



Research Working Papers

Monetary Policy and Macroeconomic Stability Revisited

by: Willem Van Zandweghe, Yasuo Hirose and Takushi Kurozumi

January 11, 2017

Revisiting what led to U.S. macroeconomic stability after the Great Inflation in the 1970s.

RWP 17-01, January 2017

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. macroeconomic 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.

JEL Classification: C11; C52; C62; E31; E52

Article Citation

- Hirose, Yasuo, Takushi Kurozumi and Willem Van Zandweghe. "Monetary Policy and Macroeconomic Stability Revisited," Federal Reserve Bank of Kansas City working paper no. 17-01, January, available at <https://doi.org/10.18651/RWP2017-01>

Related Research

- Clarida, Richard, Jordi Gali and Mark Gertler. 2000. "Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory," *Quarterly Journal of Economics* 115(1), 147-180. Available at: <https://doi.org/10.1162/003355300554692>
- Coibion, Olivier and Yuriy Gorodnichenko. 2011. "Monetary Policy, Trend Inflation, and the Great Moderation: An Alternative Interpretation," *American Economic Review* 101(1), 341-370. Available at:

<https://doi.org/10.1257/aer.101.1.341>

- Lubik, Thomas A. and Frank Schorfheide. 2004. "Testing for Indeterminacy: An Application to U.S. Monetary Policy," *American Economic Review* 94(1), 190-217. Available at: <https://doi.org/10.1257/000282804322970760>
-