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Introduction

This book may be described both as a tribute to the memory of Professor Federico Caffé and as an outcome of reflections made in the 1980s about the way in which economists could help in the choice of better policies. In Western Europe the main problem to be faced was, of course, unemployment. As a government statistician, an occasional policy adviser and a theorist, I had to pay particular attention to the weakness of the diagnoses on which policies were based. I had then to reflect on the instruments and analytical arguments used at the diagnosis stage.

It was only natural for me to select topics from these reflections when I was asked to lecture, dealing on each occasion with aspects that seemed to deserve the attention of the audience concerned. Some of these lectures were later printed, but often not in widely accessible publications. This book provides an opportunity not only for reproducing the material but also for gathering it in such a way as to make its common purpose more apparent.

Actually the two Caffé Lectures, given at La Sapienza University in Rome, did aim at covering the full range of those recent reflections. They are published here for the first time, respectively as chapters 1 and 4. Three other chapters have appeared so far only in French (2, 3 and 5). Very few libraries are likely to hold both remaining chapters in their stacks at present.

This introduction has two purposes. It aims first at making explicit the common concern and aspiration behind all the chapters, but it is devoted still more to a discussion of what policy advising may be today, after the bitter unemployment experience of the last two decades and after the various attacks upon what was taught in the early 1960s.

1. Economic diagnosis

In medicine a diagnosis consists in identifying an illness after finding and interpreting significant symptoms, for the purpose of curing a patient. Similarly when we speak of economic diagnosis we mean more than forecasting, because (a) we imply one has to search for appropriate signs and for the analytical framework within which they may be interpreted and (b) we suggest that action may be needed. The concept, then, refers both to a wider operation than forecasting and to an operation whose purpose is more focused. The frequency with which the word 'diagnosis' is now being used by economists reveals not only a feeling of urgency because of such problems as unemployment, but also the realization that one cannot rely on a prespecified model of the economy.

The realization explains why so much of this book will not only stress the role of economic analysis but still more discuss what kind of analysis may be appropriate with respect to unemployment. As a background it will be meaningful to recall in this introduction why the confidence in a particular kind of prespecified model was shaken during the past two decades. But the evolution of ideas was so related to the views about policy analysis that it is best described within this context.

Broadly speaking, policy analysis is the function of economists either working for the preparation of government policy or scrutinizing this policy for public debate. Basic to the understanding of the methodological problems, then, is the distribution of roles between politicians and economists. Before we look at this more closely, let us say for now that economists act as experts.

The study of current policies by experts goes through two stages, one for diagnosis about the main characteristics of the situation and of its trends, the other for the determination of the impacts of contemplated measured or even of contemplated policy strategies. The second stage will be considered occasionally here, but is not the main subject. It suffices to note that determination of impacts first requires an understanding of what is happening; more generally, one could not pretend to correct the unsatisfactory features of a situation – be they unemployment, inflation, the trade deficit or still others – if one had no explanation of them. The diagnosis stage has to provide the explanation.

2. Advisers and experts

Issues raised by the distribution of roles between politicians and economists are clearest when one focuses attention on the functions of economic advisers who are employed by governments. It is commonly said that political authorities choose the objectives and priorities, whereas advisers first provide a diagnosis and second study how the various policy instruments ought to be used to attain the objectives most effectively. Advisers would not have to consider the order of priorities. This statement is basically sound in order to provide an ethical reference, but it is so simple that it may give rise to misunderstandings, has disputable implications and was, in fact, disputed.

The statement does not mean that in other contexts economists should refrain from contributing to the enlightenment of the objectives that human societies should aim at achieving. Quite the contrary; philosophers need to know better the economic constraints, the many tradeoffs and their implications with respect to desirable proposals. On some issues of social philosophy the contributions of economists rank among the most valuable. Neither would there be any good ground for preventing economists from entering public debates on the objectives to be assigned to government policies. The only ethical requirement, then, is that they distinguish their role as learned citizens from their role as experts.[1]

Some went so far as to say that, even when acting as experts, economists could not avoid making value judgements (see for instance Klappholz, 1964). One of the most forceful arguments was that the economic language was impregnated with value-loaded connotations suggesting in which direction action ought to go. There is some truth in this argument, particularly when economists profess to contribute to the public debate. But one must also say that, as economic education becomes more widespread, the technical meaning of the words dominates more and more over the emotional connotations. Some obvious ethical rules of behaviour also help to minimize the difficulty.

