Niklaus Blattner: Economics is what economists do

Speech by Professor Niklaus Blattner, Vice Chairman of the Governing Board of the Swiss National Bank, at the Opening Session of the Integrated Master Programme, Faculty of Economics and Behavioral Sciences, Department of Economics, Albert-Ludwigs-Universität, Freiburg im Breisgau, 22 October 2004.

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1. Introduction

This is an important moment in the professional life of all of you who have chosen to participate in one of the three Master Programmes starting today and offered by the University of Freiburg. Your choice was either the Master of Economics and Politics, the Master of Finance or the Master of Internet Economics. A common denominator of all these programmes is economics. I felt it might be worthwhile, right at the beginning of your undertaking, to draw your attention to what economics stands for. This begs the question of what economics is. Jacob Viner (an eminent international trade theorist, 1892-1970) gave a slightly disturbing answer: "Economics is what economists do". This sounds less scientific than you might have wished. But Viner has a point: when talking about a subject that has a history of constant change and development, why not simply look at the empirical facts and take instruction from what one observes?

This is exactly what I propose to do. - I base on my own experience and observation. My justification, since we are in the country of Johann Wolfgang Goethe, is a quote from Faust: "Grau, teurer Freund, ist alle Theorie und grün des Lebens goldner Baum". ("Grey is all theory and green the golden tree of life.")

My professional life includes periods at university, in government, in business, and finally at a central bank. My experience is nevertheless limited. Moreover, most of it has been collected in Switzerland. - But let's find out what my experience and thinking still can tell you.

If you now fear that I am going to tell you the story of my life, please relax. I shall refrain from this, but I cannot, and should not, completely ignore it. I shall present sketches of what economists do, sometimes adding examples. The examples are modelled on real life; they are not real life itself. What do they say in books and movies? "Every resemblance to a real-life economist is purely accidental …"

2. Economists at university

You are all familiar with university. You went there after school. You first had to choose your field of study and then you entered a world unknown. Why does one select economics? What does it mean to stay at university and possibly end up as a professor?

One may have chosen economics out of a feeling of social responsibility. As Arthur Cecil Pigou (1877-1959) put it: "The social enthusiasm which revolts from the sordidness of mean streets and the joylessness of withered lives … is the beginning of economic science." One may have chosen economics to find out how to become wealthy. Woody Allen said: "Economics is the study of money and why it is good." Or one may have chosen economics to find out how society functions. Economics certainly offers a good starting point for this endeavour. Let me quote Alfred Marshall (1842-1924): "Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing." Or one may have chosen economics because it is so hopelessly difficult and therefore enormously attractive to, and here I quote Robert Solow, "the overeducated in pursuit of the unknowable".

In the process of studying economics, every student sooner or later will have to decide whether do drop out or to continue. Most of the students opt for the practical application of what they have learned and quit university after their final exams. Some, however, will opt to stay on.

In practice, this means to teach, to do research and increasingly to administrate since the universities have become large and slow-moving institutions. Let's forget the latter and talk about the former.

In teaching and in research lies most of the professional fulfilment of a university economist. But one will have to bear the consequences of having selected the "pursuit of the unknowable".

Looking at the subjects list according to which in the *Journal of Economic Literature (JEL)* publications are classified, you get an idea of the scope of today's economics. It ranges from A. General Economics and Teaching to Z. Other Special Topics with Z1 Cultural Economics as a last one-digit subclass. The total number of one-digit subclasses is well over 600. In fact, there are no subject limits for economists for applying their methods. This attracts many of the best minds.

