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PROJECT TYPE	ERC Advanced Grant (FP7)
TITLE	Liquidity and Risk in Macroeconomic Models
ACRONYM	LIQRISK
DURATION	01.08.2011 – 31.07.2016
BUDGET	2 070 570 €

This project was motivated by the objective to introduce financial realities into macroeconomic models. In particular the goal was to introduce leverage and liquidity in standard dynamic general equilibrium models and analyze their macroeconomic implications. LIQRISK was divided into two subprojects. The first dealt with leverage and market liquidity in developed financial economies. The second examined the demand for liquid assets by emerging countries and its global implications.

In the first subproject, LIQRISK broke new ground in the understanding of the dynamics of risk and in explaining some important features of the recent crisis. The project particularly emphasized the role of self-fulfilling changes in expectations that can lead to sudden large shifts in risk. This can take the form of a financial panic with a big drop in asset prices. Such panics become much more severe when taking place against the backdrop of leveraged institutions that are in weak financial health. The framework that we developed can account for the main features of the 2008 crisis, both during the panic and pre-panic stages of the crisis. Moreover, the project had broader implications as it highlighted the possibility of self-fulfilling joint shifts in risk and volatility of risk that can naturally occur in any market (assets, goods, labor) where demand depends on risk. Various extensions have investigated the empirical implications as well as the implications for international capital flows, exchange rates, macroeconomic activity and policy recommendations.

In the second subproject, the objective was to formalize and analyze different degrees of liquidity in international capital flows. While liquidity has been widely analyzed in microeconomic or partial equilibrium models, it has proven challenging to incorporate this feature into dynamic general equilibrium macroeconomic models. The project has innovated in finding ways to model liquidity in dynamic open economy models. This has allowed a better understanding of the pattern in international capital flows where less developed countries lend to richer economies. It has also shed light on the evolution of global imbalances before and after the crisis.