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**A New Look at Historical Monetary Policy and the Great Inflation through
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The origins of the Great Inflation, a central 20th century U.S. macroeconomic event, remain contested. Prominent explanations are poor forecasts or deficient activity gap estimates. An alternative view: the FOMC was unwilling to fight inflation, perhaps due to political pressures. Our findings, based on a novel approach, support the latter view. New econometric tools allow us to credibly identify the particular activity gap, if any, in use. Persistence-dependent unemployment (gap) responses in the 1970s were essentially the same pre- and post-Volcker. Conversely, FOMC behavior vis-à-vis inflation—also persistence-dependent—changed markedly starting with Volcker, consistent with (though not proving) the political pressures view.

JEL Classification Codes: E52, C22, C32.

Keywords: Taylor Rule, Great Inflation, Intermediate Target, Natural Rate, Persistence Dependence

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EXTENDED ABSTRACT

The Great Inflation is one of the central U.S. macroeconomic events in the last century. Despite this, its origins remain contested. Was FOMC behavior in the 1970s really due to poor forecasts, or to deficient estimates of the unemployment or output gap? Or was it rather due to an unwillingness to fight inflation, perhaps as a result of political pressures? We provide new evidence consistent with the latter view. Using novel econometric tools, which allow us to decompose the FOMC policy rule coefficients with respect to the current persistence levels of the fluctuations in the unemployment and inflation rates, we are able to identify the particular unemployment rate gap (if any) that is consistent with FOMC behavior. We find that FOMC behavior vis-à-vis unemployment rate developments was remarkably similar from the 1970s-2007; thus, the gap estimates were as good in the 1970s as they were after that. Conversely, FOMC behavior vis-à-vis inflation changed markedly starting with Volcker. Our results support, though do not directly prove, the view that political pressures were the ultimate cause of the Great Inflation. This issue is timely, as several scholars have recently argued that populism's rise might undermine support for central bank independence. However, our findings are also consistent with the view that Fed officials believed that monetary policy would be ineffective in fighting inflation.

1 Introduction

1.1 Background

The Great Inflation of the 1970s is widely regarded as one of the central events in U.S. macroeconomic history over the past 100 years. As such, it has been subject to intense scrutiny, including a prominent NBER conference (Bordo and Orphanides, 2013). Most of these studies of historical FOMC behavior have used variants of a simple monetary policy rule. These were articulated in 1992 by John Taylor (1993), who proposed a rule of the form

$$i_t = \alpha + \beta \hat{u}_{t-1} + \varphi \pi_{t-1} + e_t \quad (1)$$

where i_t is the federal funds rate, π_{t-1} is the annualized inflation rate from period $t-2$ to period $t-1$, \hat{u}_{t-1} is an estimate of (trendless) real activity (output gap, unemployment rate, or unemployment rate gap) in period $t-1$, and e_t is a stationary exogenous monetary shock. There are many variants of Equation (1); we provide an abbreviated discussion below. (For more details, see Knotek et al. (2016) and its Appendix.)

Many of these studies find that the central bank’s policy changed markedly starting with Volcker (see, e.g., Judd and Rudebusch (1998) or Clarida, Gali and Gertler (2000); more recent studies reaching this conclusion include Debortoli and Lakdawala (2016) and Chen, Kirsanova and Leith (2017)).¹ The question is, why? One prominent explanation of the pre-Volcker behavior is the “ideas” hypothesis – the notion that FOMC errors in the 1970s were due to erroneous beliefs about the structure of the economy or to erroneous gap measurements, such as an unrealistically low estimate of the natural rate of unemployment. Other studies point to biased forecasts. Finally, some studies conclude that the FOMC was unwilling to fight inflation, either owing to political pressures, or to beliefs about the effectiveness of monetary policy. We review several of these studies below.

¹Using the the time-varying parameter framework, Cogley and Sargent (2005), Kim and Nelson (2006) and McCulloch (2007) come to a similar conclusion. Not all studies reach this conclusion; e.g., Sims and Zha (2006) find that there is less evidence for significant changes in the reaction coefficients ϕ if one allows for time-varying variance in the monetary policy shock.

Our approach to this question is novel. Estimating (1) requires an estimate of $\hat{u}_{t-1} \equiv (u_{t-1} - u_{t-1}^*)$, that is, an estimate of u_t^* , the time-varying natural rate of unemployment (or an estimate of potential output). Most empirical work studying historical FOMC behavior takes for granted that the FOMC used a particular unemployment rate or output gap, imposed in a specification like Equation (1) *a priori*. But, as we discuss immediately below, there are both econometric and conceptual problems with this approach. One contribution of the present paper is that we have developed novel econometric tools that allow us to simultaneously ask whether the FOMC even used a gap, and can reconstruct an econometrically valid estimate of the gap that was actually used. As an additional benefit, our new tools (discussed in Section 2 and in the Technical Appendix) also allow us to flexibly quantify the degree to which, historically, the FOMC has paid more attention to transient versus relatively persistent fluctuations in unemployment and/or inflation.

What are the possible econometric problems alluded to above? The use of many of the most commonly-used estimates of u_t^* itself compromises inference. For instance, if one's estimate of u_t^* derives from a two-sided filter – such as an HP filter or a symmetric moving average filter – this will distort the coefficient estimate φ in Equation (1); see Ashley and Verbrugge, 2008b.² Further, estimates of u_t^* are inherently problematic in that they are imprecise, are subject to large revisions, and typically hinge on untested (and perhaps untestable) auxiliary assumptions about the natural-rate data-generating process (such as an explicit formulation of its persistence). Any or all of these assumptions may well be substantially incorrect. As might be expected, then, u_t^* estimates vary widely across concepts and methods (see Tasci and Verbrugge, 2014). (Use of an output gap instead of an unemployment gap in Equation (1), also common, does not improve matters.)³ Thus, any particular u_t^* series assumption can easily threaten the validity of the resulting inference, and may render conclusions about such things as the origins of the Great Inflation suspect.

What about the conceptual problem? The selection of a particular u_t^* measure amounts to an assumption that FOMC members were in broad agreement about that particular measure. This seems unlikely, especially during the 1970s. Subsequent to the seminal work of Friedman (1968)

²Of course, not all studies use two-sided gap estimates; for instance, authors using Greenbook data are using one-sided estimates.

³Not only are output gap estimates often derived from two-sided techniques (such as filtering or the use of a Kalman smoother), output gap estimates derived from multivariate procedures are notoriously sensitive to model assumptions; see, e.g., Jarociński and Lenza (2018). This makes their imposition particularly problematic. Our approach is simpler and does not require such assumptions.

and Phelps (1968), a few papers emerged providing estimates of a natural rate of unemployment (typically constant), but there is no evidence that these were taken on board by FOMC members.⁴ Examining FOMC *Memoranda of Discussion*, Kozicki and Tinsley (2006) note that the most prominent published estimates, those of the Council of Economic Advisers, were almost never cited in the 1970s. Hetzel (2017), an author who writes extensively about the historical evolution of central banking, asserts that during the 1970s there was a “general belief that 4 percent unemployment represented full employment” (p.13), despite a number of studies suggesting higher estimates (see references in Nikolsko-Rzhevskyy and Papell, 2012). Other textual analyses of FOMC minutes and transcripts, such as Chappell, McGregor and Vermilyea (2004) or Weise (2012), indicate that the 1970s FOMC was concerned about high and rising unemployment, and was grappling with the notion of what level was sustainable, but there was nothing like a settled concept or estimate guiding the FOMC’s deliberations during this period.⁵

Given this history, in the present study we let the data themselves speak as to whether and how the FOMC was actually responding to movements in the unemployment rate, so as to address such questions as: Has the FOMC historically acted in a manner that (implicitly or explicitly) responded to an unemployment gap of some sort? Putting this differently, is an unemployment rate gap useful (or necessary) in order to provide a good description of the FOMC’s historical behavior?⁶ Additionally, did the FOMC respond to persistent movements in the unemployment rate in a way that was systematically different from its response to business cycle fluctuations (or to even less persistent fluctuations) in that variable?⁷ Did this aspect of the FOMC’s behavior

⁴Indeed, the stagflation in the early 1970s was thought to indicate shortcomings in the concept of a natural rate of unemployment, and prompted the introduction in 1975 of a related but distinct concept, the NIRU (Modigliani and Papademos, 1975), which was later re-termed the NAIRU; see Espinosa-Vega and Russell (1997).

⁵We note in passing that several studies of monetary policy rules, such as that of Ball and Tchaizde (2002), do not use an unemployment gap specification. This is consistent with an assumption that the natural rate is constant.

⁶We agree with Kozicki and Tinsley (2006) that it is “more plausible that the 1970s FOMC gauged real resource slack by aggregate unemployment” than by using estimated output gaps. First, there is no continuous historical record of central bank estimates of an output gap; indeed, this prompted Orphanides (2003) to use the CEA’s estimates, a practice criticized by Taylor (2000) and Nikolsko-Rzhevskyy and Papell (2012). Second, pricing equations in the 1970s were mainly specified in terms of unemployment rates. Third, unemployment rate information is far more timely than output information, and revisions are less frequent and smaller. Finally, the unemployment rate has always been understood to be an indicator of prime importance for the FOMC, and employment became part of the “dual mandate” of the Federal Reserve in 1977. For these reasons, we focus on the use of u_t in studying historical FOMC policy. In our robustness checks, we provide evidence suggesting that even in the 1979-2008 period, the FOMC used unemployment rate gap estimates in preference to output gap estimates.

⁷Note that belief in a fixed natural rate of unemployment would not necessarily preclude a differential

change with the chairmanship of Volcker? If so, do our results suggest an explanation?

The work described below uses the lens of estimated simple policy rules to empirically address – and provide credible answers to – these questions. It also illustrates the application of a relatively novel econometric approach that is simple, transparent, and well-suited to the real-time data (in both u_t and π_t) which is appropriate to the FOMC context. The method allows for possible feedback in the relationship (in contrast to frequency-domain alternative methods), does not require ancillary assumptions about the data-generating processes, and is sufficiently flexible as to not presuppose the answers. It is discussed at length below, in Section 2.

Our findings are striking, but intuitively appealing upon reflection. Activity-gap estimation errors do not seem to explain the Great Inflation. Our estimates indicate that FOMC federal funds rate responses to unemployment rate fluctuations were *essentially the same* during the Martin-Burns-Miller (MBM) period as during the Volcker-Greenspan-Bernanke (VGB) period. In particular, irrespective of any belief the FOMC may have had about the natural rate of unemployment, we find that the FOMC ignored the most persistent unemployment rate fluctuations over both periods. Thus, during the *entire* period of our study, the FOMC implicitly formed an unemployment gap in much the same manner, with the most persistent (i.e., lowest frequency) fluctuations serving the role of an intermediate target.⁸ These results cast serious doubt on one part (or subset of) the “ideas” hypothesis – that the Great Inflation in the 1970s was due to an unrealistically low estimate of the natural rate of unemployment (e.g., Orphanides 2002, Romer and Romer 2002, Romer 2005). Further, these results also suggest that previous work, which has largely relied on particular gap estimates imposed *a priori*, may have come to erroneous conclusions about FOMC behavior in the 1970s.

Second, our findings also indicate that previous empirical work using (1) has been mis-specified with respect to inflation as well. Historically, the FOMC also responded in a persistence-dependent manner to real-time fluctuations in the inflation rate. We find that this behavior became much more pronounced after Volcker; and the post-Volcker FOMC was also much more aggressive in its

FOMC response to persistent versus more transient unemployment rate fluctuations.

⁸Jeffrey Fuhrer suggested the language of “intermediate target” in his discussion of Fuhrer and Olivei (2017) during the Boston Fed’s annual central banking conference in October 2017. The concept of an “interim target” dates back at least to Bonfim and Rudebusch (2000).

response to inflation. This persistence-dependent behavior accords well with intuition. Measured inflation is often subject to large transitory influences, which can affect an aggregate price index for long periods. This is one reason that policymakers have argued – e.g., Mishkin (2007) – that the central bank should not respond to transitory fluctuations in inflation.⁹

Third, we provide evidence against the conjecture that FOMC behavior in the 1970s chiefly resulted from inaccurate inflation forecasts (see, e.g., Orphanides 2002, Levin and Taylor 2013, or Fuhrer and Olivei 2017). While this mechanism could certainly operate in conjunction with policy preferences – Greenbook inflation forecasts for portions of the 1970s were downward-biased – our evidence indicates that the actual behavior of the FOMC in the 1970s is more consistent with its using real-time CPI inflation data, and simple (but reasonably accurate) inflation forecasts.

Finally, our results suggest that policy preferences – possibly driven by political pressures (see, e.g., Chappell, Havrilesky and McGregor (1993), Meltzer (2011), Weise (2012), or Levin and Taylor (2013)) – constitute a far more likely explanation of the Great Inflation.^{10,11} This finding is timely, in that several scholars have recently argued that the rise of populism worldwide might undermine support for central bank independence – see, e.g., Buiter (2016, 2017), Agur (2018), Binder (2018), Goodhart and Lastra (2018), and Masciandaro and Passarelli (2018).

