"The New Stone Soup"

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Iveagh House Lecture
Dublin, Ireland
February 10, 2020
6:45PM GMT

Remarks as prepared for delivery.

Introduction

Thank you for that kind introduction and warm welcome. It's a privilege to be back here in Ireland. This is the first country I ever visited outside of the United States, and I still remember how welcoming you were and how much I learned. So it's truly a privilege to return.

It's also a great honor to be part of such a distinguished lecture series, addressing such a distinguished audience. Now before I begin, let me say that my remarks tonight are my own, and don't necessarily reflect the views of anyone else within the Federal Reserve System.

As you know, I am a policymaker – a monetary policymaker. Many of us in this room are policymakers or people who support policymakers. And even though we come from different countries and have different areas of expertise, we all share something in common.

We each want to serve the public. We each want to be remembered for doing our best. We each want to make contributions that stand the test of time.

But times today are challenging. Countries across the globe face slow growth, low real interest rates, and persistent low inflation. This makes our economies less resilient to everyday shocks and less able to offset them with the tools we've traditionally relied on. Moreover, our futures are interconnected. Today, a shock to one country can spill over. Said simply, when one of us stumbles, all of us sway.

So my question tonight is: in the face of these challenges, what can we do?

The environment we face

First, let's talk about how we got here. And I'll start with the story in the United States.

Large structural shifts are reshaping our economy. First among them is population aging. The baby boom generation is retiring. And this is having a profound effect on labor force growth – especially since subsequent birth cohorts are so much smaller.

The numbers tell the story. During the 1970s, as the baby boom generation matured and entered the labor market in large numbers, the U.S. labor force grew by just over 2.5 percent per year. Today, labor force growth is closer to 0.5 percent per year. All else being equal, this shaves about 2 percentage points off potential GDP growth in the United States each year.[1]

This slower economic growth translates directly into lower interest rates. Slower growth decreases investment by reducing the return on capital.[2] At the same time, an aging population increases the pool of available savings,

[1] Congressional Budget Office (2020), Fernald and Li (2019).
[2] Williams (2017).

as older individuals build and preserve their nest eggs. Together, these forces increase the supply of savings relative to the demand for investment, reducing real interest rates.[3]

These patterns are not unique to the United States. We could just as easily be talking about Ireland, or any country in Europe, or just about any advanced economy around the world.[4]

And these are not our only challenges. On top of slower growth and lower real interest rates, central banks are finding it more difficult to achieve their inflation goals, even in good times.

Fundamental changes in product markets have been putting downward pressure on prices. And since many markets are global, these changes are spreading – creating a strong disinflationary trend and pulling down inflation and inflation expectations in many parts of the world.[5]

Combined, these factors – lower inflation, lower inflation expectations, and lower real interest rates – add up to one thing: less monetary policy space when the next downturn emerges.

But central bankers aren't the only ones feeling the pressure. Fiscal policymakers are also constrained. Policies enacted to offset the global financial crisis have left many advanced nations with relatively high debt-to-GDP ratios.[6] And most face looming obligations to support their aging populations at levels promised when growth was much faster.[7]

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[3] Carvalho, Ferrero, and Nechio (2016).
[4] Holston, Laubach, and Williams (2017), Jordà and Taylor (2019).
[5] Mertens and Williams (2019), Amano, Carter, and Leduc (2019).
[6] Badia and Dudine (2019).
[7] See for example Rouzet et al. (2019).

So this is where we find ourselves. Facing a future where economic shocks are inevitable, and where monetary and fiscal agents have less policy room to combat them.

So again I ask: what can we do?

Make stone soup

When faced with a tough problem, my first instinct is to turn to books, models, and other formal practices. I'm an economist after all – that's what we do. But wisdom isn't only found in traditional tools. Sometimes, you have to turn to tales.

One of my favorites is the story of stone soup. It's a European folktale I'm sure you've heard. There are many different versions, including one by Ireland's own William Butler Yeats. But I'd like to share the story as I learned it.

One day, a group of strangers came to a village. They were hungry and knocked on doors, asking for food. But the villagers had very little and were hungry themselves. They closed their doors, pulled their shades, and guarded their meager stocks.

So the strangers went into the town center and dragged over a large pot. They built a roaring fire underneath. And to the pot, they added a few stones.

As the pot began to boil, the villagers looked on, curious. Some came outside. They asked: what are you doing? The strangers, with confidence, said they were making stone soup. Then they began to imagine aloud how much better it would taste with just a few additional ingredients – an onion, a potato, a beef bone…

No one villager had everything. But each villager had *something*. So they started contributing to the pot. And when they combined it all, everyone had more. Everyone had enough.

I learned this story when I was 7 years old. And it has stuck with me all these years. I share it with you today to emphasize this point.

It's tempting to look at our cupboards and say they're bare. That the problems we're facing are too big. That the tools we have at our disposal are too limited. That the best strategy – the only strategy – is to close our doors, pull our shades, and guard our meager resources as long as we can.

But this is why we need stories. To help show us a different path.

So what lessons from stone soup can we apply to our current situation?

