John C Williams: If we fail to prepare, we prepare to fail

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Council on Foreign Relations, New York City, 6 June 2019.

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As prepared for delivery

Note: These remarks are based on those delivered at the 9th High-Level Conference on the International Monetary System on May 14, 2019.

Introduction

Thank you for that kind introduction and for the opportunity to speak again at the Council on Foreign Relations. I'm going to keep my remarks brief so that there's plenty of time for Steve to grill me on interest rates, followed by some *thoughtful* questions from the audience.

With the mention of interest rates, it's time I remind everyone that the views I express today are mine alone and do not necessarily reflect those of the Federal Open Market Committee or others in the Federal Reserve System.

John Maynard Keynes is credited with saying, "When the facts change, I change my mind. What do you do, sir?" The economic era we've experienced for the last 11 years has been defined by the Great Recession. There's the world before, and the world after, the subprime mortgage crisis, the collapse of Lehman Brothers, and the ensuing financial crisis.

The Road to Recovery

Governments and central banks have spent the intervening years working to get their economies growing, create jobs, and put regulation in place to prevent another such catastrophe.

Central banks instituted huge asset purchase programs and brought short-term interest rates to near zero—in some cases below zero—to stimulate economic recovery.

The good news is that, for the most part, monetary policy did its job. Advanced economies have seen steady growth and significant declines in unemployment. But the recovery has been slow. And despite low unemployment, inflation rates have been running persistently below central banks' goals. The Federal Reserve, like many central banks, has a goal of keeping inflation at 2 percent.

In the pre-2008 era, inflation was a major concern for the public and central banks alike. And, while I will always be vigilant about inflation that's too high, inflation that's too low is now a more pressing problem.

The experience of a slow recovery and persistently low inflation is a symptom of deeper problems afflicting advanced economies. Two changes, unrelated to the crisis, have been taking place, causing a shift in economic conditions and quietly shaping the trajectories of advanced economies.

These are the "the facts" that have changed. Today I'm going to discuss them in more detail, and explore our options for dealing with the challenges they present.

"The Facts"

Shifts in demographics and productivity growth have fundamentally altered the economic environment in which we operate.

Starting with demographics, two changes have taken place: People are generally living longer, and population growth is slowing. Dwindling birth rates are bringing population growth to a standstill. In OECD countries, population growth averaged over 1 percent back in the 1950s and 1960s, but it is now running at half a percent per year, and is expected to gradually fall before dipping into negative figures by 2070.[1]

Slowing birth rates mean fewer consumers and fewer workers. People planning on longer retirements will tend to save more. And while this is undoubtedly good news in many respects, an abundance in the supply of savings also has a big effect on the global economic picture.

When it comes to productivity, there has also been a stark step-down in growth. Rapid changes in the kinds of technology we use in our daily lives—robotic vacuum cleaners, self-driving cars, and facial recognition technology in our phones—may make this seem counterintuitive or plain wrong.[2]

But the data are clear.

In OECD economies, growth in labor productivity—the amount produced per worker hour—has averaged a little over 1 percent per year since 2005, about half the pace seen over the prior decade.

Falling R-star

So what does all this mean for the future?

Two things: First, slower population and productivity growth translate directly into slower trend economic growth. Second, an abundance of savings, and a decline in demand for savings resulting from slower trend growth, together lead to lower interest rates. All of these factors combined have contributed to dramatic declines in the longer-term neutral rate of interest, or r-star.

While a central bank like the Fed sets short-term interest rates, r-star is a result of longer-term economic factors. It's the rate expected to prevail when interest rates are neither giving the economy a boost, nor slowing it down. That's why it's called the "neutral" rate.

The evidence of a sizable decline in r-star across economies is compelling. The weighted average of estimates for five major economic areas—Canada, the euro area, Japan, the United Kingdom, and the United States—has declined to half a percent.[3] That's about 2 percentage points below the average natural rate that prevailed in the two decades before the financial crisis. A striking aspect of these estimates is that they show no signs of moving back to previously normal levels, even though many advanced economies have fully recovered from the crisis.

This poses significant challenges for monetary policy. When interest rates are low, central banks don't have much room to maneuver to deal with a crisis. They will only be able to cut interest rates by a small amount before they hit zero—or as economists call it, the "zero lower bound." Of course, central banks can, and have, used negative rates to stimulate growth, but they bring with them a separate set of challenges.

The result is that future recoveries will be slow, and slow growth is usually characterized by low inflation. Persistently low inflation creates a vicious circle, where expectations of low inflation drag down current inflation. If inflation falls, central banks will have even less room to maneuver when faced with a slowdown.[4]

A Fresh Approach

All this begs the question: what can we do to prepare ourselves and our economies for the next

crisis? There's no single silver bullet that can solve these challenges. But changes to monetary, fiscal, and other economic policies could all help us become more resilient.

Starting with monetary policy, central banks should reassess their strategies, goals, and the tools they use to achieve them.[5] This might include things like reassessing how we achieve our 2 percent goal.

Outside of monetary policy, there are a number of ways fiscal policy can support an economy. One is to strengthen the "automatic stabilizers," which, in a downturn, reduce taxes without legislation to stimulate growth. Another is to use regulation to enhance financial stability.

Finally, fiscal and other economic policies can attack the sources of slow growth and low r-star directly. Demographics are not an area where most economists, or policy makers, want to meddle—and I'm certainly not going to stand here and say people should stop living so long!

But there are things we can do to improve long-run growth. These include raising public and private investment in human and physical capital, infrastructure, and science and technology, as well as removing barriers to participation in the labor force and the economy more broadly.

It's impossible to predict the future. But we can deal with the present. The economic environment in which we operate today is a direct consequence of the demographic and productivity shifts taking place. Low neutral interest rates are very real, and they're here to stay.

Conclusion

The facts have changed, and so it is time to change our minds also. It is often said that change is hard. But, experience teaches us that it is better to prepare for the future than wait too long. Ultimately, failure to prepare often means preparation for failure.

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1 United Nations, World Populations Prospects: Key Findings and Advance Tables, 2015 Revision.

2 Antonin Bergeaud, Gilbert Cette, and Rémy Lecat, Productivity Trends in Advanced Countries between 1890 and 2012, Review of Income and Wealth, Volume 62, Issue 3, pp. 420–44, September 2016.

3 Shigeaki Fujiwara, Yuto Iwasaki, Ichiro Muto, Kenji Nishizaki, and Nao Sudo Fujiwara, Developments in the Natural Rate of Interest in Japan, Bank of Japan Review, October 2016; Kathryn Holston, Thomas Laubach, and John C. Williams, Measuring the Natural Rate of Interest: International Trends and Determinants, Journal of International Economics, Volume 108, Supp. 1, pp. S59-S75, May 2017.

4 Thomas M. Mertens and John C. Williams, Tying Down the Anchor: Monetary Policy Rules and the Lower Bound on Interest Rates, Federal Reserve Bank of San Francisco, Working Paper Series, May 2019.

5 Richard H. Clarida, Vice Chair of the Board of Governors of the Federal Reserve System, The Federal Reserve's Review of Its Monetary Policy Strategy, Tools, and Communications Practices , speech delivered at the Federal Reserve Bank of Minneapolis, April 9, 2019.