

Madrid, 10. June 2009

Germán Bernácer Prize 2008

Acceptance Speech

Markus K. Brunnermeier

Thank you, *{name of presenter/previous speaker}*.

Miguel Angel Fernández Ordóñez

José Manuel González Páramo

Guillermo de la Dehesa

It is a great privilege to be awarded this prestigious prize and I thank the committee, the sponsors, and all the other contributors and organizers of this event for bestowing it on me. I also wish to thank the Observatorio del Banco Central Europeo, as well as the Banco de España for their generous hospitality and warm reception.

I am deeply honored to receive a prize that bears the name of Germán Bernácer. Reading up on his life and work, I was impressed with the visionary nature of his writings and its potential to impact today's research agenda. To understand the links between one's own work and Germán Bernácer's makes one humble and proud at the same time. One must be humble if one realizes how farsighted Bernácer was, in that many of his ideas are still of utmost importance, decades after his expressing them. To be associated with him by the decision of a jury of such distinction, on the other hand, is a tremendous honor that fills me with deep gratitude.

Let me go into some more detail with respect to the links between Bernácer's work and my own research agenda, and why I think his ideas and approach are very much up-to-date with current policy concerns.

One of Bernácer's primary achievements is his acknowledgement of the importance of the interplay between finance and macroeconomics in understanding business cycles. My own research agenda is, very similarly, associated with both fields and their interaction. Surprisingly, until two years ago, the importance of the relation between finance and macroeconomics was much less clear to many academic economists than it is today, with the 'benefit' of the observation of the 2007 financial crisis' impact on the world economy. Yet, as early as 1926, Bernácer had already declared that:

“During the downswing, unanticipated falling prices bring about losses, which contribute (together with the constraint represented by a reduction of disposable funds discussed above) to a contraction in production and employment”.

Similarly, in my own research agenda, I am concerned with the impact of frictions that come in the form of liquidity constraints, on the real economy, via a leveraged financial sector. Losses in the financial sector are amplified and interact with falling asset prices in a vicious circle. These liquidity spirals arise since financial intermediaries are not only levered but also exposed to a maturity mismatch, i.e. they rely on short-term funding of long-term assets with low market liquidity. Without taking these liquidity frictions into accounts, the financial sector is quite meaningless for economic activity, and asset prices are merely determined by the households' consumption. However, as we are painfully experiencing now, the financial sector does have quite an impact on real economic activity. As a consequence, frictions such as liquidity constraints need to be taken into account to give the financial sector the role in economic theory that it already has in practice.

Furthermore, one has to be watchful of buildups of excessive credit growth. Credit bubbles can emerge when financial institutions find it to be more profitable to ride a bubble as long as the “music is playing” rather than to lean against it. My research shows that this can occur in situations when market participants don't know when other investors will act against an emerging bubble and will thus choose to ride it even though they know that the price exceeds the asset's fundamental value. Moreover, externalities

that are not internalized by individual financial institutions can lead to herd-like behavior that can potentially obstruct any corrective efforts.

The future financial architecture and monetary policy have to take these effects into account by creating incentives for firms to internalize externalities and spillover effects. It is important to recognize early a potential build-up of problems manifested through bubbles. Credit bubbles deserve particular attention, since their bursting impairs the financial system and with it the monetary transmission mechanism – the channel through which monetary policy is implemented.

So where was economic research going awry?

In my view, the main reason for the failure of the last few decades of macroeconomic research to explain these connections is the widespread usage of representative agent models. Absent financial frictions, Euler equations determine asset prices. In plain English, households' aggregate consumption patterns determine asset price fluctuations. In such a simplified scenario, there is no mechanism via which the financial sector frictions affect the real economy. In short, the financial sector is just a veil. In my past research, I have argued that representative agent models are incomplete and can only serve as a benchmark. It is imperative that we incorporate liquidity shortages into our models to explain real-world behavior.

Despite the efforts of many colleagues at Princeton and elsewhere, the impact of percussions in the financial markets on real economic activity is still not very well understood. I am all the more impressed to read how Bernácer devoted his attention to the interdependency of asset prices, frictions represented by an early version of a 'cash-in-advance' constraint, and the behavior of the real economy, as early as he did.

The "liquidity constraints" he considered in his writings are not the only element of his research that is as important today as it was then. He also acknowledged the limited effectiveness of short-term interest rate policy to steer the economy, which is a concern that is revived today in light of interest rates being close to zero.

Finally, I also would like to use this opportunity to thank the many people who have helped shape my views. First and foremost, I would like to acknowledge my wife Smita who has supported my academic work for 16 years, and whose honest and constructive critique helps keep me focused on important questions. Thanks also to Dilip Abreu, my coauthor on my bubbles and crashes research, who had a profound impact on my thinking during the early stages of my career. Many thanks also to all my other co-authors, specially Jonathan Parker, Lasse Pedersen, Stefan Nagel, Patrick Bolton, and Christian Julliard. Finally, I would be remiss if I did not thank my Ph.D. advisor, Margaret Bray, my many teachers and students, who sparked my interest in economics over the years.

In sum, I am deeply honored that my research is being recognized with the Bernácer prize. This is especially so, since there is a large overlap between his research interests and mine. It is quite an accomplishment that his research has survived almost 100 years of scrutiny. That is a high goal to set, but it would make me a very happy man if my research has the same level of endurance. In the meanwhile, I will derive great satisfaction from having my name linked to his.

Thank you.