POLICY RESEARCH, POLICY ADVICE, AND POLICY MAKING

by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a

Pennsylvania State University Conference on the Political Economy of Domestic and International Monetary Relations

University Park, Pennsylvania

June 13-15, 1980

Academic economists frequently express a desire to have a greater impact on economic policy and seem disappointed with what they appear to be achieving from the outside. Policy makers frequently are heard to say that they would like to get more help from academic economists, and seem disappointed with what they do get. Does economics promise more than it can deliver? Or, is the flow of communication less than adequate?

There are indications which suggest that it is lack of communication more than lack of communicable substance that is at fault. For one thing, the role of economists in government is by no means diminishing. In my agency, the Federal Reserve Board, from which most of the empirical observations in this paper will be drawn, the role of economists is rising. Increasingly the members of the Division of Research and Statistics, some 150 economists, and those of the Division of International Finance, some 50 economists, are drawn into policy advice and operations. The same applies to many of the Federal Reserve Banks, with their economists. Also, at the higher levels both of the Federal Reserve and of government agencies generally, the role of economists as policy makers seems to have grown, although the condition prevailing in 1975, when four Cabinet Members, the Chairman of the Federal Reserve Board, and the Chairman of the Council of Economic Advisers were professors of economics, and only the Secretary of State was a professor of political science, may have represented a temporary high point. The public's estimate of the ability of economists to predict and cope with economic situations and problems may have diminished in the light of recent performance. Nevertheless, popular interest in and newspaper coverage of economic matters still seems to be on the upgrade. The quality of economic reporting in the press has improved visibly.

One possible reason for believing that economic inputs into policy making are relatively neglected is that the allocation of time for such inputs is never a high priority, for either side. Academics may be reluctant to cut a class in order to participate in an important government meeting. Policy makers are always under pressure to put the urgent ahead of the important. Thus, they underinvest in economic advice, both from academics and from their own staffs.

Subject Matter and Occasion for Economic Input Into Policy Making

Economic policy, and especially monetary policy, is strongly influenced, of course, by economic theory. Classical monetary thinking, Keynesianism, and of late monetarism, have all shaped it, in different degrees at different times. There can be no question as to the importance of these basic inputs into policy making.

Such basic inputs, naturally, differ widely for different policy makers. The government, in general, is not run by economists, but by a congeries of politicians, businessmen, lawyers, and diverse technicians, including economists. In the process of running the country, they become "men of affairs," if that had not been their role previously. On the Federal Reserve Board, the proportion of economists, of course, is higher than in most other government agencies. But it is never so high either on the Board or on the Federal Open Market Committee that its economist members would feel at ease becoming at all technical. No blackboard, to my recollection, has ever disfigured the splendid proportions of the Board Room at Constitution Avenue and 20th Street.

The contingent of lawyers and businessmen have a practitioner's background in various aspects of microeconomics -- taxes, accounting, prices and wages, credit, and many others. With such a background, it is probably quite possible to vote intelligently on the FOMC, and to follow the discussion, although some grounding in macro concepts would be helpful. But as soon as macro concepts make their appearance we are apt to encounter the influence of Keynes' defunct scribbler, in the form of verities absorbed in college and not updated since. In Keynes' day, these verities dealt with the balanced budget, the gold standard, the public debt. Of today's men of affairs, very few, of course, predate the Keynesian revolution. Big deficits, high public debt, easy money, indifference toward inflation, and intolerance of unemployment are their intellectual heritage. Monetarist indoctrination from college days is still rare.

Today's men of affairs, moreover, are not dependent on intellectual baggage carried forward from the past. They absorb contemporary economics from their company economists, from organizations like the Committee for Economic Development and the Business Council, from Congressional hearings and, of course, from the press which today competently popularizes much academic output.

There is, of course, a wide range of doctrines that the man of affairs could assimilate and to which he could refer in speech and action with equal intellectual respectability. These doctrines aspire to objectivity and their originators would be chagrined to find them interpreted as manifestations of value judgments. It is precisely on grounds of value judgment, however, that the man of affairs is likely to pick his economics. He will identify Keynesianism with expansionism and monetarism with price stability. Even worse, he may come to identify Keynesians with left-of-center and monetarists and rational expectations proponents with right-of-center politics, however wrong such identifications may be.

