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What are the effects of monetary policy on output? Results from an agnostic identification procedure☆

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Abstract

This paper proposes to estimate the effects of monetary policy shocks by a new agnostic method, imposing sign restrictions on the impulse responses of prices, nonborrowed reserves and the federal funds rate in response to a monetary policy shock. No restrictions are imposed on the response of real GDP to answer the key question in the title. I find that

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"contractionary" monetary policy shocks have no clear effect on real GDP, even though prices move only gradually in response to a monetary policy shock. Neutrality of monetary policy shocks is not inconsistent with the data.
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1. Introduction

What are the effects of monetary policy on output? This key question has been the focus of a substantial body of the literature. And the answer seems easy. The "Volcker recessions" at the beginning of the 1980s have shown just how deep a recession a sudden tightening of monetary policy can produce. Alternatively, look at Fig. 1, which juxtaposes movements in the federal funds rate from 1965 to 1996 with growth rates in real GDP, flipped upside-down for easier comparison. In particular, for the first half of that sample, it is striking, how rises in the federal funds rate are followed by falls in output (visible as *rises* in the dotted line, due to the upside-down flipping). The case is closed.

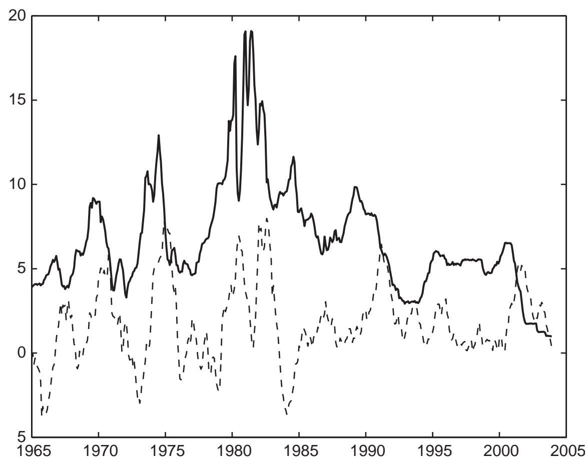

Fig. 1. This figure contrasts movements in the federal funds rate, shown as a thick, solid line with the scale on the left, with real annual GDP growth rates, transformed by multiplying with −1 and adding 5, shown as a thinner, dotted line. The transformation of GDP growth has been done to aid the visual comparison, i.e., peaks in the figure are actually particularly low values for the growth rate. "Eyeball econometrics" suggests a strong cause-and-effect from federal funds rate movements to real GDP: whenever interest rates rise, growth rates fall (i.e. the dotted line rises) shortly afterwards. This is particularly visible for 1968–1983. It seems easy to conclude from this picture, that the question about the effects of monetary policy on output is answered clearly: contractionary monetary policy leads to contractions in real GDP.

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