What remains true, however, is the fact that economists in general and advisers in particular have to interpret the priorities

[1] As often happens with ethical principles, application is not always easy, for instance when economists act as 'partisan advocates' in order to promote their ideas on what ought to be done. This action is the main focus of attention in Nelson (1987).

chosen by public authorities. Quite naturally, these priorities are never stated in directly operational terms. Even when economic language is being used, the statements cannot be precise enough to define an ordering independently of what the constraints may be. In other words, when looking precisely at a particular issue, advisers have to infer the policy choice from general guidelines and from choices made by authorities in other cases.

Such an interpretation requires judgement; one may even say value judgement, it being understood that one then refers to values that derive from the general orientations chosen by the country in its political life. Giersch (1989) brings out this point well when discussing the role of 'public economists' – a wider function than that of just government adviser; for instance: 'When he (or she) sees a problem coming up on the horizon, it is his (her) personal decision and judgement whether it is worth writing about. In raising the issue, one cannot avoid influencing the public's relative valuation of ends that are in conflict with each other' (p. 30). Similarly Wood (1987) recognizes the existence of a dilemma when he writes: 'The adviser represents and bases his advice on "science", that is on technical expertise, while his employer . . . represents action. In practice the interface between these often becomes blurred. If the "scientist" adviser limits his actions to [providing] factual data carrying no value judgements whatsoever, he may be failing in his assigned role of giving pertinent advice. Yet, if he draws too many conclusions from his data he may be usurping the prerogatives of his employer, a process that can lead to the adviser becoming an *éminence grise*.' He also notes: 'The mere fact . . . of [the adviser] being able to express a reasonably unbiased opinion or of coming to conclusions by approaches different from those normally taken by his employer, is in itself an important contribution to the decision-making process of his employer.'

So, economic diagnosis has to find its proper position between two opposing risks. It must avoid providing too little information; in this sense 'A diagnosis combines a positive description and a normative evaluation' (Giersch, 1989, p. 38). But it must also avoid hiding the general values from which this normative evaluation derives, at least if there is any possibility of misunderstanding in this respect.

One should also remember that part of the role of the experts is not directly geared to policy making, but rather to improving the public perception of the problems. In democracies at least, this perception is a fundamental ingredient for the decisions of politicians. This means that experts have to find ways of bringing their results to the attention of the public and have to spend time on this activity. Even an objectively established fact may then have to be made somewhat simpler than it really is, again with a risk of misunderstanding.

3. Policy analysis: historical background

In the 1960s a rather well-defined conception prevailed about what policy analysis was and how it had to proceed. This conception has been repeatedly questioned since then. Ideas are today more varied and often less sure. When dealing with a part of policy analysis, as this book does, an author may now feel obliged to try and explain his or her stance within the range of contemporary conceptions. A way of doing so is for the author broadly to survey the history of the field. I shall distinguish here four parts in this history, with an important overlap between two of them: before Keynes, Keynes (as the best representative of a larger group), the econometricians, and more recent reconsiderations.

Economic advising was already commonplace in the nineteenth century. The case of French economists suffices to show it. Two of them became famous precisely because of their role as policy advisers: Michel Chevalier, trained as an engineer, an adept of the industrialist Saint-Simonian movement, but progressively becoming a proponent of economic liberalism; Courcelle-Seneuil, who now appears as the first good example of a foreign economic expert because of his role in Chile. It seems that in the late nineteenth and early twentieth centuries most economic advisers were hardly more than promoters and guardians of a kind of an orthodoxy concerning the dangers of government interference with so-called economic laws. This may have occurred because of the political pressure for protectionism or because of the political appeal of socialism, both of which were considered as counter-productive by a large majority of the economic profession. This probably had also to do with the state of economic analysis, which provided hardly any other framework for the study of active economic policies than one in which they would be detrimental.[2]

[2] Robinson (1983) remarks that in the 1920s 'There was no macro-economics . . . We lived in a world that fluctuated, which we believed to be uncontrollable but somehow self-righting' (p. 260).

