Editor's Note

We are pleased to announce the debut of a column titled Economics With Attitude, by David C. Colander, Christian A. Johnson Distinguished Professor of Economics at Middlebury College. In this Column, David will explore issues related to economic policy as well as the economics profession.

Susan L. Averett and Edward N. Gamber, co-editors, *Eastern Economic Journal*

COLANDER'S ECONOMICS WITH ATTITUDE

The Fed's Research Mission and Measure of Success

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If an engineering firm had failed to warn of the possibility of a financial crisis occurring, and it occurred, they would have been, and should have been, fired. Yet, the Fed that before the financial crisis was telling everyone that all was fine and that there was no need for concern, has not been fired, and has faced little criticism for its role in the financial crisis.

In part this lack of criticism is because of its handling of the financial crisis. While it did not predict, or even warn of the crisis, once the crisis hit, it quickly adjusted policies and kept the United States and world economy afloat, avoiding a financial system collapse. It didn't do everything right, but, given the time and political constraints, its handling of the crisis was admirable.

However, the financial crisis is now over, and instead of reexamining its pre-crisis failures it is business as usual at the Fed. Specifically, there seems to have been no serious rethinking of Fed research operations that one would have expected in an organization that not only failed to warn of the problems that allowed the economy to come so close to collapse, but which, in much of its research wasn't even studying models that allowed for such crises. Its chairman, Ben Bernanke, came out explicitly and said that the problems that led to the crisis were not problems of macroeconomic theory.

I see this lack of reconsideration as a serious problem. As I have argued elsewhere, I see the financial crisis as a systemic failure of the macroeconomics profession, and

especially of the Fed (Colander *et al.* “The Financial Crisis and the Systemic Failure of Academic Economics” <http://ideas.repec.org/p/kie/kieliw/1489.html>). The problem is the nature of its research. Too much of its research is what can best be called “academic research.” Academic research is written to be published in academic journals, rather than used by policy makers. It can be contrasted with what might be called “hands-on applied policy research.” Such applied policy research is research that is done to shed light on problems and to inform policy makers, not to be published. Academic research is written for, and judged by, other academics. Applied policy research is research that is written for and judged by policy makers and others with deep operational knowledge. Applied policy research can only effectively be judged by individuals with such knowledge.

Academic research, including academic applied policy research, is what might be called “show-dog” research — all i’s are dotted and t’s crossed. It is judged by pedigree, not its usefulness. Hands-on applied policy research, whether abstract, theoretical, empirical, or heuristic, is “working-dog” research — it isn’t done to be published, but instead to shed light on real-world, real-time, policy problems. It is judged by its usefulness, not by its pedigree.

A CHANGE IN THE FED’S RESEARCH MISSION

In the past, central bank research economists saw themselves as quite different from academic research economists. To become a Fed economist took time. The Fed took students trained in academia, and gave them an education in real-world macroeconomics at the Fed. The process took 5–7 years of additional training but after that period the Fed had changed the academic scientists they had recruited from graduate programs into Fed engineers and artists who understood the real-world economy and were able to relate academic research to real-world problems. As they interacted with academic economists, they enriched academic research, infusing it with real-world insights. Fed research economists carefully followed academic work, but did not see their primary research role as contributing to it. They did, of course, sometimes contribute to it, but that was done on the side for enjoyment and to keep up with the academic field. Their bread and butter research — what their promotion depended on — was hands-on applied policy research. In the past, it was possible to distinguish a Fed research economist from an academic research economist; a Fed research economist had more real-world smarts, a knowledge of institutions, and what was called a Fed sensibility. There were problems with that insulated Fed sensibility, but it was a sensibility focused on the real world.

Twenty years ago, former Fed governor, Dewey Daane, and I lamented the fact that academic macroeconomists were not more like Fed economists in the introduction to the book we edited, *The Art of Monetary Policy* (Sharpe Publisher, 1994). We argued that teachers of monetary policy should be more like Fed economists and give less focus to teaching students about academic research. Our goal was to develop competition for the Fed sensibility, thereby improving it. We got half of our wish. Academic economists are today more like Fed economists, but the reason is that Fed economists have changed — they have become more academic.

This is precisely the opposite of what we wanted. The focus on “working dog” research is decreasing, rather than increasing. The percentage of research staff at the Fed composed of artists with institutional sensibilities and educated common sense seems to be decreasing. While this is especially true at a number of regional Feds, it seems also to be taking place at the Board. There are still a number of artists there, but more and more those artists

are being replaced by highly talented academic researchers who are less trained in the sense of nuance and institutional knowledge that characterized the earlier Fed sensibility. Today, a young Fed research economist is likely to be indistinguishable from an academic research macro economist.

The reason for the change is a failure of management at the Fed that has allowed academic publication to determine advancement at the Fed. Previously, promotion of an economist at the Fed was based on background papers and briefings for senior Fed officials (working-dog papers) along with some minor focus on publishing in academic journals (show-dog papers). Those internal papers and briefings required deep institutional knowledge and a sense of the markets. That knowledge and sense determined how the academic models would be applied. Teaching new economists that such knowledge was important, and providing them with that knowledge, was what Fed training involved. In the 1980s, that started to change, and over the past 30 years, from what I understand, that training has been reduced, as the requirements for advancement in research departments at the Fed have changed. Today, many Fed research economists are evaluated by the same publishing criteria as academic economists.

