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Macroeconomic dynamics and the IS puzzle

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Abstract

The authors solve the IS puzzle for the G7 countries. They find that five of the G7 countries have the expected significant negative relationship between the output gap and the real-rate gap; the time series of the remaining two show material deviation from expected IS-curve behavior. The authors show that the observed time dependence of the interaction between the output and real-rate gaps can be represented in a parsimonious and practical manner using the theory of anelasticity that unifies partial-adjustment specifications of the IS curve.

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Keywords Macroeconomics; IS curve,; inflation; anelasticity

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1 Introduction

New Keynesian economic dynamics is based on three major elements: a central bank that seeks to keep economic output as close to the economy's highest level of sustainable output and to keep inflation as close to a target level as possible, a Phillips curve that expresses how a deviation of output from potential drives changes in inflation, and an IS curve that expresses economic output as inversely related to the level of the real interest rate.¹ The latter of these – the relationship between output and the real interest rate – is the basis for the use of interest rates as the primary tool of monetary policy by central banks in advanced economies. Despite the centrality of the IS curve to monetary policy since the late 1970s the small empirical literature dedicated to establishing that an increase in the real rate does in fact have a negative impact on output has come to be characterized as the “IS puzzle”: a statistically significant IS-curve is not found in some studies of the United States and is not seen in any of the other G7 countries.² The goal of this paper is to solve the IS puzzle.

2 The IS Puzzle

Our approach is motivated by the work of Rudebusch and Svensson (1999, 2002) and of Goodhart and Hofmann (2005a,b) that illustrates the IS puzzle in the United States. Each study employed the specification:

$$y_{t+1} = \beta_{y_1} y_t + \beta_{y_2} y_{t-1} + \beta_r \frac{1}{4} \sum_{j=0}^3 (i_{t-j} - \pi_{t-j}) \quad (1)$$

where y_t denotes the output gap at time t and where i_t and π_t are the nominal interest rate and the inflation rate, respectively.³ Using the data shown in Table 1 Rudebusch and Svensson (1999) and Goodhart and Hofmann (2005a,b) obtain the coefficients for Eq (1) shown under the column heading of “Puzzle” in Table 2. Rudebusch and Svensson (1999) obtain a statistically significant value for β_r while Goodhart and Hofmann (2005a,b) do not; this is the IS puzzle in the United States.

¹ See, for example, Goodfriend and King (1997), Clarida et al. (1999), and Woodford (2003).

² These results are established in Rudebusch and Svensson (1999, 2002), Peersman and Smets (1999), Nelson (2001, 2002a,b), Goodhart and Hofmann (2005a,b), Hafer and Jones (2008), and Stracca (2010).

³ The output gap is the percent deviation of actual real economic output q_t from potential real output q_t^* given by $y_t = 100(q_t - q_t^*)/q_t^*$ and the annual inflation rate π_t is calculated from a quarterly inflation index p_t using $\pi_t = 400(\ln p_t - \ln p_{t-1})$.

Table 1: The data sources and methodologies used to generate the IS puzzle in the United States.

Source	Sample	Potential GDP	Inflation
Rudebusch & Svensson	1961–1996	CBO	CWPI
Goodhart & Hofmann	1982–1998	HP filter	CPI

Note: The input sources used by Rudebusch and Svensson (1999, 2002) are (i) the congressional budget office (CBO) estimates of potential GDP and (ii) the GDP chain-weighted price index (CWPI) for inflation. Those used by Goodhart and Hofmann (2005a,b) are (i) a Hodrick-Prescott filter calculation of potential GDP and (ii) the consumer price index (CPI) for inflation.

The heterogeneity of the entries in Table 1 – the time range, input for the GDP-gap calculation, and input for the real-rate calculation all differ – suggests that herein may lie the source of the IS puzzle.

We localized the sources of the IS puzzle by first reproducing the results of Rudebusch and Svensson (1999) and of Goodhart and Hofmann (2005a,b), and then varying the input data as illustrated in Table 2. As mentioned above, the IS puzzle of the United States is shown in the column labeled “Puzzle”. In the upper panel of the column labeled “Puzzle” the IS-curve coefficients (the β s) and associated t -statistics of Rudebusch and Svensson (1999) are shown. All betas are statistically significant and the sign of $\beta_r = -0.10$ is negative; all as expected for the IS curve. By contrast the $\beta_r = -0.021$ for the real rate reported by Goodhart and Hofmann (2005a,b) and shown in the lower panel is not statistically significant;

Table 2: Coefficients and associated t -statistics (in parenthesis) for the IS curve in the United States given by Eq. (1). Asterisks indicate significance at the 1 percent (***) and 5 percent (**) levels; (†) indicates reported significance at least at the 10 percent level by Goodhart and Hofmann (2005a,b).

