Inflation Gap Persistence, Indeterminacy, and Monetary Policy

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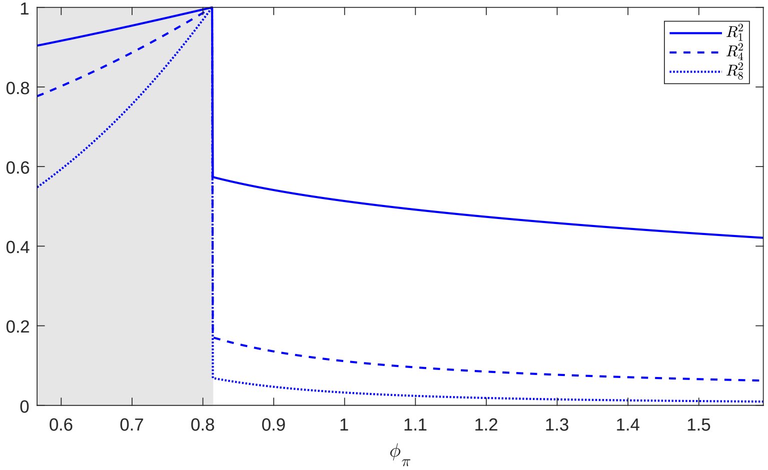
Why did inflation gap persistence decline in the early 1980s?

- A stronger policy response to the inflation gap; a more stable (implicit) inflation target; a reduction in intrinsic inertia of inflation in the Phillips curve; or price markup shocks.
- We examine the source of the decline by estimating a medium-scale DSGE model over the entire parameter space, allowing for both determinacy and indeterminacy.
- RE solutions under indeterminacy can display greater persistence than the unique solution under determinacy.
- We measure inflation gap persistence by its predictability.
- We find that the Fed's change from a passive to an active policy response to the inflation gap can fully explain the decline in inflation gap persistence.

Effect of policy response to inflation gap on predictability



A stronger policy response rules out indeterminacy and dampens responses to shocks under determinacy