I know this not only from conversations with people at the Fed, but also from a written account of Loretta Mester, an economist at the Philadelphia Fed. In an article designed to encourage young economists to consider a career at the Fed (*CSWEP Newsletter*, Spring/Summer, 2006), she provides a good sense of the change in incentives that have occurred. First, she notes "Research time at the Philadelphia Fed surpasses that which a new PH.D would get at most academic departments." She points out the research at the Fed means "the same thing as is meant in academia" — research on self-chosen topics rather than directed research. She then states that research economists at the Fed can expect to spend half to three-quarters of their time working on their own research agendas, not on the Fed's research agenda. In addition, she points out that the time researchers spend on Fed research is secondary to their own research. Fed research is arranged far in advance so that "it does not interfere with the economist's independent research." She states that in the past, "one could succeed in the department by focusing more on policy work or taking on other directed research projects" but that "this is not the case today." Today, one must do academic research to succeed.

She concludes by pointing out that this independent research is strongly supported; Fed researchers are provided with superb support facilities, and money to bring in visiting scholars, and to organize conferences and workshops that relate to their research. The only real problems with a Fed job for an academic economist that she sees are: (1) the lack of tenure pressures and (2) the need to do some policy work.¹ The latter is a problem because "some economists may find the non-research parts of the job policy work — to be onerous."

If her summary is correct, and from informal discussions with Fed economists it is, today academic research is the primary path to promotion for research economists at a number of the regional Feds, and a more important path than it was at the other regional Feds and the Board. Measuring research output by academic article publication metrics is a major reversal of previous situation where the Fed training turned academic economists into Fed economists.² It means that the distinction I made earlier between Fed economists and Fed understanding of the economy and academic economists' understanding is disappearing.

WHO IS TO BLAME?

I am not faulting Fed research economists — academic economists are trained to do academic research, and will naturally choose to do so unless provided with incentives to do

otherwise. If they can get the institutions to pay them to do the academic research, and advance based on that research, they have an incentive to do so.

If Fed research economists are not to blame, who is? The blame should go to senior management at the Federal Reserve banks who seem to have allowed an academic research culture to overwhelm the Fed's earlier focus on applied policy research. Mester states that that is what has happened. She writes that "senior management of the Bank sometimes has to be educated regarding the Research Department's mission and its measure of success." This suggests a serious failure of management from a public policy point of view. A key measure of success for Fed research should be preventing financial crises, and by that measure it failed miserably.

CONCLUSION

Let me be clear; I am not arguing that the Fed should not do any academic research. What I am arguing is that the majority of Fed research should have a different primary focus than academic research, and that advancement within Fed research departments should not depend primarily on academic publication. In my view, hiring economists to do primarily their own academic research is a misappropriation of public funds. Fed research should be primarily judged by its usefulness in recognizing, preventing, and solving real world problems.

How can the Fed improve the real-world focus of its research? One way is for management to significantly reduce the weight it gives to academic publications in judging research output. It should measure research output by the depth of understanding in the briefings and background papers its research economists write, as judged by policy makers, real-world practitioners, and others with deep institutional knowledge.

That change will be hard to introduce, especially at some of the regional Feds where the hands-on applied policy research focus has most decreased. One way to encourage a stronger real-world focus is for all the Feds to use some of the slots for hiring new research economists to bring in practitioners in banks and other financial institutions on one year research sabbaticals. These practitioners would work jointly with the existing Fed researchers in developing research — analyzing where the next crisis might come from and how it might be avoided. The goal of this program is to blend the real-world insights and institutional knowledge of bank practitioners with academic insights. The researchers would be required to present their work to a group of bank senior management and Fed senior policy makers. In the longer term, the Federal Reserve Banks could have a group of top financial practitioners review their research focus and avenues for advancement and make recommendations for reform.

Why has management at the Fed allowed this situation to occur? I suspect an important reason why is that it doesn't face a bottom line. The Fed can print money, which means that for Fed management hiring another research economist has essentially a zero cost to the Fed; it simply reduces the amount of seignorage that the Fed turns over to the Treasury. This lack of a bottom line accounts for current situation and the failure of senior management to direct research toward real-world policy issues. This, in my view, is a serious problem. If the Fed had redirected the efforts of its hundreds of talented research economists away from esoteric academic research, and toward hands-on applied policy research, I suspect it could have significantly improved our understanding of applied monetary policy, and very likely avoided the financial crisis. If they had, they would have earned far more than what they are paid.

Notes

1. The lack of tenure pressure results from the fact that once at the Fed you are pretty much assured of tenure — there is a 2-year probationary period — but as those first 2 years are spent starting a research program, and you are not expected to publish in those first 2 years, there is less pressure to get articles published than in academia.
2. While this was a discussion of a regional Fed, from discussions I understand that the situation extends to the entire Fed, to differing degrees. The old style Fed training seems to be decreasing.

References

- CSWEP Newsletter, Spring/Summer. 2006. The Art of Monetary Policy, in edited by David Colander, and Dewey Daane. Armonk, NY: Sharpe Publishing, pp. 8–9.