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From Academic to Policy Maker

CEPR – CEPREMAP Lectures on Policy Making

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Introduction

Ladies and gentlemen

Kenneth Galbraith once remarked that “Economics is extremely useful as a form of employment for economists”. In monetary policy, a new observable trend seems to be to delegate the decision-making powers to people who have a strong academic background. Let me give you some examples:

- Otmar Issing – who became the Bundesbank’s Chief economist already in 1990.
- Mervyn King and Charlie Bean from the Bank of England (or, formerly, Willem Buiter, Charles Goodhart, Stephen Nickell).
- Ben Bernanke, Frederic Mishkin and Randall Kroszner from the Board of Governors of the Federal Reserve System. In fact, half of the current Board members are persons who have spent most of their professional career as academics.
- Charles Plosser, Bill Poole and Janet Yellen from the Fed’s regional Reserve Banks.

And there seems to be an unbroken trend as the developments over the past couple of months have shown: Lars Svensson became a member of the Executive Board of the Swedish Riksbank only a week ago and Athanasios Orphanides is the new Governor of the Central Bank of Cyprus.

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Sending academics to politics clearly solves a problem inherent in academic policy advice: getting the message across to do the right thing. Policy makers and their academic advisors typically face different problems. The question is: Is the ivory tower not managing to get its message across in clear and accessible terms? Or is the political field per se unwilling to accept advice that does not take account of political restrictions and interests?

So, why are there so many academics in monetary policy? What explains this trend in central banking? Is there something special about monetary policy compared with other fields of public policy?

I want to highlight one aspect: Monetary policy is indeed remarkably different from other fields of public policy in that it is conducted by independent institutions. This is true of the euro area, but the independence of central banks is now a global phenomenon. Independence means that monetary policy is shielded from the day-to-day conflicts and power struggles that characterise other areas of policy. This state of affairs may make it easier to delegate the decision-making power to "technocratic experts in macroeconomic and monetary matters".

The independence of a central bank is not an end in itself. Rather, central bank independence helps to maintain a long-term stability orientation of monetary policy by insulating decision-making bodies from short-term-motivated political

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influence and, thus, contributes to enhancing monetary policy's credibility. It also makes a central banker's job interesting and attractive for academics.

Has independence helped in containing inflation? The decline in trend inflation worldwide is in part explained by monetary policy in many countries being geared towards price stability, which is enhanced by the increasing independence of central banks in achieving their goals. Globalisation will have played a supportive role, but, in the final analysis, it is monetary policy that is responsible for medium to long-term inflation outcomes.

Academic research has contributed in important ways to such a consensus view. Take as examples the rational expectations revolution, the literature on time inconsistency, and the empirical research on the macroeconomic outcomes of central bank independence. Monetary policy is arguably the policy area most heavily influenced by academic contributions. And central banks are devoting significant resources to their own research activities. This might be a further reason why, over the past years, academic researchers have been taking up leading positions at central banks.

Some personal reflections on academics and policymaking

Let me come back to the heart of the issue – academics and policymaking. Keeping with the theme of my speech, I will offer a few thoughts on my transition from academia to the policy world – in particular, how the former experience has prepared me for the latter.

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At least for me, but I suppose for all of my colleagues who have travelled the road from academia to policymaking, it is certainly true that I never imagined sitting in the driving seat of a central bank when I decided to become an academic.

Before I was appointed as President of the Bundesbank, I held various tenures at German universities. My administrative experience during most of that time was limited to the often painful bureaucratic duties and procedures that are part and parcel of life at German universities. But for some years of my academic career, I enjoyed the privilege of being Director of the Frankfurt-based Center for Financial Studies. This meant the management of a research institute full of talented economists with productive ideas, and it meant staying in close contact with monetary policy makers and bankers alike which helped me to shape my impression of the environment under which concrete political and business decisions were made.

Like most of my colleagues, as a young economist an academic career was attractive to me because it offered the freedom to analyse economic questions I personally found interesting. My fields of interest have always been monetary macroeconomics and international economics. Throughout my academic career I kept a focus on the empirical dimension of the problems at hand. And now, having turned into a central banker, I still find it extremely useful to underpin the analysis of current economic issues with empirics. However, I now have the privilege of using my limited time for asking only questions which are relevant to policy. It is my staff that is finding the answers.

Let me give you an example: In the euro area, the relationship between growth, export performance and trade has gained much attention. I therefore wanted to know more about the facts and myths of this matter.

At the heart of the issue is the diverging export performance of Germany and France: Since 2000, Germany has been experiencing a sharp rise in net exports. By contrast, net exports in France initially declined and then turned negative in 2004. Similarly, the French deficit in bilateral Franco-German trade increased considerably in the second half of the 1990s and is now between 1% and 1½% of French GDP.

This development is seen as worrying by several French politicians: A preference for a weaker euro has been voiced time and again, partly as a consequence of the recent election campaign, but evidently even more because of a different understanding of policy. It is always easy to find a scapegoat. For me as an economist, however, facts come first. So what exactly has caused the difference in export performance?

The traditional argument is that such differences can be explained by the geographical and sectoral patterns of trade specialisation. A closer look at the geographical structure of German and French export markets tells us that

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patterns are indeed different. However, in the period from 2001 to 2006, real demand in German export markets did not grow significantly more strongly than in French export markets: it was, on average, a mere 0.3 pp higher. Nevertheless, German firms outperformed French firms when it came to increasing nominal exports of goods to almost all parts of the world. For example, exports to the new EU member states rose, on average, by 8.2% in Germany (compared with 3.3% in France).