These broad perceptions do not necessarily apply in every individual policy decision. One may place great value on price stability and still favor a particular cut in the discount rate. More technical economics, especially in the area of forecasting, then assumes considerable importance. Every policy maker necessarily acts on expectations. The question is only whether these expectations are formed by casual observation or by systematic forecasting techniques.

The forecast presented by the Federal Reserve Board's staff, based on the Board's version of the MPS model modified by judgmental contributions, plays a powerful role in FOMC deliberations. Given the wide range of outside forecasts, the weight given to the Board staff forecast may well be excessive despite its good performance in comparison with other major macro models. Nothing is more sobering, in evaluating any single forecast, than inspection of an array of 20 or 30 widely differing forecasts of GNP, prices, and unemployment. The Reserve Bank presidents on the FOMC do have the advantage of being exposed to their own Bank's forecasts in addition to the Board forecast. Board Members have a harder time forming their own quantitative projections.

As far as forecasts are concerned, the views of the major producers in any event are readily obtainable. How much weight any forecast should carry is debatable, particularly in the light of recent performance in the profession generally. Theory tells us that the more uncertain the forecast the smaller should be the policy reaction. The growing acceptance of the belief that we do not know enough to fine-tune the economy properly relates not only to our uncertainty about the effect of policy actions, but also to the uncertainty of the forecasts upon which these actions might be based.

All this adds up to saying that the input of economics on policy making is pervasive and strong but that nevertheless it rarely points unambiguously toward any particular policy, either in the long run or the short. This gives great importance to the ability to form individual opinions, which, in turn, leads back to the need for continuing contact with the sources of ideas, a very important part of which has been past academic contributions. But the question that the policy maker today addresses to the theorist is "what have you done for me lately?" The answer is that, after monetarist concepts and recommendations had made their recent mark, not much that is new and powerful has been added to the theoretical base of monetary policy making.

One reason for the present low level of economic inputs into monetary policy making, therefore, may be that not many good new ideas have been around lately. This weakness on the side of academic supply can be seen in the diminishing credibility of many Keynesian propositions, the observed limitations of monetarists' ideas as they are increasingly implemented by policy, and the remoteness from reality of rational expectations theory. For new ideas in labor market analysis, which seem to have flowed well, there seems to have been inadequate demand on the government side. The needs of government for economic inputs, moreover, also come in waves. For instance, the Bank Holding Company Act amendments of 1970 created a strong demand for microanalysis of banking markets, but as it happened a large body of research in this field had been completed during the 1960's off which the bank regulators still are living. This clearly has implications for the kind and volume of economics produced within the Federal Reserve.

Trends in Research Activity at the Federal Reserve

In recent years, there appears to have been a trend toward a reduction in research activity by the economic staff of the Federal Reserve, both at the Board and at the Reserve Banks. A greater proportion of research has become more directly policy oriented. The reason is not a reduction in the number of professional economists employed, which has remained roughly constant. It is, rather, that the Federal Reserve Board particularly has been handed a wider range of functions, and has had to meet increasing demands on existing functions. This has been met in good part by shifting staff time from research to policy advice and related operations. The Bank Holding Company legislation of 1970 brought a massive surge in activity in this area, through a bunching of applications for acquisitions. As these activities diminished, the International Banking Act, the Financial Institutions Regulatory Act, and the Monetary Control Act began to make heavy demands on staff time.

Congressional staffs have increased massively, and this has led to an increase in Congressional demands for reports, Congressional correspondence, and the writing of testimony for appearances of Board Members before Congressional committees. Economic developments such as floating exchange rates, the development of the Euromarkets, a larger number of international meetings, and growing inter-agency activities have added to the need for staff work in the international area.

All this has meant that at each staff level there is less time for the kind of research work that used to be done some years ago. Economists are drawn into policy work at an earlier stage in their careers than in the past. Some people like this and some do not. Many staff members have to work harder to maintain the academic credentials that economists hired from among the more talented graduates of the higher-ranked universities are normally concerned with.