For success at a university, articles published in refereed journals are all-important. The well-known rule, not exclusive to economics, is: publish or perish! When applying for a university position, the applicant knows that the selection committee bases its choice on the list of publications submitted. Who decides what papers are to be accepted for publication? In refereed journals the selection of articles is largely delegated to anonymous referees. These are academic economists of good reputation. The editors of the journals apply the principle of peer review. Nevertheless, Bruno Frey (University of Zurich) recently attacked this system in an article - itself published in a refereed journal - under the heading *"Publishing as Prostitution"*. He argues that in the current system authors might unduly trim their own original ideas in order to enhance their academic success.[1]

To research and to publish is one thing. But professors also have to teach. This is an area where students exercise their own judgment. But let me tell you what my own experience is. Whether a teacher belongs to the economists driven by "social enthusiasm" (Pigou), by the wish to find out "how society functions" (Marshall) or by the "pursuit of the unknowable" (Solow), to teach is not only challenging but also most rewarding.

First, one has to define the contents of a course and then how to present it. Then, one has to find out how to stimulate curiosity because this is the best motivation for learning. One has to understand how students react to complexity, and one has to be prepared to answer their questions as they arise. Ideally, a professor is able to take his students on a journey of learning that never ends. Once the course is over, a student should know more than before, have an interest in applying what he or she has learned and never forget the most important lesson: what she or he was taught is never a recipe, but only a first step in an ongoing sequence of learning, collecting experience and further learning.

If you think this sounds too good to be true you may have a point. So let me end this section by painting a bleaker type of university economist: the university economist is a master of his profession who prefers not to apply his knowledge to the resolution of real-life problems, but to improve his knowledge further in order to impress his peers. If it cannot be helped, he shares part of his riches with his students. - You might find this type of economist too, but only very, very rarely!

3. Economists in government

"Give me a one-handed economist! All my economists say, 'on the one hand … on the other'." - You surely know this quote which goes back to the late Harry S. Truman (1884-1972), when he was President of the USA. It is an expression of the impatience that befalls politicians when they call on economists for advice. Another quote by the same man is: "If you can't stand the heat, get out of the kitchen." The two quotes describe better than almost anything the challenges an economist has to face when he chooses to work for the government.

Politicians are usually confronted with sensitive questions. The replies are decisive for a politician's success. Frequently time is short and straightforward answers are preferred - as long as they fit the preferences. Politicians have a natural predisposition to seek advice that is compatible with their political needs. Economists acting as civil servants or as government advisers are therefore quite naturally tempted to behave opportunistically. This will not pay since in the long term a serious loss of professional reputation is inevitable. Economists must not let themselves be carried away by a desire to please. Their added value lies in an objective application of their analytical and empirical tools. Economics is, not without justification, sometimes called the "dismal science" (Thomas Carlyle, 1820-1905). Economics is about tradeoffs. An economist's duty is to identify tradeoffs, especially when it hurts. For a politician to take decisions without knowing the relevant tradeoffs is surely even more painful because it necessarily leads to disappointment and eventually to failure.

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1 Frey, B.S. (2003), "Publishing as Prostitution? - Choosing between One's Own Ideas and Academic Success", in: Public Choice, 116, 1-2, 205-23.

In examples of economists' work in government controversy plays a central role because economists regularly disagree. Different economists time and again identify different tradeoffs. This may be deemed a fundamental weakness of economics. I do not share this view. I rather think that although a lack of consensus among economists makes life more difficult for politicians, it ultimately improves their rationality. Politicians have to assume full responsibility; they must not pass it on to advisers. Just as everyone benefits from a "second opinion" from doctors before undergoing medical treatment, politicians benefit from a second or even a third opinion from economists before deciding on a particular political programme.

The example - or should I say controversy - I have selected to illustrate the task of economists in government is the introduction of the euro, which took place on January 1, 1999.

From the perspective of an economist, the launch of a common currency promises benefits and causes costs. Since the benefits are mainly the result of structural improvements and the costs are due largely to the greater difficulty in steering inflation and economic activity, it is difficult to offset the advantages of a monetary union against its disadvantages. Whether a monetary union, on balance, creates benefits or causes costs depends on a whole range of factors. Robert A. Mundell can be summarised as follows: in order to form a so-called optimal currency area, the member countries must be structured along similar lines and exhibit a high degree of flexibility.

