

Nout Wellink: The interaction between economic science and policy making

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, on receiving an Honorary Doctorate at Tilburg University, Tilburg, 12 June 2008.

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I would like to congratulate CenTER with its 20th Anniversary, but also with its academic record. I consider it an outstanding achievement that you are in the top three economics faculties in Europe and number 24 in the world. I can only hope that you achieve your objective of entering the top 20 soon.

As for me, I am especially grateful to receive an Honorary Doctorate from this renowned Catholic University. Being a Roman Catholic myself, I deem it appropriate to start with a confession. At the start of my professional career, I was asked to become an academic here at the Tilburg University. I hesitated for a while, but eventually I declined the job. At first, I therefore sensed a slight feeling of guilt concerning the honour that is being conferred upon me today: to receive academic recognition exactly from this university, where with a little twist of fate I could have spent my working life, contributing to scientific knowledge. But then, on further reflection, I started to like the idea. Although I did not become a full time academic, I have always kept a strong interest in scientific research. In fact I believe that throughout the years my policy work has benefited greatly from scientific input. The organisers have interpreted this fact the other way around, when they emphasize my contribution to the application of scientific insights in solving real world problems. I thank them for this. I accept my Honorary Doctorate with delight. I would like to dedicate it to the interaction between economic science and policy making.

Tensions between economic science and policy?

In my view, the interaction between science and policy has brought tremendous progress in both fields. We should be careful to maintain and improve this interaction when possible.

Although this point may seem to be self-evident at first sight, it is questioned by some. Several observers notice an increasing gap between highly formalised theory and the practical needs of policy making. An illustration of such a perceived gap in my own field of monetary economics is given in a recent overview paper by Gregory Mankiw, who himself has been an academic as well as Chairman of the Council of Economic Advisors in Washington. On the basis of a thorough review in a highly-ranked journal, he concludes that recent developments in macro economic modelling have had “close to zero impact on practical policy making”. Another example has been given by my British colleague Mervyn King with respect to modern communication strategies. He argues that the success of such strategies in stabilising inflation expectations at a low level is not yet fully understood from a scientific perspective. His claim is, therefore, that monetary policy is ahead of economic science in that respect.

Let me be clear on these points. There are indeed limits on the extent to which policy judgement can be based on science. In almost any policy decision, experience, intuition, “Fingerspitzengefühl”, or whatever name we can put to it, plays a crucial role. Perhaps the role of these elements has even increased in recent times. The outside world has become increasingly international and the economic system has become more complex. Let me give you just one example. At DNB, it is our job to assess the pass-through of the credit market crisis of the past year onto the real economy. The scientific approach would be to rely on model estimates. But unfortunately, the degree of uncertainty that always surrounds such

estimates jumps to even higher levels in times of financial stress. This illustrates that our judgement cannot be based on science alone. But does this imply that there is a gap between science and policy? I do not think so. After all, our research department has responded to the gap in our knowledge by shifting its attention to economic interactions under extreme events. I would therefore rather stress a natural interaction between science and policy than the existence of a gap.

Fostering the interaction between science and policy

On the interaction between science and policy, a first thing to note is that macro-economic science actually emerged from the need to address practical policy issues related to the Great Depression in the 1930s. Science and policy perform complementary tasks. Without any understanding of how the real world operates, it would be rather difficult to influence it. Similarly, it seems less relevant to understand what is going on, if these insights are not used for better policies. Scientists and policy makers therefore need to make efforts to understand each other. Policy makers can learn from structuring their thinking and ensuring its consistency. Scientists can learn from incorporating the flexibility and practical relevance that is needed for solving real world problems under political constraints. I therefore do not believe in a model in which universities focus exclusively on science while policy making institutions abstain from any role in scientific research. The potential synergies between both functions are large, but it takes continuous efforts to realise those.