I believe that similar cycles have occurred at other government agencies from time to time. Historically, this has sometimes been followed by a concentrated effort to restore a research component to staff activity by creating some new kind of research department. The circumstances that produce such a concentrated effort, which usually is a severe burden on the budget, may differ -- a new agency head, evidence of inability to cope with agency problems or to keep up in bureaucratic infighting with other departments, are among the observable sources of impulse.

Occasional relief from budgetary squeezes plays a role. Different agencies may find themselves in different stages of this cycle. The same no doubt is true of different academic disciplines. It is my impression that in economics generally now the cycle is at a stage where demand for and expenditures on economists are relatively low. That is bound to affect the attractiveness of jobs in the economics area within government and the distribution of research between academia and government.

Academic Versus Governmental Research

The declining trend of research activity in certain government agencies raises not only the question of career attractiveness for those with a basic orientation toward academia, but the more fundamental one of the distribution of research between academia and government. The standard allocation is, of course, that basic research belongs in the universities and the research institutions and applied research in government, without anything like a rigid line being drawn. Obviously there is room for both in both places. The reduction in government research means that it would be desirable to have a larger volume of policy-oriented research done in universities. This shift seems to accord with the shift in priorities observable in National Science Foundation grants, which increasingly seem to stress applied research. But if, as seems to be the case, the foundations also are leaning increasingly toward "results," while the universities' own resources are clearly stretched more tightly than they used to be, the burden of cutbacks will fall heavily on basic research.

Concern about this trend has been expressed many times. Outside of economics the risks and costs of running out of basic research may well be much larger than in our field. Nevertheless, the trend is very worrisome. If it cannot be reversed or stopped, a possible antidote would be more rapid circulation of academics through government. The United States is fortunate in having a high degree of mobility between academia and government. If the trend is toward an imbalance to the disadvantage of basic research, a possible compensatory factor would be a more rapid return of academics from temporary government employment. The decline in the relative attractiveness of government employment for academics with a bent for basic research would encourage this, at the cost, of course, of frustrating the government's effort to attract more academic talent for operating and policy work.
In any event, this "circulation" through government would remain a feasible prospect for only a small part of the economics profession and would be open in even lesser degree to non-economist academics such as political scientists.

Demand for and Supply of Economic Expertise

To make academic economists' inputs into government effective, both sides must understand their market. Academics as well as policy makers must understand clearly what academics have to offer. On both the supply and the demand side, considerable improvement in understanding is possible.

In the course of my own work, I have been on both sides of this market from time to time. Let me first lay out my past perplexities as an academic supplier to the government of what goes under the name of economic expertise, and then describe my present frustrations as a user of such expertise.

The academic adviser to government may see himself in the role of a Max Weber type value-free expert, or as somebody pleading a point of view -- in either case, he will have positions that he wants to defend and others that he wants to oppose. The difference between the Weber style and the other kind of expert is only that the first makes his case on technical grounds, while the second weights his technical argument with his values. In either case, the outside expert faces the problem of making his/her advice effective.

Advice is effective to the extent that it is accepted and to the extent that it affects the view and action of the advisee. The two effects normally are inverse to each other. The advice most likely to be accepted is to the effect that the advisee is doing the right thing and should go on doing it. By adopting the same point of view as the advisee, however, the adviser changes nothing. The farther the adviser's viewpoint moves away from that of the advisee, the greater the potential change that he can effect, but the less also the probability of acceptance. Effectiveness of advice can be defined as the distance from the advisee's point of view weighted by the probability of the advice being accepted. So measured, effectiveness is zero both when the adviser's point of view coincides with that of the advisee and when it differs so much as to have zero chance of acceptance. Somewhere in between there is a maximum. With some simple, but not implausible, assumptions about these relationships, we can conclude that the maximum occurs mid-way between the advisee's view and a totally unacceptable view.