The benefits of a monetary union consist in a reduction of transaction costs for changing money, the elimination of internal exchange rate uncertainty, tighter competition thanks to easier price comparisons, the expansion of trade within the common currency area, the prevention of competitive depreciation and speculative attacks on a currency, and growth in the liquidity of the financial markets. The most significant costs of a currency union arise from the loss of the individual countries' independent monetary policies.

The loss of monetary policy autonomy is particularly felt when the size or number of asymmetric shocks is large. Such disruptions affect the economic structure, business activity and inflation of member countries in different ways. Thus, they cannot be combated with a uniform economic policy. A controversy that has not yet completely died down is this: was the reunification of the two Germanys after 1989 a shock that significantly impaired the prospects for a successful integration of Germany into the European Monetary Union? Related to this is today's debate on the economic soundness of the *Stability and Growth Pact*. Is it right to adhere strictly to the Maastricht Treaty's stability requirement even if in Germany business conditions diverge strongly from the euro-zone average?

The jury is still out. But in the eyes of most economists when asymmetric shocks abound, a uniform monetary policy and similarly restricted fiscal policies are not recommendable.

In a longer-term perspective, the costs of the loss of monetary and fiscal policy independence will be progressively lower as the pace of economic adjustment accelerates over time. The speed with which the economy recovers depends largely on the flexibility of the labour market and on job mobility. When salaries develop in line with a regional economy, when direct investment is strong and when the workforce is mobile, regional shocks are more easily absorbed. This type of reasoning favours reform programmes like Hartz IV in Germany.

Let me stop short. It is not my task to offer advice to European authorities in general or to German authorities in particular, all the more so since the creation of the European Monetary Union has proven a great success despite the inevitable teething troubles that regularly come with great innovations. I wanted to give a pertinent example of the work of economists in and for government. There were economists advocating an early European Monetary Union and they gave their reasons. There were other economists who would have preferred seeing more economic convergence between and within euro-zone member countries first, and they spoke out too. Both groups of economists did their jobs remarkably well. Today, most economists speak out in favour of labour market reform and other programmes for reform to make the euro zone work. Other economists prefer macroeconomic demand management. All of them want to help politicians to realise their legitimate economic ambitions. The economists' papers, non-papers, reports and opinions are welcome. Economists in government work hard and their work is useful. Their professional life is fascinating.

4. Economists in business

The Occupational Outlook Handbook of the US Department of Labor contains the following description of what economists in business do: "Economists working for corporations are involved primarily in microeconomic issues, such as forecasting consumer demand and sales of the firm's products. Economists working for corporations might also analyze their competitors' growth and market share and advise their company on how to handle the competition. Other economists working for corporations monitor legislation passed by Congress, such as environmental and worker safety regulations, and assess its impact on their business. Corporations with many international branches or subsidiaries might employ economists to monitor the economic situations in countries where they do business, or to provide a risk assessment of a country into which the company might expand."[2] - This list is by no means complete but it provides a good first impression.

Let me tell you the story of a young economist who joined a large multinational business corporation many years ago. The post he held was that of a junior economist in the "central staff of economics". Coming straight from university, he was clearly impressed by the sheer size of the headquarters and the complexity of the organisational structure of the company. There was a plethora of administrative units and of important production units. The organisation was of the matrix type, i.e. there were *product divisions*, there were so-called *"regions"* responsible for large segments of the globe like Europe, North America, Latin America and Asia, there were *central functions* like human resources, legal services, research and development and there were *central staff units* like corporate planning, politics and economics. Numerous important persons assuming significant responsibilities rushed from meeting to meeting and from business lunch to business lunch, mostly with clients and corporate visitors from abroad and sometimes just with local colleagues. The food and the wines served at the visitors' restaurant easily matched what was on offer in the best restaurants in town.

