THE DEUTSCHE BANK PRIZE IN FINANCIAL ECONOMICS

2009

Robert J. Shiller

The Deutsche Bank Prize in Financial Economics 2009 is awarded to the U.S. economist Robert J. Shiller. The Jury has chosen Professor Shiller for his pioneering research in the field of financial economics, relating to the dynamics of asset prices, such as fixed income, equities, and real estate, and their metrics. His work has been influential in the development of the theory as well as its implications for practice and policy-making. His contributions on risk sharing, financial market volatility, bubbles and crises, have received widespread attention among academics, practitioners and policy makers alike.

The award will be presented to Robert Shiller by Josef Ackermann (Chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG) in a ceremony to be held in Frankfurt on 30 September 2009.

Prior to the award ceremony, the international academic symposium “Financial Innovation and Economic Crisis”, a scientific discussion on themes highlighted in Shiller's work, will take place at Campus Westend. We are delighted to announce that Robert C. Merton, the John and Natty McArthur University Professor at Harvard Business School and Nobel Laureate in Economics, has already confirmed his participation as plenary speaker in this event.

Josef Ackermann

“There could probably not be a more appropriate time to honor Professor Robert J. Shiller with the Deutsche Bank Prize in Financial Economics for his outstanding research work on the volatility of asset prices and the related macroeconomic risks. Professor Shiller has not only developed financial instruments and databases to gauge the extent of over-exuberance on capital and property markets. He has also used these instruments to give timely warnings on the risks of such over-exuberance. However, his research has not been confined to problem analysis; he has also published numerous studies aimed at solving the problems. For this reason, his research findings have spread far beyond the academic community and are relevant for policymakers and financial market players alike.”

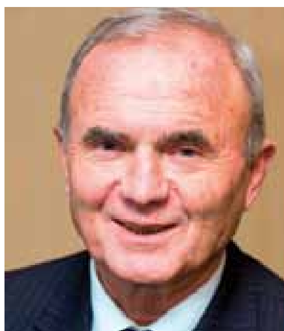
→ CFS Symposium “Financial Innovation and Economic Crisis”
Date: 30 September 2009 12:00 – 17:00
Venue: Campus Westend, Goethe University, new lecture hall (Hörsaal 2)
Please register for this event online on www.db-prize-financialeconomics.org.
-- The number of participants is limited --

 Email: db-prize@ifk-cfs.de • www.db-prize-financialeconomics.org

Jury members

A Jury of international financial experts decides on the recipient of the Deutsche Bank Prize in Financial Economics. The members of this year's Jury are: **Michael Binder** (Goethe University and CFS), **Otmar Issing** (CFS President), **Takatoshi Ito** (University of Tokyo), **Jan Pieter Krahnen** (Goethe University and CFS), **Reinhard H. Schmidt** (Goethe University), **Klaus Schmidt-Hebbel** (OECD), **Marti Subrahmanyam** (Stern School, New York University), **Maria Vassalou** (SAC Capital Advisors LLC and EFA), **Norbert Walter** (Deutsche Bank Group), and **Volker Wieland** (Goethe University and CFS). Chairman of the Jury is CFS Director Jan Pieter Krahnen. *More than 3600 university teachers and researchers from more than 55 countries had the opportunity to submit a suggestion for the nomination. At this occasion, the Jury would like to thank the nominators for their immense support during the nomination procedure.*

Statements by the Jury members



Otmar Issing

"There is one name that has been at the centre of the debate around the identification of "bubbles" in asset prices: Professor Robert Shiller. His warnings against excessive share and real estate prices are based on pioneering studies which have brought significant theoretical and empirical impulses to economic research. The combination of his top-class academic research and his contributions to objectifying the public debate make him the ideal candidate to receive the Deutsche Bank Prize in Financial Economics 2009."

Jan Pieter Krahnen

"Through his innovative work exploring the dynamics of asset prices, Robert Shiller has become a pioneer in the field of financial economics. His findings on the volatility of share prices, the occurrence of price bubbles and resultant crises, as well as on the distribution of macroeconomic risks are not only of great academic importance, they have also broken new ground in economic practice."