⁹Some analysts have attempted to address this issue by making use of so-called “core” inflation measures in Equation (1). This expedient is valid, however, only if all movements in the core inflation measure are identically persistent, which is emphatically not the case; for example, see Bryan and Meyer (2010) and Dolmas and Wynne (2008). As an example of the historical analysis of transitory shocks to inflation, FOMC Greenbooks in early 1969 explicitly highlighted transitory inflation fluctuations deriving from federal pay increases – clearly the FOMC regarded these as transitory. Note that the issue we raise here is distinct from whether π_t should instead enter Equation (1) in terms of an “inflation gap,” where this gap is the difference between π_t and an inflation target, π^* . As in the case of u_t , ideally one would want to let the data inform us as to how the FOMC was actually responding to movements in the inflation rate – e.g., whether it was ignoring transient movements in this variable, or focusing on the most persistent movements – and whether this behavior changed with the chairmanship of Volcker. Occasionally, policy rules are specified in terms of expected inflation (which will implicitly focus attention on the most persistent part of inflation), or on an inflation gap versus a time-varying inflation target (e.g., Cogley and Sbordone 2008). Our approach allows for, but does not impose, restrictions along these lines.

¹⁰Some examples of political pressure from the 1970s are a matter of public record; we discuss this below. Meltzer (2011) argues that such pressures might not always be evident in public discussions. Lakdawala (2016) also finds that FOMC preferences for fighting inflation, while varying over time, drastically rose around the appointment of Volcker. Note that our results could also be viewed as being consistent with another “ideas” hypothesis – that the FOMC was overly pessimistic about the sacrifice ratio.

¹¹We view our results as complementary to those of Cogley, Primiceri and Sargent (2010), who argue that superior policy outcomes following Volcker resulted mainly from superior inflation anchoring, as we might suggest that more aggressive responses to inflation (and the associated willingness to accept concomitantly higher unemployment) could lead to such superior anchoring.

1.2 Equation (1): Discussion

There are many variants of Equation (1). Theory often suggests forward-looking versions (e.g., Clarida, Gali and Gertler (2000)); real-time lags in data collection motivate the use of lagged inflation and real activity in a backward-looking monetary policy rule (e.g., McCallum and Nelson (1997)), as we formulate it here; and interest rate smoothing considerations, as well as the statistical properties of i_t , motivate adding lags of i_t to the right-hand side of (1). As will be evident below, our methods sidestep problems with instruments and identification in forward-looking policy rules (see, e.g., Jondeau, Bihan and Galles (2004)), though information from forecasts is incorporated gracefully. Some studies extend the policy rule to include other variables such as bond yields (e.g., Roskelley (2016)) or stock and house prices (e.g., Aastveit, Furlanetto and Loria (2017)).

2 Methodology

In this paper, we allow the data to speak as to how the FOMC has historically responded to fluctuations with various persistence levels in the unemployment rate and in the inflation rate. Our approach is simple and transparent, but delivers new insights into historical FOMC behavior. Following Clarida, Gali, and Gertler (2000), we primarily consider two sub-sample periods. The first of these is January 1965 to August 1979, which roughly corresponds to the Martin-Burns-Miller period and is here denoted MBM. The second sub-sample runs from September 1979 to August 2008. It covers Volcker’s, Greenspan’s, and part of Bernanke’s tenures, ending as the “zero lower bound” episode began; it is here denoted VGB.

We estimate the central bank’s assumed monetary policy rule using a new method proposed by Ashley and Verbrugge (2008b).¹² This method allows us to avoid imposing a u_t^* estimate, but to instead test whether, and quantify how, the FOMC in fact distinguished between fluctuations with differing persistence levels. Essentially, we use a one-sided filtering technique to partition the real-time unemployment rate and inflation rate into components with differing levels of persistence. It is then straightforward, using standard regression techniques and tests, to determine whether the FOMC responded (in real time) to the persistent part in the same manner that it responded to

¹²The Technical Appendix describes the latest version of this method.

the less persistent part, or to the high-frequency part. The technique is briefly described as follows (for more details, refer to the Technical Appendix here, or to Ashley and Verbrugge 2008b).

We use moving windows to filter the real-time data at each time t , partitioning the time t observation into various persistence (or frequency) components. One-sided filtering is necessary for two reasons: first, two-sided filtering cannot be conducted in real time; and second, two-sided filtering results in distorted coefficient estimates and destroys the ability to make causal statements (except in limited cases).¹³ The precision of the partitioning is substantially enhanced by extending the data in each window with forecasts or “projections” (see also Stock and Watson (1999), Mise, Kim and Newbold (2005), or Clark and Kozicki (2005)). Thus, for example, to partition the unemployment rate at time t , we apply the Ashley-Verbrugge filter to a rolling window of 96 observations ending in t , augmented with a set of 1- through 24-month forecasts, starting at time $t+1$. The Ashley-Verbrugge filter is then applied to this 120-month window, and the time- t decomposition is saved. (The inflation rate is partitioned in the same manner, except in that case, a 42-month window is augmented by 18 months of forecasts. We argue below why distinct window lengths for the two variables are appropriate.) Figures 1 and 2 display the resulting components of each of these two variables, in each case partitioning the data by persistence level into three persistence components.

Is this method subject to our previous critique, the imposition of concepts from the future? No. We are not arguing that the FOMC made use of techniques from the future in order to guide their decisionmaking.¹⁴ Instead, what we are asking is whether the FOMC, using the tools it had on hand at various points in time (such as forecasts, judgment, various trend estimates, or detailed studies of particular unemployment rate or inflation movements), has in fact historically acted as if it was making this type of persistence distinction in its decisionmaking. Indeed, one may note that our

¹³Two-sided filters (such as the HP filter) applied to both the explanatory and dependent variables, as in classical RBC studies or in recent New Keynesian DSGE modeling, distort relationships among variables that are contemporaneously cross-correlated or in a feedback relationship, because two-sided filtering inherently mixes up future and past values of the time series; see Ashley and Verbrugge (2009b) for a more detailed exposition of this point. For the same reason, and because such calculations are incompatible with the use of real-time data, two-sided cross-spectral estimates or filtering with wavelets should similarly be eschewed for this kind of analysis.

¹⁴While economists were already making use of the conventional tools of spectral analysis by the early 1970s, given the early cogent critique of Granger (1969) and the relative paucity of that sort of research, it is safe to say that such methods were not at the forefront of FOMC decisionmaking in the 1970s, and probably not through the chairmanship of Bernanke either.

method uses real-time information to assist in identifying persistent versus transient movements, in roughly the same manner that an informed observer might do using judgment.¹⁵ In particular, we are using new tools to better understand and describe the historical behavior of the central bank, allowing the data to inform us as to the manner in which the central bank actually responded to fluctuations in these macroeconomic variables.

To investigate the “poor forecasts” explanation of the Great Inflation, for the MBM period we conduct a straightforward out-of-sample forecasting exercise; see Section 3.3. We find that, while Greenbook forecasts were downward biased for parts of the 1970s, we can better predict FOMC behavior during this time period using CPI inflation in conjunction with simple-but-reasonable CPI inflation forecasts.

While the original Taylor-type monetary policy response function is attractive in its simplicity, our extension of it broadens its generality and descriptive power, yielding novel results. By allowing the data a chance to tell us if the FOMC treated apparently persistent fluctuations differently than fluctuations that appeared to be more transient, without imposing a particular gap estimate, we obtain a clearer picture of how the FOMC actually behaved, and how its behavior evolved between the MBM and VGB periods.

3 Empirical Results

3.1 Data Description and Discussion of Partitioning

We use real-time data on the civilian unemployment rate (u_t) and the 12-month growth rate in the (real-time) CPI inflation rate (π_t),¹⁶ taken from the St. Louis Federal Reserve Bank’s ALFRED

¹⁵This appears to be consistent with the viewpoint of Meyer, Venkatu and Zaman (2013), who state: “By specifying the inflation threshold in terms of its forecasted values, the FOMC will still be able to ‘look through’ transitory price changes, like they did, for example, when energy prices spiked in 2008. At that time, the year-over-year growth rate in the Consumer Price Index (CPI) jumped up above 5.0 percent but subsequently plummeted below zero a year later when the bottom fell out on energy prices. At the time, the Committee maintained the federal funds rate target at 2.0 percent, choosing not to react to the energy price spike.”

¹⁶Specifically, we use the inflation rate defined as the 12-month growth rate in percentage terms – i.e., $100\ln(CPI_t/CPI_{t-12})$ – where CPI_t is the nonseasonally adjusted CPI for urban wage earners and clerical workers until February 1978 and the nonseasonally adjusted CPI for all urban consumers thereafter. The value for CPI_{t-12} in π_t is that which was available when CPI_t was released.

data set. (In our investigation of the experience of the 1970s, for comparison purposes we also make use of real-time quarterly GNP deflator data, and inflation forecasts deriving from FOMC Greenbooks, both available from the Real-Time Data Research Center at the Federal Reserve Bank of Philadelphia.) For our projections of the unemployment rate, a case where univariate models can be slow to detect turning points in the data, we also make use of the Survey of Professional Forecasters projections of this variable, also available from the Federal Reserve Bank of Philadelphia. (We linearly interpolate these quarterly forecasts in order to obtain monthly forecasts.)

As the backward-looking filtering employed here uses up a good deal of sample data as a ‘start-up’ period, our regressions begin in January 1965. Our sample period ends in August 2008, just prior to the point when the sample variation in i_t becomes minimal. The data we are analyzing correspond closely to those that were available to the FOMC at the time it set the federal funds rate (i_t).¹⁷

Our treatment of the federal funds rate, and the information available to the FOMC during its meeting each month, warrants some discussion. Over most of our sample, the federal funds rate experienced notable day-to-day changes, and was also subject to end-of-month effects as banks addressed regulatory constraints. Our goal is to estimate the FOMC reaction function, which models the FOMC fed funds rate decision in its meeting, in reaction to or based upon the information that the FOMC had available when it made the decision. However, FOMC meeting dates – and conference phone conversations at which decisions could also be taken – did not occur on the same day each month.¹⁸ Hence, for each month we estimate the monthly fed funds rate by taking a trimmed-mean estimate of the fed funds rate over the six business days following an FOMC meeting, trimming the highest and lowest daily rates of that period, and taking the average over the remaining four observations. If there was no meeting that month, we implicitly assume an FOMC meeting on the 20th day of the month, at which the rate was left unchanged.¹⁹ For the monthly unemployment rate and inflation rate series, we then utilized the information that was actually

¹⁷Source: <http://research.stlouisfed.org/fred2/>. See Orphanides (2001) for evidence that estimated monetary policy rules are likely not robust to the vintage of the data.

¹⁸In fact, occasionally, there were two or more meetings in a single month. In those cases, we selected one of the meetings, preferentially the meeting or conference call at which a rate change took place. Earlier in the sample, when Greenbook forecast information was more variable, we also gave consideration to meetings at which richer forecast information was included in the Greenbook.

¹⁹A referee suggested that we alternatively use the intended federal funds rate from Romer and Romer (2004). We did so, and results are nearly unchanged, reflecting the fact that these series are nearly identical.

available immediately prior to the FOMC deliberations that month. Most commonly, the FOMC had available the unemployment rate from the previous month, and the CPI inflation rate from two months prior. However, for meetings that occurred late in the month, CPI inflation data from the previous month were often available. (We describe below a robustness exercise that used GNP deflator information aligned with the same meeting dates.)

As noted above, following Clarida, Gali, and Gertler (2000), we primarily consider two sub-sample periods: January 1965-August 1979, the MBM period; and September 1979-August 2008, the VGB period. The Great Inflation occurred during the MBM period. Most of the VGB period is also referred to as the Great Moderation – see McConnell and Perez-Quiros (2000) and Kim and Nelson (1999) – as it is characterized by low variance in most macroeconomic variables. (Since the onset of the Great Recession, of course, many macroeconomic variables have become more volatile.)

Each monthly observation on u_t and π_t is here decomposed into frequency (persistence) components, as noted above and described in the Technical Appendix, using moving windows. In specifying the length of the moving windows used in decomposing the real-time unemployment rate, we note that the natural rate of unemployment is usually thought to be quite slowly varying. For instance, Boivin (2006) uses a five-year moving average of the unemployment rate as a proxy for the natural rate. A shorter window – say, 36 months – would risk including business cycle effects within the lowest-frequency unemployment rate component, and likely not properly distinguish very persistent supply-side pressures on the unemployment rate from less persistent business-cycle-related influences on the unemployment rate. Put differently, this short window length choice would impose the restriction that the central bank responds in much the same way to an unemployment rate fluctuation with a reversion period of 36 months as it does to a fluctuation with substantially larger reversion periods – e.g., of 5 years, or even 10 years. Hence, we conjectured that a 10-year window would likely result in a satisfactory decomposition for the unemployment rate.²⁰ As will be evident below, the outcome of the empirical analysis presented here will inform us as to whether or not a shorter window would have been adequate. In specifying the length of the moving windows used in decomposing the real-time inflation rate, in contrast, we considered that a central bank might very well react differently to a fluctuation in the real-time inflation rate that has persisted

²⁰ An exercise – not reported here – that estimated the width of a moving average of the unemployment rate that best matched prominent estimates of the NAIRU resulted in a moving average of nine years.

just 12 months – as compared to one that has persisted ca. 36 or 48 months – but that it seems unlikely *a priori* that it would attend to a 60-month-long fluctuation substantially differently than to one that has persisted substantially longer than this.²¹ We thus judged that a moving 60-month window would suffice for the inflation rate.²²

In previous versions of the paper, we have explored more disaggregated partitions of the data – e.g., splitting u_t and π_t each into 10 components with differing persistence levels and estimating a distinct policy rule coefficient for each of these components. We also explored more parsimonious specifications in which the parameter variation across the 10 components was constrained by a quadratic or cubic polynomial, as in Almon (1965). While the latter is a bit more satisfactory (and the former method still yields reasonable results), it is abundantly clear that a tripartite partition suffices, yielding the same economic inferences in a much more transparent manner. Accordingly, here we only quote results from a tripartite partition of each variable.