Look for strangers

The first lesson is to seek the perspectives of others. As policymakers, we like to think that our education, experience, and institutional history are a sufficient foundation for good decision-making. We especially want to think this when times are tough and people are counting on us to fix things.

But these are the very circumstances when pausing and engaging with those outside of ourselves is most important.

Let me give you an example. For much of our history, central bankers have used the natural tension between unemployment and inflation to evaluate the stance of monetary policy – whether we've got it right or not. But over the past decade, this natural tension has been harder to see. Unemployment has fallen dramatically while inflation has remained relatively muted. The question is, what should we make of this?

As a labor economist and policymaker, I've thought a lot about this. But I actually found the answer by listening to those less familiar with the tradeoff. Last year, the Federal Reserve conducted a series of listening events as part of our monetary policy framework review. We talked to academics, policymakers, and – most importantly – business and community leaders.[8]

Here's what we learned. A historically low unemployment rate does not mean that the labor market is historically tight. And letting the economy run past what we thought was possible has tremendous benefits, especially for disadvantaged groups. Eleven years into the expansion, many more workers have entered the labor force and found jobs than anyone thought possible. By finding full employment experientially, we have improved the lives of countless Americans.[9]

Importantly, few models would have predicted this. Little history would have told us this was possible. Our traditional approach would have said to curb this growth, eliminate the possibility of unwanted inflation, and be satisfied with bringing unemployment back to its historical average. If we had stayed within this mindset, we might very well have cut the expansion short.

In other words, if we hadn't talked to others – the proverbial strangers – we wouldn't have seen all that was possible.

[8] See the discussion of the "Fed Listens" initiative on the Federal Reserve Board of Governors web site: https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm.
[9] See for example Aaronson et al. (2019), Petrosky-Nadeau and Valletta (2019).

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We have more than we think

Here's the second lesson from stone soup. The bravest thing the villagers did was to contribute to the soup without fully knowing what would come of it. In other words, they had to act despite considerable uncertainty about the outcome.

As policymakers, we face a similar challenge. There is no doubt that we are collectively more constrained than in the past, and that we face greater uncertainty about the impact of our tools and their ability to achieve our goals. Still, we have to act like the villagers.

After more than 40 years of fighting to bring inflation *down* to target, the new economic environment requires that monetary policymakers push inflation *up* to target.[10] And while this will not be easy, we have the tools we need. Options like average inflation targeting, nominal income targeting, and boosting the inflation target are already being researched and widely debated.

But having the tools and actually being willing to *use* them are two very different things. And with very limited experience using these tools in this way, we feel uncertain. We've exercised the muscle of pushing inflation down for so long that changing direction feels unnatural. But that is exactly what we will need to do. We need to embrace the mindset that inflation a bit above target is far better than inflation a bit below target in today's economic environment.[11]

A similar mindset shift will be necessary for fiscal policymakers. With monetary policy facing its own limits, fiscal policy will need to play a larger

[10] Jordà and Nechio (2018).
[11] Mertens and Williams (2019).

role in smoothing through economic shocks. But in a world of fiscal discipline, it's hard to commit to the idea of more.

But *more* is exactly what we need. Expanding the array of automatic stabilizers that form part of the social safety net can help mitigate the depth and duration of economic downturns.[12] Think of unemployment insurance, which kicks in automatically when things are bad, helping individuals smooth through a tough time while limiting the amplification of their loss throughout the economy. Although more work is needed, recent research suggests that these types of programs will likely be especially powerful in the new economic reality we face.[13]

Perhaps most importantly, we need to continue investing in our future growth. Countless research studies have shown that spending on things like infrastructure, research and development, and education pays off and actually increases the productive capacity of the economy in the longer run.[14] In today's low interest rate environment, such investments are relatively easy to finance and will pay a high rate of return in the future.[15] We should take advantage of the opportunity.

A better global legacy

Before I conclude, I'd like to leave you with some final thoughts.

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[12] See, for example, the panel discussion including Janet Yellen and others at the 2020 American Economic Association Annual Meetings: https://www.aeaweb.org/conference/2020/preliminary/1357.

[13] McKay and Reis (2016), Christiano, Eichenbaum, and Trabandt (2016), Boushey, Nunn, and Shambaugh (2019).

[14] Fernald (1999), Leduc and Wilson (2012), Jones and Williams (1998), Bosler et al. (2018).

[15] Elmendorf (2019).

We all look at the world through the lens of our own experiences. We only know what we know. But what stone soup tells us is that it's possible to widen our lens. The villagers in the story were able to see a new path forward when they engaged with the strangers. Their mindsets changed. And then, they were brave enough to act.

As policymakers, we must actively look for perspectives outside of our own. And we need to be courageous enough to take action, even in times of uncertainty. We don't have the luxury of waiting for strangers to knock on our doors.

So let this be our legacy. In the face of challenges, with limited tools and less than clear paths, we chose an abundance mindset over a scarcity mindset. We came together and worked to hand future generations a better world than the one we inherited.

As policymakers, I think we can all live with that. Maybe even be proud of it.

Thank you.

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