Takatoshi Ito

"Professor Shiller is a very versatile scholar. He first became well-known among macro-finance professors because of his excellent work on asset price volatility and on an asset price bubble (sustained deviation of a market price from fundamental value).Then, he has started to write more policy relevant articles and books, warning about tech bubble and housing bubble. He also transformed his research on housing prices into a commercial venture to calculate and publish a housing price index. Now, the Case-Shiller index is a standard, reliable housing price index everyone uses, and there is securities trading based on this index. Housing prices are notorious in non-comparability due to each housing unit being unique in its location, floor space, years since built, and other characteristics. The Case-Shiller index is calculated using repeated sales units so that many of the characteristics can be regarded the same. His ability to transform research from basic to policy-relevant, and from basic to commercially useful should be highly regarded, and the award is timely and well-deserved."

Klaus Schmidt-Hebbel

"The Deutsche Bank Prize is awarded to an outstanding economist who has made path-breaking contributions to theory, empirics and /or policy in the fields of finance, money or macroeconomics. Nobody fulfills these conditions better than Robert Shiller. His analytical and empirical work on asset price dynamics, equity price volatility, asset and housing price bubbles, financial crises, and risk diversification has extended significantly the frontier of financial economics. His prescient work and warnings on the development of the 1990s-early 2000s stock market boom and bust and the 2000s housing and stock market bubble that led to the ongoing global financial crisis and recession are proof of Shiller's rare combination of analytical strength and empirical insightfulness. There is no better recipient of the 2009 Deutsche Bank Prize in Financial Economics than Professor Shiller."

Marti Subrahmanyam

"Professor Robert Shiller is one of the world's foremost researchers on financial markets and has been working in the intersection of macroeconomics and financial markets for almost four decades. His work spans a broad spectrum of issues that are both academically challenging and practically relevant. Noteworthy examples of his extensive research on the limits of market efficiency include his papers on "excess volatility", predictability of asset returns, behavioral macroeconomics, and real estate economics. His work on pricing metrics, particularly in the area of real estate, has had a major impact on practice and policy making. Given the breadth of his research, Professor Shiller is uniquely qualified to address the important issues relating to the current global financial crisis."

Maria Vassalou

"Shiller's important work on the excess volatility puzzle has far-reaching implications for economic models of price fluctuations. His contribution has greatly shaped the evolution of both academic and practitioners' thinking on the pricing of assets in speculative markets."

ROBERT J. SHILLER – THE PRIZEWINNER 2009

Robert Shiller is the Arthur M. Okun Professor of Economics at the Cowles Foundation for Research in Economics, Yale University, and Professor of Finance at the International Center for Finance, Yale School of Management. He received his Ph.D. in Economics from the Massachusetts Institute of Technology (MIT) in 1972. Robert Shiller has been a Research Associate at the National Bureau of Economic Research since 1980. In 2005, he also served as Vice President of the American Economic Association. He regularly writes the column "Economic View" for the New York Times. In 1996, he received the Paul A. Samuelson award for his book Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks.

By combining theoretical and empirical analysis on the volatility of asset prices, in particular stocks, bonds and real estate, Robert Shiller has made a decisive contribution to the understanding of price fluctuations in these markets. His research has led to the development of financial instruments to hedge against macroeconomic risks. Amongst other things, Robert Shiller has been jointly responsible for developing the Standard & Poor's/Case-Shiller Home Price Index for the most important metropolitan regions in the U.S., which is widely used in academic research and investment management. He is also the co-founder and Chief Economist of MacroMarkets LLC, which designs innovative financing instruments in order to complete financial markets.

Based on his analyses Robert Shiller has been very influential for the tone of research in this field and delivers valuable insights for the world of practice. He predicted the peak of the new-economy euphoria and the collapse of the market and published the best-selling book Irrational Exuberance in the year 2000. In 2005, he was one of the first to identify a real estate bubble in the U.S., and predicted that it would burst and trigger a financial crisis. In his new book Animal Spirits, co-written with Nobel Prize winner George Akerlof, Robert Shiller makes the case for a more active state role in financial markets owing to the existence of the "human factor".

Selected Books

Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism, Princeton University Press, March 2009, with George Akerlof, translated into 7 languages.