As for the sectoral structure, no clear competitive advantage can be discerned either. Whereas France has a larger share in exporting consumer goods, Germany has a larger share in exports of cars, capital goods and intermediate goods. But since 2001, exports in all of these sectors (including consumer goods) have been growing more dynamically in Germany than in France.

If the traditional analysis explains very little in terms of the differences in export performance, what else accounts for these differences? Are the worried voices right after all? No, they are not.

First of all, intra-euro-area trade is more important for France than it is for Germany. In France, the share of exported goods to other EMU countries amounted to 48% of all exports in 2005, whereas in Germany it was 5 pp lower. Consequently, France appears less dependent on the euro's exchange rate than Germany. However, the BDI (the Federation of German Industries)

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said last month that German industry could live with the strong euro, as long as it does not rise sharply.

Even more importantly, the wishful thinking behind a policy-driven weakening of the euro does not go to the core of the problem. All things considered, differences in export performance are linked to differences in competitiveness. As far as price competitiveness is concerned, it has increased in both Germany and France since the start of EMU. But in Germany, the increase has been more pronounced. One reason for this has been wage policy moderation in Germany. In addition to that – and unlike French firms – German firms have boosted their competitiveness by increasingly outsourcing their production processes to low-cost countries.

So, to some extent, the recent weakness of French export performance compared to Germany can be explained by stronger gains in German price competitiveness. But what is more important: overall export performance in France cannot adequately be explained by traditional factors. Estimations usually contain a noteworthy residual term. What accounts for it? Its reasons actually are more of a microeconomic nature, as has already been put forward by the French Council of Economic Analysis[1]. Examples are product differentiation, technological progress, reputation, marketing, or the export readiness of SMEs. For instance, the figure for French firms that export is only

[1] Rapport du Conseil d'Analyse économique: Evolution récente du commerce extérieur français, Nov. 2006.

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4%, compared with 11% in Germany. Moreover, French export firms are, on average, smaller than German ones.

The upshot of this is that competitiveness is enhanced by firms, not in exchange rate markets. If politicians want to support domestic industries they should do so by increasing the flexibility of labour and product markets through structural reforms, not by interfering with market forces.

But let me come back to my original theme – academics and policy-making. When it comes to core monetary policy issues in my current job, my professional background is clearly something I benefit from. Our models and forecasting techniques are quite familiar to me from my former academic life.

The way monetary policy has evolved over the past few years towards more transparency and accountability, the role of monetary policy strategies in that respect, and the eminent role of communication has been heavily shaped by academic research. And in most of these issues my academic background provides a solid base to grasp the key issues at stake.

However, there are some major aspects of monetary policy decision-making that are not reflected in undergraduate or graduate courses. The most important aspect deals with the analysis of the current stance. The way the multitude of economic data is transformed into a coherent narrative and perspective is something that is not taught at universities. Partly, there is good

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reason for this, as this is a hands-on business where practical experience is inherently essential. But all of us involved in the monetary policy process must try to synthesise a range of disparate information, including official data, anecdotal evidence, and qualitative developments, to construct a “narrative” about how the economy is evolving: What forces are determining economic activity now, and what do they suggest for the future?

Fortunately, before becoming President of the Bundesbank, I was a member of the German Council of Economic Experts, better known as the “five wise men”. Here, I became pretty familiar with the thousands of economic statistics and with the necessary balance between theory and a good dose of judgment in forming an adequate assessment of the current stance of the economy. Moreover, my time at the Council helped me to shape my thinking about a host of other economic issues, such as social security, labour markets and issues of taxation.

This is not to say, however, that my former profession has equipped me with all the knowledge necessary for central banking. Central banks cover fields that are far more wide-ranging than the core monetary policy principles just outlined. We deal with financial stability issues, have responsibilities in the banking supervision process, are responsible for the proper functioning of the payment system, distribute cash services to banks, companies and households, and play an important role in international fora like the IMF and the different G-settings. Here, my learning curve over the past three years has

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been quite steep. Arguably, not every aspect in that regard is equally interesting to me, but my experience since I took office has been that most of these issues are intellectually demanding and rewarding at the same time.

Describing his own personal experience, Ben Bernanke has emphasised that one common theme in all these fields is to realise that the “devil is in the institutional details” and to appreciate this dictum is the foundation of all serious policy work. This is certainly true and arguably the thin line academics have to cross to become serious policymakers. And, here, our academic background might be of some help in that we have learned to grasp the underlying economic content of multifaceted and complex issues. But it is certainly not enough to guarantee coherent and appropriate policy decisions. But these challenges are common to everyone taking up a political job without former practical experience in this area.

One final remark: Another aspect where my former academic life did not fully prepare me to meet current challenges has to be mentioned. And this aspect is not common for most of my academic colleagues that have now turned into policymakers: The Bundesbank, an institution of roughly 11,000 employees, is an institution in transition.

The adjustment to the single monetary policy of the Eurosystem has meant a cultural watershed to the Bundesbank. Having formerly been the anchor of the European monetary system, the Bundesbank has been facing necessities of

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adjustment and workload involved has been more wide-ranging than it has been for other national central banks of the euro area. We are currently well under way in restructuring and refocusing our medium-term strategy. Obviously, change management is something typically not included in economics I or II courses – so I had to learn on the job how to cope with all the difficulties that this entails.

Admittedly, some of the tensions and issues that are inherent in policymaking for a large institution which is confronted with a massive shift in external conditions are the price to be paid in comparison with a purely academic life. On the other hand, working together for a public good like price stability is worth paying such a price for.

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