

# DISCUSSION PAPER SERIES

No. 4114

## MONETARY POLICY RULES, ASSET PRICES AND EXCHANGE RATES

Jagjit S Chadha, Lucio Sarno  
and Giorgio Valente

*INTERNATIONAL MACROECONOMICS*



**C**entre for **E**conomic **P**olicy **R**esearch

[www.cepr.org](http://www.cepr.org)

Available online at:

[www.cepr.org/pubs/dps/DP4114.asp](http://www.cepr.org/pubs/dps/DP4114.asp)

# MONETARY POLICY RULES, ASSET PRICES AND EXCHANGE RATES

**Jagjit S Chadha**, University of Cambridge  
**Lucio Sarno**, Warwick Business School and CEPR  
**Giorgio Valente**, Warwick Business School

Discussion Paper No. 4114  
November 2003

Centre for Economic Policy Research  
90–98 Goswell Rd, London EC1V 7RR, UK  
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999  
Email: [cepr@cepr.org](mailto:cepr@cepr.org), Website: [www.cepr.org](http://www.cepr.org)

This Discussion Paper is issued under the auspices of the Centre's research programme in **INTERNATIONAL MACROECONOMICS**. Any opinions expressed here are those of the author(s) and not those of the Centre for Economic Policy Research. Research disseminated by CEPR may include views on policy, but the Centre itself takes no institutional policy positions.

The Centre for Economic Policy Research was established in 1983 as a private educational charity, to promote independent analysis and public discussion of open economies and the relations among them. It is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions. Institutional (core) finance for the Centre has been provided through major grants from the Economic and Social Research Council, under which an ESRC Resource Centre operates within CEPR; the Esmée Fairbairn Charitable Trust; and the Bank of England. These organizations do not give prior review to the Centre's publications, nor do they necessarily endorse the views expressed therein.

These Discussion Papers often represent preliminary or incomplete work, circulated to encourage discussion and comment. Citation and use of such a paper should take account of its provisional character.

Copyright: Jagjit S Chadha, Lucio Sarno and Giorgio Valente

CEPR Discussion Paper No. 4114

November 2003

## **ABSTRACT**

### **Monetary Policy Rules, Asset Prices and Exchange Rates\***

We examine empirically whether asset prices and exchange rates may be admitted into a standard interest rate rule, using data for the US, the UK and Japan since 1979. Asset prices and exchange rates can be employed as information variables for a standard 'Taylor-type' rule or as arguments in an augmented interest rate rule. Our empirical evidence, based on measures of the output gap proxied by marginal costs calculations, suggests that monetary policy-makers may use asset prices and exchange rates not only as part of their information set for setting interest rates, but also to set interest rates to offset deviations of asset prices or exchange rates from their equilibrium levels. These results are open to several alternative interpretations.

JEL Classification: E40, E44, E52 and E58

Keywords: asset prices, exchange rates, interest rate rules and monetary policy

Jagjit S Chadha  
Department of Applied Economics  
Austin Robinson Building  
Cambridge  
CB3 9DE  
Tel: (44 1223) 335 280  
Fax: (44 1223) 335 299  
Email: [jagjit.chadha@econ.cam.ac.uk](mailto:jagjit.chadha@econ.cam.ac.uk)

Lucio Sarno  
Finance Group  
Warwick Business School  
University of Warwick  
Coventry  
CV4 7AL  
Tel: (44 2476) 528219  
Fax: (44 2476) 572871  
Email: [lucio.sarno@warwick.ac.uk](mailto:lucio.sarno@warwick.ac.uk)

For further Discussion Papers by this author see:  
[www.cepr.org/pubs/new-dps/dplist.asp?authorid=120657](http://www.cepr.org/pubs/new-dps/dplist.asp?authorid=120657)

For further Discussion Papers by this author see:  
[www.cepr.org/pubs/new-dps/dplist.asp?authorid=138519](http://www.cepr.org/pubs/new-dps/dplist.asp?authorid=138519)

Giorgio Valente  
Finance Group  
Warwick Business School  
University of Warwick  
Coventry  
CV4 7AL  
Tel: (44 2476) 528537  
Fax: (44 2476) 572871  
Email: giorgio.valente@warwick.ac.uk

For further Discussion Papers by this author see:  
[www.cepr.org/pubs/new-dps/dplist.asp?authorid=157421](http://www.cepr.org/pubs/new-dps/dplist.asp?authorid=157421)

\*This Paper is forthcoming in *International Monetary Fund Staff Papers*. This Paper was partly written while Lucio Sarno was a Visiting Scholar at the International Monetary Fund and at the Central Bank of Norway. The authors are indebted for their constructive comments to Tam Bayoumi, Alina Carare, John Driffill, Oyvind Eitrheim, Bob Flood, Charles Goodhart, Marcus Miller, Charles Nolan, Silvia Sgherri, Peter Smith, Mark Taylor, Dan Thornton and other participants to the 2002 Macro, Money and Finance Annual Conference at the University of Warwick. The authors alone are responsible for any errors that may remain and for the views expressed in the Paper.

Submitted 29 October 2003

## **NON-TECHNICAL SUMMARY**

It has become commonplace to characterize monetary policy using an interest rate rule (see Taylor, 1993, 1999, 2001). Such an interest rate rule relates the setting of short-term money market rates to the evolution of two key variables, price inflation and the output gap. A considerable and influential research effort has been directed at establishing to what extent this kind of rule can explain the dynamics of policy rates in major industrialized countries (see Clarida, Gali and Gertler, 1998, 2000). The main virtue of this 'Taylor' rule is its simplicity but therein lies a vice, as there is controversy as to whether such a rule can be an adequate representation of a process as complex as that of monetary policy.

