Summary of President Evans Presentation on Countering Downward Bias in Inflation

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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.

Summary of President Evans Presentation on Countering Downward Bias in Inflation

President Charles L. Evans discussed the implications of long-run economic trends for monetary policy frameworks and strategies. 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/2020/02-27-20-countering-downward-bias-in-inflation-slides-pdf.

Key highlights of President Evans's remarks

- President Evans focused on how the effective lower bound (ELB) on policy rates in a low neutral rate environment can result in both inflation and inflation expectations running persistently below target, thus posing a risk to the attainment of the Federal Reserve's statutory mandates.
- He discussed some alternative monetary policy approaches that could alleviate this downward inflation bias. He stressed that to be effective, such approaches
  - need to be outcome-based and clearly communicated;
  - must contain a credible commitment to counter the effects of the ELB and bring inflation and inflation expectations up to target; and
  - likely would involve extended periods with inflation above target to counter the downward inflation bias.

Synopsis of President Evans's remarks

- President Evans noted that the U.S. economy is in a historically atypical situation, with inflation persistently underrunning the Federal Reserve's inflation target and the unemployment rate below most estimates of its long-run normal level.
- Two important long-term trends are shaping the U.S. and many other advanced economies:
    - Trend growth and the neutral level of real interest rates (*r**) have declined significantly since the early 2000s. Low growth and low *r** are expected to persist well into the future.
    - At the same time, inflation has been underrunning central banks' targets.
- Consequently, nominal policy interest rates are likely to be constrained by the ELB much more frequently than in the past. This could limit the ability of central banks to use conventional monetary policy tools to counteract downturns and, under traditional approaches to policy, would result in a tendency for inflation and inflation expectations to underrun target.
- President Evans stressed that the overarching aim of U.S. monetary policy is to achieve the dual mandate goals of full employment and symmetric 2 percent inflation over the medium term.
    - When confronted with the ELB, policymakers must commit to provide extraordinary accommodation in order to meet their mandate. And there likely will be a need to raise inflation and inflation expectations to be consistent with the Fed's symmetric inflation objective.

- Countering the ELB inflation bias may require more periods of above-target inflation than experienced in the past. Policymakers must recognize this and convey to the public that periods with above-target inflation are essential to achieving the dual mandate goals over the long run.

- President Evans discussed several alternative monetary policy approaches that would offset the downward inflation bias.
  - He first considered the adoption of a state-contingent price-level target as presented in Evans (2010a, 2012, 2017) and Bernanke (2017).[1]
    - To illustrate the approach, he noted that as a result of the inflation misses since the financial crisis, the price level today in the U.S. is 5.3 percent below a 2 percent trend line starting from the cyclical peak in 2007.
    - The average inflation rate required to return to the trend line depends on the time horizon to close the gap, ranging from about 4.7 percent with a two-year horizon to 2.9 percent with a six-year horizon—both noticeably above the Federal Reserve's 2 percent target.
  - President Evans next discussed an approach from Bianchi, Melosi, and Rottner (2020), in which policymakers follow an asymmetric version of the Taylor (1999) rule that responds more aggressively when inflation is below target than when it is above target.

[1] See also Federal Open Market Committee (2010a, 2010b) for transcripts of FOMC meetings where President Evans discussed this approach. Details of his proposal for a state-contingent price-level objective were presented in Evans (2010b).

    - He noted that inflation objectives that have a point target, such as 2 percent, are easier to communicate than objectives defined by an inflation range.
- He also considered two approaches that consider ranges around the inflation target.
    - One version has been proposed by Harris (2016) and Mertens and Williams (2019). It says that in recognition that inflation will be driven down to the lower end of the range when policy is constrained by the ELB, policymakers should aim for inflation at the top of the range when the economy is away from the ELB.
    - A second version is discussed in Bianchi, Melosi, and Rottner (2020). It sets an asymmetric inflation range with a wider band above target inflation than below it—for instance, from 1.75 percent to 2.5 percent—and has policy act less aggressively when inflation is within the range than outside of it.
- President Evans pointed out how in these alternatives, policy parameters can be calibrated so that inflation averages its target over long periods of time, thus solving the ELB inflation bias problem.
    - In addition, unlike state-contingent price-level targeting, the asymmetric policy response and the two inflation-range approaches do not require a mechanical makeup for past deviations of inflation from target.
    - He also noted that a symmetric inflation range that is a zone of policy indifference cannot be structured to overcome the downward inflation bias.

- President Evans raised some important questions about policy approaches that require delivering above-target inflation for extended periods of time:
    - Can policymakers credibly commit to pursuing the policies prescribed by some of these alternatives?
    - How will central banks communicate such strategies effectively?
    - How will the public react 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 instability 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.
    - Because long-run economic trends have increased the chances of returning to the ELB, policymakers must be prepared to rely on unconventional tools, such as quantitative easing and forward guidance, to provide adequate policy accommodation when appropriate.
    - 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 operational framework chosen.

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