In particular, here we isolate the most persistent fluctuations that are resolvable given the length of the filtering window; thus, the most persistent fluctuations in the unemployment rate consist of all fluctuations that take longer than 120 months to complete, while the most persistent fluctuations in the inflation rate consist of all fluctuations that take longer than 60 months to complete. We will denote these here as the “very persistent” fluctuations.²³ Next, we split out the “transient”

²¹A (centered) 36-month moving average is often used as an estimate of trend inflation; see, for example, Cecchetti (1997) or Brischetto and Richards (2007); Giannone and Matheson (2007) and Higgins and Verbrugge (2015) argue for using even shorter moving averages.

²²Our empirical results are not particularly sensitive to specifying somewhat shorter (or longer) moving windows for use in decomposing u_t and π_t . As noted in the Technical Appendix, this filtering provides a usefully accurate decomposition for the last sample observation in a moving window only if the sample observations in the window are augmented by a number of projected observations. We use 18 months of projections for the inflation rate partitioning, and 24 months of projections for the unemployment rate partitioning. These choices imply that roughly 80 percent of each window consists of sample data. Based on minimizing BIC as a selection criterion, the π_t projection forecasting model chosen for use here combines a random walk and an ARMA(6,2) process. The u_t forecasting model builds upon forecasts from the Survey of Professional Forecasters. These are quarterly, and we linearly interpolate them. Then we augment these with a forecast based upon an AR(2) model. As with the window lengths themselves, we find that our empirical results are not sensitive to minor changes in the number of projections or the form of the projection forecasting model used, but it *is* necessary to use at least 12 projection months and some kind of reasonable projection model for filling out each window. RATS code implementing this decomposition methodology is available from the authors. For non-RATS users, we also have available a ready-to-use Windows-based executable that implements the decomposition using simple AR(p) projection; in this case all that the user needs to do is specify the order p , the number of projections, and the window length – the program then produces the maximal number of frequency (persistence) components and the user can aggregate these components into frequency (or persistence) bands.

²³As we explain below, the extremely persistent component will include all frequency-0 fluctuations, in addition to all fluctuations corresponding to reversion periods longer than the filtering window. Analysts may choose to include fluctuations with lesser persistence, although here we do not do so. In terms of the

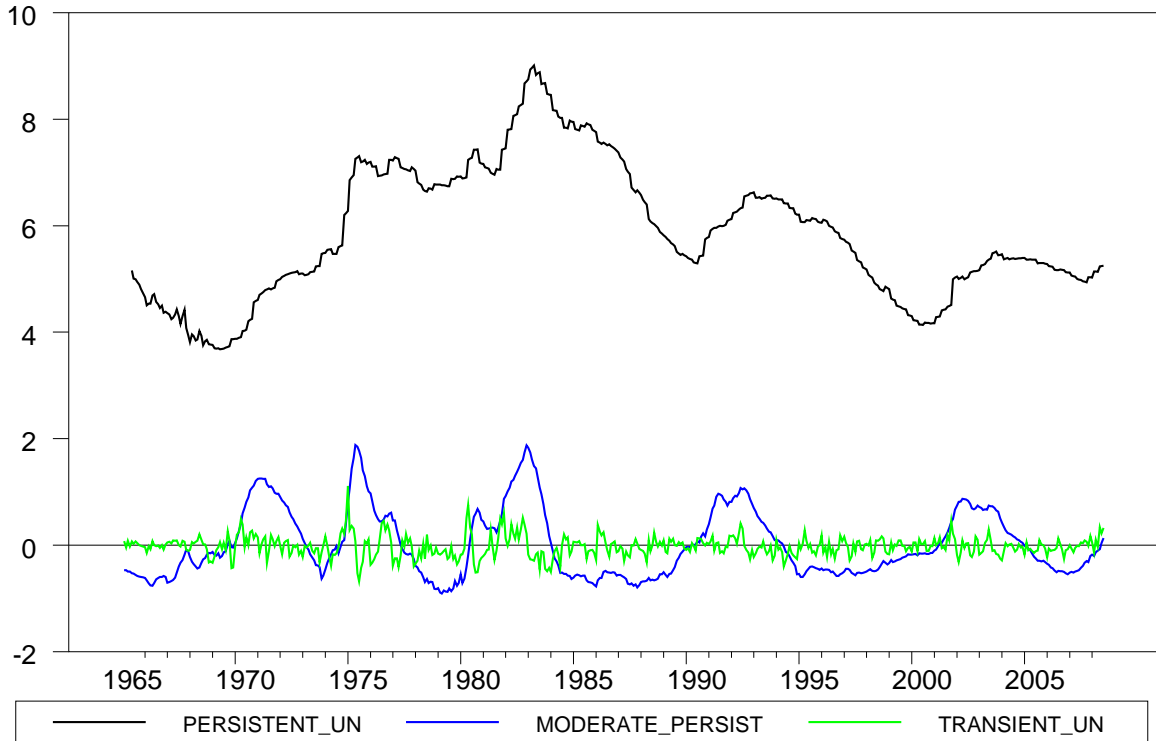


Figure 1: Components of Unemployment Rate by Persistence

fluctuations of each variable, where these consist of all fluctuations that take 12 months or less to complete. We will be able to investigate whether the FOMC effectively ignored these fluctuations. Below we refer to the remaining component of u_t or π_t as the “moderately persistent” fluctuations.

Time plots of “extremely persistent” components (“persistent_un” or “persistent_pi”), “moderately persistent” components (“moderate_persist”), and “transient” components (“transient_un” or “transient_pi”) are displayed in Figure 1 for the u_t components and in Figure 2 for the π_t components.

A few words of explanation may be in order. The very persistent component is not as smooth as one would, from the nomenclature, expect; and there appears to be a modest correlation between the very persistent and the moderately persistent components. The first issue comes about because both

frequency domain analysis that underlies these decompositions, a 120-month reversion period corresponds to the sinusoidal frequencies proportional to $1/120$; see the Technical Appendix for details.

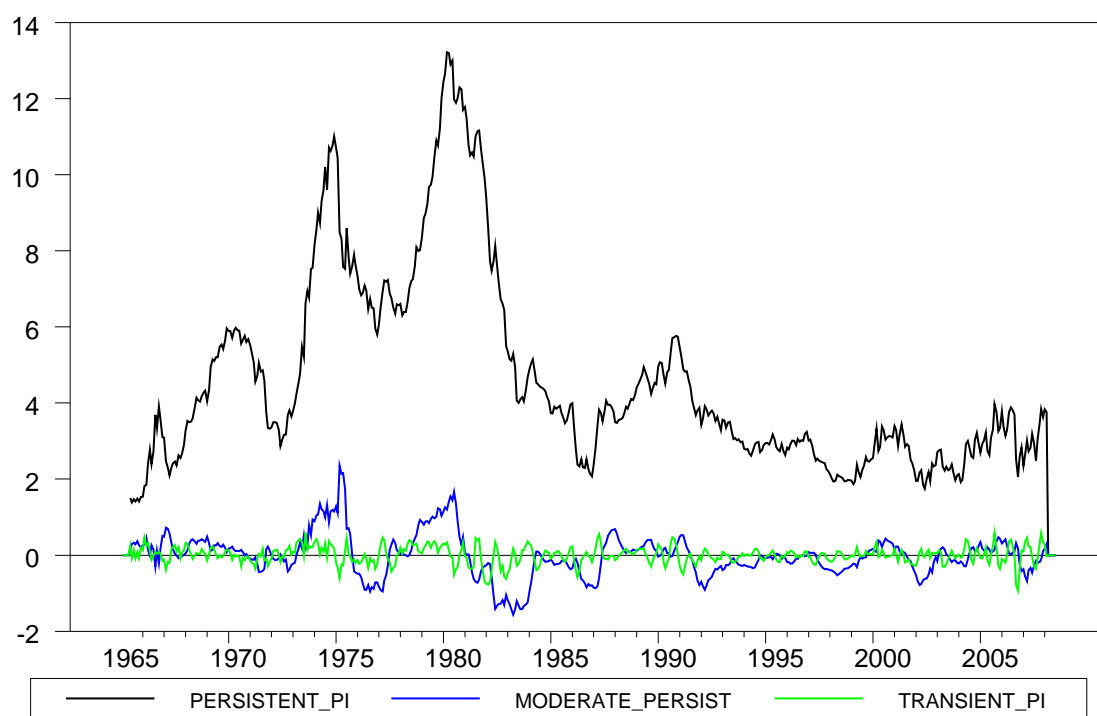


Figure 2: Components of Inflation Rate by Persistence

the real-time data and the projections used in each window can and do shift each period, leading to not-particularly-smooth fluctuations in what otherwise would have been a very smooth “very persistent” component. The windowing procedure implies that the extremely persistent component will incorporate a nonlinear adaptive trend, including all zero-frequency components as well as all components whose period exceeds the width of the window. (See the Technical Appendix for a figure demonstrating how the lower frequency movements of the data are estimated by our procedure.) The second issue arises for similar reasons. Had the entire data sample been subsumed into one long window, these components would be precisely uncorrelated. But in real time, there is always a time- t innovation that represents a departure from the time $t - 1$ forecast of the variable at time t . The movement at time t must be decomposed into various persistence components – and without observations of the variable at times $t + 1, t + 2$, etc., it is impossible to parse the time- t change into its persistence components without error. A given innovation in real-time u_t or π_t will unavoidably be somewhat misattributed across the components, yielding both a modest level of correlation between the components.²⁴

3.2 Specification and Results

3.2.1 Specification

Our empirical specification was guided by prior work and by theoretical considerations, in conjunction with a desire to allow the data to speak as clearly as possible.

First, the federal funds rate is highly persistent. Empirical estimates of central bank policy functions from around the world generally indicate the presence of substantial inertia (see, e.g., Goodhart 1999 or Coibion and Gorodnichenko 2012), consistent with partial adjustment of the interest rate toward its target. Rudebusch (2002) disagrees with the interest rate smoothing interpretation and provides evidence that monetary policy inertia is more likely due to persistent shocks that the central bank faces. Consolo and Favero (2009) argue, in the forward-looking context, that the inertia is an artifact of a weak-instrument problem for expected inflation. In their study of the

²⁴Most of the resulting inter-component correlations we observe in Figures 1 and 2 are actually quite small, typically around 0.1. The most persistent part of each series has a correlation with the moderately persistent part on the order of 0.2 (u_t) to 0.35 (π_t), however.

U.S. Great Inflation episode in the 1970s, Humpage and Mukherjee (2015) find that inertia was deliberate. Incorporating inertia is found to improve outcomes in many theoretical models (see, e.g., Woodford 2003, Taylor and Williams 2011). On the basis of their regime-switching-VAR evidence, Jackson, Owyang and Soques (2016) argue that gradual policy changes may be contraindicated for fighting recessions. In the U.S. at least, there is some evidence for “double inertia” (see Carlstrom and Fuerst, 2014): in both periods, two lags of the federal funds rate are necessary to yield serially uncorrelated fitting errors. From an econometric standpoint, ignoring such persistence is likely to lead to severe parameter estimate distortions (see Ashley and Verbrugge, 2008a); these distortions are avoided here by the inclusion of lags in i_t .

Second, as discussed in the introduction, it is common to see an estimate of a “natural rate of unemployment” and/or an inflation target in a central bank policy reaction function specification. Such inclusions are inherently awkward because these quantities are time-varying (albeit slowly so), but their time variation cannot be identified without making strong (and untestable) assumptions about their time-evolution. Such variables are not included in our base model specification below (Equation (2)) because the estimation methodology we use in our immediately subsequent model specification – i.e., Equation (3) – will allow for the coefficients on u_t and π_t to differ for slowly varying (“highly persistent”) fluctuations in these variables. In this manner, we gracefully allow for, but do not impose, a gap specification.

Hence, given the “double inertia” and timing discussion above, our base model specification is given by:

$$i_t = \delta_1 i_{t-1} + \delta_2 i_{t-2} + (1 - \delta_1 - \delta_2)(\alpha + \beta u_{t-1} + \varphi \pi_{t-2}) + e_t. \quad (2)$$

To investigate whether the FOMC reaction function differentiated between highly persistent movements of each variable, moderately persistent movements of each variable, and higher-frequency movements of each variable, we re-specify Equation (2) to allow for the possibility that the coefficients on π_t and u_t depend on the persistence levels of the fluctuations in these variates. This yields the model:

$$i_t = \delta_1 i_{t-1} + \delta_2 i_{t-2} + (1 - \delta_1 - \delta_2) \left(\alpha + \sum_{k=1}^3 \beta_k u_{t-1}^k + \sum_{j=1}^3 \varphi_j \pi_{t-2}^j \right) + \epsilon_t. \quad (3)$$

In Equation (3), the superscripts on u_t and π_t distinguish the components of these variables, as partitioned into three persistence levels. In particular, u_t^1 is the “highly persistent” component of u_t ; u_t^2 is the “moderately persistent” component of u_t ; and u_t^3 is the “transient” component of u_t , as described in Section 3.1 above. This model specification allows us to estimate distinct policy-response coefficients (β_1 , β_2 , and β_3) for these components of unemployment rate fluctuations, as these may have been perceived by the FOMC based upon the real-time data available to it at the time a decision was made. The variables (π_t^1 , π_t^2 , and π_t^3) and coefficients (φ_1 , φ_2 , and φ_3) are analogously defined, corresponding to the “highly persistent,” “moderately persistent,” and “transient” components of inflation rate data.