Accordingly, an important issue for central banks in recent years, for example, has been what weight to place on asset prices in setting interest rates. In periods of growing optimism, which may be associated with extended periods of economic expansion, asset prices may climb to unsustainable levels even if the path of likely returns (from, say, productivity gains or earnings growth) is unchanged (Shiller, 2000). The possibility of a sharp correction in asset prices may then leave the real economy unduly fragile and this vulnerability may become an issue for monetary policy-makers. Furthermore, macroeconomic imbalances may be exacerbated by the possibility that monetary policy makers may explicitly target asset prices. A useful dichotomy is whether asset prices movements are a concern for central banks only because they contain information about future inflation – they are used as information variables – or whether they should be seen as variables to which central banks should react in addition to expected inflation and possibly the output gap. While some authors claim that including stock prices in the central bank's policy rule may be optimal (e.g. Cecchetti, Genberg, Lipsky and Wadhvani, 2000; Bordo and Jeanne, 2002) and that central banks react significantly to stock market movements by changing the short-term interest rate (e.g. Rigobon and Sack, 2003), other studies argue that central banks should not respond directly to asset prices (e.g. Bernanke and Gertler, 1999, 2001).

Furthermore, in an open economy, the exchange rate is both a source of extraneous shocks and a mechanism for adjusting to fundamentals' shocks and thus monetary policy choices are not independent of exchange rate dynamics. Some recent contributions argue that central banks may respond to the exchange rate, and this is particularly relevant in the case of small open economies (see Taylor, 2001). At the empirical level, some researchers provide evidence that exchange rates are statistically significant in interest rates rules depicting the reaction functions of several major central banks (e.g. Clarida, Gali and Gertler, 1998).

In this paper we extend this analysis to consider jointly the role of asset prices and exchange rates in the interest rate rule in order to assess whether three major central banks – the US Federal Reserve Bank, the Bank of England and the Bank of Japan – have responded to asset prices and exchange rates during the last couple of decades or so or whether they have used asset prices and exchange rates only as information variables that can help predict future inflation or output. In our study we allow asset prices and exchange rates to act both as information variables and as monetary policy targets, which enables us to investigate in an augmented interest rate rule whether and how central banks react to asset prices and exchange rates disequilibria.

In this Paper we investigate a general monetary policy rule comprising inflation and the output gap as well as asset prices and exchange rates in a unified framework, while examining the role of alternative measures of real marginal costs and the output gap. Using quarterly data since 1979 for the US, the UK and Japan we confirm the main results of the empirical literature on forward-looking monetary policy rules. We also show that our baseline estimation including asset prices, exchange rates and an adjusted labour share as the appropriate proxy for the output gap yields significant parameter estimates for all the arguments in the interest rate rule of the US and the UK, and for all the arguments except asset prices in the case of Japan. These results are open to several alternative interpretations, which we discuss in the Paper.

# 1 Introduction

It has become commonplace to characterize monetary policy as the minimization of inefficient economic fluctuations via the implementation of an interest rate rule (see Taylor, 1993, 1999, 2001). Such an interest rate rule relates the setting of short-term money market rates to the evolution of two key state variables, price inflation and the output gap. A considerable and influential research effort has been directed at establishing to what extent this kind of rule can explain the dynamics of policy rates in major industrialized countries (see, *inter alia*, Clarida, Gali and Gertler, 1998, 2000, and the references therein). The main virtue of this ‘Taylor’ rule is its simplicity but therein lies a vice, as there is controversy as to whether such a rule can be an adequate representation of a process as complex as that of monetary policy.

Accordingly, an important issue for central banks in recent years, for example, has been what weight to place on asset prices in setting interest rates (see, for example, Greenspan, 1999; Batini and Nelson, 2000; Goodhart, 2000; Bordo and Jeanne, 2002). In periods of growing optimism, which may be associated with extended periods of economic expansion, asset prices may climb to unsustainable levels even if the path of likely returns (from, say, productivity gains or earnings growth) is unchanged (Shiller, 2000). The possibility of a sharp correction in asset prices may then leave the real economy unduly fragile and this vulnerability may become an issue for monetary policy makers. Furthermore, macroeconomic imbalances may be exacerbated by the possibility that monetary policy makers may explicitly target asset prices. A useful dichotomy is whether asset prices movements are a concern for central banks only because they contain information about future inflation - they are used as information variables - or whether they should be seen as variables to which central banks should react in addition to expected inflation and possibly the output gap. While some authors claim that including stock prices in the central bank’s policy rule may be optimal (e.g. Cecchetti, Genberg, Lipsky and Wadhvani, 2000; Bordo and Jeanne, 2002) and that central banks react significantly to stock market movements by changing the short-term interest rate (e.g. Rigobon and Sack, 2003), other studies argue that central banks should not respond directly to asset prices (e.g. Bernanke and Gertler, 1999, 2001).<sup>1</sup>

---

<sup>1</sup>For an extensive discussion of the issues related to the role of asset prices in designing macroeconomic policy, see the International Monetary Fund’s *World Economic Outlook* (May 2000, Chapter 3, “Asset Prices and the Business

Furthermore, in an open economy, the exchange rate is both a source of extraneous shocks and a mechanism for adjusting to fundamentals' shocks and thus monetary policy choices are not independent of exchange rate dynamics. Some recent contributions argue that central banks may respond to the exchange rate, and this is particularly relevant in the case of small open economies (see, *inter alia*, Obstfeld and Rogoff, 1995; Taylor, 2001). At the empirical level, some researchers provide evidence that exchange rates are statistically significant in interest rates rules depicting the reaction functions of several major central banks (e.g. Clarida, Gali and Gertler, 1998).