	Puzzle	CWPI	CPI	PCE
<i>1961-1996:</i>				
β_{y_1}	1.16 (14.5)	1.185*** (14.70)	1.224*** (15.20)	1.200*** (14.85)
β_{y_2}	-0.25 (-3.2)	-0.278*** (-3.51)	-0.304*** (-3.80)	-0.288*** (-3.62)
β_r	-0.10 (-3.3)	-0.073** (-2.40)	-0.016 (-0.53)	-0.057 (-1.81)
<i>1982-1998:</i>				
β_{y_1}	1.308† (12.12)	1.362*** (14.27)	1.367*** (14.49)	1.361*** (14.13)
β_{y_2}	-0.457† (-4.37)	-0.441*** (-4.62)	-0.440*** (-4.66)	-0.440*** (-4.60)
β_r	-0.021 (-0.66)	0.001 (0.03)	0.019 (0.66)	0.000 (0.0)

not as expected for the IS curve.

Our reproduction of the Rudebusch and Svensson (1999) result is shown in the upper panel of Table 2 in the column labeled CWPI. Our coefficient values are consistent with those of Rudebusch and Svensson (1999) and we therefore conclude that their results for the IS curve can be reproduced. Similarly, our reproduction of the Goodhart and Hofmann (2005a,b) results are shown in the lower panel of Table 2 in the column labeled CPI. Given the consistency between our results and those of Goodhart and Hofmann (2005a,b) for the statistically-significant coefficients and for the identity of the statistically-insignificant coefficient we conclude that the results of Goodhart and Hofmann (2005a,b) can also be reproduced, and in this case that includes our reproducing the IS puzzle.

The origins of the IS puzzle are revealed in the remaining entries of Table 2.⁴ We begin by examining the impact of changing the inflation measure on the coefficients. As mentioned above, Rudebusch and Svensson (1999) use the CWPI measure while Goodhart and Hofmann (2005a,b) use the CPI. The impact of the CPI measure on the Rudebusch and Svensson (1999) result can be seen by comparing the coefficients in the columns labeled CWPI and CPI in the upper panel of Table 2. Moving from CWPI to CPI eliminates the statistical significance of the real rate coefficient. For completeness we also show the result for the personal-consumption expenditure (PCE) deflator; use of this inflation measure also creates an IS puzzle. Variation of the inflation measure for the time range of Goodhart and Hofmann (2005a,b) shown in the columns labeled CWPI and PCE in the lower panel of Table 2 reveals that the lack of statistical significance for this time range is indeed robust; changing the inflation measure does not restore statistical significance to β_r . Thus we conclude that one source of the IS puzzle is the choice of inflation measure.

Next, comparing the coefficients in the upper and lower panels of the column labeled CWPI we find a second source of the IS puzzle; changing the time range of the input data can eliminate the statistical significance of the real-rate coefficient. Examination of the CPI and PCE columns demonstrates that this change in time range does not restore the statistical significance of the real rate in either case. Thus, we conclude that a second source of the IS puzzle is the choice of time range of the input data.

These origins of the IS puzzle – changes in the inflation measure and changes in the time range of the input data – can be seen in Figure 1 where the data used to generate the coefficients in Table 2 are shown.

⁴ The results in the upper panel do not change materially when the HP filter with $\lambda = 1600$ is used to calculate potential output. Thus, the difference introduced by using the CBO estimate of potential GDP is not a source of the IS puzzle.