3.2.2 Results

The first two columns of Table 1 display NLS estimates of δ_1 , δ_2 , β , and φ separately over the MBM and VGB subperiods, corresponding to Equation (2). As noted above, the inclusion of two lags in i_t in this model suffices to yield serially uncorrelated model fitting errors. Eicker-White standard errors are quoted for all coefficient estimates, here and below, to account, at least asymptotically, for any heteroskedasticity in ϵ_t .²⁵ The coefficients δ_1 and δ_2 can be taken to quantify the “double-inertia” interest rate smoothing behavior by the FOMC alluded to in Section 3.2.1, so it is noteworthy that the null hypothesis that both of these coefficients are zero can always be rejected with $P < 0.0005$, and that these coefficient estimates are fairly stable across the two periods.²⁶

²⁵Possible parameter estimation distortion due to three outlying observations in the fitting errors – for July 1973, May 1980, and Feb 1981 – was addressed using dummy variables to shift the intercept. The estimated coefficients on these dummy variables were always highly significant – and (negative, negative, positive) in signs, respectively – but their exclusion did not substantively affect the inference results reported below. Consequently, the listing of these coefficient estimates – and the model intercept term (α) – is, for simplicity, suppressed in Table 1.

²⁶Fed funds rate dynamics were significantly more volatile prior to 1983 than afterwards. What might explain these changes? One potential explanation is regime shifts. First, the Federal Reserve formally adopted monetary targets in 1970. However, by the mid-1970s the fed funds rate had essentially become the operational target. Then, in October 1979, ostensibly to control high inflation, the Federal Reserve switched to targeting monetary aggregates. During this period, there were several episodes during which large fluctuations in the federal funds rate prompted no FOMC response (see Gilbert, 1994). Finally, in October 1982, the Federal Reserve effectively began targeting the fed funds rate again (although arguably this may not have always been the chief focus of attention; for instance, during a conference call on January 9, 1991, Richard Sternlight, who was manager of the trading desk at the Federal Reserve Bank of New York, remarked, “Somewhat by default we might place more guidance on, of all things, the federal funds rate...”). Regime switches often lead to uncertainty, experimentation, and apparent policy reversals, and the associated diminishment of any beneficial effects arising from stable expectations.

The base model specification – Equation (2) – imposes the assumption that the FOMC did not distinguish the most persistent movements in u_t and π_t from other fluctuations. As one might have expected, during the VGB period, this is a profound misspecification. While β and φ enter with conventional signs and statistical significance during the MBM period, during the VGB period the estimates would appear to indicate that the FOMC ignored fluctuations in u_t in this period, since $H_0 : \beta = 0$ cannot be rejected at conventional levels of significance. Taking these coefficient estimates at face value also indicates that the FOMC’s response to inflation rate fluctuations was notably smaller in the MBM than in the VGB period: on average the FOMC increased the federal funds rate by only 0.63 percent for every 1 percent increase in the inflation rate in the MBM period, whereas, in the VGB period, the estimated response is 1.82 percent. The FOMC’s short-run response to a 1 percent increase in the unemployment rate is only economically meaningful during the MBM period, and even then it is of only modest economic significance (−0.84 percent).²⁷

But these base model results are artifactual; during this period, the implicit u_t target of the FOMC was varying substantially. Allowing for (but not imposing an assumption that) the possibility that the FOMC could distinguish the most persistent movements in u_t and π_t from other fluctuations – in Equation (3) – yields interestingly different results, which we now describe.

²⁷If one re-estimates Equation (2) using a conventional unemployment rate gap, one finds – in keeping with most of the literature – evidence for a response to unemployment rate fluctuations in the VGB period. Evidently, the apparent non-response to unemployment rate fluctuations in the VGB period indicated in Table 1 for Equation (2) arises from the fact that the FOMC does not respond to extremely persistent movements in the unemployment rate, and these comprise a large part of the variance.

Table 1: Estimation Results

Equation (2)			Equation (3)			F-test: $\gamma^{MBM} = \gamma^{VGB}$ $\gamma = \{\delta_i, \beta_i, \varphi_i\}$
	MBM Period	VGB Period	Persistence (in months)	MBM Period	VGB Period	
δ_1	+1.46 (0.09)	+1.37 (0.08)	δ_1	+1.29 (0.07)	+1.28 (0.07)	0.10
δ_2	-0.55 (0.09)	-0.42 (0.08)	δ_2	-0.38 (0.08)	-0.37 (0.07)	0.13
			β_1	-0.49 (0.36)	+0.29 (0.35)	0.18
$\beta_{(u_t)}$	-0.84 (0.26)	+0.08 (0.36)	β_2	-1.59 (0.54)	-2.81 (0.50)	0.09
			β_3	-6.43 (2.50)	-5.63 (1.95)	0.60
			φ_1	+0.64 (0.20)	+1.71 (0.31)	0.03
$\varphi_{(\pi_t)}$	+0.63 (0.16)	+1.82 (0.48)	φ_2	+0.04 (0.63)	-0.72 (1.11)	0.41
			φ_3	+1.04 (1.83)	-5.18 (1.74)	0.01
F-tests:						
			$\beta_i = 0 \ \forall i$	0.002	0.000	
			$\beta_i = \beta_j \ \forall i, j$	0.043	0.000	
			$\beta_2 = \beta_3$	0.048	0.16	
			$\varphi_i = 0 \ \forall i$	0.004	0.000	
			$\varphi_i = \varphi_j \ \forall i, j$	0.64	0.000	
			$\varphi_2 = \varphi_3$	0.85	0.012	

We begin by discussing an anomalous coefficient estimate: φ_3 is estimated to be significantly negative during the VGB period, ostensibly indicating high-frequency accommodation of inflation rate fluctuations. However, this result is actually an artifact, because this coefficient was unstable during the VGB period. Between October 1979 and October 1982, rather than targeting the fed funds rate, the FOMC was targeting nonborrowed reserves (as a means to control monetary aggregates, and hence inflation). During this period, the fed funds rate was highly variable, with

reversals that roughly line up with high-frequency inflation shifts. This is consistent with the view that high-frequency shifts in inflation occurred along with (and perhaps causing) high-frequency shifts in money demand that, in turn, induced high-frequency shifts in the fed funds rate. To test this, we allowed for a break in φ_3 after 1982. In that case, φ_3 is statistically different from zero only during the pre-1983 period, while other inferences are unaffected.

With respect to the persistence-decomposed u_t fluctuations, we note that the null hypothesis $\beta_1 = \beta_2 = \beta_3$ can be rejected in both periods, very strongly in the VGB period. The source of that rejection is clear: β_1 , the coefficient on the very persistent component of u_t , is statistically insignificant in both periods. Thus, we can conclude that during the MBM period, *just as in the VGB period*, the FOMC did not respond to – i.e., was ignoring – the most persistent unemployment rate fluctuations. (Equivalently, the FOMC was implicitly forming a “gap” term or intermediate target consisting of u_t^1 , and only responding to $\{u_t - u_t^1\}$.)²⁸ Now turn to the β_2 estimates, i.e., the coefficients on the “moderately persistent” components of u_t for the two periods. The point estimates in Table 1 suggest that during the VGB period, even more than in the MBM period, the FOMC aggressively responded to those unemployment rate fluctuations that are, perhaps, the most responsive to policy changes; however, the hypothesis that $\beta_2^{MBM} = \beta_2^{VGB}$ cannot be rejected at the 5 percent level of significance.²⁹ So there is no real evidence here that this response is in fact different across the two periods. Thus, we find that the FOMC *in both periods* ignored very persistent movements in u_t , and has significantly focused on responding to less-persistent fluctuations. We note that our methodology has allowed us to determine this without making use of any ancillary assumptions.

This continuity of behavior that we find vis-a-vis fluctuations in the unemployment rate is evidence against one part of the “views” explanation of the Great Inflation. Our results suggest that conceptual or measurement struggles related to the activity gap do *not* explain FOMC behavior in the 1970s, as some analysts have asserted. Instead, as noted above, over the time span in our study the FOMC *always* ignored very persistent fluctuations in the unemployment rate, a response that stands in sharp contrast to its strong (and stable) response to moderately persistent fluctuations

²⁸To see this, note that $i_t = \beta(u_{t-1} - u_{t-1}^1) = \beta((u_{t-1}^1 + u_{t-1}^2 + u_{t-1}^3) - u_{t-1}^1) = \beta(u_{t-1}^2 + u_{t-1}^3)$.

²⁹We here note that one cannot reject the hypothesis that $\hat{\beta}_2 = \hat{\beta}_3$ in either period at the 5 percent significance level. We discuss the corresponding $\hat{\varphi}_2 = \hat{\varphi}_3$ hypothesis test below, along with the implications of imposing these restrictions.

in the unemployment rate. The implicit gap, $(u_t - u_t^1)$, comprises a new activity gap estimate that is quite different from its predecessors. Notice that u_t^1 , the most persistent part of u_t , *includes* very-low-frequency movements in the unemployment rate – of the sort comprising conventional (and slowly moving) natural rate estimates, such as the CBO’s – but it is not *limited to* those movements. Our insignificant estimate for β_1 – i.e., our finding that the FOMC ignored u_t^1 , the most persistent component of u_t – is consistent with its viewing such movements as being natural rate fluctuations, or alternatively as treating u_t^1 as an intermediate target. Our results thus suggest that much previous work (which has often focused on particular estimates of an output gap, rather than on an unemployment gap) may have come to erroneous conclusions with respect to historical FOMC behavior.

With respect to inflation rate (π_t) fluctuations, we find that – in contrast to its continuity of response to the unemployment rate over both periods – the FOMC’s response to inflation movements changed in not just one, but *two* ways between the MBM and the VGB periods. First, comparing the φ_1, φ_2 , and φ_3 estimates for the two periods, the VGB FOMC became notably more aggressive in its response to inflation – something other authors have noted (e.g., Clarida, Gali and Gertler 2000 or Conrad and Eife 2012). Indeed, in contrast to many studies,³⁰ we can reject the hypothesis $\varphi_1^{MBM} = \varphi_1^{VGB}$ at the 5 percent level of significance. And second, in the VGB period the FOMC also became much more focused on fighting the *persistent* fluctuations in inflation, and ignoring more transient movements. While the φ_k coefficient estimates themselves are consistent with a differential-inflation-persistence-response interpretation in the MBM period, the formal statistical test of coefficient equality fails to reject the null hypothesis that the FOMC responded to all inflation fluctuations in the same way during this period; the rejection p-value for this null hypothesis is 0.64. We interpret this as indicating that the FOMC during the VGB period became either more focused on (or more accurate at) identifying persistent inflation fluctuations.

³⁰See, e.g., Coibion and Gorodnichenko (2012) and the discussion therein.

3.3 Robustness

3.3.1 Standard errors

Because of the potential for distortion in least-squares inference with regard to coefficients on highly persistent regressors in samples of modest length – as noted in Ashley and Verbrugge (2008a) – we also used wild bootstrap simulation to test the various within-period null hypotheses indicated in the lower portion of Table 1, as a robustness check. (The wild bootstrap was used in view of strong evidence for heteroskedasticity in the model errors.) With one exception, the resulting inferences were essentially unchanged: the standard error estimates and inference p-values for the hypothesis test results given in Table 1 were generally quite similar to those obtained using the NLS asymptotic heteroskedasticity-robust standard errors. The only exception to this is the rejection p-value for the test of the joint null hypothesis that the coefficients on all three u_t components were equal in the MBM period, where the wild bootstrap simulations resulted in a rejection p-value of 0.09, whereas the p-value resulting from the NLS asymptotics yields a rejection p-value of 0.04. Each of these p-values is, itself, just an (asymptotically-justified) sample estimate. Consequently we take the inference here to be rejection at the 4 percent to 10 percent level of significance.³¹

3.3.2 Specification

As we have noted above, our results are robust to a number of specification choices. Two in particular may be noteworthy. First, it may be argued that during the VGB period, the FOMC was implicitly using a time-varying target natural rate of interest (r_t^*) concept. If we modify (3) to incorporate an r^* in the parenthetical expression, and then use the real-time r_t^* estimate from Fuhrer and Olivei (2017),³² or the one-sided r_t^* estimate from Laubach and Williams (2003, 2015), our results are nearly unchanged.

Second, one might ask: is our Equation (3) model for the VGB period significantly better than

³¹This 9% significance level is likely an artifact of the nonlinear least squares estimation technique that Equation (3) requires, due to the gap expression. But when we instead reformulate these models using two lagged dependent variables in the specification, which does not impose the nonlinear coefficient restrictions in (3), and estimate by OLS (with HAC standard errors), the null hypothesis $\beta_i = \beta_j \forall i, j$ is resoundingly rejected at the 0.00001 level of significance.