In this paper we extend this analysis to consider jointly the role of asset prices and exchange rates in the interest rate rule in order to assess whether three major central banks - the US Federal Reserve Bank, the Bank of England and the Bank of Japan - have responded to asset prices and exchange rates during the last couple of decades or so or whether they have used asset prices and exchange rates only as information variables that can help predict future inflation or output. In our study we allow asset prices and exchange rates to act both as information variables and as monetary policy targets, which enables us to investigate in an augmented interest rate rule whether and how central banks react to asset prices and exchange rates disequilibria.

A subsidiary issue is the extent to which the output gap is correctly measured. In the empirical literature on central banks' reaction functions, the output gap has generally been measured by detrending output using deterministic trends (e.g. Taylor, 1993; Clarida, Gali and Gertler, 1998, 2000) or smoothed trends representing the equilibrium level of output consistent with perfectly flexible prices (see, *inter alia*, Kozicki, 1999, and the references therein). In practice, however, the efficient level of output may behave quite differently in response to real shocks such that potential output may not follow a smooth trend. As a result the output-gap measure that is relevant for monetary policy purposes may be different from the one captured by detrended output (Woodford, 2001). Recently, several contributions (e.g. Gali and Gertler, 1999; Gali, Gertler and Lopez-Salido, 2001) have shown that, under certain restrictions on technology and labor market structure within a local neighborhood of the steady state, real marginal costs are directly related to the output gap.

In this paper we tie together these different, albeit related, strands of the literature in that we investigate a very general monetary policy rule comprising inflation and the output gap as well as 

---

Cycle").



asset prices and exchange rates in an unified framework, while examining the role of alternative measures of real marginal costs and the output gap. Using quarterly data since 1979 for the US, the UK and Japan we confirm the main results of the empirical literature on forward-looking monetary policy rules. However, we also show that our baseline estimation including asset prices, exchange rates and an adjusted labor share as the appropriate proxy for the output gap yields significant parameter estimates for all the arguments in the interest rate rule of the US and the UK, and for all the arguments except asset prices in the case of Japan. These results are open to several alternative interpretations, which we discuss below.

The remainder of the paper is set out as follows. In Section 2 we discuss a general empirical framework for forward-looking monetary policy rules emphasizing the role of output-gap measures as well as asset prices and exchange rates dynamics. Section 3 describes the data. In Section 4 we report and discuss our empirical results. A final section concludes.

## 2 Monetary policy rule specification

In this section we briefly review the standard framework of analysis of forward-looking interest rate (or Taylor) rules, which we then generalize to an interest rate rule which explicitly allows for asset prices and exchange rates to act both as information variables and monetary policy targets. Finally, we also discuss a subsidiary issue relating to the calculation of the proxy of the output gap used in interest rate rules.

### 2.1 Forward-looking Taylor rules

Following Clarida, Gali and Gertler (1998, 1999, 2000), assume that within each operating period the central bank has a target for the nominal short-term interest rate,  $r_t^*$  which is a function of the state of the economy represented by the gaps between expected inflation and output from their respective targets:

$$r_t^* = r^* + \beta [E(\pi_{t+k_\pi} | \Omega_t) - \pi^*] + \gamma [E(x_{t+k_y} | \Omega_t)], \quad (1)$$

where  $r^*$  is the desired nominal interest rate when both inflation and output are at their target levels;  $E(\pi_{t+k_\pi}|\Omega_t)$  and  $E(x_{t+k_y}|\Omega_t)$  denote the expectations of inflation at time  $t+k_\pi$  and the output gap at time  $t+k_y$ ;  $\pi^*$  is the level of inflation (implicitly or explicitly) targeted by the central bank; the output gap  $x_{t+k_y} \equiv y_{t+k_y} - y_{t+k_y}^*$ , where  $y$  is output and  $y^*$  if the efficient level of output.<sup>2</sup>

Consider the implied target for the *ex ante* real interest rate.<sup>3</sup> Central banks will pursue monetary policy aimed at stabilizing inflation if the parameter  $\beta > 1$ , while rules characterized by  $\beta \leq 1$  will tend to be destabilizing. Clearly, the parameter  $\gamma$  is consistent with stabilizing output directly only if  $\gamma > 0$  (see Clarida, Gali and Gertler, 2000).

Equation (1) may be, however, too restrictive to describe the behavior of short term rates. As documented in earlier contributions (e.g. Goodfriend, 1987), central banks may operate smoothing changes in interest rates for different reasons (e.g. effects on capital markets, loss of reputation, private consensus building). In order to account for this behavior we can specify equation (1) assuming that the current short-term interest rate  $r_t$  adjusts to the target rate  $r_t^*$  according to a partial adjustment mechanism of the form  $r_t = [1 - \rho(1)]r_t^* + \rho(L)r_{t-1} + v_t$ , where  $\rho(L)$  is an  $n$ -lag polynomial,  $L$  is the lag operator and  $v_t$  is a zero-mean exogenous interest rate shock. Allowing for smoothing in the above fashion in equation (1) results in an interest rate rule where in each period central banks act on the short term interest rate reducing the gap between the current target rate and its past value:

$$r_t = \alpha + \lambda\pi_{t+k_\pi} + \vartheta x_{t+k_y} + \rho(L)r_{t-1} + \varepsilon_t, \quad (2)$$

where we have eliminated the unobserved conditional expectations by rewriting equation (1) in terms of realized variables;  $\alpha = [1 - \rho(1)](r^* - \beta\pi^*)$ ;  $\lambda = [1 - \rho(1)]\beta$ ;  $\vartheta = [1 - \rho(1)]\gamma$ ; and the error term  $\varepsilon_t = v_t - [1 - \rho(1)]\{\beta[\pi_{t+k_\pi} - E(\pi_{t+k_\pi}|\Omega_t)] + \gamma[x_{t+k_y} - E(x_{t+k_y}|\Omega_t)]\}$  is the sum of a zero-mean exogenous shock and a linear combination of forecast errors which are orthogonal to the variables considered in the information set  $\Omega_t$ . Given estimates of the parameters in the

---

<sup>2</sup>This rule can also be obtained in a framework where the central bank faces a quadratic loss function over inflation and output (see, *inter alia*, Svensson, 1997; Bernanke and Woodford, 1997, and the references therein).