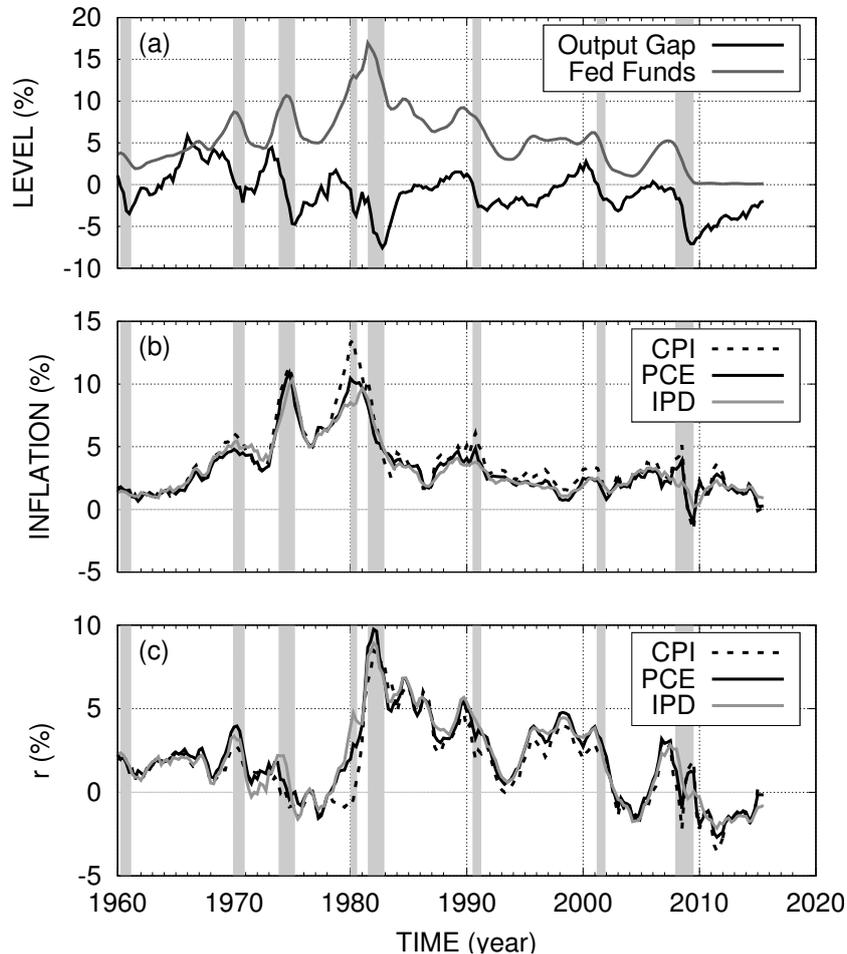


Figure 1: The time series from which the IS-curve coefficients in Table 2 were calculated. The data for these figures was obtained from the Federal Reserve Bank of St. Louis Economic Data Data (FRED) website.

In panel (a) we see the output gap and the Fed Funds rate as a function of time together with the grey bars indicating recessions. Panel (b) shows the three inflation measures discussed above as a function of time. Finally, in panel (c) we see the real rate that follows from the Fed Funds rate in panel (a) and the inflation measures in the panel (b).

The reason that the time range matters is likely associated with the dramatic movement in both the output gap and the real interest rate seen before 1982. To begin the analysis in 1982 is to exclude the period during which each of these variables experienced their greatest dynamic range and to focus the analysis on a period during which movement in the real rate is somewhat less correlated with

the output gap. Indeed, it appears that the late 1970s and early 1980s are a sort of natural experiment regarding the IS curve.

Similarly, the choice of inflation matters because the time series of the CPI inflation measure differs significantly from that of the PCE and IPD inflation measures during some time intervals. Of particular importance to our study is the comparatively dramatic rise and fall of CPI inflation in and around 1980 shown in the middle panel of Figure 1 which results in a materially different real rate during this time as shown in the lower panel of this figure.

This sensitivity to inflation measure, however, brings into focus the implicit manner by which the natural-rate component⁵ of the real-rate gap in Eq. (1) has been calculated: either as the mean rate of demeaned time series or as a non-zero constant term in the regression. Furthermore, Eq. (1) expresses the rather strong assumption that, in contrast to the output gap, all lags of the real rate have the same coefficient. This, together with the somewhat *ad hoc* origin of Eq. (1) suggest a reexamination of the specification the IS curve and it is to this that we now turn.

3 Time-Dependence of the IS Curve

In equilibrium the IS curve is given by

$$y = Jr \tag{2}$$

where y is the output gap, r is the real interest-rate gap (the rate gap), and J is a constant that should have a negative sign. Implicit in this version of the IS curve is (i) a unique equilibrium output gap for each level of the rate gap, (ii) instantaneous achievement of the equilibrium response, and (iii) linearity of the response. Relaxing the second of these three assumptions to allow for time-dependence in the achievement of the equilibrium response is the basis of anelasticity and the notion of a standard anelastic economy in which the IS curve assumes the dynamic form⁶

$$\tau_r \frac{dy}{dt} + y = \tau_r J_U \frac{dr}{dt} + J_R r \tag{3}$$

where τ_r is the relaxation time at constant rate gap and the proportionality constant J is now represented by two terms: J_U that represents any instantaneous response and J_R that represents the equilibrium proportionality. The difference $J_R - J_U$ is

⁵ The natural rate of interest is “the real short-term interest rate consistent with output equaling its natural rate and constant inflation.” See, for example, Holston et al. (2017).