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Keynes is the most visible and representative figure within the group of deeply involved economists who took a different stand about economic policy matters during the interwar years. His approach was well described by Robinson (1983):

> Faced by [a practical] problem, he tackled it ordinarily in three stages. First, he analysed the problem in all its aspects more searchingly, more radically than any of the rest of us. Second, he set out to discover what factors in the situation had created the problem and what factors needed to be changed if a satisfactory solution was to be achieved . . . Third, and most important, he went ahead to change some institutional setting, to change the traditions of operating some sacrosanct institution, to change the political policies, to change public opinion'. (pp. 256–7)

Remarkable in this quotation is the lack of reference to any 'Keynesian theory'. Each policy problem is said to have been diagnosed and analysed afresh. This is, of course, a simplification. If we look in retrospect at the policy analyses written by Keynes, we may see what his economic theory of the world was, we may compare it with those held by other economists of his generation and we may even find antecedents in the literature. But this theory was not ready-made for applications; it was not his final word; he had to think again about the specifics of each situation.

This probably explains why he was so unsympathetic to the econometricians, and to the work of Jan Tinbergen in particular. What other explanation could there be? Keynes had been influential in the creation of the Central Statistical Office, of British national accounts and of the Economic Section of the Treasury, which was using this empirical base and would later use econometric models. The theory underlying the first generation of econometric models was very much in the spirit of his own ideas. To outside observers Keynes and the econometricians could only appear as close cousins. But one may guess Keynes did not want his approach to new problems and his intuition about their proper analysis to be constrained by the straitjacket of a preconceived econometric model.

4. The 1960 methodology

Econometricians in the 1940s were indeed well engaged in founding, for policy analysis, a methodology that was to become the main reference twenty years later. The Dutch school following Jan Tinbergen and the Norwegian school inspired by Ragnar Frisch were born; Lawrence Klein was becoming ready to promote the methodology in the United States and throughout the world.

The principle was to analyse the effects of contemplated policies within a macroeconometric model that would be the best available representation of the dynamics underlying economic evolution. The model would give the best prediction of the effects, so that the choice of policies would be based on objective and sound assessment of feasibilities and tradeoffs. The principle was based on two propositions: (i) policy analysis requires forecasts, (ii) macroeconometric models provide the best forecasting tool. The two following quotations are interesting to read again today.

> *Gouverner c'est prévoir* is perhaps an exaggeration – it means [not only that policy-making] requires prediction . . . but that there is an identity . . . between both concepts; . . . however, prediction plays such an essential role in the policy-making process that this French dictum may be accepted as a vivid expression of an important requirement for rational policy. Rational policy-making is the adaptation of the policy-maker's instruments to his changing environment in such a way that the result is 'good' or even 'optimal' . . . First, the changing environment has to be predicted; second, a forecast of the effects of the policy-maker's measures, i.e. of changes of instrument values, is required; third, a plan of action must be made. (Theil, 1958, pp. 2–3)

> We want . . . to discover the best possible theory or theories which explain the fluctuations we observe. If we know the quantitative characteristics of the economic system, we shall be able to forecast . . . the course of certain economic magnitudes such as employment, output, or income; and we shall also be able to forecast . . . the effect upon the system of various economic policies . . . We view the economic system as describable by a set of simultaneous equations expressing all the interrelationships among the measurable economic magnitudes which guide economic behavior. (Klein, 1950, pp. 1–2)

The point of departure between Keynes and the econometricians was proposition (ii) above, or equivalently Klein's last sentence. It is, indeed, where one may dispute the methodology that was widely adopted in the 1960s. But clarity of the discussion requires that one distinguishes between the several methodological choices that were made with confidence when experts decided to rely on forecasting from macroeconometric models. I think it is appropriate to list six such choices:

(i) Proper forecasts cannot be just 'judgemental'.
(ii) Proper forecasts cannot come just from statistical extrapolation.
(iii) Proper forecasts cannot come just from pure economic reasoning with no reference to statistical data except for a rough description of the current situation.
(iv) Proper forecasts cannot come from partial models neglecting feedback resulting from important macroeconomic relationships.
(v) Proper forecasts can come from a macroeconometric model built before the specifics of the current situation were known.
(vi) Proper forecasts can come from the type of macroeconometric models that were experimented with by, for instance, Lawrence Klein.

My purpose here is not to discuss where in this list Keynes disagreed with the econometricians; I have already suggested he could not accept (v); I have reasons to think he would have frowned upon (iii). But this is secondary today, when we want to assess the value of the criticism raised much more recently against the methodology promoted by econometricians.