In The Netherlands we have a strong tradition of basing policy on scientific insights, thanks to the efforts made by Tinbergen and the Netherlands Bureau for Economic Policy Analysis (CPB). As for central banks, I believe that the worldwide movement towards independence has been one of the driving factors of a greater orientation towards a scientific foundation of policies. Being free from political influence and preferences, our legitimacy partly depends on it. As such, we have found practical ways for fostering mutual understanding between science and policy. One is the direct way. Several central banks have appointed renowned academics in top positions. Ben Bernanke is at the FED, Mervyn King at the Bank of England, Athanasios Orphanides at the central bank of Cyprus and Stanley Fischer at the Bank of Israel. It is not only that policy discussions benefit from contributions of these people; they also use their networks for bringing topical policy issues into the scientific debate.

Another way for bringing science and policy closer is by hiring specialists in central banks who understand the language of a specific discipline. This is what we do at DNB. We employ researchers in all fields that relate to our core tasks. For example, research in recent years has focused on Mervyn King's point about why modern monetary policy strategies may work in stabilising inflation expectations. But it has also dealt with decision-making within committee structures, economic modelling, payment systems, behavioural finance, the efficiency of banks, financial conglomerates and so on. Researchers at DNB actually have a challenging job in bridging science and policy. They have to keep themselves up to date with scientific developments in their field; they work independently; on policy-relevant topics; and they are asked to translate their findings into practical policy advice. This last element is probably what distinguishes research at central banks from research at universities, where the incentives for specialising in a more fundamental type of research are stronger.

Impact of economic science on policy

I have argued that science and policy perform complementary functions, and that central banks perform a key function in fostering mutual understanding. Let me now address the impact of science on policy. I very much believe in the maxim that "most of the fundamental ideas of science are essentially simple, and may, as a rule, be expressed in a language comprehensible to everyone". This is not something that I have made up myself, but is actually a quote by Einstein. In my own field of monetary policy the fundamental ideas of

science have indeed been intuitive and simple. They have had a tremendous impact on policy. I guess that most of you are familiar with many of the key insights. On the relevance of price stability; on the costs of inflation; on the inability of monetary policy to raise the structural growth rate of the economy; on the importance of central bank independence from political influence.

The point here is that these essentially simple insights were distilled from a huge and often very complicated body of research. I am thinking here about contributions in the 1960s and 1970s on the shape of the Phillips curve, research on time inconsistency that emerged from the late 1970s onwards, research on central bank independence in the 1980s and 1990s, and recent discussions on central bank accountability and communication. Perhaps current researchers can take comfort in the fact that one day the outcomes of current scientific debates may also become glaringly obvious. But in the meantime we need to struggle on before science reveals the answer to us.

Conclusion

Let me conclude with a forward looking perspective. It seems obvious that globalisation and financial innovations will continue, so that complexity in the economic and financial system will continue to increase. Take the financial turmoil of the past year, to which I referred already. Obviously there is a need to tailor our policies, for example financial supervision and monetary policy, to the dynamics that we have witnessed in the financial sector. But in order to do so we need a thorough understanding of what is going on. With a more complex and dynamic financial system, our demand for high quality analysis and research can only increase.

At the same time, while demands are increasing, resources are under pressure. The efficiency operations of the current government that apply to the ministries and the CPB also apply to DNB. While I fully support the need for an efficient government and an efficient central bank, I also see a risk that knowledge-intensive functions could be under disproportionate pressure. A key characteristic of research is that it requires relatively long time horizons, and that its pay-off emerges in the medium rather than in the short run. As a result, it can easily be crowded out by the many policy issues that continue to require immediate attention.

The challenge is to protect key research areas from such pressures, and to maintain the human capital base in our institutions. The need for research will always remain, whether policy makers immediately like the answers or not. For each question that we answer, new ones arise. I truly believe that the interaction between science and policy has brought tremendous progress in both fields. We should continue our efforts to foster mutual understanding. Let me once again show my gratitude for the honour that you have conferred upon me and thank you for your attention.