Different advisers, of course, may have different utility functions and not all may derive maximum utility from maximum effectiveness of their advice. The yes-man will value acceptance of his advice above everything and therefore place his bets close to the viewpoint of the advisee. The congenital oppositionist will prefer to insist on his own point of view even if he is sure to be totally rejected. Aiming at the point of maximum effectiveness does mean, usually, shading one's own preferences and adapting them somewhat to those of the advisee, but it is this advisory strategy that has the biggest impact.

Choosing among these alternative strategies of advice requires, of course, that the adviser know the lay of the land pretty well, both as regards the policy issues involved and the political and other options facing the advisee. In practice, I have found very often that my advisee knew a great deal more about the issue than I did and that the things I did know were not necessarily applicable to his situation. Nevertheless, economics often supplies a good guide to policy. Competition, optimal allocation of resources, the marginal principle, can all be helpful in disentangling conflicting pros and cons. Economics does have something to offer even if its precepts do not always prevail.

The adviser is aided by the fact that the policy maker, in the last analysis, must boil down and simplify his problem in order to be able to act. At an early stage of the decision process, governmental deliberations typically dissolve into a welter of often unrelated details. But the human mind, and particularly that of a person with many decisions to make, cannot cope with all these complexities. In one way or another, some aspects of the problem are eliminated as unessential and others get elevated to a key role. On these the final decision then is made. If the adviser is able to focus on them, he has a good chance of being effective.

The Realities of Policy Making

How does this process look from the point of view of the policy maker? Temperaments vary, from the self-confident operator who feels sure he is right, to the worrier who needs to rehash all options before he can make up his mind. It is the worrier who thus becomes an attractive advisee for the academic. The worrier will feel this need particularly if at one time he was an academic and is aware of the fact that he has not kept up with his discipline. Given the pace and workload of government, that eventuality becomes a virtual certainty within a very few years in office. Few things are more unnerving than the feeling that one has overlooked something that one ought to be aware of. By the same token, it is reassuring to touch base with an adviser who is on the frontier of thought, or simply to make sure that the expert does not know much more than the policy maker does. When one has touched all the bases in that way, one has become a kind of negative expert knowing that there is nothing new to know.

The policy maker's principal problems, with respect to receiving advise, are when, on what topics, and from whom to solicit it. The first two -- when and on what -- require some knowledge of the state of the arts and the state of professional opinion on rapidly evolving situations. A congenital worrier can spend too much time learning that there is nobody who can help him. It is on the third -- from whom -- that he faces his most difficult decisions. Given the tested principle that there is no conceivable view that is not backed by some economist, the policy maker can proceed, of course, on the principle of "pick your policy, pick your adviser." Or he can pick a gaggle of advisers of predictably different views, which also makes him appear impartial and, having received conflicting advice, proceed to do what he wanted to do in the first place.

Assuming, however, that he is seriously interested in receiving advice, he needs to know a good bit about his advisers. In a world of value-free economists, he would be able to ignore ideology. In practice that would be naive. He, therefore, needs to know ideological biases very well if he wants to adjust for these and arrive at value-free views. Likewise, he needs to understand the variance around the views with which he is presented. Academic economists do not have to live with their mistakes and some of them, therefore, are prone to understate the degree of uncertainty attached to their analysis. For instance, in 1975 the Federal Reserve was advised by leading experts on both sides of the fence dividing monetarists and Keynesians that it should sharply raise the stock of money to make room for recovery. This was clearly high-risk advice which in the light of subsequent history does not stand up well.

Much of the time, of course, advice from the two sides of the Keynesian-monetarist fence is conflicting (ignoring the fact that there are a few right-of-center Keynesians whose policies may come closer to those of the monetarists). In that case, the Board and the FOMC will be reasonably safe in the middle. If they duck in between, the two sides will be shooting at each other. Even more important than such balance between academic partisans is similar balance in the Congress. Monetarism has enjoyed a considerable vogue among politicians, understandably, since it tends to absolve them from responsibility for the consequences of poor fiscal policy. In that view, most of the responsibility rests with the Federal Reserve, which therefore tends to acquire some Keynesian leanings in self-defense. The difficulties of obtaining good advice may be particularly severe for the Federal Reserve because these difficulties reflect differences of view about macroeconomics. Differences on the relative evils of inflation and unemployment are wide, and they tend to be associated with different evaluations of the cost of dealing with either. It would be a rare adviser who believes that inflation could be dealt with at moderate costs but prefers expansion, or who sees the costs as enormous but nevertheless proposes to incur them.