Clearly the junior economist felt great from the very first day. He sensed that he was expected to contribute to the development of this grand corporation, that he was finally in a position to apply what he had learnt at university and that his superiors, the more senior or even very senior economists in his unit, were waiting for him to deliver. It was all the more sobering for the young economist to find that during many months his main task consisted in reading the economic section of newspapers in order to compose summaries that went as newsletters to other organisational units which had the same newspapers on their desks.

Later on, after having been observed attentively by superiors, more serious tasks were given to the young economist. The corporate planning unit requested economic data serving as exogenous variables in their divisional or regional planning exercises. The young economist was enthusiastic. He thought that now the moment had come to apply his macroeconomic and econometric forecasting skills. But again he was disappointed. Senior colleagues explained that forecasting had long been outsourced to independent forecasting institutes. What was required from the junior was simply to take these outside forecasts and fit them into the tables according to the requirements of the planners. He then found out why his professional skills were not in demand. The reason was not the greater efficiency and quality of outsourcing. The reason simply was that outsourcing made it easier for the company's economics unit to avoid responsibility. The planning of corporate production was a heavy responsibility indeed. The exogenous economic variables affected the outcome of the planning process decisively. Erroneous economic data were likely to produce disaster, and for disaster nobody in the central staff of economics was prepared to accept the blame. Therefore, economic forecasting was outsourced. If disaster did strike, the external provider of the data would be blamed. He would lose his contract and a different forecasting firm would be hired. In this way, the blame was externalised elegantly.

It is not surprising that under such circumstances the young economist had to reassess his professional situation and to look for other fields to develop his skills. But he kept many valuable souvenirs. Don't forget that he acquired first-hand knowledge of what a powerful giant multinational company can be, but also how fragile it can become when the growth of its organisation is not sufficiently controlled. - Incidentally, this same company is still prospering, but over the decades it has been thoroughly reorganised many times. Restructuring has become a habit. If the former young economist revisited "his" company today, he would not recognise it anymore. The complicated matrix organisation, including the central staff of economics, has disappeared. Responsibility is structured in much simpler ways. The hierarchy is considerably flatter. The game of externalising blame can no longer be played as easily as in former times. Even the quality of food and wine served at the visitors'

2 http://www.bls.gov/oco/ocos055.htm.

restaurant is more modest. One might still be offered a cigar after lunch, but the selection would most likely be narrower than in the 'good old days'.

With respect to the disappearance of economics units in business corporations, John J. Casson writes: "During the past two decades, several corporations, including IBM, Citibank, American Express and General Electric, eliminated their economists units. According to a recent article in *The New York Times*, the poor forecasting record of economists was a principal reason for such cutbacks. A re-examination of the results of a survey conducted by the author found another possible explanation for corporate disenchantment with their economists. It appears that many business economists have not furnished information that can be employed in business planning."[3]

Neither the story of the young economist nor Casson's findings should de-motivate those of you who think of venturing into business after university. There are two conclusions to be drawn. The first is: the professional quality of the business economist is important. But professional quality alone is not sufficient. Quality may easily be drowned in a flood of bad management following from an over-complex organisation. This leads to a second conclusion: every young economist confronted with bad management has a choice. Albert O. Hirschman distinguishes two possibilities of reaction besides 'loyalty', i.e. keeping mum, namely 'exit' or 'voice'.[4] In my story the young economist decided to exit the corporation. This was fine because he made his way elsewhere. Had he chosen 'voice', i.e. had he stayed with the company and fought for its improvement he would have had a good chance of succeeding within the organisation instead of outside of it. Indeed, not a few of our young economist's colleagues who stayed with this or similar companies and helped to drive them forward were duly rewarded. Today some of them are even on the companies' boards.