<sup>3</sup>The *ex ante* real interest rate can be obtained as  $rr_t^* = r_t - E(\pi_{t+k_\pi}|\Omega_t)$ . Substituting this into equation (1) we get that  $rr_t^* = rr^* + (\beta - 1)[E(\pi_{t+k_\pi}|\Omega_t) - \pi^*] + \gamma[E(x_{t+k_y}|\Omega_t)]$ , where  $rr^* = r^* - \pi^*$ .

forward-looking Taylor rule (2), one can therefore recover the implied estimates of  $\beta$  and  $\gamma$ .

## 2.2 Augmenting forward-looking Taylor rules with asset prices and exchange rates

Equation (2) does not explicitly consider the role of asset prices and exchange rates as monetary policy targets (or instruments). It is under debate whether and how asset prices and exchange rates should be taken into account in formulating monetary policy (see Taylor, 2001; Clarida, 2001). While asset prices may be used as indicator variables, in the last decade or so several major central banks have started taking into consideration the apparent increase in financial instability, of which one important dimension is represented by the volatility of asset prices. In fact, as recorded in several contributions, asset booms and busts have been important factors in macroeconomic fluctuations in both industrial and developing countries (see, for example, Borio, Kennedy and Prowse, 1994). Similar arguments apply to the role of exchange rates in central banks' reaction functions (e.g. Clarida, Gali and Gertler, 1998; Taylor, 2001).

Thus, we consider a baseline equation - which may be termed augmented Taylor rule - of the form:

$$r_t = a + \lambda \pi_{t+k_\pi} + \vartheta x_{t+k_y} + \chi e_{t-1} + \varkappa s_{t-1} + \rho(L)r_{t-1} + \varepsilon_t, \quad (3)$$

where  $e_{t-1}$  and  $s_{t-1}$  denote the lagged real exchange rate and stock price;  $a = [1 - \rho(1)](r^* - \beta\pi^* - \phi s^* - \delta e^*)$ , where  $s^*$  and  $e^*$  denote the equilibrium levels of asset prices and exchange rates respectively;  $\lambda = [1 - \rho(1)]\beta$ ;  $\vartheta = [1 - \rho(1)]\gamma$ ;  $\chi = [1 - \rho(1)]\delta$  and  $\varkappa = [1 - \rho(1)]\phi$ , where  $\delta$  and  $\phi$  are the parameters determining the central bank's response to exchange rates and asset prices disequilibria; and  $\varepsilon_t = v_t - [1 - \rho(1)]\{\beta[\pi_{t+k_\pi} - E(\pi_{t+k_\pi}|\Omega_t)] + \gamma[x_{t+k_y} - E(x_{t+k_y}|\Omega_t)]\}$ . Equation (3) generalizes the standard forward-looking Taylor rule to account for the possibility that both asset prices and exchange rates enter the interest rate rule. Clearly, equation (3) nests not only the standard forward-looking Taylor rule estimated, for example, by Clarida, Gali and Gertler (2000), but also its variants which allow only for either exchange rates (e.g. Taylor, 2001) or asset prices (e.g. Bernanke and Gertler, 1999; Gilchrist and Leahy, 2002) respectively.

Let  $\mathbf{z}_t$  denote a vector of instruments comprising the central bank's information set at the time the instrument rate  $r_t$  is chosen (i.e.  $\mathbf{z}_t \in \Omega_t$ ). Equation (3) implies a set of orthogonality conditions because the elements of  $\mathbf{z}_t$  include lagged variables that help forecast inflation, output as well as contemporaneous variables that are uncorrelated with the interest rate shock  $v_t$ . More formally, since  $E[\varepsilon_t|\mathbf{z}_t] = 0$ :

$$E[r_t - a - \lambda\pi_{t+k_\pi} - \vartheta x_{t+k_y} - \chi e_{t-1} - \varkappa s_{t-1} - \rho(L)r_{t-1}|\mathbf{z}_t] = 0. \quad (4)$$

This set of orthogonality conditions is the basis of the estimation of the parameter vector  $\{\beta, \gamma, \phi, \delta, \rho\}$ , using the Generalized Method of Moments (GMM), with an optimal weighting matrix that accounts for possible serial correlation in  $\varepsilon_t$ . To the extent that the dimension of the vector  $\mathbf{z}_t$  exceeds the number of parameters being estimated, equation (3) implies overidentifying restrictions that can be tested to assess the validity of the set of instruments used (Hansen, 1982). The results of this test can be interpreted as follows: under the null hypothesis the central bank adjusts the interest rate according to equation (3), with the expectations of future inflation and the output gap based on the relevant information available to policy makers at time  $t$ . Under general assumptions this implies that there exists a set of parameters  $\{\tilde{\beta}, \tilde{\gamma}, \tilde{\phi}, \tilde{\delta}, \tilde{\rho}\}$  such that the residuals obtained from estimating (3) are orthogonal to the information set  $\Omega_t$ . Under the alternative hypothesis the violation of the orthogonality conditions will lead to the statistical rejection of the model.

