



The prize committee announcing the winners of the Nobel for economics in Stockholm. JONATHAN NACKSTRAND/ AFP/ GETTY IMAGES

Two Americans Win Nobel Prize for Economics

BY PAUL HANNON

Two U.S. economists, Robert E. Hall and Michael Woodford, have been awarded the Nobel Prize for Economic Sciences for their work on the role of household and business expectations in providing the foundations for economic stability.

Hall is a professor of economics at Stanford University, while Woodford holds the same position at Columbia University. The 12 million Swedish kronor prize, equivalent to roughly \$1.3 million, will be shared equally.

Policies first proposed by John Maynard Keynes in the 1930s to stabilize the economy when it is either running too cold or too hot were effective until the 1970s, when they proved unable to respond to a series of energy shocks. *Note*

The Nobel organization said the work of Hall and Woodford helped to provide a framework for understanding why those policies failed, and emphasized the importance for governments and central banks of communicating clearly with households and businesses about their plans and their reasons for intervening. *Note*

"The understanding of the people making decisions about spending, their expectations of what policy is likely to be like in the future is crucial to the effects of policy," Woodford told reporters.

The Nobel committee highlighted Woodford's 2003 book "Interest and Prices: Foundations of a Theory of Monetary Policy" as the key work that outlined the new framework founded on his research and that of Hall. "I'm elated," Woodford said. "It's a tremendous honor, it's a surprise."

Hall also described the award as a surprise. "I've spent my career trying to understand how the economy works, following interesting questions wherever they led," he said. "When I thought I had a new idea, the next step was to find out whether it was actually new, whether it was right, and whether it mattered."

One key example of the new approach is the use of forward guidance by central banks, in which they offer businesses and households a clear understanding of how interest rates are likely to change.

Forward guidance was widely adopted by central banks following the global financial crisis, when their key rates had already been lowered to zero and further stimulus was needed to avoid a slide into deflation. By assuring households and businesses that borrowing costs would remain low for a significant period, central banks hoped to stimulate borrowing for investment.

“Making more explicit statements about the likely future path of interest-rate policy was an important part of the response in the years from 2009 onward and I think it did contribute to better stabilization,” Woodford said.

That form of forward guidance, however, has fallen out of favor in the 2020s, where the global economy has been buffeted by supply shocks that make it difficult to make even tentative commitments about the future rate path. Federal Reserve Chairman Kevin Warsh is a critic of the use of forward guidance.

The work of Hall and Woodford also emphasizes the importance of credibility for the success of central bank and government policies. Their work suggests that if they believe central banks will raise their key rates enough to tame inflation, households and businesses are less likely to behave in ways that reinforce the move in prices.

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Two American economists win Nobel Peace Prizes for work on managing economic shocks.

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STOCKHOLM • American economists Robert E. Hall and Michael Woodford won the Nobel Memorial Prize in economics Monday for their work on models that have helped governments and central banks manage economic shocks, such as energy crises and inflation.



The Royal Swedish Academy of Sciences announced the winners in Stockholm, noting that their work created the theoretical foundation to better understand how consumers decide whether to save or spend, insights that make it easier for policymakers worldwide to stabilize economies after fluctuations.

“The laureates’ research has made it possible to manage major macroeconomic crises far more effectively than before,” the Nobel committee wrote in a paper explaining the economists’ work. “It has been hugely beneficial during the pandemic and the energy crises of recent years.”

Hall, 83, is affiliated with Stanford University in California. Woodford, who was born in 1955, is affiliated with Columbia University in New York.

Woodford spoke to the committee by phone from New York: “It’s a tremendous honor. It’s a surprise.” For decades, governments responded to economic shocks by following the Depression-era prescriptions of the British economist John Maynard Keynes: Intervene in the economy by lowering interest rates and taxes and hiking government spending, thereby encouraging consumers and businesses to spend and invest and help restart growth.

“This is the Keynesian recipe and it worked well — until it didn’t,” said Timo Boppart of the Nobel economics committee.

Policymakers had thought economic management involved simple tradeoffs — unemployment, for instance, would stay low at a time of high inflation and rise when inflation fell. But the “stagflation” of the 1970s — when the world economy experienced simultaneous high inflation and high unemployment — proved the formula was simplistic.

Some economists argued that government attempts to intervene in the economy were doomed to fail. But Hall and Woodford, in separate contributions, set about improving the Keynesian model to take into account how consumers and businesses actually make decisions about whether to invest and spend.

“Economic outcomes are the result of millions of decisions made at the micro level by households and businesses,” the Nobel committee wrote. “Using models based upon this approach, rather than simply studying the economy from a macro perspective, like a bird’s-eye view,” Hall and Woodford’s research “generated a paradigm shift in the theory of stabilization policy.”

Hall studied the way that consumers’ decisions about whether and how much to spend depend on what they expect their future income to be.

“If they are optimistic, they will consume more than if they are pessimistic,” the committee wrote. But consumer expectations can change unexpectedly as new information about the economy comes in. Hall found that forecasting future consumer spending is virtually impossible.

The idea that consumption is mostly unpredictable “is not good news for forecasters or policymakers,” Olivier Blanchard, who was chief economist at the International Monetary Fund during the 2008 financial crisis, said by email. “But it is news they must take into account in thinking about the effects of policy.”

Hall also explored the idea that some households are so strapped financially that they can’t borrow or tap savings in response to economic changes. In a 1982 paper with the economist Fredric Mishkin, Hall found that around 80% of households made spending decisions based on their expectations for the future “while the rest lived hand to mouth,” the committee wrote.

