Policy Regimes, Policy Shifts, and U.S. Business Cycles

Saroj Bhattarai — Penn State
Jae Won Lee — Rutgers University
Woong Yong Park* — University of Hong Kong

Abstract

Using an estimated DSGE model that features monetary and fiscal policy interactions and allows for equilibrium indeterminacy, we find that a passive monetary and passive fiscal policy regime prevailed in the pre-Volcker period while an active monetary and passive fiscal policy regime prevailed post-Volcker. Since both monetary and fiscal policies were passive pre-Volcker, there was equilibrium indeterminacy that gave rise to self-fulfilling beliefs and resulted in substantially different transmission mechanisms of policy as compared to conventional models: unanticipated increases in interest rates increased inflation and output while unanticipated increases in lump-sum taxes decreased inflation and output. Unanticipated shifts in monetary and fiscal policies however, played no substantial role in explaining the variation of inflation and output at any horizon in either of the time periods. Pre-Volcker, in sharp contrast to post-Volcker, we find that a time-varying inflation target does not explain low-frequency movements in inflation. Finally, in a counterfactual exercise, we show that had the monetary policy regime of the post-Volcker era been in place pre-Volcker, inflation volatility would have been lower by 40% and the rise of inflation in the 1970s would not have occurred.

JEL Classification: C52, C54, E31, E32, E52, E63

Keywords: Monetary and fiscal policy regimes; Monetary and fiscal policy transmission; Indeterminacy; Self-fulfilling beliefs; Inflation and output dynamics; Bayesian estimation of DSGE models

*Bhattarai: 615 Kern Building, University Park, PA 16802, sub31@psu.edu. Lee: 75 Hamilton Street, NJ Hall, New Brunswick, NJ 08901, jwlee@econ.rutgers.edu. Park: School of Economics and Finance, University of Hong Kong, Pokfulam Road, Hong Kong, wypark@hku.hk. This version: September 2012.