³²We thank these authors for sharing these data with us.

a conventional CBO-gap-based alternative? One metric is its ability to forecast out of sample. We thus ask: how do the predictions based upon our decompositions compare to those from an alternative model that uses a more conventional estimate of u_t^* , such as that of the CBO, and ignores the distinction between persistent and transient movements in inflation? We used the Diebold-Mariano forecast comparison test to compare one-step-ahead forecast errors from two linear models over the VGB period, estimated over rolling 10-year windows.³³ To make the treatment of u_t comparable across models, we specified both models in “gap” form: in the CBO model, the unemployment gap was defined to be $(u_t - u_t^{*,CBO})$, while in our model, the unemployment gap was defined to be $(u_t - u_t^{persistent})$. In both models, this gap term was lagged one month. Regarding the treatment of π_t , the CBO model simply uses the real-time estimate of π_t , while our model uses the real-time estimate of $\pi_t^{persistent}$. In both models, this term was lagged two months. Then each model included a constant and one lag of the fed funds rate. Our model significantly outperformed the CBO model: the p-value of the Diebold-Mariano test statistic was < 0.0005 . (These results are consistent with those of in-sample tests: if our specification includes both our unemployment rate partition and the CBO gap, the CBO gap is not statistically significant.)

Third, it may be argued that the FOMC may have been more reliant upon output gap estimates than upon unemployment gap estimates during the VGB period; if so, the reaction function is misspecified for the VGB period.³⁴ To investigate this, we constructed an (appropriately one-sided) estimate of the output gap, following Ince and Papell (2013). This approach uses real-time quarterly GDP data (available monthly). At each month t , we extended the data using the real-time SPF nowcast and four quarterly forecasts, postpended with an additional 8 quarters of projections, to yield a total of 12 quarters of projections. Then, again following Ince and Papell (2013), we HP-filtered the window to obtain a real-time quarterly output gap for each month. In the in-sample test, we appended this output gap estimate to Equation (3) and re-estimated the model over the VGB period. The output gap entered with a t-statistic of 1.07, while inferences regarding the unemployment rate gap were unaffected. Out-of-sample forecast tests, conducted the same way as in the CBO gap above, also indicate that our unemployment-rate-based “gap indicators” are a better predictor of actual FOMC behavior over the VGB period than the output gap; the p-value

³³This is not a true real-time forecast comparison, since the CBO estimate is taken from the future. One might argue, however, that this biases the comparison against our Equation (3) model.

³⁴We are indebted to a referee for pointing this out and suggesting this test.

of the Diebold-Mariano test statistic was 0.026.

Fourth, one might ask whether our conclusions continue to hold if we impose that $\beta_2 = \beta_3$ and $\varphi_2 = \varphi_3$ (i.e., if we partition u_t and π_t into two components, rather than three). They do: our qualitative conclusions are either materially unaltered or strengthened under this simpler specification, with one caveat. As noted above, in the VGB period, φ_3 is estimated to be significantly negative; if we impose $\varphi_2 = \varphi_3$, then φ_2 is estimated to be significantly negative. If, however, we then allow for this coefficient to break after 1982, our conclusions are unchanged, except that δ_2 is no longer statistically distinguishable from zero.

3.4 The Great Inflation

3.4.1 “Ideas” versus a change in policy preferences

As noted above, our results shed some light on the origins of the Great Inflation. They imply that one version of the “ideas” hypothesis – the “bad gap” version, that FOMC errors in the 1970s were due to erroneous beliefs about the structure of the economy, in particular an unrealistically low estimate of the natural rate of unemployment (e.g., Orphanides 2002, Romer and Romer 2002, Romer 2005) – cannot fully explain FOMC policy during that time period. Our findings point in this direction because we show that FOMC behavior with respect to the fed funds rate response to the unemployment rate remained rather stable between the MBM and VGB periods: during both periods, it ignored the most persistent fluctuations in u_t , implicitly forming the gap in the same manner. Putting this differently, FOMC behavior in the 1970s does *not* seem related to mismeasurement of u_t^* . So what can explain the high inflation of that period?

As noted above, during the VGB period, the FOMC became more aggressive in its response to inflation, and more focused on fighting the *persistent* fluctuations in inflation. What accounts for this distinct change in behavior? There are two possibilities, which our analysis cannot distinguish between.

One possibility is another variant of the ideas hypothesis, “policy ineffectiveness.” There is some evidence to suggest that some Fed officials – notably Arthur Burns and G. William Miller – held

the belief that inflation was driven by wage-cost pressures, and that monetary policy would be ineffective in combatting inflation.

The second possibility is a change in policy preferences, possibly driven by political pressures and their easing (see, e.g., Chappell, Havrilesky and McGregor (1993), Meltzer (2011), Weise (2012), or Levin and Taylor (2013)). A striking example of such pressure during the early 1970s is related in Abrams (2006). Citing the Nixon tapes, Abrams (2006) states: “Richard Nixon demanded and Arthur Burns supplied an expansionary monetary policy and a growing economy in the run-up to the 1972 election” (p. 178). The pressure President Nixon applied was somewhat unconventional. Abrams writes: “In his memoir *After the Fall*, William Safire (1975, pp. 491-95), who was a speechwriter for Nixon during this time, recounts how the Nixon administration kept up a steady stream of anonymous leaks to pressure Burns” (p. 185). Abrams argues further that “Without invoking political pressure, the surge of expansionary monetary policy leading up to the 1972 election seems hard to explain.” In 1979, after leaving the FOMC, in his “The Anguish of Central Banking” speech, Burns (1979) himself indicated that “at any time within that period, [the FOMC] could have ... terminate[d] inflation with little delay” and that it did not do so for political reasons.

3.4.2 Whither the “poor forecasts” explanation

What about the conjecture that FOMC behavior in the 1970s resulted from inaccurate inflation forecasts (see, e.g., Orphanides 2002, Levin and Taylor 2013 or Fuhrer and Olivei 2017)? This mechanism could certainly operate in conjunction with other explanations. To investigate whether poor forecasts drove FOMC behavior during this period, in parallel to our treatment of the real-time monthly CPI inflation rate, we constructed monthly estimates of the highly persistent part of the quarterly GNP deflator. For this exercise, one-sided filtering was conducted for each month using a five-year window of quarterly data based upon 15 quarters of real-time data, augmented with the monthly real-time nowcasts and 4 quarterly forecasts in the Greenbook of that month. (Early in the sample, in order to obtain a sufficient number of forecasts, we had to augment Greenbook forecasts. We did this using SPF forecasts when available, or using simple univariate forecasts that treated available Greenbook forecasts (or Greenbook + SPF forecasts) as additional data.) We find that,

as one might have expected based upon previous research, the implied (Greenbook-based) estimate of $\pi_t^{persistent}$ is systematically lower than our baseline CPI-based estimate during a large portion of the 1970s.

High collinearity of the components of the GDP deflator with those of the CPI led to inconclusive in-sample tests. We conducted a second out-of-sample forecast comparison test to determine which model – our baseline CPI-based model, or the alternative GNP-deflator-with-Greenbook-forecasts – better predicted or described actual FOMC behavior. As before, we used the Diebold-Mariano forecast comparison test to compare two linear models over the MBM period, estimated over rolling 10-year windows. Both models treat u_t identically, with this variable entering in gap form as in $(u_t - u_t^{persistent})$; in both models, this term was lagged one month. Regarding the treatment of π_t , the GNP deflator model uses the *current* real-time estimate of $\pi_t^{persistent}$, while our model uses our real-time estimate of $\pi_t^{persistent}$, lagged two months. Then each model included a constant and one lag of the fed funds rate. Despite our model’s informational disadvantage – the GNP deflator model always uses all available inflation information, including CPI inflation and other inflation-relevant data, while our baseline model ignores other inflation-relevant data and is sometimes one month out of date relative to the GNP deflator data – our baseline model significantly outperformed the GNP deflator model: the p-value of the Diebold-Mariano test statistic was 0.037. This indicates that the actual behavior of the FOMC in the 1970s is more consistent with its using real-time CPI inflation data (where identification of the persistent part of inflation fluctuations uses information from simple-but-reliable inflation forecasts). We conclude that while poor inflation forecasts may have contributed to the Great Inflation, they are not the chief explanation.³⁵

³⁵We have conducted several different investigations into the post-sample forecasting effectiveness of our models, comparing the ability of models incorporating frequency-partitioned explanatory variables relative to analogous models specified without frequency dependence; two of these were reported above. These results were encouraging, in that a disaggregated model is always somewhat superior on this metric, lending credence to our modeling approach. We note, however, that the present study is about inference rather than forecasting, and we lay no claim here to having developed a new forecasting approach. For a study along those lines, see, e.g., Carlstrom and Zaman (2014).

4 Conclusions

Using the lens of simple monetary policy reaction functions, we apply recently developed econometric tools to deepen our understanding of FOMC behavior and how it changed between the MBM and VGB periods. Standard simple monetary policy rules like Equation (2) properly allow for persistence in the fed funds rate but arbitrarily impose an assumption regarding an activity gap, as well as an assumption of persistence-independence vis-a-vis the inflation rate reaction. In this paper, we relax these restrictions and test them. Our results are surprising along some dimensions, but accord well with intuition and some other accounts. Our study reaches the following conclusions.

First, we note that estimates of Equation (2) – which imposes a constant natural rate of unemployment and persistence-independence in the FOMC reaction function vis-a-vis the unemployment rate – lead to the conclusion that the FOMC was unresponsive to unemployment rate fluctuations in the VGB period. While we agree that Equation (2) is rarely estimated in this form, we note that this fundamentally misleading result underscores the necessity in this instance of allowing for a distinction between the response to persistent movement in the unemployment rate versus the response to a less persistent fluctuation. By extension, we would argue that there are likely many other macroeconomic relationships in which the relationship between two variables differs by persistence level. In such cases, restricting this relationship to be the same will quite likely miss out on uncovering some interesting features in the data, and may well lead to over-simplified and distorted inferences. And, given the tools now at our disposal, such restrictions are not necessary.

Second, in the VGB period, the FOMC’s response to inflation movements changed in not just one, but two, ways. First, the VGB FOMC became more aggressive in its response to inflation – something other authors have noted (e.g., Clarida, Gali and Gertler 2000). But second, it also became much more focused on fighting the *persistent* fluctuations in inflation, and began ignoring more transient movements.³⁶

³⁶While the coefficient estimates themselves are consistent with a differential-inflation-persistence-response interpretation in the MBM period, formal statistical tests fail to reject the null hypothesis that the FOMC responded to all inflation fluctuations in the same way during this period. We interpret this as indicating that the FOMC during the VGB period became either more focused on, or more accurate at identifying, persistent inflation fluctuations. Broadly speaking, this accords with the analysis of Goodfriend and King (2013); in discussing that paper, Svensson (2013) states “... that a major explanation for the Great Inflation

Third, by allowing the data themselves to inform us about FOMC responses to persistent fluctuations versus higher-frequency fluctuations, we notably find that a) the FOMC during the MBM period did in fact respond to an unemployment gap, and that b) mismeasurement of u_t^* (or the output gap) is *not* an entirely convincing explanation of FOMC behavior in the 1970s, as some analysts have argued. Instead, whether or not such an equilibrium concept was understood formally, or simply incorporated into judgment (whether consciously or unconsciously), the FOMC in *both* periods ignored extremely persistent fluctuations in the unemployment rate, although it arguably got better at this in the VGB period. We follow Fuhrer and term this persistent component of the unemployment rate the FOMC’s “intermediate unemployment rate target.” This lack of response to extremely persistent fluctuations stands in sharp contrast to the FOMC’s strong response to *moderately* persistent fluctuations of the unemployment rate, those fluctuations presumably most responsive to policy.

The continuity of FOMC behavior between the MBM and VGB periods sheds some light on the origins of the Great Inflation and suggests that much previous work, imposing *a priori* gaps on the data, may have come to erroneous conclusions about FOMC behavior in the 1970s. In particular, our results imply that the “ideas” hypothesis – that FOMC errors in the 1970s were due to erroneous beliefs about the structure of the economy, particularly conceptual or measurement errors regarding the activity gap (e.g., Orphanides 2002, Romer and Romer 2002, or Romer 2005) – cannot fully explain FOMC policy during that time period. Our forecasting results further imply that the “poor inflation forecasts” hypothesis also fails to explain FOMC behavior. Hence, taken together, our results suggest that policy preferences – possibly driven by political pressures – are far more likely to be the central explanation of the Great Inflation.

Economic theory often suggests that decision-makers distinguish between fluctuations with different degrees of persistence. The relatively straightforward technique used here illustrates how one can easily test this hypothesis – even in settings where (as here) feedback is likely, so that ordinary spectral analysis is inappropriate. This methodological innovation can lead to sharp new insights about the process generating such data, whereas ordinary time-series techniques (in either the time domain or the frequency domain) would both fail to reliably uncover features of this nature in the

could be a small weight on inflation stabilization and a drifting inflation target does not seem so far-fetched” (p. 213).

data-generating process, and yield distorted inference results for having glossed over them. Any empirical finding of persistence-dependence deriving from the new econometric methodology used here is very clearly interpretable in intuitive economic terms. This methodology is therefore particularly well suited to guiding the construction of deeper and richer structural model specifications for the economic processes underlying the data-generating mechanism whose properties have been thus unveiled.