At a micro-level, as I have noted before, differences tend to become more technical. It becomes easier here to give "value-free" advice. In some cases, nevertheless, there are more clearly defined constituencies on micro-issues than there are on the broad issue of inflation versus unemployment. Frequently, in these cases, the division is between business and the consumer, or business and labor. Where clear partisanship is involved, the policy maker knows whose advice he is getting and will treat it, not as technical advice, but as *ex parte*.

In surveying the professional scene, one becomes aware of one peculiar anomaly. Relations between the Federal Reserve and the academic profession are not as cordial as one would wish them to be. The Federal Reserve is the professional home of large numbers of economists. It is probably the most "economically oriented" of all the Washington agencies. Its subject matter is the bread and butter of economic thinkers and practitioners. Nevertheless, economists have conspicuously abstained from treating the Federal Reserve as "their" agency in the way in which, one might say, large parts of the profession have identified with the fiscal policy process.

That the Federal Reserve should be a political whipping boy is understandable, perhaps even desirable. When the Fed acts as a buffer between the politicians and the printing press, it is fulfilling its proper function. This is not, however, its ideal role with respect to the economics profession.

The credibility of monetary policy with the public is damaged by comment from the profession implying that monetary policy is a simple matter that, with a little intelligence and good will, could reliably produce predictable results. Nor is the credibility of monetary policy strengthened by comment about a small number of individuals pursuing objectives that are not in the national interest and ignoring the needs of the people. The public is very much in need of information about the Federal Reserve, as frequent press comments on the mysteries of the Fed make clear. This purpose would be better served, however, by a less consistently negative attitude on the part of the profession.

The Policy Maker and His Staff

The economic enlightenment which I have discussed so far comes to the policy maker from the academic consultant. In fact, the policy maker ordinarily receives a much larger input from the agency's staff, especially at the Federal Reserve. Much more can be said about the Federal Reserve's outstanding staff than can be encompassed in this paper. Because of its intellectual strength, it is by far the most important source of economic input into the Federal Reserve Board and Federal Open Market Committee. Even though its research function has somewhat declined of late, it reflects enormous concentration of strength in the areas it covers, greatly exceeding the density of coverage of major topics that is possible even in the economics departments of leading universities. It is precisely, however, because the staff is not an economics department of a university that its intellectual influence on the advisees is of a peculiar nature.

The staff, being hierarchically organized, at the Board and within each Reserve Bank, tends to speak with one voice. Sometimes, of course, when there are significant differences among its members, such differences surface. Differences within the staff may show through in the various decision options that the staff usually produces on particular issues. In other circumstances, such options may represent structured alternatives not indicative of any particular positions within the staff. Board Members can, of course, deal with individual staff members and learn their views, but, by the nature of its organization, the staff tends to resist systematic attempts by Board Members to infiltrate its decision processes. It may reasonably fear that such intrusion may affect the staff's objectivity or that it might interfere with the achievement of a single voice. It would also take time away from work for the Board as a whole.

These bureaucratic imperatives carry over into the relations of the staff with academics, with whom most professional staff members can reasonably view themselves on an intellectual level. Given the great resources that the staff is able to throw into any particular investigation, the staff can reasonably assume that it has done, or at least could readily do, as much research on any point of major interest as single academics.

The staff, moreover, on many issues is guided by prior decisions of the Board. This is particularly true in the regulatory area. Once the Board has made up its mind, the staff's function becomes one of implementing and defending.

