Acceptance Speech for the 1996 Paul A. Samuelson Award for Outstanding Scholarly Writing on Lifetime Financial Security

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I am very honored to receive, for my book "Macro Markets", this the first Paul A. Samuelson Award from TIAA-CREF. It is especially meaningful for me to receive this recognition from TIAA-CREF. They have, under the leadership of John H. Biggs, been an extraordinary innovator not only in pension management but also increasingly in influencing the management of productive activities that make for the financial security of all of us. By encouraging firms to create independent boards and by encouraging director involvement, TIAA-CREF has made an important contribution to the very productivity that fuels our nation's economic engine. Receiving this award for my book on risk management from TIAA-CREF is therefore a significant honor.

This award is particularly meaningful to me because of the panel of distinguished judges (James C. Hickman, Olivia S. Mitchell, Stephen A. Ross, John B. Shoven and Robert M. Solow). These are people who are widely lauded as some of our most important leaders, on the cutting edge of finance and economic theory.

I was first introduced to the works of Paul A. Samuelson at the age of 14, when my older brother brought home from college a copy of Samuelson's introductory textbook of economics, which I read with interest. I felt very fortunate later, as a graduate student at MIT, to have Paul Samuelson as my teacher. I have continued to admire his work over the years, including much of his most recent work, that has to do with lifetime financial risk management.

My book, "Macro Markets", proposes new institutions, new markets, that would make possible a higher level of economic efficiency by allowing for a greater sharing of economic risks around the world. The book is futuristic in its ambitions, proposing new markets for the next century. The book solves a number of technical problems that stand in the way of creating these markets.

The focus of the books is not on proposals for the elimination of risk but rather on improving the sharing of risks. What do we mean by risk sharing? I will illustrate by an example. Consider two countries of about the same size, country A and country B. If people in country A have substantial risks to their economy that are independent of the risks that face people in country B, then even without doing anything to eliminate the causes of these risks, we can make people in both countries better off by pooling these risks, so that people are more diversified. This pooling could easily be achieved if there would be new liquid, international markets: markets for claims on the national income of these countries themselves. The financial managers for people in country A could take short positions in new financial assets corresponding to claims on country B's income, while the financial managers in country B would do the opposite of this. Markets would clear, since for every short there would be a long in the other country. Everything adds up and is feasible in the new equilibrium; there is no reliance here on any imagined benefactor or any imagined productive opportunity to produce welfare gains. If people in each country hedged half of their own national income risks, then after hedging, each country would be effectively exposed only to the income risk of the two countries combined.

This book is part of a major research effort of my own, but I must also acknowledge the effort of others. I have been working with Stefano Athanasoulis of Iowa State University to develop a theory of the welfare benefits of new markets, and an associated theory of market construction. I have also been working with Ryan Schneider of McKinsey, Inc., to develop new occupational income indices that might someday be used to settle risk management contracts for individual wage earners. I, along with Karl Case and Allan Weiss, have been working to try to get real estate futures markets established. The three of us have founded a firm, Case Shiller Weiss, Inc., that might be used someday in the settlement of risk management contracts. Allan Weiss and I have also been working together to devise and promote home equity insurance policies.

Not all of these ideas are as futuristic as they may at first seem. We now actually have the beginnings of derivative markets in commercial real estate price indices in the U.K. Barclays de Zoete Wedd, a U.K. investment bank, has created in 1996 a futures-market analogue for U.K. commercial real estate. This year, U.K. group led by AMP Asset Management in London has plans to launch true futures contracts in commercial real estate.

Other fundamental financial innovations are being undertaken now. On January 29, the U.S. Treasury plans to introduce its TIPS (Treasury Inflation Protection Securities). These are very important innovations because they create true riskless assets of substantial maturity (ten years), and we may hope to see private issuance of such securities once the market becomes established. In theoretical finance, the riskless asset plays a very important role. Relatively risk-averse investors are supposed to tilt their portfolios towards heavier investment in the riskless asset; less risk-averse investors might even short the riskless asset. By doing this, investments can be better tailored to investment needs, and ultimately the ability to tailor people's investment to their preferences can make more capital available for investments.

Despite these auspicious beginnings, we are still only at the beginning of the financial innovations that we need. There are still today no derivative markets in single-family home prices, and still no true real estate derivative markets outside the U.K. Despite the creation of the inflation-protected government securities, we ultimately need, in addition to these riskless assets, assets representing many different kinds of risks, so that trading in these assets can facilitate better sharing of risks around the world.

We ought to have derivative markets for real estate, commercial as well as owner-occupied, in major metropolitan areas around the world. We should have markets for the real estate of New York and Los Angeles, for London and for Tokyo. A pension fund someday might invest in single-family homes in many locations around the world indirectly by taking positions in such derivative markets.

There should also be futures markets in measures of aggregate incomes. I think that is would be useful to start with markets for claims on the national incomes of the United States, the European Union, and Japan. These markets might best be started initially as markets for intermediate-term claims on national incomes, let us say ten-year claims on each of them, like the maturities on the new TIPS. To pique the interest of risk managers in these national income contracts, it is possible that the claims should be not just on total national income, but also on components of national incomes, such as investments or consumption. Certainly, industries whose income are affected by the volatile investment component of national incomes might be inclined to hedge the risk of this by taking positions in a market for the investment component of incomes.

It is important that we do so soon, since we will not be able to appreciate the advantages that such markets may offer until we actually start them. Big markets grow from small beginnings, and the growth process is slow, as people gradually acquire understanding how these markets work. Public interest in and attention to the markets might promote initial liquidity, and the markets might grow from there.

Let me close by expressing my expectation that the Samuelson Award instituted by TIAA-CREF will, by recognizing my work and that of those who will win awards in subsequent years, improve the state of the dialogue in financial research.