5. Economists in central banking

"Never has central banking been more subjected to scientific analysis than during the last two decades. Increasingly, the economic profession has moulded the behaviour of the central banker into abstract economic models. This has made it possible to analyse how the central banker can be given incentives that will make him do the right thing: how he should set interest rates optimally; how he should be made accountable; and what his punishment should be if he fails to comply with the terms of his contract. Yet, after the scientific onslaught of the last decades, there is still the feeling that, after all, central banking is mainly an art, and that the success of a central banker depends on such intangibles as feeling the mood of the market."[5] - This quote from Paul De Grauwe tells us that central banking is a place where economists are particularly challenged. They have to excel as professional economists and, at the same time, they need to understand what drives the moods out there in the markets. "Scientific analysis must be combined with artistic feelings to produce a successful central banker."[6]

Central bankers assume responsibility for price stability as well as for financial stability. This in some countries includes banking supervision and financial market oversight. At the same time, they take care of the side effects of their policy on economic growth, employment and international trade. In other words, theirs is the world of economics in a very comprehensive sense of the term. The better central bankers understand real and monetary macroeconomics, microeconomics, financial market economics, labour economics, industrial economics, international trade, public finance and public choice, the better equipped they are for their task.

The favourite intermediary targets or policy instruments of central banks are short-term interest rates. When attempting to influence the rate of inflation by changing interest rates one needs reliable economic models. In the Swiss National Bank, we start with a definition of price stability. There is price stability as long as the annual increase in the consumer price index does not exceed 2%. We then use an inflation forecast over a period of three years. The three years correspond to the known range of

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[3] Casson, John J., "The Role of Business Economists in Business Planning", http://www.findarticles.com/p/articles/mi_m1094/is_n3_v31/ai_18481623.

[4] Hirschman, Albert O., Exit, Voice and Loyalty, Cambridge Mass., 1970.

[5] De Grauwe, Paul, "Central Banking as Art or Science? - Lessons from the Fed and the ECB", in: International Finance, 5:1, 2002, p. 129.

[6] Loc.cit., p. 130.

monetary policy lags. To forecast inflation, we have developed a number of state-of-the-art econometric models. The results of these models are translated in what we call ‘consensus forecast’. It shows different inflation paths as a function of alternative short-term target rates of interest. The Governing Board has to select the preferred target rate of interest (3M-CHF-LIBOR), which is implemented through daily money market operations. It is in the process of selecting the target rate of interest that art comes into the picture. The econometric models are not sufficient. Judgment is needed. This judgment is of a sophisticated nature. The Board members have to understand the limits of the models in order to be able to identify the weakness of their results. They also have to understand what is actually going on in the economy despite imperfect statistical data. “The art of central banking requires more than just intuition.”[7]

At the Swiss National Bank, we review monetary policy at least every quarter. In addition, our economists produce quarterly financial stability reports. Our economists pursue programmes of academic research and regularly publish their papers in refereed journals. The Swiss National Bank pretty much resembles a department of economics at university. The professors are there, the research economists and the statisticians are there. The students are lacking. But many of us continue to teach at one of the Swiss universities.

This picture of the activities of economists at a central bank is not unique for Switzerland, but is similar to that found in most central banks.

7. Conclusion

The title of my paper is “Economics is What Economists Do”. By presenting a review of what this may mean at university, in government, in business and in central banking, I hope I was able to support your motivation for your study of economics. Listening to my talk, you might have noted that the real issue is not so much what an economist does as how she or he does it. After having been an economist for more than three decades myself I have never regretted having chosen economics as my profession. You are young, and you presently face one of those crossroads that inevitably shape a life. The future is full of surprises. I wish you the necessary enthusiasm and strength without which professional and personal development is hardly achievable. - Remember my quote from Goethe. It is Mephisto who says: “Grey is all theory and green the golden tree of life.”

Good luck to you all!

7 Duchatczek, Wolfgang, Schubert, Aurel, “The Art of Central Banking Requires More Than Just Intuition”, paper to be found at www.ecb.int/events/pdf/ conferences/eastats/duchatczek.pdf.