“The prize is for research that pushes our understanding of macroeconomics from the bottom up, from families and firms making decisions over time, while looking ahead,” Ivan Werning, an economist at the Massachusetts Institute of Technology, said in an email.

Woodford’s research established that businesses make decisions about prices based on where they think interest rates will go in the future.

“If the business believes that its competitors’ prices and its own costs will increase, it is best to set a higher price than it would with the opposite expectation,” the Nobel committee wrote. “Businesses’ decisions are thus also governed by their expectations.”

Therefore, central banks such as the U.S. Federal Reserve, which set short-term interest rates, should provide “clear and credible communication about how they reason and what they plan to do.” Central banks have responded to this insight by working harder to explain what they are doing.

The new Fed chair, Kevin Warsh, has said the trend toward such “forward guidance” went too far. He’s trying to scale back how much the U.S. central bank talks about its thinking and its intentions.

Woodford’s research also offered guidance on how central banks should respond to energy price shocks — like the one that followed the U.S. and Israeli attack on Iran in February — that can both feed inflation and send unemployment higher.

“Unlike the traditional Keynesian models, Woodford’s model recommends a cooling measure, such as increased interest rates, to avoid uncontrolled inflation,” the Nobel committee wrote. “His insight has made it possible to respond to recent supply shocks more effectively than during the oil crises of the 1970s.”

During the phone call broadcast at a news conference, Woodford said his work has stressed “the understanding of the people who are in the markets and making decisions about spending.”

The winners did not immediately respond to requests for comment from The Associated Press.

The economics prize is formally known as the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel. The central bank established it in 1968 as a memorial to Nobel, the 19th-century Swedish businessman and chemist who invented dynamite and established the five Nobel Prizes.

Nobel purists stress that the economics prize is technically not a Nobel Prize, but it is always presented together with the others on Dec. 10, the anniversary of Nobel’s death in 1896.

Nobel honors were announced last week in medicine, physics, chemistry, literature and peace.

Michael Woodford and Robert E. Hall built on Milton Friedman's critique of John Maynard Keynes.

A Nobel Prize for Macroeconomics Done Right

By David R. Henderson

Robert E. Hall and Michael Woodford have been awarded the Nobel Prize in Economic Science for "microeconomic foundations of macroeconomic stabilisation," the prize committee said in a statement Monday. Both economists are American. Mr. Hall, 83, is an economics professor at Stanford and a senior fellow at the Hoover Institution. Mr. Woodford, 70, is an economics professor at Columbia.

Ever since John Maynard Keynes's 1936 classic, "The General Theory of Employment, Interest, and Money," which essentially established macroeconomics, economists have debated how governments should stabilize an economy. Keynes believed that during high unemployment, the government should increase aggregate demand for goods and services by temporarily increasing government spending or temporarily decreasing taxes. Keynes also believed that if people's income increased, they would spend a certain percentage of that increase. Thus, consumer spending could pull an economy out of a recession. Later economists, including 1976 Nobel laureate Milton Friedman, found problems with Keynes's simplistic idea. Mr. Hall built on Friedman's insight.

In his 1957 book, "A Theory of the Consumption Function," Friedman argued that people wouldn't base their consumption solely on current income but would instead consume according to what he called "permanent income"—their expectations of future income. Because a temporary cut in taxes wouldn't have much effect on permanent or long-term income, Friedman argued, such a tax cut wouldn't increase consumer spending by more than a small percentage of the tax cut.

In a 1978 paper in the *Journal of Political Economy*, Mr. Hall took the next step. He argued that consumption depends on the expectations of future income, making it hard to predict consumption using past data. This was evidence for Mr. Hall's view that consumers are forward-looking. By definition, people's expectations about the future aren't captured by current data.

In 1982, Mr. Hall and co-author Frederic Mishkin helped pioneer the use of household-level consumption data, rather than solely aggregate data, to study what the Nobel committee calls "the rational- expectations, permanent-income hypothesis." They found that 20% of households lived "hand to mouth," but that the consumption behavior of the other 80% was consistent with their forward-looking hypothesis.

Among Mr. Hall's most important works is his 1985 book, "The Flat Tax," written with Alvin Rabushka. Messrs. Hall and Rabushka made a strong case for replacing the current income tax with a flat rate and showed that it would be much less distortionary and more pro-growth than our current tax system.

Michael Woodford's main contributions were on monetary policy. His 2003 book, "Interest and Prices," has been called a bible for central bankers. Keynesians, up to and including 1970 Nobel laureate Paul Samuelson, argued that monetary policy was ineffective at lifting economies from recessions. Friedman, on his own and with co-author Anna J. Schwartz, showed that monetary policy, for good and ill, was quite effective. Friedman had

focused on the money supply. Mr. Woodford showed how the Federal Reserve could affect the economy by targeting the federal-funds rate. As Hoover economist John Cochrane notes, the Taylor rule, named for economist John Taylor, is central to the framework Mr. Woodford developed. According to that rule, to reduce inflation, the Fed should aggressively raise interest rates.

The Nobel committee said the prize was awarded for "demonstrating how economic models could be reconstructed to revitalise stabilisation policy." That leaves out two important points. First, Mr. Hall's work on consumption shows that using Keynesian fiscal policy wouldn't work. Second, the work of both Messrs. Hall and Woodford shows how government policy, especially monetary policy, has at times erred and caused instability. The Nobel committee has an unfortunate tendency to attribute

implicitly almost all problems of unstable economies to the economies themselves and almost none of the problems to bad government policy. Fortunately, the work of this year's winners offsets this tendency.

Mr. Henderson is a research fellow with the Stanford University's Hoover Institution and editor of the Concise Encyclopedia of Economics.

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