Willem Van Zandweghe (Federal Reserve Bank of Kansas City)

Monetary Policy and Macroeconomic Stability Revisited

(co-authored with Yasuo Hirose and Takushi Kurozumi)

Abstract

A large literature with canonical New Keynesian models has established that the Fed's policy change from a passive to an active response to inflation led to U.S. macro-economic stability after the Great Inflation of the 1970s. We revisit this view by estimating a staggered price model with trend inflation using a Bayesian method that allows for equilibrium indeterminacy and adopts a sequential Monte Carlo algorithm. The model empirically outperforms a canonical New Keynesian model and demonstrates an active response to inflation even in the Great Inflation era, during which the U.S. economy was likely in the indeterminacy region of the model's parameter space. A more active response to inflation alone does not suffice for explaining the shift to determinacy after the Great Inflation, unless it is accompanied by a decline in trend inflation or a change in policy responses to the output gap and output growth.