

Research Seminar "Quantitative Economics"

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Abstract

Can the Fed Control Inflation? Stock Market Implications (Daniel Andrei & Michal Hasler)

Abstract

This paper examines the stock market implications of investor uncertainty about the Fed's inflation-fighting ability. In a general equilibrium model, investors learn about the Fed's ability to control inflation. Uncertainty about this ability amplifies volatility and the risk premium, particularly during pronounced monetary tightening and easing cycles. This effect is stronger during tightening, as learning magnifies stock responses to inflation shocks. Moreover, if the Fed's credibility wanes, investors see inflation as more persistent, boosting volatility and the risk premium. Empirical tests validate the model's predictions, underscoring the role of learning about the Fed's inflation management in shaping financial markets.