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Opening remarks at the CEMFI 25th Anniversary Conference

Lessons of the Crisis for Research Agendas in Economics

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I would like to thank Rafael Repullo, the director and founder of CEMFI, who has been kind enough to invite me to participate in this special 25th Anniversary celebration for CEMFI. It is a great pleasure to introduce this conference in which outstanding academic economists like Christopher Sims and Andrei Shleifer will be offering presentations that, I am sure, will be of great interest.

Unquestionably, CEMFI has played an essential role in the development of the highest quality teaching and research in economics in Spain. This role was especially important in its early years, when CEMFI was virtually the only option for receiving a top-level education in Spain in financial and monetary economics.

Over the past twenty five years, CEMFI has not only managed to retain the spirit of its early years; it has also broadened its horizons, becoming an international point of reference as an academic centre. By way of example, CEMFI receives more than 250 applications every year from students from the leading universities in more than 50 different countries. The applications undergo a rigorous selection process until they are narrowed down to a limited number per course, at times as low as 20. Of course, this could not be possible without the excellent nucleus of professors CEMFI boasts.

Throughout the years, CEMFI has been blessed in being able to attract and retain renowned researchers of the stature of Manuel Arellano, Samuel Bentolila, Rafael Repullo and Enrique Sentana, who together with a new generation of excellent economists, make up one of the best Departments of Economics in Europe.

Among CEMFI's many contributions in the past twenty five years, let me emphasise the role it has played in improving the standard professional quality of the economists employed by both the public and private sectors. The Banco de España has naturally been one of the entities to benefit most from this. Currently, we are fortunate to have 60 CEMFI graduates working for the Bank and, in several cases, occupying substantially senior positions. But the contribution CEMFI has made to the profession does not just stop at improving human capital. Through its publications and seminars series, CEMFI participates prominently in both the academic and the policy debates on an equal footing with other outstanding academic institutions.

Indeed, the role of economic research in policy-making is a recurrent topic for discussion in the profession. Let me use the rest of my time to offer some brief remarks on this.

Taking policy decisions typically requires addressing analytical questions and/or conceptual problems on which economists have often accumulated knowledge by developing models and gathering and interpreting data through the lenses of well-established empirical methodologies. However, the research input does not always noticeably feed the policy decision process. In particular, it is often the case that we lack a sufficient degree of consensus on the "right" model and the "relevant" empirical evidence to justify a particular decision.

Moreover, quite frequently, the available analysis of policy alternatives falls short of taking into account all the political and social constraints involved. In addition, when gaps between available knowledge and policy needs are apparent, the timing of policy-making is not always compatible with that of research, as there are decisions that cannot be delayed until the research comes up with new results, new insights and new evidence.

During the crisis, we have witnessed a clear manifestation of these problems. Policy-makers have been under pressure to address questions that required urgent answers and action, for which available models, among them a wide variety of DSGE models in use at central banks, were not well-suited. Having been designed for other uses, DSGE models have not yet been able to fully incorporate relevant complex links between the real and financial sectors of the economy.

Yet it is no less true that from time to time policy-makers have not paid sufficient attention to policy-relevant available economic research –I mean good economic research- and that, by doing so, they have contributed to increasing the probability of making policy mistakes. Let me give an example.

By looking at all the relevant deficiencies in the institutional design of EMU that the crisis has uncovered, it is natural to wonder whether somebody had already told us this but we did not want to hear.

Frankly, despite the opportunistic proliferation of ex-post prophets, I believe that nobody fully anticipated the nature and, much less so, the magnitude of the current European crisis. More importantly, nobody really put forward at the right time a magic solution to prevent it.

Yet, it is also clear that a few academics wrote insightful pieces many years back that would have merited careful reading and consideration by European leaders. One example is, obviously, one of our guests this afternoon, Professor Chris Sims. In an outstanding article written in 1999, he identified what he called "the precarious fiscal foundations of EMU" whose consequences have unfortunately become very real and have prompted a large-scale policy reform which is yet to be fully completed.

In any case, it is simply unfair to ask academic economists to deliver solutions to complex institutional deficiencies which are largely rooted in political constraints or, more generally, in behavioural patterns of relevant agents that involve a departure from economic rationality.

Nevertheless, let me highlight a few issues that I believe are, and will continue to be, among the most instrumental ones for the current conduct of policy-making in Europe.

The first issue –and the order is not at all random- is the identification of the best policy strategy to end fragmentation in European markets. This development is very much associated, as we all know, to the destabilising link between banking and sovereign risk, which is severely damaging the monetary policy transmission mechanism. We are still struggling in Europe to identify –and naturally to implement- the right combination of initiatives in three different fields: domestic policies, monetary policy and institutional design.

In connection with this latter area, the design of an effective resolution regime for troubled financial institutions in a multi-country monetary union context would very much benefit from a deeper economic analysis of the relevant trade-offs involved.

Another area where further knowledge would be most welcome is fiscal policy, in general and with regard to its interactions with monetary policy. At present, a fierce debate rages between those who believe in “expansionary fiscal austerity” and those who, on the contrary, are convinced that fiscal consolidations, in the current context of depressed private demand, are self-defeating. The economic literature has illustrated this debate with a wide variety of new estimates of the so-called “fiscal multipliers” which, to a large extent, are taken as sufficient statistics of what fiscal policy can and cannot achieve. From my perspective, biased by the Spanish situation, I fail to extract sufficient guidance from this literature on how best to approach the debate in a country with no monetary autonomy, relatively high private indebtedness and subject to the adverse impact of still-excessive sovereign and redenomination risk.

In any case, I think that in order to understand the effects of fiscal policy in the current complex economic set-up we need much more than extending the set of estimates of fiscal multipliers, even under new methodological approaches.

Finally, a third set of issues on which deeper academic analysis would be welcomed is the interaction between regulatory reform and potential growth.

I had the privilege of viewing the slides that Andrei Shleifer is expected to use in his presentation later on. I trust I will not be unveiling any confidential information if I anticipate that he will be arguing most convincingly that the “neglected risk” by both public and private players is one of the most powerful factors behind the crisis. That of course speaks quite loudly in favour of more stringent capital and liquidity requirements for financial institutions.

Yet, we still need to fully understand the overall macroeconomic effects of a tougher prudential policy with a view to fine-tuning the different available regulatory instruments and, if needed and possible, to adjusting other policies in order to offset potentially adverse effects on the availability of financing.

In any event I find that, beyond what research can do to optimise policy design, researchers themselves and, more generally, economists with deep-rooted training in advanced economic analysis, can and do contribute to making policy mistakes less frequent and severe and to improving the management of both public and private projects.

That is why we at the Banco de España, as the sponsors of CEMFI, are so proud of the support provided to this academic centre over the years. Such support has been substantially vindicated by the numerous outstanding contributions CEMFI has made to the Bank itself, to the economics profession and to the country at large.

So, happy anniversary.