⁶ See Hawkins (2015) and references therein.

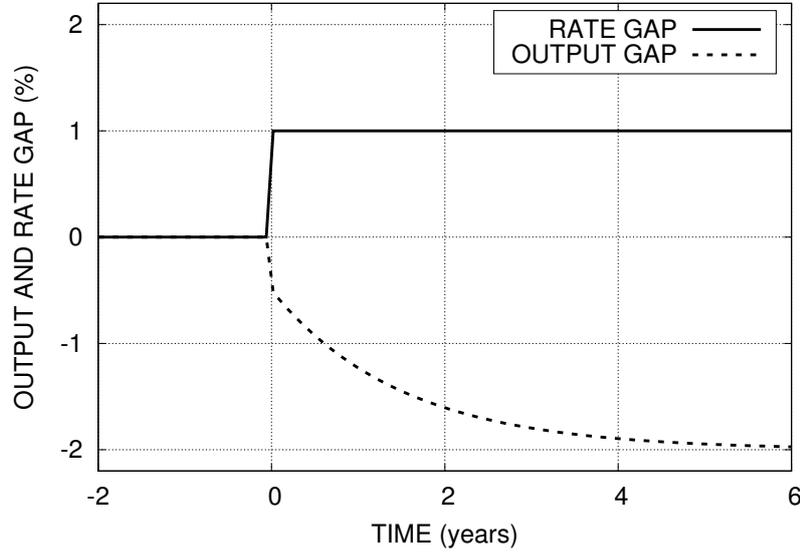


Figure 2: An illustration of the response of the output gap to a step change in the rate gap using $J_R = -2$, $J_U = -0.5$, and $\tau_r = 1.5$ years.

the time-dependent component of the response. In the equilibrium limit we recover IS curve seen in Eq. (2) above as $y = J_R r$.

Some intuition for this dynamic form of the IS curve can be had from a consideration of a simple rate shock. If the rate gap is shocked and held at a constant level r the time-dependent output gap becomes

$$y_t = \left(J_U + \delta J \left[1 - e^{-t/\tau_r} \right] \right) r \quad (4)$$

where $\delta J \equiv (J_R - J_U)$. The output-gap response to this step change in the rate gap is illustrated in Fig. 2. At $t = 0$ the rate gap increases by 1% and in response to this the output gap has a very rapid response of $J_U = -0.50\%$ followed by a slower relaxation to $J_R = -2.0\%$.

The partial-adjustment form of the IS curve obtained by discretizing Eq. (3)

$$y_{t+1} = y_t + J_U (r_{t+1} - r_t) + \frac{3}{2} \tau_r^{-1} (J_R r_t - y_t) - \frac{1}{2} \tau_r^{-1} (J_R r_{t-1} - y_{t-1}) \quad (5)$$

has an output-gap lag structure similar to that of Eq. (1) but a rate-gap lag structure that differs from Eq. (1) in that each lag has a different coefficient.⁷ A further simplification can be had by noting that with a quarterly measurement frequency

⁷ This discretization employed here was the Adams-Bashforth 2-step method discussed by Hawkins and Arnold (2000) and references therein.