Subprime Solution: How Today's Global Financial Crisis Happened and What to Do about It, Princeton University Press, September 2008, translated into 6 languages.

The New Financial Order: Risk in the 21st Century, Princeton University Press, April 2003, translated into 7 languages

Irrational Exuberance, Princeton University Press, 2000 & 2005 Republished, Broadway Books, April 2001, translated into 15 languages, winner of the Commonfund Prize.

Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks, Oxford University Press, 1993, winner of the Paul A. Samuelson Award from TIAA-CREF.

Market Volatility, MIT Press, Cambridge MA, 1989.

THE AWARD WINNERS IN 2005 AND 2007

The Deutsche Bank Prize in Financial Economics is awarded biannually and carries an endowment of □ 50,000 which is donated by the Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft. The award honors internationally renowned economic researchers whose work has significantly influenced research in financial economics and macroeconomics, and has led to fundamental advances in economic theory and practice.

The prize was awarded for the first time in 2005 to Eugene F. Fama, Professor of Finance at the University of Chicago, for developing and researching the concept of market efficiency. An international scientific symposium on "Market Efficiency Today" was organized on the occasion of the award ceremony.

In 2007, Michael Woodford, Professor of Political Economy at Columbia University in New York, received the prize in recognition of his fundamental contributions to the theory and practical analysis of monetary policy. The academic CFS Symposium "The Theory and Practice of Monetary Policy Today", held in honor of Professor Woodford's work, took place prior to the presentation of the award.

Sabine Neumann and Daniela Dimitrova (CFS)

Professor Shiller wrote the following article as guest writer for the Financial Times

A failure to control the animal spirits

By Robert Shiller

Published: Financial Times – 9 March 2009

Lydia Lopokova, wife of the economist John Maynard Keynes, was a famous ballerina. She was also a Russian émigré. Thus Keynes knew from the experience of his in-laws the horrors of living in the worst of socialist economies. But he also knew first-hand the great difficulties that come from unregulated, unfettered capitalism. He lived through the British depression of the 1920s and 1930s. Thus Keynes was inspired to find a middle way for modern economies.

We are seeing, in this financial crisis, a rebirth of Keynesian economics. We are talking again of his 1936 book The General Theory of Employment, Interest and Money, which was written during the Great Depression. This era, like the present, saw many calls to end capitalism as we know it. The 1930s have been called the heyday of communism in western countries. Keynes's middle way would avoid the unemployment and the panics and manias of capitalism. But it would also avoid the economic and political controls of communism. The General Theory became the most important economics book of the 20th century because of its sensible balanced message.

In times of high unemployment, creditworthy governments should expand demand by deficit spending. Then, in times of low unemployment, governments should pay down the resultant debt. With that seemingly minor change in procedures, a capitalist system can be stable. There is no need for radical surgery on capitalism.

Adherents to Keynes's message were so eager to get this simple policy implemented, on both sides of the Atlantic, that they failed to notice – or perhaps they intentionally disregarded – that the General Theory also had a deeper, more fundamental message about how capitalism worked, if only briefly spelled out. It explained why capitalist economies, left to their own devices, without the balancing of governments, were essentially unstable. And it explained why, for capitalist economies to work well, the government should serve as a counterbalance.

The key to this insight was the role Keynes gave to people's psychological motivations. These are usually ignored by macroeconomists. Keynes called them animal spirits, and he thought they were especially important in determining people's willingness to take risks. Businessmen's calculations, he said, were precarious: "Our basis of knowledge for estimating the yield 10 years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing." Despite this, people somehow make decisions and act. This "can only be taken as a result of animal spirits". There is "a spontaneous urge to action".

There are times when people are especially adventuresome – indeed, too much so. Their adventures are supported in these times by a blithe faith in the future, and trust in economic institutions. These are the upswing of the business cycle. But then the animal spirits also veer in the other direction, and then people are too wary.

George Akerlof and I, in our book Animal Spirits (Princeton 2009), expand on Keynes's concept and tie it in to modern literature on behavioural economics and psychology. Much more clarity about the psychological underpinnings of animal spirits is possible today.

