Can we Identify the Fed’s Preferences?

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Abstract

A pre-test of Ramsey optimal policy versus time-consistent policy rejects time-consistent policy and (optimal) simple rule for the U.S. Fed during 1960 to 2006, assuming the reference new-Keynesian Phillips curve transmission mechanism with cost-push shock. The number of reduced form parameters is larger with Ramsey optimal policy than with time-consistent policy although the number of structural parameters, including central bank preferences, is the same. At least one of the two models of policy is over-identified or under-identified. The new-Keynesian Phillips curve model is under-identified with Ramsey optimal policy (one identifying equation missing) and hence under-identified for time-consistent policy (three identifying equations missing). Finally, estimating a structural VAR for Ramsey optimal policy during Volcker-Greenspan period, the new-Keynesian Phillips curve slope structural parameter and the Fed’s preferences (weight of the volatility of the output gap) are not statistically different from zero at the 5% level.

Keywords: “both”