In keeping with this, we conclude with a discussion of the implications of our work for DSGE modeling. Most of the DSGE models used for studying optimal monetary policy are essentially linearized approximations to richer models, and are typically driven by exogenous AR(1) driving processes; thus, they yield linear empirical specifications. Ultimately, this is why policy rules resembling (1) are often found to be optimal (or nearly so) in such DSGE models. Above, we have discussed some episodes – corresponding to different Fed chairmanships – during which we find that empirical estimations of the policy rules apparently used by the FOMC are persistence-dependent to a statistically significant degree. Apparently, the FOMC in its historical behavior did routinely distinguish between unemployment and inflation rate fluctuations with differing perceived persistence levels, and differently so across the two chairmanship episodes we consider.

As demonstrated in Ashley and Verbrugge (2008b), these persistence-dependence results are the natural reflection of a neglected nonlinearity in the empirical policy rule specification. As has been noted many times (e.g., Fernandez-Villaverde 2011), linearization eliminates many phenomena of interest, such as asymmetries and threshold effects; persistence-dependence is another real-world phenomenon that is eliminated. Our persistence-dependence results – and analogous results on inflation dynamics that we obtain in Ashley and Verbrugge (2018), or on consumption behavior in Blundell, Low and Preston (2013), or on the money-interest rate link in Cochrane (1989) – suggest that DSGE modeling might benefit from specifying a richer dynamic structure that endogenously generates persistence-dependent optimal policies.

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5 Technical Appendix

5.1 Modeling Frequency Dependence

In this section we discuss the technique used here for modeling frequency dependence in the monetary policy rule, Equation (2) above.³⁷

The idea of regression in the frequency domain can be traced back to Hannan (1963) and Engle (1974, 1978), and is further developed in Tan and Ashley (1999a, 1999b), who developed a real-valued reformulation of Engle's (1974) complex-valued framework.

Consider the ordinary regression model:

$$Y = X\beta + e \quad e \sim N(0, \sigma^2 I) \quad (4)$$

where Y and e are each $T \times 1$ and X is $T \times K$. Now define a $T \times T$ matrix A , whose $(s, t)^{th}$ element is given by:

$$a_{s,t} = \begin{cases} (\frac{1}{T})^{\frac{1}{2}} & \text{for } s = 1; \\ (\frac{2}{T})^{\frac{1}{2}} \cos(\frac{\pi s(t-1)}{T}) & \text{for } s = 2, 4, 6, \dots, (T-2) \text{ or } (T-1); \\ (\frac{2}{T})^{\frac{1}{2}} \sin(\frac{\pi(s-1)(t-1)}{T}) & \text{for } s = 3, 5, 7, \dots, (T-1) \text{ or } T; \\ (\frac{1}{T})^{\frac{1}{2}} (-1)^{t+1} & \text{for } s = T \text{ when } T \text{ is even.} \end{cases} \quad (5)$$

It can be shown that A is an orthonormal matrix, so its transpose is its inverse and Ae is still distributed $N(0, \sigma^2 I)$. Pre-multiplying the regression model (4) by A thus yields,

$$AY = AX\beta + Ae \rightarrow Y^* = X^*\beta + e^*, e^* \sim N(0, \sigma^2 I) \quad (6)$$

where Y^* is defined as AY , X^* is defined as AX , and e^* is defined as Ae . The dimensions of the Y^* , X^* , and e^* arrays are the same as those of Y , X , and e in Equation (4), but the T components of Y^* and e^* and the rows of X^* now correspond to frequencies instead of time periods.

To fix ideas, we initially focus on the j^{th} component of X , i.e., column j of the X matrix, corresponding to the $j - 1^{st}$ explanatory variable if there is an intercept in the model. The T

³⁷See Ashley and Verbrugge (2008b) for details; this section provides the most up-to-date exposition, however. Additional descriptions are given in Ashley and Tsang (2013), Ashley and Li (2014), and Ashley and Verbrugge (2019).

frequency components are partitioned into M frequency bands, and $M T \times 1$ dimensional dummy variable vectors, D^{*1}, \dots, D^{*M} , are defined as follows: for elements that fall into the s^{th} frequency band, $D^{*s,j}$ equals $X_{\{j\}}^*$, and the elements are zero otherwise. The regression model can then be generalized as:

$$Y^* = X_{\{j\}}^* \beta_{\{j\}} + \sum_{m=1}^M \beta_{j,m} D^{*m,j} + e^* \quad (7)$$

where $X_{\{j\}}^*$ is the X^* matrix with its j^{th} column deleted and $\beta_{\{j\}}$ is the β vector with its j^{th} component deleted.

To test whether the j^{th} component of β is frequency-dependent (i.e., to test whether the effect of the j^{th} variable in X on Y is frequency or persistence dependent) one can then simply test the null hypothesis that $H_0 : \beta_{j,1} = \beta_{j,2} = \dots = \beta_{j,M}$.

In the present application, we focus on two columns of X : the real-time unemployment rate and the real-time inflation rate; these columns are denoted j and k below. By the same reasoning used above, one can quantify (and test for) frequency dependence in the two model coefficients β_j and β_k corresponding to these two columns by re-writing the regression model (Equation 7) as:

$$Y^* = X_{\{j,k\}}^* \beta_{\{j,k\}} + \sum_{m=1}^M \beta_{j,m} D^{*m,j} + \sum_{m=1}^M \beta_{k,m} D^{*m,k} + e^*. \quad (8)$$

To make this regression equation a bit more intuitive, one can back-transform Equation (8) from the frequency domain into the time domain by pre-multiplying both sides of this equation with the inverse of A , which (because A is an orthonormal matrix) is just its transpose:

$$A'Y^* = A'X_{\{j,k\}}^* \beta_{\{j,k\}} + A' \sum_{m=1}^M \beta_{j,m} D^{*m,j} + A' \sum_{m=1}^M \beta_{k,m} D^{*m,k} + A'e^*. \quad (9)$$

This yields the time-domain specification:

$$Y = X_{\{j,k\}} \beta_{\{j,k\}} + \sum_{m=1}^M \beta_{j,m} D^{m,j} + \sum_{m=1}^M \beta_{k,m} D^{m,k} + e. \quad (10)$$

where $X_{\{j,k\}}$ is the original X matrix, omitting columns j and k and $\beta_{\{j,k\}}$ is the original β vector, omitting components j and k .

Note that now the dependent variable is the same time series (Y) as in the original model, Equation (4). Similarly, all of the explanatory variables – except for the j^{th} and k^{th} – are the same as in the original model. Indeed, the only difference is that these two explanatory variables have each been replaced by M new variables: i.e., the explanatory variable X_j has been replaced by $D^{1,j} \dots D^{M,j}$ and the explanatory variable X_k has been replaced by $D^{1,k} \dots D^{M,k}$. Each of these M variables can be viewed as a bandpass-filtered version of the original data (the j^{th} or k^{th} column of the X matrix), with the nice property that the M frequency component variables corresponding to column j of the X matrix add up precisely to the j^{th} column of X and the M frequency component variables corresponding to column k of the X matrix add up precisely to the k^{th} column of X .

In other words, the j^{th} column of X – for example – is now partitioned into M parts. Reference to the definition of the A matrix in Equation (5) shows that the first (lowest-frequency) component utilizing the first row ($s = 1$) of the A matrix and corresponding to $m = 1$, if the first band has only a single component, is proportional to the sample average of the data for this explanatory variable. Similarly, the last component (corresponding to $m = M$, if the last band has only a single component – as it will whenever M is an even number) utilizes the last row ($s = T$) of the A matrix³⁸ and is essentially a sequence of changes in the data; hence this is the highest-frequency component that can be extracted from the data on this variable. (As noted above, we provide a simple example with a 10-period-window in Section 5.3 below to clarify and provide intuition.) To test for frequency dependence in the regression coefficient on this j^{th} regressor, then, all that one need do is test the joint null hypothesis that $\beta_{j,1} = \beta_{j,2} = \dots = \beta_{j,M}$. Similarly, X_k is replaced by $D^{1,k} \dots D^{M,k}$ and one tests the null hypothesis that $\beta_{k,1} = \beta_{k,2} = \dots = \beta_{k,M}$.

However, because the A transformation mixes up past and future values (as in any Fourier-based bandpass filter, or any two-sided filter for that matter), it can be shown that these M frequency components are correlated with the model error term e if there is feedback between Y and either of these two explanatory variables, leading to inconsistent estimation of the parameters $\beta_{j,1}, \beta_{j,2}, \dots, \beta_{j,M}$ and $\beta_{k,1}, \beta_{k,2}, \dots, \beta_{k,M}$ in that case. Feedback between the federal funds rate and inflation or unemployment rates is certainly likely, so this is an important issue here.

To avoid this problem in general, Ashley and Verbrugge (2008b) suggest modifying the procedure

³⁸When T is even; it uses the last two rows when T is odd.

described above in order to obtain a *one-sided* filter for partitioning a variable into its frequency components. In particular, they provisionally³⁹ suggest decomposing X_j , the j^{th} explanatory variable data vector, into frequency components by applying the transformation described above within a moving window of length T . (Since the discussion from this point forward entirely focuses on extracting the frequency component from such moving windows, the symbol T_{full} will henceforth be used to denote the length of the full sample, as this is now distinct from dimensionality (T) of the A matrix for each window. T is a constant – that is, the windows do not increase in length as they move through the sample.) Letting the window for decomposing X_j at time period t consist of the data from time $t - T + 1$ to time t , then for time t only the time t frequency component values (of the T values that are calculated from this window) are retained.

The filtering of X_k is similar to that for X_j , but we note that there is no need to constrain the window length (T) to be identical for both X_j and X_k : this is a modeling decision that should be based on relevant economic theory and on the data themselves. Indeed, we discuss this issue above (in Section 3.1) and do set distinct window lengths for use in obtaining the frequency components for each of the two explanatory variables in the Taylor rule formulations considered here. In particular, we set a window length of $T_j \equiv 60$ months for decomposing the inflation rate data (“ X_j ”) into its frequency/persistence components, and we set a window length of $T_k \equiv 120$ months for similarly decomposing the unemployment rate data. Thus, the transformation matrix A defined in Equation (5) is of dimension $T_j = 60 \times 60$ months for the inflation rate data and is of dimension $T_k = 120 \times 120$ months for the unemployment rate data. For expositional clarity, however, we focus almost entirely on the case $T_j = 60$ in the remainder of the present subsection, and below.

Decompositions by frequency must be performed on trendless data, and accordingly, frequency-domain filters typically detrend the sample data prior to performing the decomposition, and add the trend back afterwards. The procedure here is no different in this respect, except that detrending must occur within each sample window. We consequently instead separately detrend the data in each window prior to filtering using a linear time trend regression. Upon detrending the data within the window, one implication is that the first (low-frequency) component $D^{1,j}$ is now zero (at machine precision). Of course, these trend estimates are not dropped: after converting the data

³⁹The word “provisional” is used here because – to fix ideas– this description initially ignores the use of projections for each window; the need for these projections is discussed below.

back to the time domain, Ashley and Verbrugge (2008b) add the time- t estimate of the (within-window) trend to the lowest-frequency component $D^{1,j}$. That is, included in the most persistent component of X_j at time t is the trend estimate of this variable pertaining to time t (i.e., the trend is estimated for the time- t window, and the time- t portion of that trend is added to the most persistent component at t).

It would then, at the outset, appear that the sample average over the T_j observations – corresponding to the zero-frequency component ($m = 1$), and obtained using the first row of the A matrix – thus becomes a moving average of order T_j once the filtering is now being applied to a moving window, so that this first component is now extracting a backward-looking nonlinear trend from the full sample of data, using a moving average of order T_j . It is well-known, however, that moving average trend estimates of this type have very poor properties. In particular, they are known to induce pronounced phase shifts in the estimated trend time series that substantially distort lag length selection and the apparent turning points in the time series.

There is a second weakness in this provisional procedure. When decomposing X_j using a window, one must confront the usual problem of “edge effects” near the window endpoints.

Both the turning point problem and the edge effect problem are addressed by augmenting the data within a window with projections. In particular, as in Dagum (1978), Stock and Watson (1999), Kaiser and Maravall (1999), Mise, Kim and Newbold (2005), and Clark and Kozicki (2005), we augment the window sample data with projected data, here postpending to the 42 sample data points (ending with period t) in our 60-month π_t windows 18 months of projected values. (And we similarly postpend 24 months of u_t projections to the 96 sample data points (ending in period t) in our 120-month u_t windows). Thus, for example, a 60-month window incorporating the real-time data on X_j as of period t includes 42 past values of X_j – as known at time t – plus projections (forecasts) of its values for months $t + 1$ to $t + 18$. This window of data is then used, as described above, to compute the corresponding $M = 31$ components of X_j – i.e., the vectors $D^{1,j} \dots D^{31,j}$. The 42nd element of each of these 60-vectors is then used as the period- t filtered value of X_j for this particular frequency.