For example, social psychologists, notably Roger Schank and Robert Abelson, have shown how much stories and storytelling, especially human-interest stories, motivate much of human behaviour. These stories can count for much more than abstract calculation. People's economic moods are largely based on the stories that people tell themselves and tell each other that are related to the economy.

We have seen these stories come and go in rapid succession in recent years. We first had the dotcom bubble and the envy-producing stories of young millionaires. It burst in 2000, but was soon replaced with another bubble, involving smart "flippers" of properties.

This mania was the product not only of a story about people but also a story about how the economy worked. It was part of a story that all investments in securitised mortgages were safe because those smart people were buying them. Those enviable people who are buying these assets must be checking on them, therefore we do not need to. We need only run alongside them.

What allowed this mania and these stories to persist as long as they did? To a remarkable extent we have got into the current economic and financial crisis because of a wrong economic theory – an economic theory that itself denied the role of the animal spirits in getting us into manias and panics.

According to the standard "classical" theory, which goes back to Adam Smith with his Wealth of Nations in 1776, the economy is essentially stable. If people rationally pursue their own economic interests in free markets they will exhaust all mutually beneficial opportunities to produce goods and exchange with one another. Such exhaustion of opportunities for mutually beneficial trade results in full employment. By this theory it could not be otherwise.

Of course, some workers will be unemployed. But they will be unable to find work only because they are in a temporary search for a job or because they insist on pay that is unreasonably high. Such unemployment is viewed as voluntary, and evokes no sympathy.

Classical theory also tells us that financial markets will also be stable. People will only make trades that they consider to benefit themselves. When entering financial markets – buying stocks or bonds or taking out a mortgage or even very complex securities – they will do due diligence in seeing that what they are buying is worth what they are paying, or what they are selling.

What this theory neglects is that there are times when people are too trusting. And it also fails to take into account that if it can do so profitably, capitalism will produce not only what people really want, but also what they think they want. It can produce the medicine people want to cure their ills. That is what people really want. But if it can do so profitably, it will also produce what people mistakenly want.

It will produce snake oil. Not only that: it may also produce the want for the snake oil itself. That is a downside to capitalism. Standard economic theory failed to take into account that buyers and sellers of assets might not be taking due diligence, and the marketplace was not selling them insurance against risk in the complex securities that they were buying, but was, instead, selling them the financial equivalent of snake oil.

There is a broader moral to all this – about the nature of capitalism. On the one hand, we want to take advantage of the wisdom of Adam Smith. For the most part, the products produced by capitalism are what we really want, produced at a price that we are willing and able to pay. On the other hand, when confidence is high, and since financial assets are hard to evaluate by those who are buying them, people will and do buy snake oil. And when that is discovered, as it invariably must be, the confidence disappears and the economy goes sour.

It is the role of the government at two levels to see that these events do not occur. First, it has a duty to regulate asset markets so that people are not falsely lured into buying snake-oil assets. Such standards for our financial assets make as much common sense as the standards for the food we eat, or the purchase medicine we get from the pharmacy. But we do not want to throw out the good parts of capitalism with the bad. To take advantage of the good parts of capitalism, when fluctuations occur it is the role of the government to see that those who can and want to produce what others want to buy can do so. It is the role of the government, through its counterbalancing fiscal and monetary policy, to maintain full employment.

The principles behind such an economy are not the principles behind a socialist economy. The government insofar as possible is only creating the macroeconomic conditions that will allow the economy to function well.

That is the role of government. Its role is to ensure a "wise laisser faire". This is not the free-for-all capitalism that has been recommended by the current economic theory, and seems to have been accepted as gospel by economic planners, and also many economists, since the Thatcher and Reagan governments. But it also is a significant middle way between those who see the economic disasters and unemployment of unfettered capitalism, on the one hand, and those who believe that the government should play no role at all.

The idea that unfettered, unregulated capitalism would invariably produce the good outcomes was a wrong economic theory regarding how capitalist societies behave and what causes their crises. That wrong economic theory fails to take account of how the animal spirits affect economic behaviour. It fails to take into account the roles of confidence, stories and snake oil in economic fluctuation.

The article can be found online on www.ft.com

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