematic for policymakers who have to quickly react to macroeconomic developments. Which theory or model should their trust? In this project we show that all these theories are more similar than it seems. Their details do not matter for conclusions about the effects of some policies. What matters instead is how changes in prices of assets affect supply and demand in financial markets. This can be measured in the data and we attempt to do it in this project.

Information about demand and supply can be used to formulate optimal asset market policies. To evaluate whether a considered policy would improve economic conditions, the policymaker can verify whether it would move interest rates and prices of assets in a way that brings it closer to an optimal financial index that we derive in this project. We show that it is possible to construct such an index by using information about supply and demand in financial markets as well as data on returns on various assets.

Finally, we contribute to the discussion about the relative role of risk and liquidity in macroeconomics. Instead of looking at assets as they are, we treat them as bundles of two valued attributes: safety and liquidity. For example, cash is relatively safe, but risky in an inflationary environment. We measure which one of these two attributes is more important and how they are related. This matters for policymakers: they can usually increase the amount of liquidity in the economy, but it is harder for them to increase the amount of safety.