In our experience, the estimated values of the coefficient (β_k) on $D^{k,j}$ and its estimated stan-

dard error are generally not very sensitive to the number of projection periods chosen (as long as at least 12 months of projections are used), nor to the details of how the projections (forecasts) are produced.⁴⁰ Since it is well known that the FOMC makes extensive use of forecasts in its decisionmaking, utilizing projections of this nature in our windowed bandpass filters seems particularly appropriate. As in the procedure described above – “provisional” because we there omitted discussion of these projections – the estimated trend (now at time t) is included in the zero-frequency component $D^{1,j}$. Because of this window-specific detrending, where the last 18 months of the data in, for example, a 60-month window are projections, the resulting backward-looking nonlinear trend time series (which then includes both the zero-frequency component at time t , and also all frequency components with frequency $< \frac{\pi}{30}$, i.e., with reversion periods longer than 60 months) is now a component that embodies the very-low-frequency fluctuations. These complications ensure that this most-persistent component does not exhibit substantive phase and turning point distortions.

This moving-window approach is used in the present paper for an additional, and here crucial, reason. The moving window makes it possible – and, indeed, easy – to use real-time data for the values of X_j and X_k : the data used in each window are simply those available at the time period that is the window’s endpoint. The frequency decomposition is in this way gracefully consistent in each period with the data that were available to policymakers at the time. Conversely, any two-sided approach – whether a conventional analysis based upon gain and transfer analysis (further discussed below), or an approach based upon wavelets – inherently rules out the use of real-time data.

Presuming that T_j and T_k (the window lengths, for decomposing X_j and X_k , respectively) are both even numbers, then reference to Equation (5), and to Table 2 below (for which T is set to 60), makes it evident that there will be $M_j = \frac{T_j}{2} + 1$ distinct frequency components – and hence $\frac{T_j}{2} + 1$ coefficients to estimate in the leftmost sum within Equation (10); similarly there will be $M_k = \frac{T_k}{2} + 1$ distinct frequency components – and hence $\frac{T_k}{2} + 1$ coefficients to estimate in the rightmost sum. In the present application, T_j was set to 60 – for the windows used in partitioning the sample variation in $\pi(t)$ – yielding 31 distinct frequency components, and T_k was set to 120 – for the windows used in partitioning the sample variation in $u(t)$ – yielding 61 distinct frequency

⁴⁰See footnote 20 for details on the particular projection models used here.

components. While not outright infeasible, it is clearly not desirable to be estimating all 92 of these coefficients. In economic applications, one will generally be interested in more highly aggregated frequency bands, so as to facilitate exposition of one’s results on economic or intuitive grounds, as in Ashley and Tsang (2013) and Ashley and Li (2014), where the frequency components are aggregated into just three bands.⁴¹ In Section 3.1 we do the same, defining (for the inflation rate variable, π_t) a low frequency (“very persistent,” or “persistent_pi(t)”) component corresponding to fluctuations with reversion periods greater than 60 months, a medium frequency (“moderately persistent” or “moderate_persist_pi(t)”) component corresponding to fluctuations with reversion periods greater than or equal to 12 months and less than or equal to 60 months, and a high frequency (“transient” or “transient_pi(t)”) component corresponding to fluctuations with reversion periods of less than 12 months.⁴² Referring to Table 2 (with regard to the 60-period windows for the π_t data), the “persistent_pi(t)” component thus consists of all frequency components with reversion periods greater than the length of the window, 60 months; the “moderate_persist_pi(t)” component is the sum of the five components with intermediate frequencies (components 2-6, corresponding to reversion periods of 12, 15, 20, 30, and 60 months); and the “transient_pi(t)” component comprises the sum of the remaining 25 (highest frequency) components, which all revert more quickly.⁴³ One might consider this particular *a priori* partitioning of the 31 components (of π_t) or the 61 components (of u_t) into just three bands to be a bit arbitrary. On the other hand, these three aggregated bands are economically interpretable in terms of roughly the same calendar that the FOMC’s policymakers live on.

This is a good point at which to contrast the frequency decomposition used here with superficially similar procedures in the existing literature. For example, in contrast to trend-cycle

⁴¹The A matrix allocates two rows for every nonzero frequency except – for T even – the highest one. The reversion period corresponding to each frequency is proportional to the reciprocal of its frequency, so the number of components with the very highest frequencies are most numerous. For example, in the 120-month windows, 21 of the 60 nonzero frequencies all correspond to reversion periods of a quarter or less.

⁴²The frequency components for u_t are analogously named. For this variate, however, the window length is set to 120 months, so the “persistent_un(t)” component includes all frequency components corresponding to reversion periods greater than 120 months.

⁴³We note that this definition of the three bands implies that the “low frequency” component in fact consists solely of the zero-frequency fluctuations, corresponding to the first row of the A matrix. Thus, this component is a straightforward nonlinear trend estimate for the time series, based on a moving window, here of length 60 months for the inflation series and of length 120 months for the unemployment rate series. This trend component will thus typically be so smooth as to be statistically indistinguishable from a stochastically trended – i.e., $I(1)$ – time series. Here this nonlinear trend is taken to be “fixed in repeated samples” in the regression models where it appears as an explanatory variable, in much the same way as one would treat any other – e.g., linear – trend term.

Frequency	Component	Frequency	Reversion Period ^a	Row Number(s) in A^b
1		0	>60	1
2		$\pi/30$	$60/1 = 60.00$	2,3
3		$2\pi/30$	$60/2 = 30.00$	4,5
4		$3\pi/30$	$60/3 = 20.00$	6,7
5		$4\pi/30$	$60/4 = 15.00$	8,9
6		$5\pi/30$	$60/5 = 12.00$	10,11
7		$6\pi/30$	$60/6 = 10.00$	12,13
8		$7\pi/30$	$60/7 = 8.57$	14,15
9		$8\pi/30$	$60/8 = 7.50$	16,17
10		$9\pi/30$	$60/9 = 6.67$	18,19
11		$10\pi/30$	$60/10 = 6.00$	20,21
12		$11\pi/30$	$60/11 = 5.45$	22,23
13		$12\pi/30$	$60/12 = 5.00$	24,25
14		$13\pi/30$	$60/13 = 4.62$	26,27
15		$14\pi/30$	$60/14 = 4.29$	28,29
16		$15\pi/30$	$60/15 = 4.00$	30,31
17		$16\pi/30$	$60/16 = 3.75$	32,33
18		$17\pi/30$	$60/17 = 3.53$	34,35
19		$18\pi/30$	$60/18 = 3.33$	36,37
20		$19\pi/30$	$60/19 = 3.16$	38,39
21		$10\pi/30$	$60/20 = 3.00$	40,41
22		$11\pi/30$	$60/21 = 2.86$	42,43
23		$12\pi/30$	$60/22 = 2.73$	44,45
24		$13\pi/30$	$60/23 = 2.61$	46,47
25		$14\pi/30$	$60/24 = 2.50$	48,49
26		$15\pi/30$	$60/25 = 2.40$	50,51
27		$16\pi/30$	$60/26 = 2.31$	52,53
28		$17\pi/30$	$60/27 = 2.22$	54,55
29		$18\pi/30$	$60/28 = 2.14$	56,57
30		$19\pi/30$	$60/29 = 2.07$	58,59
31		$30\pi/30$	$60/30 = 2.00$	60

Table 1: **Frequencies and Reversion Periods for a 60-Month Window** ^aIn months, calculated as 2π divided by the frequency. The sinusoids comprising the elements of the row(s) of the A matrix corresponding to this reversion period complete a full cycle in this many months. Thus, the scalar product of such a row with a time-series vector whose fluctuations self-reverse substantially slower than this will be very small. ^bThe A matrix is defined in Equation (3).

decomposition methods (e.g., Beveridge-Nelson), our approach does not decompose an explanatory variable like X_j into just two components: an arbitrarily-persistent $I(1)$ or $I(1)$ -like trend and a stationary $I(0)$ fluctuation. Our decomposition instead produces M components (adding up to X_j) that span a complete range of persistence levels. And it allows the data themselves – via regression analysis applied to Equation (10), or the closely related Equation (3) in Section 3.2.1 – to quantify how the coefficients $\beta_{j,1}, \dots, \beta_{j,M}$ vary across all of these persistence levels. Further, our decomposition still yields consistent parameter estimation where (as is typically the case with economic relationships) one cannot rule out feedback (or bi-directional causality); this is in contrast to the earlier spectral regression models cited at the outset of this section, which employ two-sided filtering and hence yield inconsistent parameter estimation in the presence of feedback. Finally, our approach is uniquely appropriate to the present analysis of the FOMC’s historical policy rules, because the central bank makes its policy decisions in real time. In particular, the current real-time history of each of the relevant explanatory variables (the inflation and unemployment rates) corresponds exactly to the data we use in each window for the decomposition of the current value of each variable into its frequency/persistence components.

We note, in this context, that an analogous kind of analysis based on the gain and phase of a transfer function model for the federal funds rate – as in Box and Jenkins (1976, Part III) – would be problematic because such models characteristically involve lagged values of the dependent and explanatory variables. For one thing, models containing lagged variables are inherently awkward when using real-time data because it is not clear whether the period- t datum to be used for X_j lagged, say, two periods, should be the value for that period as known currently (i.e., in period t) or at the time (i.e., in period $t - 2$). In addition, transfer function gain and phase plots are substantially more challenging to interpret than our $\beta_{j,1}, \dots, \beta_{j,M}$ coefficients, especially where (as here) bi-directional causality is likely. For example, Granger (1969) notes, “In many realistic economic situations, however, one suspects that feedback is occurring. In these situations the coherence and phase diagrams become difficult or impossible to interpret, particularly the phase diagram.”

5.2 The Appeal of this Frequency-based Approach to Disaggregation by Persistence Level

The focus of this paper is to investigate, in a data-driven way, the degree to which and the manner in which the FOMC has responded to persistent fluctuations in the unemployment rate and the inflation rate differently than it has to more transitory fluctuations in those variables. Thus the objective of partitioning two of the explanatory variable time series – X_j and X_k in Section 4.1 above, which are the real-time unemployment and inflation rates in the present application – is not the bandpass filtering *per se*. Rather, we decompose the unemployment and inflation rates into frequency components so that we can separately estimate the historical impact of fluctuations of distinctly different persistence levels in these two variables on the federal funds rate and make inferences concerning these differential impacts; this allows a richer consideration of how FOMC policy has varied over the several time periods considered.

No representation is made here that the bandpass filtering described in Section 5.1 above is asymptotically optimal – e.g., as in Koopmans (1974) or Christiano and Fitzgerald (2003) – although the relevance of asymptotic optimality in filtering windows of data that are only of length 60 or 120 months, and that might need to be considerably smaller in other applications, is debatable.⁴⁴ On the other hand, our method of decomposing a time series into M frequency components has several very nice characteristics, which make this decomposition approach overwhelmingly well-suited to the present application:

1) The M frequency components that are generated from an explanatory variable (i.e., from a column of X) by construction partition it. That is, these M components add up precisely to the original observed data on this column of X . This makes estimation and inference with regard to persistence dependence (or its inverse, frequency dependence) in the corresponding regression coefficient particularly straightforward: we simply replace this explanatory variable in the regression

⁴⁴In this context we note that it is feasible – albeit somewhat awkward – to iteratively employ a Christiano-Fitzgerald (2003) low-pass filter to partition the data in such a way that the frequency components still add up to the original data. This procedure involves applying the filter repeatedly, at each iteration varying the frequency threshold and applying the filter to the residuals from the previous iteration. This procedure is, of course, no longer even asymptotically optimal, but it does yield frequency components that still add up to the original data – as the ones in our present formulation do automatically. Experiments with decompositions along these lines did not yield substantially different frequency dependence results in the present application, but we are investigating this topic in future work.

model by a linear form in the M components and analyze the resulting M coefficient estimates.

2) Due to the moving windows used, this particular way of partitioning the data on an explanatory variable into these M frequency components by construction utilizes backward-looking (i.e., one-sided) filters. As demonstrated in Ashley and Verbrugge (2008b), this feature is crucial to consistent OLS coefficient estimation where there is bi-directional Granger-causality (i.e., feedback) between the dependent variable and the explanatory variable being decomposed by frequency. The dependent variable in the present context is the federal funds rate, which is quite likely to be in a feedback relationship with the unemployment and inflation rates.

3) Finally, this way of partitioning the data on an explanatory variable into frequency/persistence components is not just mathematically valid and straightforward, it is also intuitively appealing. In particular – in contrast to many analyses in the frequency domain – our decompositions are not a “black box.” The next section illustrates this point with a simple example.

5.3 An Illustrative Example with a Very Short Window

An example with a window 10 periods in length illustrates the sense in which the frequency components defined above are extracting components of, say, X_j of differing levels of persistence. This window length is sufficiently large as to illustrate the point, while sufficiently small as to yield an expositionally manageable example.⁴⁵ In particular, Table 3 displays the multiplication of the matrix A – whose elements are defined in Equation (5) – by the 10-component sub-vector of X_j corresponding to a window beginning in the particular period 21 and ending in period 30. For this illustrative example, we will assume that there are no projections, so that this window corresponds to time period 30. We will also assume that the data are trendless over these 10 observations.⁴⁶

The first row of the A matrix is just a constant. The operation of this row of A on this particular 10-dimensional sub-vector of X_j is just calculating the sample mean over these 10 observations.

⁴⁵ As described above, the empirical implementation in this paper uses a window 60 months in length (for π_t) and 120 months in length (for u_t). See Table 2 for an explicit listing of the component frequencies, the corresponding reversion periods, and the corresponding A matrix rows for a 60-dimensional A matrix.