In line with some recent empirical literature, we assume that the real exchange rate follows a persistent but stationary process, implying that purchasing power parity (PPP) holds in the long run (see the review of Sarno and Taylor, 2002 and the references therein). The real exchange rate equilibrium level can then be captured by a constant included in the intercept term of the reaction function so that effectively the exchange rate variable entering (3) is the lagged deviation from PPP. Indeed, it is often assumed in international macroeconomic models that the instrument rate is affected by past values of exchange rates disequilibria (see Obstfeld and Rogoff, 1995; Taylor, 2001; Hunt and Rebucci, 2003). Defining the real exchange rate as the domestic price of foreign currency, the resulting monetary policy rule acts to stabilize the exchange rate if  $\delta > 0$ . In other

words, an appreciation of the real exchange rate will require a cut in short-term interest rates.

Even if equation (3) denotes a forward-looking Taylor rule, it has been assumed, as in Bernanke and Gertler (1999), that only past (once-lagged) stock prices disequilibria affect the instrument rate,  $r_t$ . This assumption implies that central banks might intervene only when asset prices have been observed to deviate from equilibrium, rather than anticipating potential misalignments. Given our formulation, in order to stabilize asset prices we must have  $\phi > 0$ . This implies that whenever asset prices positively (negatively) deviate from their equilibrium level, for example because of poor regulatory practice or ‘irrational exuberance’ (Shiller, 2000), central bankers will increase (decrease) the instrument rate in order to offset the anomalous price dynamics.

### **2.3 A subsidiary issue: the role of output-gap measures**

In the previous sub-sections we have discussed how central banks may act setting a target for the nominal short-term interest rate as a function of the state of the economy, which includes, *inter alia*, the output gap. In the empirical literature on central banks’ reaction functions the output gap has generally been measured by detrending output using quadratic deterministic trends or smoothed trends representing the equilibrium level of output that would be obtained under perfectly flexible prices (see Hodrick and Prescott, 1997; Baxter and King, 1999, and the references therein). In practice, the efficient level of output is likely to behave differently in response to different real shocks (e.g. shocks related to changes in technology, government expenditure plans, productivity or consumers preferences). As a result the output-gap measure that is relevant for monetary policy purposes may be different from the one captured by detrended output.

A series of recent contributions (see, *inter alia*, Gali and Gertler, 1999; Gali, Gertler and Lopez-Salido, 2001) emphasize this point in the context of a structural derivation of the Phillips curve. They show that under certain restrictions on technology and labor market structure (see Rotemberg and Woodford, 1999) within a local neighborhood of the steady state, real marginal costs are proportionately related to the output gap. A measure of real marginal costs might therefore be considered as an appropriate proxy for the output gap (Woodford, 2001).

The most common measure of marginal cost used in the literature is represented by the cost of increasing labor input. If output is a differentiable function of the labor input and firms are wage

takers, then the (real) marginal cost is equal to the (real) wage divided by the marginal product of labor. More formally, assume for simplicity that the aggregate production function is given by a Cobb-Douglas specification  $Y_t = A_t N_t^{1-\alpha}$ , where  $Y_t$  is aggregate output,  $N_t$  is employment at time  $t$ ,  $A_t$  is a common technology factor, and  $1 > \alpha > 0$ . The real marginal cost (RMC) can be defined as:

$$RMC_t = \frac{W_t/P_t}{(1-\alpha)(Y_t/N_t)}, \quad (5)$$

where  $W_t$  is the nominal wage, and  $P_t$  is the aggregate price level. Real marginal costs move over time according to observed fluctuations in economic activity and employment. Indeed, there is a large literature supporting the view that marginal costs increase more than prices during expansions inducing real marginal costs to increase. This is motivated on the basis of two arguments. First, holding constant other determinants of labor supply, real wages must rise during expansions to induce more people to work. Second, if one makes the standard assumption that the production function is concave, for a given level of technology the marginal product of labor is a decreasing function of labor input (see Rotemberg and Woodford, 1999). This behavior is therefore consistent with a procyclical dynamics of real marginal costs.

However, variations in real unit labor costs have often been found to be negatively (instead of positively) correlated with detrended gross domestic product (GDP) - e.g. Rotemberg and Woodford (1999), Woodford (2001), Gali, Gertler and Lopez-Salido (2001), Sbordone (2002). In order to shed light on this countercyclical behavior, it is instructive to decompose movements in real unit labor costs in order to isolate the factors driving this variable. Following Gali, Gertler and Lopez-Salido (2001), real marginal costs are equal to the measure of distance of output from its efficient level:

$$rmc_t = \log \mu_t^w + [(c_t - \varphi n_t) - (y_t - n_t)], \quad (6)$$

where  $c_t$  is consumption,  $\mu_t^w$  is the gross wage markup and lowercase variables are defined in logarithms. The expression in brackets  $[(c_t - \varphi n_t) - (y_t - n_t)]$  is the (log-linearized) measure of distance of output from its efficiency level, or, using the Gali, Gertler and Lopez-Salido's (2001)

terminology, the ‘inefficiency wedge.’ In equation (6),  $(c_t - \varphi n_t)$  is the marginal cost of labor supply, and  $\varphi$  is the inverse of the elasticity of labor supply. If we assume for simplicity an economy with just consumption goods ( $c_t = y_t$ ), then we can derive an expression that explicitly links the ‘inefficiency wedge’ to the output gap:

$$[(c_t - \varphi n_t) - (y_t - n_t)] = -\Theta + \omega (y_t - y_t^*), \quad (7)$$

where  $\Theta$  is an indicator of steady state distortions due to the existence of market power in labor and goods markets, and  $y_t^*$  is the level of output that would be obtained under perfectly flexible prices and wages.