Before turning to this criticism I must, however, pause at choice (i), which was not explicitly criticized but with respect to which mental reservations remain, especially when one speaks about the role of diagnosis in policy analysis. By 'judgemental forecast' can only be meant one that is left to the judgement of the expert. But a forecast ought not to be accepted blindly. Having good judgement does not discharge the expert from the duty of explaining how the conclusion was reached; then the expert will reveal having made methodological choices covered by points (ii) to (vi), even if not formalizing the procedure. It goes without saying that, whatever the methodology, judgement is required to apply it well in each case.

5. New assessments

I need not dwell on the fact that the macroeconometric methodology is no longer presented in academic teaching with the same confidence as it was thirty years ago. Even such a good representative of the Norwegian school as Leif Johansen was careful in the following statement given shortly before his death:

> Considered as a trend the development in the direction of more widespread use of econometric models will hardly be reversed. However, the trend is not quite stable and invulnerable. Lack of success, conspicuous failures, and inability to come to grips with important problems because of inadequate formulations may drive the models more or less off the scene; political developments in the direction of more modest and less detailed targets for economic policy, or more reliance on free market mechanisms and simple rules for economic policy may also reduce the need for econometric models in connection with policy-making. (Johansen, 1982, pp. 91–2)

Indeed, one first notes that quite a few economists advocate a return to the concept of policy advising that prevailed at the beginning of the century. Such was for long the position taken by Milton Friedman, who argued repeatedly against government attempts at stabilizing business fluctuations. Ideas put forward by some adepts of the public choice movement go in the same direction. Even more specific and technical critiques on the econometric methodology often lead their authors to suggest that active macroeconomic strategies are bound to fail. Policy advising would then not need precise forecasts, or rather the type of useful forecasts would be given by pure economic reasoning, in contradiction to principle (iii) above.

The revival of this position imposes a serious reflection to those dissenting from it. In the first Caffé Lecture, published here as chapter 1, I present in simple terms some of my arguments why macroeconomic public control of modern market economies is needed. I have written enough elsewhere for a long explanation to be superfluous here (in particular Malinvaud, 1984 and 1991a). My position of course draws on what I believe to be satisfactory theories about the functioning of these economies.

A quite valuable point was, however, made by the critics of the practice used in the 1960s, namely that policy analysis then neglected important feedback generated by the budgetary or monetary measures that were discussed. Some of this feedback in particular comes from the fact that a government decision reveals something about the way in which policy-makers react to changes in their environment. While the expert tends to think about the decision as if it were an isolated act with no implication for future actions, economic agents may interpret it as a sign of what the government strategy really is and will be. Such an interpretation may lead to private behaviour quite different from that assumed by the expert. In other words, when forecasting the effects of government measures, one should be clear about what is really at stake: major political decisions in the economic field may concern the 'policy regime' more than the particular budget discussed or the interest rate at a particular time. This makes policy analysis more difficult, but does not in itself fundamentally change the methodology; indeed it amounts to taking principle (iv) still more seriously into account than was earlier found to be necessary.

What was called New Classical Macroeconomics rejected, above all, assertion (vi) and claimed that the current macroeconometric models were not theoretically sound: their rationalization of behaviour was incomplete; their representation of markets was inadequate. The criticism was more than the normal expression of the feeling that better specifications would improve the reliability of macroeconometric models. It amounted to saying that a completely new paradigm had to be used for macroeconomic thinking: the hypothesis of rational behaviour had to be made more systematic and to contain in particular what was called rational expectations; all markets had to be viewed as exactly and permanently cleared. Such a stance forces anyone to take sides: to be for New Classical Macroeconomics and then to reject the earlier methodology, or to believe that the principle of this earlier methodology remains appropriate and to reject New Classical Macroeconomics. Being faced with such a dichotomy I believe that the 1960 line of attack on policy analysis still is the proper one, notwithstanding some theoretical progress due to research done under the auspices of New Classical Macroeconomics.

Indeed, what alternative was proposed? During some years it was the creed of 'policy ineffectiveness', a phrase which was claimed to be proved true by arguments applied to outrageously simple models of the economic system. This creed recommended 'laissez-faire' and amounted to a return to the conception of policy advising that was current at the beginning of the century.

Now the so-called Real Business Cycles school proposes the study of macroeconomic models, which are claimed to be based on a