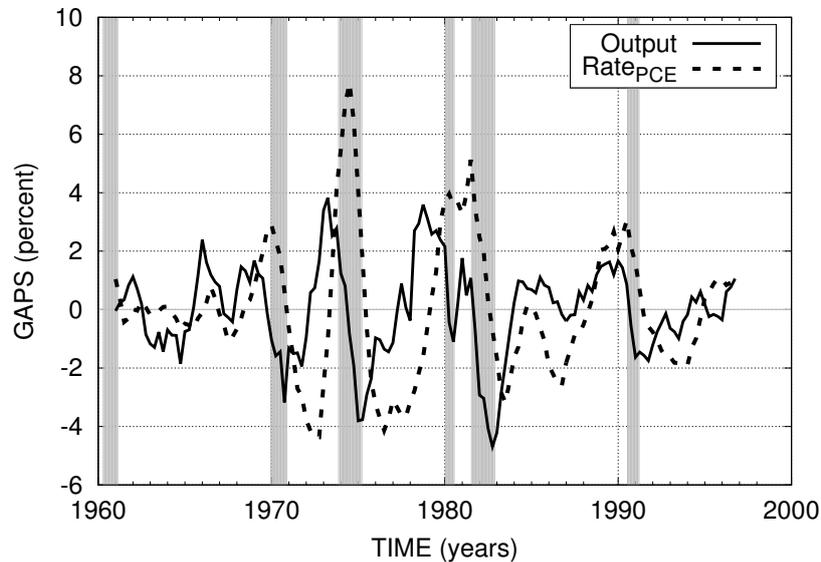


Figure 3: The output and rate gaps for the United States. The data for this figure was obtained from the Federal Reserve Bank of St. Louis Economic Data (FRED) website.

the instantaneous component of the response J_U will not be observed; consequently we set $J_U = 0$.

To calculate the natural-rate component of the rate gap we employed the Hodrick-Prescott filter used to calculate potential output in the output gap.⁸ The output gap is shown together with the rate gap for the PCE inflation measure in Figure 3; the rate gaps for the other inflation measures are essentially identical to that of PCE and, in the interest of clarity, not shown.

In Figure 3 we see the dynamic monetary-policy interplay between the rate gap and the output gap, with the rate gap rising in response to an increase in the output gap and falling in response to a decline in the output gap. The lead-lag nature of these dynamics clearly illustrated in this Figure indicates why Eq. (3) is an appropriate representation of the IS curve.

The coefficients for Eq. (3) obtained by fitting Eq. (5) over the period studied by Rudebusch and Svensson (1999, 2002) are shown in Table 3. This analysis demonstrates that this specification is more robust to the choice of inflation measure. The proportionality constant J_R is rather close to two in the two cases with statistically significant values for $1/\tau_r$ indicating that $y \approx -2r$ in equilibrium.

⁸ While consistent with current practice and providing methodological coherence across long-wavelength calculations, developing approaches to the calculation of the natural rate (e.g., Holston et al. (2017) and references therein) hold promise for future work on this issue.

Table 3: Coefficients and associated *t*-statistics (in parenthesis) for the IS curve in the United States given by Eq. (3). Asterisks indicate significance at the 1 percent (***) and 5 percent (**) levels.

	CWPI	CPI	PCE
$1/\tau_r$	0.086** (2.49)	0.055 (1.57)	0.071** (2.05)
J_R/τ_r	-0.165*** (6.41)	-0.139*** (6.25)	-0.159*** (6.36)

The success of this analysis in other G7 countries is contingent on the existence of the lead-lag relationship between the output gap and the rate gap found in the United States; an indication of active rate-based monetary policy. As the time series in Fig. 4 illustrate, however, this appears to be the case for only a portion of the G7 countries. The output-rate relationship of the United Kingdom and Germany is similar to that of the United States with changes in output generally leading changes in rate and this relationship is described well by Eq. (3) as indicated by the

