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**Long-Run Economic Trends and  
Monetary Policy Frameworks and Strategies**

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Bank of Italy  
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FEDERAL RESERVE BANK OF CHICAGO

The views expressed today are my own and not necessarily those of the  
Federal Reserve System or the FOMC.

# **Long-Run Economic Trends and Monetary Policy Frameworks and Strategies**

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Chicago Fed President Charles L. Evans discussed the implications of long-run economic trends for monetary policy frameworks and strategies. He was speaking to a group of central bankers and academics at the Bank of Italy. His comments reflected his own views and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

The slides President Evans used during his presentation are available online, <https://www.chicagofed.org/~media/publications/speeches/2019/05-06-19-long-term-economic-trends-and-monetary-policy-frameworks-and-strategies-slides-pdf.pdf>.

## **Synopsis of President Evans's remarks<sup>1</sup>**

- There are two important long-term trends that are shaping the U.S. economy, as well as many other advanced economies.
  - The neutral level of real interest rates and the growth potential of many advanced economies have declined significantly in recent years. In the absence of structural changes, these trends are expected to continue well into the future.
  - At the same time, inflation in advanced countries has been underrunning the central banks' targets.

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<sup>1</sup> Some of President Evans's remarks at the Bank of Italy were similar to his OMFIF City Lecture given in London last fall and his speech delivered in Stockholm, Sweden, last week (Evans, 2018, 2019).

- These trends imply that the likelihood of nominal policy interest rates hitting the zero lower bound (ZLB) has increased significantly, potentially limiting the ability of central banks to use conventional monetary policy tools to counteract downturns in the future.
- A number of alternative monetary policy frameworks have been proposed to address this potential challenge, including nominal gross domestic product (GDP) targeting, price-level targeting, state-contingent or temporary price-level targeting, and average inflation targets. As part of the wide-ranging review of the Federal Reserve’s monetary policy strategies, tools, and communications, the System will hold a conference in June at the Chicago Fed, at which some of these alternatives likely will be discussed.<sup>2</sup>
- Without prejudging the outcome of this important review, President Evans pointed out some features common to several of the proposed alternative frameworks:
  - The alternative frameworks can require policymakers to commit to provide extraordinary accommodation not only during ZLB episodes, but also afterward. Policy prescriptions from simple rules are inadequate.
  - The policies can require a successful commitment to produce temporary—though potentially protracted—periods of above-target inflation following episodes when inflation has persistently run below target.

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<sup>2</sup> Further information about this event is available online, <https://www.federalreserve.gov/conferences/conference-monetary-policy-strategy-tools-communications-20190605.htm>.

- A related set of issues could arise following a protracted period of overshooting a simple level or average inflation target: Policymakers would commit to pursuing tighter-than-usual policies to bring inflation down, potentially generating significant increases in unemployment.
- President Evans elaborated on the potential implications for inflation using an illustrative example from one alternative framework. He considered the hypothetical case of adopting a state-contingent price-level target today as proposed by Evans (2010) and Bernanke (2017).
  - He noted that, given the inflation misses since the financial crisis, the price level today is more than 4.5 percent below a 2 percent trend line starting from the cyclical peak in 2007.
  - The average inflation rate required to close the gap depends on the time horizon to close the gap—ranging from about 3.5 percent with a two-year horizon to 2.7 percent with a six-year horizon—both noticeably above the 2 percent goal most central banks have.
- President Evans also discussed some important questions raised by these features, such as the following:
  - Can policymakers credibly commit to following through on such policies?
  - How will the central banks communicate such strategies effectively?
  - What would the public's reaction be to extended periods of inflation exceeding the central bank's inflation goal? What would be the impact on inflation expectations?

- What are the financial stability implications associated with the alternative frameworks? Are financial markets and the regulatory environment resilient enough to limit financial stability risks that might arise?
- President Evans concluded with his views on general principles that should guide monetary policy strategies, irrespective of the framework.
  - Policymakers should focus on outcome-based strategies; in the U.S., that means undertaking policies that best achieve the dual mandate goals of the FOMC over the medium term.
  - Because long-run economic trends have increased the chances of returning to the ZLB, policymakers must be prepared to rely on unconventional tools, including quantitative easing and forward guidance, to provide adequate policy accommodation during some future ZLB-constrained downturns.
  - Given the necessary focus of monetary policy on the dual mandate goals, financial stability risks are best addressed using macro- and microprudential supervisory and regulatory tools that increase the resiliency of financial markets.
  - Credibility is key to achieving the dual mandate goals, irrespective of the framework chosen.
  - In the current policy framework, it is important to enhance the credibility of the symmetric nature of the 2 percent inflation goal. This means a willingness to embrace inflation modestly above 2 percent 50 percent of the time and following through with policy actions and communications aimed at achieving this outcome. President Evans stated he could accept core inflation rates of

2-1/2 percent as long as there was no obvious upward momentum and the path back toward 2 percent could be well managed.

## References

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