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Nonlinearities, Smoothing and Countercyclical Monetary Policy*

Laura E. Jackson[a]†, Michael T. Owyang[b], Daniel Soques[c]

[a] *Department of Economics, Bentley University, 175 Forest Street, Waltham, MA 02452 USA.*
[b] *Research Division, Federal Reserve Bank of St. Louis, P.O. Box 442, St. Louis, MO 63106 USA.*
[c] *Department of Economics and Finance, University of North Carolina at Wilmington, 601 South College Road Wilmington, NC 28403. USA.*

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Abstract

Empirical analysis of the Fed's monetary policy behavior suggests that the Fed smooths interest rates– that is, the Fed moves the federal funds rate target in several small steps instead of one large step with the same magnitude. We evaluate the effect of countercyclical policy by estimating a Vector Autoregression (VAR) with regime switching. Because the size of the policy shock is important in our model, we can evaluate the effect of smoothing the interest rate on the path of macro variables. Our model also allows for variation in transition probabilities across regimes, depending on the level of output growth. Thus, changes in the stance of monetary policy affect the macroeconomic variables in a nonlinear way, both directly and indirectly through the state of the economy. We also incorporate a factor summarizing overall sentiment into the VAR to determine if sentiment changes substantially around turning points and whether they are indeed important to understanding the effects of policy.

[JEL codes: C24, E32]

keywords: time-varying transition probabilities, Markov-switching, monetary policy

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†Corresponding author: ljackson@bentley.edu

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