

The Importance of Connecting the Research World with the Policy World

Monetary policymakers throughout the world face many intellectual challenges. In calm times, we tend to grow comfortable with existing models and existing conceptions of how the world works. Of course, we recognize that economic models are simple abstractions of the world around us and that

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the real-life economy might behave quite differently. Nonetheless, when actual macroeconomic behavior departs dramatically from predictions, as it has in the past five years, it is still a shrill wake-up call. Not surprisingly, such events make us reconsider our fundamental conceptions about how the economy works.

The St. Louis Fed has long sought to provide perspectives on whether the policies adopted in the past still serve us well and whether developments at the research frontier can be applied to improve policy. One priority is to encourage better dialogue between leaders in the research world and policymakers. **I have been dissatisfied with a state of affairs that has evolved over the past 25 or 30 years in which a certain group of economists worked on rigorous models and published in journals and a separate group of economists focused on policymaking issues. These two groups often did not interact.** Yet, the issues discussed in the academic journals are our core ideas about how the economy works and how to think about the economy. Those ideas should be an integral part of the thinking of any policymaker.

As an example of present-day disconnect, research by Jess Benhabib, Stephanie Schmitt-Grohé and Martín Uribe—on what can be thought of as a liquidity trap steady-state equilibrium—has influenced my thinking about how we should attack policy issues in the aftermath of the crisis. Benhabib et al. theorize that two possible focal points for the economy exist—a desired steady state with relatively high nominal interest rates and inflation at target, and an unintended steady state with very low short-term nominal interest rates and

mild deflation. The Japanese economy seems to have been stuck in this second, unintended steady state for quite a while. Much of the thinking in the monetary policy world is that the U.S. should not repeat the Japanese experience. Yet, despite the important work by Benhabib et al., and despite the policy desire to avoid the Japanese experience, in the research closer to policymaking it is a rarity to see the second steady state even included as part of the analysis. **This is the type of intellectual disconnect that should not happen—but unfortunately it does.**


Unemployment issues provide another example. In this area, I have been influenced by some recent theoretical studies by Federico Ravenna and Carl Walsh. These authors put a rigorous and state-of-the-art version of unemployment search theory into a standard monetary policy framework with an eye toward describing optimal policy in terms of both unemployment and inflation. The core monetary policy advice that comes out of the model is that the policymaker should “maintain price stability.” That is, the policymaker in the model does best by maintaining inflation close to target on average, without placing special emphasis on unemployment, even though there is an important unemployment problem in the model. That is an important finding given that unemployment has been much higher than what we have been used to in the U.S. in recent years. My sense is that the Ravenna and Walsh results have received insufficient attention in the policymaking world.

In macroeconomics, the intellectual challenge is every bit as great as it is in other fields that have unsolved problems. The economy is a gigantic system with billions of human decisions made every day. Furthermore, people look to the future and try to predict the behavior of the system as they make their decisions today. How are all these decisions being made? How are people reacting to the market forces around them and to the changes in the environment around them? How can we effectively summarize their behavior at an aggregate level? How is policy interacting with all those decisions? These are not questions that can be addressed with a wave of the hand,



a clever speech or a witty blog posting. There is just no substitute for heavy technical analysis—plenty of math and statistics combined with plenty of computing power and plenty of intellectual creativity—to get to the bottom of these issues. We might as well admit that progress in attaining satisfactory answers is going to be slow, but still this is the only reasonable course to make progress.

Individual researchers often wish to focus attention on relatively small problems that can be analyzed effectively. This is natural: We need an answer in a reasonable amount of time. **But working on stripped-down problems is inadequate in the medium and longer run to get a clear understanding of how the economy works and how various policies are affecting macroeconomic outcomes.** The macroeconomic research effort in the U.S. and around the world needs upgrading. At some point, the economics profession needs to have bigger, more elaborate models with many more important features, remaining consistent with microeconomic theory and evidence, to see more clearly how those features interact and to obtain a more sound understanding of how policy affects the entire picture.

It is clear to me that policymakers must be receptive to working through and understanding rigorous theory, while researchers must be receptive to grappling with policy issues. Success is much more likely when the theorist and the policymaker communicate with each other. The foundation for good policy to deal with our pressing and vexing policy issues is rigorous and relevant theory. There are simply no shortcuts. 

James Bullard, President and CEO
Federal Reserve Bank of St. Louis