The countercyclical behavior of real marginal costs can be explained by using equations (6)-(7) to obtain:

$$rmc_t = \log \mu_t^w - \Theta + \omega (y_t - y_t^*). \quad (8)$$

Equation (8) tells us that the presence of frictions in the labor market may drive the dynamics of real marginal costs. In fact, as documented in Woodford (2001) and Gali, Gertler and Lopez-Salido (2001) and as suggested by equation (8), while the ‘inefficiency wedge’ moves closely with the business cycle over time, the wage markup should behave in a countercyclical fashion, suggesting the likelihood of temporary wage rigidities. By removing this markup component from real marginal costs it should be possible to get a representative measure of the output gap which might be used as an indicator of stabilization.

Figure 1 shows our time series for real unit labor costs after adjusting for wage markup, and detrended output gap for the US, the UK and Japan. The calculation of the adjusted labor costs follows exactly our description of the mark-up adjustment given above, assuming, as is standard in this literature, the labor supply elasticity  $\varphi = 1$  (Gali, Gertler and Lopez-Salido, 2001, p. 1263). The graphs in Figure 1 suggest that the prediction of the simple decomposition outlined above is confirmed, as evidenced by the fact that the adjusted real marginal cost measure appears to be positively correlated with the business cycle.

We now turn to a description of our data set.

### 3 Data

Our data set comprises quarterly time series spanning from September 1979 to December 2000 for the US, the UK and Japan.<sup>4</sup> We use as instruments interest rates the Federal funds rate for the US, the base rate for the Bank of England, and the call money rate for the Bank of Japan. The baseline inflation measure is, for all three countries examined, the (annualized) rate of change in the consumer price index (CPI), although we also report results using the GDP deflator. These time series are obtained from the International Monetary Fund's *International Financial Statistics* database.

The baseline output-gap measure is the adjusted labor share calculated as in Gali, Gertler and Lopez-Salido (2001, p. 1263). The data on consumption per household, employment per household, real wage and labor productivity have been calculated using data from the *OECD Quarterly National Accounts* and *OECD Quarterly Labor Force Statistics*.<sup>5</sup> Results are also reported for alternative measures of the output gap, taken as the quadratically-detrended and Hodrick-Prescott (HP) detrended GDP respectively.

The measure of stock prices disequilibrium in the baseline estimation is the dividend-price ratio calculated using *Datastream* composite stock price indices for each country examined.<sup>6</sup> The measure of real exchange rate is the log-real effective exchange rate, obtained for each country from the International Monetary Fund's *International Financial Statistics* database.

The instrument set includes lags of the instrument rate, inflation, output gap, as well as the same number of lags of a world commodity price index and the spreads between the respective long-term bond rate and the short-term bill rate. These time series are also obtained from the International Monetary Fund's *International Financial Statistics* database.

---

<sup>4</sup>We decided to use this sample period because, as documented in previous contributions, there is evidence of structural instability in monetary policy reaction functions when using pre-1979 data (see Clarida, Gali and Gertler, 1998).

<sup>5</sup>For further details, see the relevant discussion in Gali, Gertler and Lopez-Salido (2001), which we followed closely in the construction of our time series.

<sup>6</sup>A robustness exercise was carried out using measures based on the S&P 500 index for the US, the FTSE100 index for the UK and the NIKKEI 225 index for Japan (see Section 4.3).



## 4 Empirical results

In this section we report our main empirical results from estimating both standard forward-looking Taylor rules as well as augmented forward-looking Taylor rules which also allow for exchange rates and asset prices to enter the central bank's reaction function. We then report a battery of robustness checks and provide a discussion of the alternative potential explanations of our findings.

### 4.1 Forward-looking Taylor rules

Table 1 reports GMM estimates of the interest rate rule parameters  $\{\tilde{\beta}, \tilde{\gamma}, \tilde{\rho}\}$  in a standard forward-looking Taylor rule for each of the US, the UK and Japan. We begin with an interest rate rule - equation (2) - where only expected inflation and expected output gap are considered as explanatory variables, also experimenting with various measures of these two arguments. Following previous research (Clarida, Gali and Gertler, 1998, 2000), we consider a specification of the interest rate rule with two lags of the interest rate for the US and only one lag for the UK and Japan. We allow for a maximum of four lags of the variables in the instrument set. The first four specifications we estimate consider two measures of inflation, namely the CPI and the GDP deflator, and two conventional measures of the output gap, namely quadratically- and HP-detrended GDP.

The estimation results reported in Table 1 (specifications 1 to 4) yield parameters values that are consistent with the results recorded in the literature (e.g. see Clarida, Gali and Gertler, 1998, 2000). In particular, for the US, for each specification considered, the estimate of  $\beta$  is always correctly signed, strongly statistically significant and greater than unity, while the estimate of  $\gamma$  is not statistically different from zero at conventional levels of significance (see Panel a) of Table 1). In turn, this implies that the Federal Reserve has responded only to deviations of expected inflation from the implicit inflation target, not to the expected output gap, over the sample examined. For the UK (see Panel b) of Table 1), the estimate of  $\beta$  is also correctly signed and strongly statistically significant for each of specifications 1 to 4; the estimated  $\beta$  is only slightly greater than unity and generally lower than for the US reaction function. Estimates of  $\gamma$  obtained using the HP-detrended GDP series are not statistically significant at conventional significance levels (see Kozicki, 1999). For Japan (see Panel c) of Table 1), the estimate of  $\beta$  is again correctly signed and significant,

and its size is somewhere in between the estimates for the UK and the ones of the US reaction function. Estimates of  $\gamma$  are statistically significant but very small in magnitude. Also, for all of these specifications and for each country, the overidentifying restrictions cannot be rejected and hence the Hansen test supports the validity of the instrument set used.

