For release on delivery
10:15 a.m. EST
January 7, 2005

Panel Discussion: The Transition from Academic to Policymaker

Remarks by

Ben S. Bernanke

Member, Board of Governors of the Federal Reserve System

at the

Annual Meeting of the

American Economic Association

Philadelphia, Pennsylvania

January 7, 2005

I appreciate the opportunity to reflect on my two and a half years as an academic turned policymaker. One difference I have noticed since moving to Washington is that people seem to find my ideas and insights of greater interest than they used to--although, so far as I know, I have not become any smarter in the past few years. This increase in interest is particularly marked in regard to my views on current policy issues and the economic outlook. So, for the sake of truth in advertising, I should say at the outset that I will not be commenting on current issues today, except in the most general terms. Instead, keeping with the theme of this panel, 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. Obviously, I will be speaking for myself and not the Federal Reserve Board. I should also note that my policy experience has been limited to my time at the Federal Reserve--in some ways, a unique institution in Washington--and may not generalize to other contexts.

I always thought I would be an academic lifer. I went straight to graduate school from college and never considered any job other than an academic position when I graduated. Before I was appointed to the Board of Governors in August 2002, my adult work experience consisted of six years teaching at Stanford's Graduate School of Business, seventeen years at Princeton (a joint appointment in the economics department and the Woodrow Wilson school of public policy), and several years spent as a visiting faculty member at other institutions, including MIT (my graduate alma mater). The sum of my political experience consisted of two terms on the local school board, six grueling years during which my fellow board members and I were trashed alternately by angry parents and angry taxpayers. On the administrative side, I served seven years as the chair of the Princeton economics department, where I had responsibility for major policy decisions such as whether to serve bagels or doughnuts at the department coffee hour.

Academia appealed to me as a young person because of the freedom it offered to explore old ideas and develop new ones. I also liked the relaxed dress code. The biggest downside of my current job is that I have to wear a suit to work. Wearing uncomfortable clothes on purpose is an example of what former Princeton hockey player and Nobel Prize winner Michael Spence taught economists to call “signaling.” You have to do it to show that you take your official responsibilities seriously. My proposal that Fed governors should signal their commitment to public service by wearing Hawaiian shirts and Bermuda shorts has so far gone unheeded.

Although the dress code continues to be a drawback, I am pleased to be able to report that the intellectual challenges of my new job have been as rewarding as those I encountered as an academic. The Federal Reserve’s responsibilities are quite broad, including not only monetary policy but the regulation and supervision of banks, oversight of the payments system, the making and enforcement of various regulations to protect consumers in their financial dealings, and the promotion of financial stability generally, among others. Getting up to speed on these diverse topics required some concentrated effort on my part. Much of what I had to absorb was institutional detail--some interesting, some less so--but I have also come to appreciate that the dictum that “the devil is in the details” applies with great force to all serious policy work. My academic training has helped considerably by leading me always to focus on the underlying conceptual framework on which the legal, procedural, and institutional details depend.

With an underlying framework in mind, seeing what is at stake and making a reasonable and coherent decision on a policy issue becomes easier, though rarely easy.

The development and implementation of consumer protection regulation provide one example. As economists, we have a predisposition in favor of free markets, but we also understand that missing or asymmetric information can undermine the efficiency and fairness of market-determined allocations. Financial contracts are inherently complex and consequently difficult for consumers to understand fully, even if the other party to the contract has no intention to mislead or deceive. From an economist's perspective, the proper objective of consumer protection regulation is not to prohibit voluntary financial transactions but to ensure that consumers receive the information they need to make rational decisions at the lowest possible social cost. Setting industry standards for what information must be disclosed to consumers and, perhaps, for the format of the disclosure is one means by which a regulator can achieve this objective. Ideally, a regulator like the Federal Reserve serves as a coordinating device to help financial institutions as well as consumers minimize informational problems and transaction costs in the financial marketplace. Following guidelines established by the Congress, the Fed and other regulators can also improve market functioning by clarifying property rights of various kinds--for example, by making rules about the use of personal information collected in the course of financial relationships. Of course, to achieve its social objectives as efficiently as possible, a regulator needs to gather as much information as it can from market participants. The Fed never imposes a substantive regulation without extensive consultation with those who will be affected--in this case, both financial institutions and consumers--through formal comment periods, policy advisory groups, and a variety of more-informal contacts.

Bank supervision and regulation, also a major responsibility of the Fed, provides another example of how conceptual frameworks developed by researchers inform the policy process. Many economists (myself included) have studied the special features of the banking industry, documenting its important role in the economy but also noting the potential instability of institutions that finance long-term, illiquid investments with short-term, liquid deposits. Deposit insurance and other government protections reduce the risk of banking instability but create the potential for moral hazard and other problems. The challenge for bank supervisors is to ensure the safety and soundness of banking institutions---that is, to minimize moral hazard and to protect the deposit insurance fund--without inhibiting economically valuable activities or technological innovation by banks. Designing regulations to accomplish these objectives has become markedly more difficult as banking organizations have become larger and more complex.