⁴⁶ As noted in Section 5.1 above, in actual practice a portion of every moving window consists of projections, and data within every moving window are detrended. These complications are suppressed in the present subsection so as to focus attention on the A matrix in a setting so simple as to elucidate how the application of this matrix is extracting components for which the terms “frequency” and “reversion period” are intuitively meaningful verbal constructs.

Period	Matrix A										Data
> 10	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32	$X_j(21)$
10	0.45	0.36	0.14	-0.14	-0.36	-0.45	-0.36	-0.14	0.14	0.36	$X_j(22)$
10	0.00	0.26	0.43	0.43	0.26	0.00	-0.26	-0.43	-0.43	-0.26	$X_j(23)$
5	0.45	0.14	-0.36	-0.36	0.14	0.45	0.14	-0.36	-0.36	0.14	$X_j(24)$
5	0.00	0.43	0.26	-0.26	-0.43	0.00	0.43	0.26	-0.26	-0.43	$X_j(25)$
3.3	0.45	-0.14	-0.36	0.36	0.14	-0.45	0.14	0.36	-0.36	-0.14	$X_j(26)$
3.3	0.00	0.43	-0.26	-0.26	0.43	0.00	-0.43	0.26	0.26	-0.43	$X_j(27)$
2.5	0.45	-0.36	0.14	0.14	-0.36	0.45	-0.36	0.14	0.14	-0.36	$X_j(28)$
2.5	0.00	0.26	-0.43	0.43	-0.26	0.00	0.26	-0.43	0.43	-0.26	$X_j(29)$
2	0.32	-0.32	0.32	-0.32	0.32	-0.32	0.32	-0.32	0.32	-0.32	$X_j(30)$

Table 2: **An Example With a Window of Length 10 Periods.** The first row of A times the data vector simply yields $1/\sqrt{T}$ times the sample mean of the data in this 10-period window. As the window moves through the data set, this operation extracts any, possibly nonlinear, trend as a moving average. Rows two and three take a weighted average of the window data, using smoothly-varying weights that take a full 10 periods to reverse, so any fluctuation in the window data that reverses in a couple of periods yields a small value. The product of row 10 and the window data is essentially calculating five changes in the data that occur during the window period. A long, smooth variation in the window data yields a small value for this frequency component.

Thus, as this window progresses through the entire sample of data X_j , the first component of the vector formed by multiplying each 10-dimensional sub-vector of X_j on the left by A represents a one-sided, real-time, nonlinear trend estimate based (in this example) on a 10-period moving average. This is the “zero-frequency” component of the full X_j vector, corresponding to a sinusoidal reversion period unbounded in length. This component of X_j includes all of its variation at frequencies so low (i.e., reversion periods so large) that they are essentially invisible in a window that is only 10 periods in length.

Higher-frequency (lower-persistence) components of X_j are, conversely, distinguishable using this window. The “Period” column in Table 3 is the number of observations over which the sine or cosine used in the corresponding row of the A matrix completes one full cycle. This is 10 observations for rows two and three of this A matrix, $\frac{10}{2} = 5$ observations for rows four and five, $\frac{10}{3} = 3\frac{1}{3}$ observations for rows six and seven, $\frac{10}{4} = 2\frac{1}{2}$ observations for rows eight and nine, and $\frac{10}{5} = 2$ observations for row 10.⁴⁷ In the most common convention, the frequency is defined as $\frac{\pi}{2}$ times the inverse of the cycle length (period) of the corresponding sine or cosine for that row of the A matrix, in which case the frequencies run from zero (for row one) to π for row 10.

⁴⁷The number of observations in the sub-vector is an even integer – 10 – in this example, implying that the sine and cosine terms are multiples of one another for what becomes a singleton last (10th) row of the A matrix.

To see intuitively why multiplication of the X_j vector by, for example, rows two and three extract only slowly varying fluctuations in X_j , notice that these two rows are smoothly varying weights that will be applied to the 10 components of X_j in forming its dot (or scalar) products with these two rows. Slowly varying fluctuations in X_j will thus have a large impact on these two dot products, whereas rapidly reverting variations in X_j will have little effect on the values of these two dot products. Hence, components two and three of the matrix product AX_j will “contain” only those parts of X_j that are slowly varying.

Conversely, it is evident upon inspection of the last row of the A matrix that only high-frequency (low persistence) fluctuations – i.e., fluctuations that reverse in just two months or so – will contribute significantly to the 10th component of AX_j .

Thus, the first rows of the A matrix are distinguishing and extracting what are sensibly the “low-frequency” or “large period” or “highly persistent” or “relatively permanent” components of this 10-month X_j sub-vector as the window moves through the sample. Conversely, the last rows of the A matrix are distinguishing and extracting what are sensibly the “high-frequency” or “small period” or “low persistence” or “relatively temporary” components of this X_j sub-vector.

5.4 Application to a Simple DGP

In this section, we illustrate the decomposition used here via its application to an artificially generated time series simulated using a particularly simple data-generating process.⁴⁸

The data-generating process is composed of the sum of four distinct sine waves, plus a white noise error. More specifically,

$$y_t = 2x_{1,t} + x_{2,t} + x_{3,t} + 0.5x_{4,t} + u_t$$

with $u_t \sim N(0, 1)$, where

⁴⁸We are not suggesting that u_t or π_t is generated in this way; the intent here is solely to present an illustrative example.

<i>Component</i>	<i>Period</i>
$x_{1,t} = \sin(0.05t)$	125.7
$x_{2,t} = \sin(0.14(t + 25))$	44.9
$x_{3,t} = \sin(4t)$	1.57
$x_{4,t} = \sin(22t)$	0.29

We apply our one-sided filtering method, as described above, with moving windows of length 60, of which 24 are projections. Here the projections are obtained from the average of forecasts from a univariate AR(4) model in levels and forecasts from a univariate AR(4) model in first-differences. Here the “very persistent” component is defined to include all fluctuations whose period is longer than 58 time units and simply denoted “persistent” in Figure 3. The cutoff for the transient component is set to a reversion period of 12 time units. Thus, “persistent” should reflect $x_{1,t}$ and “moderate” in Figure 4 should reflect $x_{2,t}$.

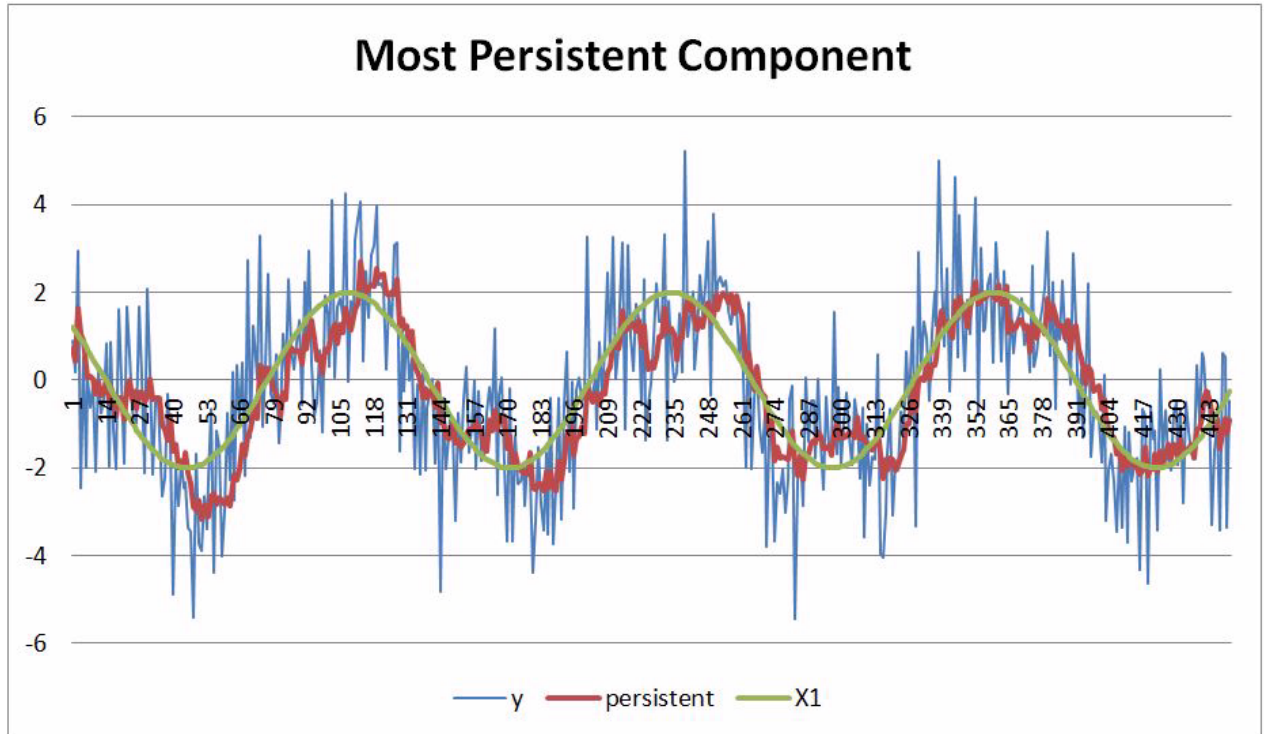


Figure 3: For the simple DGP, our procedure accurately estimates the most persistent component

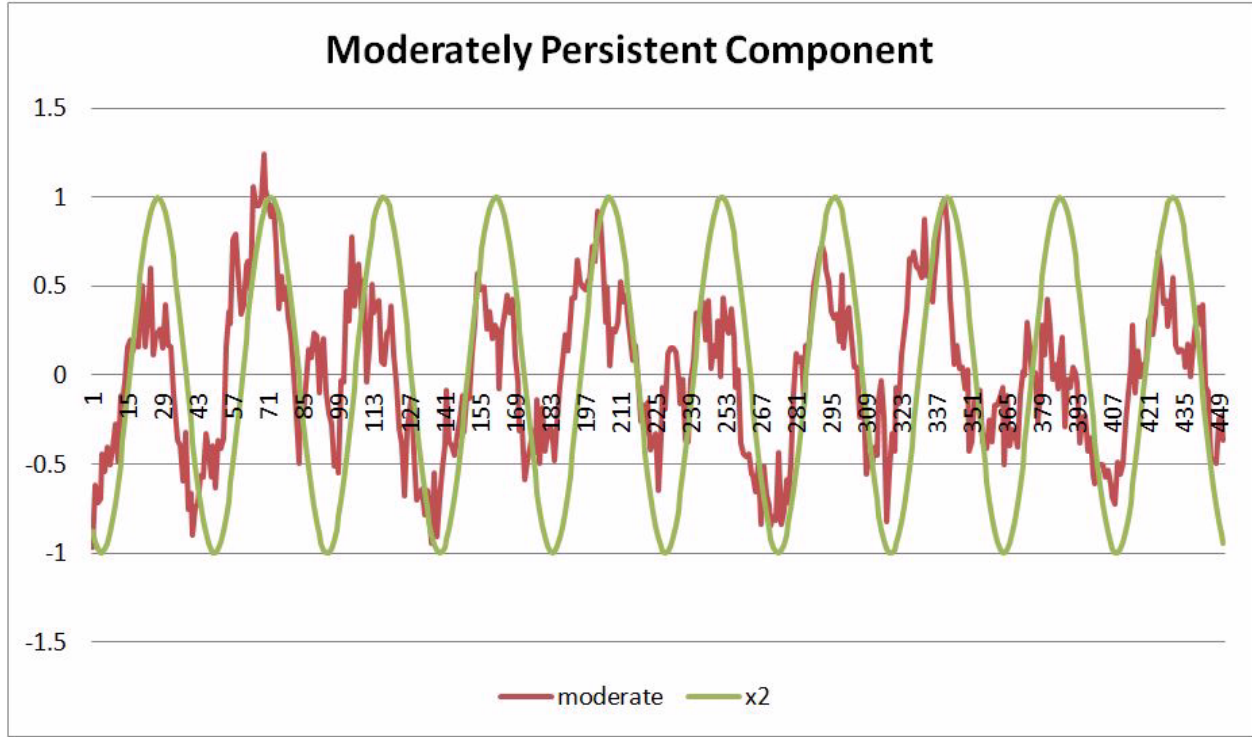


Figure 4: For the simple DGP, our procedure accurately estimates the moderately persistent component

As described above, the most persistent component (here simply labeled “persistent”) is effectively estimated using a nonlinear adaptive trend. Its behavior is mainly driven by the window length, which determines the frequency cutoff, and by the length and quality of the projections within that window.

As is evident in Figure 3, our procedure does a reasonable job of estimating $x_{1,t}$, though it is modestly fooled by moderately persistent movements deriving mainly from $x_{2,t}$. And as is evident in Figure 4, our procedure likewise does a reasonable job of estimating $x_{2,t}$.⁴⁹

⁴⁹ A linear regression of the most persistent component on x_1, \dots, x_4 yields a coefficient of 0.93 on x_1 and 0.53 on x_2 , with small loadings on x_3 and x_4 . A linear regression of the moderately persistent component on x_1, \dots, x_4 yields a coefficient of 0.00 on x_1 and 0.37 on x_2 , with very small loadings on x_3 and x_4 . Finally, a linear regression of the transient component on x_1, \dots, x_4 yields a coefficient of 0.05 on x_1 and 0.06 on x_2 , with loadings of 0.90 and 0.91 on x_3 and x_4 .