The last four specifications in Panels a) to c) of Table 1 show the results from estimating the forward-looking Taylor rule with arguments in expected inflation and output gap where the relevant measure of the output gap is given by a proxy of real marginal costs. Woodford (2001) argues that this output-gap measure may be more appropriate in this context. Specifications 5 and 6 are estimated using the real marginal cost as a proxy for the output gap, while specifications 7 and 8 consider the real marginal cost adjusted for the wage markup, following the procedure described in Section 2.3. The parameters estimates yield, also in this case, fairly clear results. Whenever we consider real unit labor cost into the interest rate rule, the estimated parameter  $\gamma$  is found to be statistically significant for each country examined, but with the wrong sign. This finding can be heuristically explained by the documented evidence of negative correlation between general measures of output gap and real marginal costs (see, *inter alia*, Gali, Gertler and Lopez-Salido, 2001; Woodford, 2001).

Specifications 7 and 8 are estimated using real marginal costs adjusted for wage markup. As discussed in Section 2.3, this correction circumvents the problem of the negative correlation between real marginal costs and the business cycle. Interestingly, using this measure of real marginal costs, the estimated parameter  $\gamma$  is, for each country, correctly signed (positive) and statistically significant, providing evidence in favor of the adjusted real marginal costs measure (Woodford, 2001).

## 4.2 An augmented forward-looking Taylor rule

Next, we estimate the interest rate rule parameters  $\{\tilde{\beta}, \tilde{\gamma}, \tilde{\phi}, \tilde{\delta}, \tilde{\rho}\}$  for the US and the UK in an augmented forward-looking Taylor rule of the form (3) using CPI inflation and the adjusted real marginal costs as proxies for inflation and output gap respectively, and using the dividend-price ratio and the real effective exchange rate as proxies for stock market and exchange rates disequilibria respectively. The target horizon for the forward-looking variables is assumed to be

one quarter for both inflation and the output gap (i.e.  $k_\pi = k_y = 1$  in equation (3)).

The results of the GMM estimation of equation (3), reported in Table 2, produce estimates of the parameters that are *all* statistically significant and exhibit the expected sign for both the US and the UK. For Japan, the only insignificant parameter is the one associated with asset prices. More precisely, the estimated parameters  $\phi$  and  $\delta$ , associated with asset prices and exchange rates disequilibria respectively, are positive for each country examined, although they are small in absolute value. Interestingly,  $\delta$  is always statistically significant for each country and  $\phi$  is statistically significant for the US and the UK but insignificantly different from zero for Japan.<sup>7</sup> Further the large  $p$ -values of the test for overidentifying restrictions suggest that the instrument set used is valid.

The results in Table 2 also confirm the presence of interest rate inertia (detected in all of our previous specifications and well documented in the relevant literature), as captured by the lagged values of interest rates in equation (3). These findings support the view that the Federal Reserve, the Bank of England and the Bank of Japan smooth the adjustment of interest rates towards their target values (see, *inter alia*, Clarida, Gali and Gertler, 2000; Eijffinger and Huizinga, 2000).

Some recent contributions point out that monetary policy rules estimated over long sample periods may be affected by parameter instability (see, *inter alia*, Oliner, Rudebusch and Sichel, 1996; Rudebusch, 1998, 2001). In order to test for parameter instability, we carried out a Hansen (1992) test for the null hypothesis of parameter stability, applied individually to each of the estimated parameters reported in Table 2. The results, reported in square brackets in Table 2, show that for each country examined the null hypothesis of parameter stability cannot be rejected at conventional statistical significance levels.

Before discussing and further interpreting our empirical results, we report some robustness checks carried out on our baseline estimation results.

---

<sup>7</sup>As discussed in our robustness section below, these findings hold up when using different measures of asset prices disequilibria; see Section 4.3.

### 4.3 Robustness

In order to investigate the robustness of the results in Table 2, we re-estimated equation (3) using alternative measures of inflation, asset prices disequilibria and alternative target horizons for each of the forward-looking variables. As discussed below, in each country and over different specifications, this robustness analysis confirms, at least in a qualitative sense, the findings of our baseline estimates reported in Table 2. Using a different measure of inflation based on the GDP deflator (see Specification 1 of Table 3), the estimated parameters are not qualitatively different from the estimates recorded in Table 2.

In the baseline results discussed in the previous subsection, we assumed that the central banks examined have a one-quarter horizon for each of the forward-looking variables (inflation and output-gap). We examine the robustness of our results to this particular assumption. In particular, we consider in turn the cases in which central banks have a target horizon of up to one year for inflation and up to two quarters for the output gap. This is the horizon often referred to as appropriate in describing the lag with which monetary policy affects the target variables (see Bernanke and Mihov, 1998; Clarida, Gali and Gertler, 2000). The results from estimating equation (3) using these different horizons for the forward-looking variables are reported as Specifications 2-5 in Table 3. These results suggest that, while the estimates of  $\gamma$ ,  $\delta$ ,  $\phi$  are virtually unaffected, the magnitude of  $\beta$  changes. However, the differences across specifications are not marked since the new estimates are always located in the confidence intervals implied by the standard errors of the parameters estimated in previous specifications.

Next we check for robustness the statistical significance of the parameter in the monetary policy rule associated with asset prices, using two different measures of asset prices disequilibria. First we employ a permanent-transitory decomposition as in Cochrane (1994) in order to retrieve transitory deviations from the equilibrium asset price level. Second, following Bernanke and Gertler (1999), we employ lags of the log-differences in asset prices. As we can see in Table 3 (Specifications 6 and 7), the estimates are qualitatively and quantitatively similar to our baseline estimates confirming that for each country the coefficient in the monetary policy rules associated with asset prices disequilibria are small in absolute value but statistically significant at conventional

statistical levels.<sup>8</sup>

Overall, the robustness checks reported here suggest that our baseline estimates given in Table 2 appear to be fairly robust to changes in the proxy for inflation, asset prices disequilibria, and to the choice of the horizon over which the central bank forms expectations of inflation and the output gap for the purpose of implementing monetary policy.

