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The " Price Puzzle" under Changing Monetary Policy Regimes

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ABSTRACT

This paper examines the " price puzzle" , the rise in the price level following a contractionary monetary policy shock, using monthly US data from 1960 to 2006. Deviating from the standard practice is including commodity prices to " solve the puzzle" , our benchmark VAR contains output, prices, the federal funds rate and M1 money stock, while the augmented VAR includes the 10-year long bond yield. Splitting the sample at October of 1979, we find very contrasting patterns and rationalize them under the changing relationship between money and the funds rate across periods. First, the price puzzle is confined to the pre-Volcker period. Second, in the pre-Volcker period the funds rate respond largely to their own shocks, while the post-Volcker period witnesses a larger role for output fluctuations. Third, positive output shocks are more recently followed by price increases, federal funds hikes, and monetary contractions, very much consistent with the " Taylor rule" . Fourth, the " monetarist experiment" of late 1979-1982 reinforces our basic results: the more explicit the reliance on money supply, the less visible the price puzzle becomes.

KEYWORDS

Federal Funds Rate; Monetary Policy Shocks; Price Puzzle; Vector Autoregressions (VARs); United States

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