Much of the staff's work is in the public domain, through the large volume of reports, testimony, material prepared for open meetings, and individual publications by staff members. The staff, therefore, is by no means sheltered against the public gaze and against criticism from their professional peers. An important exception is material prepared for immediate monetary policy purposes. Confidentiality of this material helps to preserve the objectivity of the staff. It minimizes the staff's risk aversion that would no doubt limit some of its expressions of judgment if every word could be brought into the political arena. For the Board, confidentiality of staff forecasts and related advice is essential to maintain confidence in the professional quality of the staff's judgment. If staff reports and recommendations were to become a basis for political debate, policy makers' desire to obtain such materials would diminish and the risks to the Federal Reserve of publicly aired conflicts would increase.

For the outsider, all this may add up to an impression of inflexibility on the part of the staff. But that may well be an excessively subjective reaction. Not every bright new idea can be sure of the full welcome that its outside originator may feel it deserves. Moreover, continuing involvement with the ideas of outside academics on the part of staff members can make life as difficult for senior staff as involvement with individual Board Members. That there is no suppression of thought is evidenced by the Board's liberal publications policy for staff members, including points of view that differ from those of the Board, so long as the Board's operations are not seriously prejudiced.

Bureaucratic tendencies toward a single staff position also reflect the operating responsibilities of the staff. The greater the responsibility to get things done and get them done on time, the less is the opportunity to dawdle by the wayside in purely intellectual pursuits. All the greater is the need for deliberate efforts to seek academic inputs and to cultivate activities that will help staff members maintain the professional quality that they and the organization prize.

Group Dynamics

On major policy issues involving values such as the choice between more and less expansive policies, the general tendency of any well-known academic usually is predictable. It is easy for the policy maker, therefore, to elicit the kind of advice that he would like to receive. Groups of academics, nevertheless, seem to manifest subtle shifts in attitude that supply more objective policy guidance. This remains true even though the individual members of such a group may vary from time to time, so long as they are replaced by others of broadly similar outlook. The position of members of such a group relative to each other tends to remain the same. But the spectrum shifts, and that is highly significant for a policy point of view. It is the nearest thing to unanimity that a diversified but continuous group is likely to achieve.

Few things are harder for an academic than to confess error. The annals of advice that academic advisers have given to policy makers contain interesting exhibits of policies that fortunately were not adopted. But it is not customary to bring up old mistakes. The policy mistakes of academics are buried in dead storage files in some warehouse. The mistakes of policy makers are republished monthly in the nation's major economic time series.

In addition to gradual shifts in the direction of policy advice, there appear to be shifts in value judgments, such as the relative cost of inflation and unemployment. There also seem to be trends affecting the spectrum of opinion as regards the variables that should be empirical rather than ideological, such as the level of full-employment unemployment or its latter-day counterpart, the nonaccelerating inflation rate of unemployment.

These

These shifts are part of the group dynamics observable in panels or rotating groups of policy advisers.

There are several groups in Washington to which these observations apply. They deal with macro policies as well as with other policy-oriented topics, at the Federal Reserve, at the Treasury, at Brookings, at the American Enterprise Institute, among no doubt many others. These groups involve a considerable overlap of individuals and have a considerable degree of continuity of particular individuals. They all serve as a means of communication between academics and government officials, although they differ considerably in the emphasis on, respectively, new research and communication to government officials of existing research.

In some cases, a substantial effort is made at rotation of academic participants, with particular emphasis on bringing in younger members of the profession. It is these, very often, who have new ideas to communicate. Experience nevertheless has shown that this communication is difficult. Lacking government experience, younger academics who are new in these groups do not find it easy to hit the right level of abstraction and relevance, and to put their ideas across clearly to people who surely are listening with a great deal of interest. The old hands have a considerable advantage in this respect and their ideas come across more clearly and easily. As a result, a frequency distribution of participants in such meetings reads pretty much like a standard list of the leading members of the economic departments of the leading universities, making allowance for the absence of distinguished names that are not known to have strong policy interests.

This situation is symptomatic of a much broader problem of communication between academics and government. There is willingness and interest on both sides.

But the information, the knowledge of new ideas, does not flow smoothly. Broader, more frequent, and more intensive contacts are needed if government is to be enabled to absorb all the academia has to offer. It seems in keeping with the trend of the times to suggest that this impediment will not be removed by some macro approach, but only by a multitude of painstaking micro efforts.

#