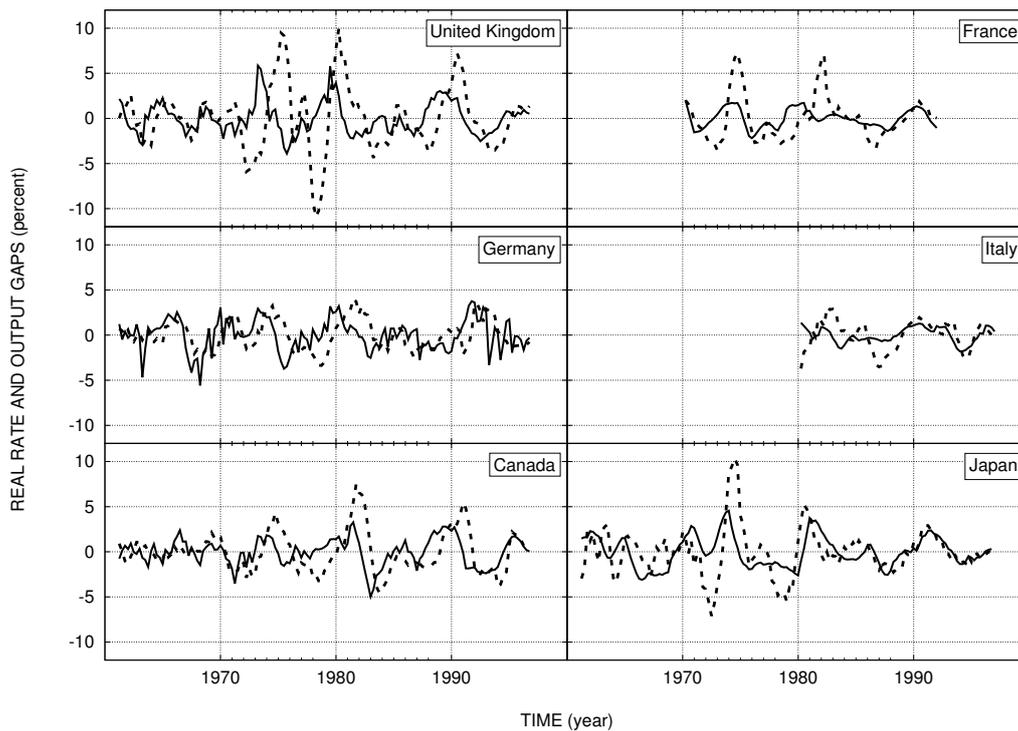


Figure 4: Output and rate gaps for ex-U.S. members of the G7. The data for these figures was obtained from Global Financial Data (GFD).

Table 4: Coefficients and associated t -statistics (in parenthesis) for the IS curve given by Eqs. (2) or (3). Asterisks indicate significance at the 1 percent level (***).

Country	$1/\tau_r$	J_R/τ_r	J_R or J
United Kingdom	0.152*** (3.82)	-0.105*** (5.06)	-0.691
Germany	0.268*** (5.08)	-0.128*** (2.00)	-0.478
Canada	—	—	-0.135*** (5.53)
France	—	—	-0.057*** (3.62)
Italy	—	—	-0.028 (1.07)

Note: The values of J_R for the United Kingdom and for Germany are the ratios of J_R/τ_r and $1/\tau_r$. The retail price index (RPI) was used to calculate inflation in the United Kingdom; the consumer price index (CPI) was so used for the other G7 countries.

coefficients in Table 4. Canada, Italy, and France did not have statistically significant coefficients for $1/\tau_r$. Since this suggested that the equilibrium IS curve was more appropriate specification we ran regressions using Eq. (2) which yielded the coefficients J shown in Table 4. With this equilibrium specification Canada and France are seen to have statistically significant IS curves. Italy, by contrast, shows hints of an IS curve but the relationship is not statistically significant. Finally, the data for Japan successfully resisted our attempts at parameterization. Inspection of the time series for Japan reveals interactions, such as the real-rate gap change leading the output gap change in 1980, that are inconsistent with the IS-curve generally and suggests a richer dynamical model is needed to describe the IS relationship in Japan. Of particular interest is that in all G7 countries except for Italy and Japan a statistically significant negative relationship between the output gap and the real-rate gap is observed, and thus it can be said that for these countries the IS puzzle is solved.

4 Summary

As one of the three components of New Keynesian economic dynamics the IS curve is of considerable importance to academic economists, central bankers, and other policy makers. In particular, the negative dependence of the output gap on the real interest rate is fundamental to the use of interest rates as macroeconomic policy tools. Thus, the IS puzzle – the observation that the output gap is not dependent on

the real rate in a statistically significant manner – is a major concern to those for whom interest rates are a key monetary policy tool.

We have found that the IS puzzle has two primary sources: (i) lack of robustness of the IS curve as specified by Eq. (1) with respect to how inflation is measured and (ii) the choice of time range over which the relationship between the output gap and the rate gap is studied. Beginning with the latter of these two sources, if a material change in the rate gap is not present in the data, estimation of the dependence of the output-gap on the rate gap will be complicated significantly by the presence of other factors that bear on the the value of the output gap. The sensitivity of the IS curve with respect to inflation measure was reduced significantly by a respecification of the IS curve that incorporates a time-dependent natural rate of interest and the observed lead-lag dynamics of the output gap and the real-rate gap.

In summary, we have shown that the IS puzzle is a result of both the chosen time-range of the data used to study the IS curve and the specification of the IS curve. With a time-range chosen to include a materially dynamic range for the real-rate gap and a specification of the IS curve that includes a time-dependent natural rate the real-rate gap the IS puzzle in the G7 countries can be solved.

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