

More Theory, Please

BY JOHN A. WEINBERG

This issue of *Region Focus* features a special section on the “state of modern economics.” Some of the articles report on debates regarding the direction of the discipline. Are economists asking the right questions? Are they employing the right methods? Is their work relevant to the general public? In short, has the economics profession lost its way?

These are all healthy questions to ask. Economists shouldn’t blindly proceed, simply assuming that they are heading in the right direction. Occasionally, a little self-reflection is necessary.

But, I think, the hand-wringing that some economists have been doing is overwrought. I am sympathetic to the argument that much economic research should ultimately have policy relevance. After all, I work as an economist in the Federal Reserve System. That doesn’t mean, however, that this research must eschew formal, mathematical modeling. Quite the opposite.

Economics has a long and storied past. The classical economists of the 18th and 19th centuries had valuable insights, many of which remain relevant today. Those insights, however, can be made more precise by the use of contemporary formal methods. Such methods also permit us to find new implications or limitations to the classical economists’ ideas.

Indeed, the formal methods of modern economic theory are essential to policymaking. To take just one example, let’s consider central bank lending. In the wake of the credit market turmoil that began in 2007, the Fed and other central banks expanded their provision of credit to the financial system. It is impossible to understand the arguments for or against such actions without reference to a theory of how financial markets function and under which conditions they may malfunction. Moreover, without the tools of formal analysis we cannot determine whether the theory on which we are basing our policy choices “makes sense,” or exactly what assumptions are needed to make its logic correct.

Of course, the relevance of a theory relies on its ability to explain some observable facts — that is to say, data. This requires the use and refinement of formal quantitative tools. For policymakers, the desirability of various choices often comes down to questions of magnitude. How big of a change will a certain policy choice produce?

Consider the issues of subsidies and taxes. Economists know that when you subsidize something, you are likely to get more of it, and when you tax something, you are likely to

get less of it. That’s helpful to know, but it often isn’t sufficient. For instance, you might wish to subsidize a certain activity — say, education — if you believe it yields positive externalities. But, first, you want to know how large those externalities will be — and if there would be a more efficient way to achieve them. To determine this, we must turn to contemporary tools of data analysis.

For macroeconomists, the “New Keynesian” framework has become a workhorse model for policy analysis. It is rich enough to generate quantitative predications about how key macroeconomic indicators are likely to perform under alternative settings. This, of course, is key to central bankers and other policymakers. But even as this framework is used

extensively, researchers are studying its limitations. This will ultimately lead to even better models and better policy.

In the introductory article to the special section, the question is asked: “Why isn’t there a Milton Friedman today?” While this question might seem to suggest that modern economists have gotten bogged down in mathematical minutiae to the detriment of speaking to the public, I think the answer actually lends support to my argument. It’s true that most people know Friedman from his *Newsweek* columns, his books *Capitalism and*

Freedom and *Free to Choose*, and his television appearances. He wanted to directly address the public, and he did so eloquently. But you can’t divorce his popular work from his academic work. Friedman was first and foremost a great economist. It was his technical, scientific contributions that informed his policy views and popular writings, not the other way around. Without Friedman the mathematically inclined economist, there likely would not have been Friedman the influential policy analyst.

We can question whether the economics profession adequately rewards speaking to the public — there is, in my opinion, an important role for economic education — but that public communication will be most valuable if it reflects recent advances in economic theory and quantitative analysis. The discipline is making significant strides in understanding a wide range of economic phenomena. We should not abandon that work. Rather, the trick is to effectively communicate it to a broad audience. It’s not an easy task, but one well worth pursuing. **RF**

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