

[« Previous post](#) | [Free exchange home](#)

August

17:41 GMT +00:00

6th

## Lucas roundtable: Mind the frictions

Posted by: The Economist | LONDON

Categories: Lucas roundtable

*Markus Brunnermeier is Edward S. Sanford Professor of Economics at Princeton University. He works on macroeconomics and finance. This discussion can be followed in its entirety [here](#).*

BOB LUCAS rightly points out that a branch of macroeconomics proved very useful in weathering the recent crisis. Research by Ben Bernanke and Mark Gertler, Nobu Kiyotaki and John Moore, Rick Mishkin and other macroeconomists provided helpful policy guidance, exactly because their models emphasise the importance of financial frictions for the macroeconomy. However, the bulk of macroeconomic research simply assumes financial frictions away. The financial system and its institutional details were often seen as a distraction from the main drivers of the economic activity. In these models the failure of a large financial institution, like Lehman, would be of no real consequence. But I think we can all agree—if we learnt one thing from the current financial turmoil it is that financial frictions and financial institutions are of essential importance for the macroeconomy.



In my view these frictions are also the root cause for the failure of the efficient market hypothesis (EMH). For example, bubbles can emerge and persist due to limits to arbitrage. Of course, as Bob Lucas points out, when it is commonly known among all investors that a bubble will burst next week, then they will prick it already today. However, in practice each individual investor does not know when other investors will start trading against the bubble. This uncertainty makes each individual investors nervous about whether he can be out of (or short) the market sufficiently long until the bubble finally bursts. Consequently, each investor is reluctant to lean against the wind. Indeed, investors may in fact prefer to ride a bubble for a long time such that price corrections only occur after a long delay, and often abruptly. Empirical research on stock price predictability supports this view. Furthermore, since funding frictions limit arbitrage activity, the fact that you can't make money does not imply that the "price is right".

This way of thinking suggests a radically different approach for the future financial architecture. Central banks and financial regulators have to be vigilant and look out for bubbles, and should help investors to synchronise their effort to lean against asset price bubbles. As the current episode has shown, it is not sufficient to clean up after the bubble bursts, but essential to lean against the formation of the bubble in the first place.

This calls on us economists to further develop our tools (including mathematical tools) to integrate the insights financial economists have developed on frictions and the formation of bubbles into the fully fledged dynamic stochastic general equilibrium macro and monetary models that macroeconomists have been working with. Bringing financial economists, macro- and monetary economists together to take on this challenge of building a new workhorse model that incorporates financial frictions would be a great first step in this important (and exciting) endeavor.

[+ Share](#)
[Permalink](#)