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CONTENTS

X. Zhu and S. Rahman, A regime-switching Nelson–Siegel term structure model of the macroeconomy 1
A.S. Mandilaras, The international policy trilemma in the post-Bretton Woods era 18
P. Caraiani, Estimating DSGE models across time and frequency 33

(Contents continued on outside back cover)

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Monetary policy rules in light of the great recession

Scott Sumner

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ACCEPTED MANUSCRIPT

MONETARY POLICY RULES IN LIGHT OF THE GREAT RECESSION

SCOTT SUMNER -- MERCATUS CENTER

OCTOBER 23, 2016

There is a great deal of academic research suggesting that monetary policy should use a rules-based approach (e.g., Kydland and Prescott 1977, McCallum 1985, Plosser 2014). During the mid-1980s to the early 2000s, monetary policy did seem to follow something close to the Taylor Rule. This period also saw good macroeconomic outcomes, including low and stable inflation, as well as less volatility in real GDP growth. There was a sense that the monetary policy problem had been mostly solved.[1] This consensus view of monetary policy was often termed ‘New Keynesian’.

The period from 2002 to early 2006 saw unusually low interest rates (relative to the Taylor Rule) as well as a large housing boom, often called a ‘bubble’. Housing began declining after early 2006, and a banking crisis of increasing severity developed over the next few years. The overall economy slumped badly in 2008-09. By the end of 2008, interest rates had fallen close to zero in the United States, and have only recently begun to inch higher. Not surprisingly, this had led to a lot of soul searching in the economics profession.

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[1] See Blanchard (2008).

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