The new Basel II international capital accord, which the Fed helped to design in collaboration with other banking regulators from the United States and around the globe, may well be the most economically sophisticated regulation scheme ever devised.[1] The new system is designed to use information provided by the banks themselves about their loss experience, together with algorithms that mimic the most up-to-date risk-management techniques, to establish minimum capital standards for banks that approximate the appropriate level of economic capital. In addition, Basel II provides for enhanced supervisory oversight and public disclosure of financial information by banks.

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[1] As a member of the Basel Committee, Fed Vice Chairman Roger W. Ferguson, Jr., has played a particularly key role in the development of Basel II.

As many economists have noted, greater transparency on the part of financial institutions improves the efficiency with which financial markets price financial claims on banks, including equity and subordinated debt. By aggregating private-sector information about banks' financial condition, prices and yields determined in financial markets may in turn provide important information to regulators.

Difficult challenges lie ahead in implementing the new capital accord, and I do not want to enter into a full discussion of the many issues raised by Basel II today. My point here is only that Basel II is not your grandfather's bank regulatory scheme; it is an approach that draws on the most sophisticated financial methodologies as well as on extensive research on banking and bank supervision. As with most other policy issues, getting the myriad details right will be critical to the success of this new regulatory regime. But the general design of Basel II owes a great deal to research conducted both in academia and in central banks. As in the case of consumer financial regulation, I have found my academic background to be quite helpful for understanding the critical issues in bank supervision policy.

I have enjoyed very much being introduced to the wide range of Fed policy activities. However, because my professional background is in macroeconomics and monetary economics, monetary policy remains for me the most interesting aspect of my job at the Fed. Once again, I have found the knowledge and habits of thinking developed in my academic days to be quite useful. The models and forecasting methods used by the Federal Reserve staff, for example, draw heavily on decades of academic research and thus feel comfortably familiar. Academic research (by which I mean to include technical research done in central banks and other non-academic institutions) also bears directly on many strategic aspects of monetary policymaking. For example, the Federal Open Market Committee has recently been engaged in developing its communications strategy, a topic which I believe to be of vital importance and on which I have spoken on numerous occasions. My thinking on this and numerous other aspects of monetary policy is heavily influenced by contemporary research in monetary economics, as can be seen by the footnotes and citations in my speeches.

A part of monetary policymaking for which my background left me imperfectly prepared is what central bankers call "current analysis." One of the biggest practical challenges of making monetary policy--and a prerequisite for any serious forecasting exercise--is getting an accurate assessment of the current economic situation. Doing this well requires a deep knowledge of the data mixed with a goodly dose of economic theory and economic judgment. Members of the Board staff continuously analyze the arriving data to learn what they can about the level and composition of economic activity, inflation, and other key aggregates. At the most mechanical level, this exercise requires a detailed understanding of how the U.S. statistical agencies use the information in current data releases to estimate economic aggregates--how the components of retail sales are linked to estimates of personal consumption, for example. But often the linkages between data releases and the key economic aggregates are not so straightforward. For example, drawing the implications of a surprisingly favorable employment report for consumer spending requires the analyst to take a view on how households are likely to respond to increased labor income and improved labor market conditions. A certain amount of uncertainty in the estimates is unavoidable, of course; indeed, identifying the sources of uncertainty is an important part of the analysis. However, the requirements of internal consistency--production must always equal sales plus inventory investment, for example--provide numerous cross-checks and substantial discipline on this process.

More generally, all of us involved in the monetary policy process must try to synthesize a range of disparate information, including official data, anecdotes, and qualitative developments, to construct a "story" about how the economy is evolving: What forces are determining economic activity now, and what do they portend for the future? Chairman Greenspan is, of course, a master of current analysis and near-term forecasting, and many members of the National Association for Business Economics have finely honed these skills as well. Current analysis is not taught in graduate school, probably for good reason; it seems more amenable to on-the-job training. It is, nevertheless, an intellectually challenging activity--analogous, it seems to me, to the efforts of a detective to reconstruct a sequence of events from a range of diverse and subtle clues--and I have enjoyed the opportunity to become more proficient at it.

I will close with a personal observation. In focusing today on the substantial intellectual continuities between academia and the policy world, I have not yet mentioned an important aspect of the policymaker's job: the satisfaction of public service. For me, knowing that I am using my skills to further the commonweal and the national interest is an important compensation for the personal sacrifices that a policy position can entail--a view that I know to be widely shared among my colleagues at the Federal Reserve. Whether you are a veteran economist or just starting out in the profession, I urge you to consider seriously any opportunity that arises to serve in a policymaking capacity, be it as a principal or as a supporting staff member. You will feel good about it, and you will learn a lot.