#### 4.4 Discussion

The results of our baseline estimation reported in Table 2 deserve further discussion. To aid our discussion, in Figure 2 we report, for each country examined, the actual value and the estimated target value of the instrument rates implied by Specification 1 in Table 1 and by our baseline estimation reported in Table 2. The target value differs from the fitted value in that the latter incorporates the interest rate smoothing parameters and the former implicitly sets these parameters to zero (as in equation (1)).

The interest rates implied by the estimated rules characterize well the behavior of the instrument rates. Upon examination of Figure 2, we find that the two different specifications (i.e. the standard forward-looking Taylor rule and the augmented forward-looking Taylor rule which allows for both exchange rates and asset prices) are both satisfactory in tracing the dynamics of the instrument rates. Indeed, this simple visual analysis of the models' target predictions suggests that the contribution of the two additional variables allowed for - asset prices and exchange rates disequilibria - is not sufficient to distinguish clearly between the two specifications.

However, looking at Figure 3, where the contribution in percentage terms of each explanatory variable to the target value is shown, provides more insightful information. The graphs in Figure 3 suggest that, even if the level of the implied instrument rate target is very similar to the one implied by the standard forward-looking Taylor rule, the contribution of the different explanatory variables to its determination is different. In each country, central banks set up their targets mainly according to inflation dynamics. However, the other explanatory variables in the augmented policy

---

<sup>8</sup>We also executed the same robustness exercise using the S&P500, FTSE100 and NIKKEI 225 indices for the US, the UK and Japan respectively over a shorter sample period (because of data availability). In addition, we checked whether having asset prices and exchange rates enter the augmented policy rule contemporaneously made a difference. The results, not reported, are qualitatively and quantitatively similar to the ones reported in Tables 2-3.

rule also make some contribution to the instrument rate target determination.

At face value these results may suggest that the Federal Reserve and the Bank of England use asset prices and exchange rates as targets and the Bank of Japan targets exchange rates, implying that they attempt to stabilize these variables in much the same way as they stabilize inflation or output. However, central bankers have often been clear that they do not target asset prices, either because asset prices are not necessarily related to the objectives of monetary policy or because they are only important insofar as they provide information about expected inflation. Alternatively, it could be that targeting asset prices is very difficult in practice given the difficulty of establishing their true equilibrium values (e.g. see Gertler, Goodfriend, Issing and Spaventa, 1999, and the references therein).

Nevertheless, several heuristic explanations can be used to justify our findings, which we present below. First, central banks may lie because there may be gains from secrecy. They might target asset prices and exchange rates but they do not want to admit it - e.g. see the case of foreign exchange intervention operations, which are often secret even though standard theory suggests that official intervention in the foreign exchange market is (more) effective if it is announced (e.g. Sarno and Taylor, 2001).<sup>9</sup>

Second, asset prices that have explanatory power in characterizing interest rate changes are only a proxy for that part of expected inflation and output which is not explained by the instruments used in the GMM estimation. Asset prices play a role in helping to get closer to the central banks forecasting information set. The main implication of this conjecture is that central banks do not target asset prices *per se* but they use them as good information variables (e.g. Clarida, 2001).

Third, central banks stabilize asset prices because they provide some information for aggregate price and output determination outside of their impact on firms' cost schedules. In other words, if asset prices only reflect the expected profit stream that accrues to firms who employ capital and labor at their rental prices and maximize profits subject to marginal costs, then asset prices are irrelevant. However, if asset prices diverge from this path and send incorrect signals to the corporate sector, there may be a *prima facie* case for offsetting this signal.

Finally, under a different perspective, our findings can be justified by the fact that what we are

---

<sup>9</sup>See also the related arguments put forth by Carare and Stone (2003).

depicting in our estimation as a systematic rule may be, in fact, driven by occasional discretionary policy aiming, for example, at curbing bubbles or large misalignments in asset prices and exchange rates. This interpretation finds some support by looking at Figure 3. This figure suggests that asset prices and exchange rates disequilibria are particularly important in determining the interest rate target at times that are easily recognizable as large misalignments. For example, they are clearly recognizable for the US, the period following the 1987 crash of the stock price bubble, the dot-com bubble in the mid to late 1990s, and the appreciation of the dollar in the mid 1980s. For the UK, one could claim that asset prices disequilibria have hardly been economically important, while exchange rates disequilibria have been particularly important in the period around the sterling devaluation of 1992 that characterized the exit of the UK from the Exchange Rate Mechanism, and the protracted sterling appreciation of the mid to late 1990s. For Japan, exchange rates were largely unimportant until 1986 or so, when they became important for some time, and then in the early to mid 1990s, consistent with the results reported by Jinushi, Kuroki and Miyao (2000) and McKinnon and Schnabl (2003).

Overall, it seems to us fair to conclude that, while both asset prices and exchange rates disequilibria are statistically significant in forward-looking Taylor rules, the evidence provided in this section suggests that, although these variables may not be key for *systematic* monetary policy, they induce a response from central banks when misalignments are relatively large.<sup>10</sup>

## 5 Conclusions

We have examined the relationship between short-term interest rates, macroeconomic fundamentals and asset prices and exchange rates in order to estimate monetary policy rules using quarterly data for the 1979-2000 period for the US, the UK and Japan. In particular, we have not only limited

---

<sup>10</sup>Our interpretation that the reaction of central banks to asset prices and exchange rates disequilibria may depend on the size of the disequilibria themselves suggests that a nonlinear characterization of interest rate rules may be a logical extension of our research. The possibility of a nonlinear reaction function can also be rationalized on the theoretical work of Bordo and Jeanne (2002) and is indeed suggested by the earlier work on escape clauses of Flood and Isard (1989). However, a nonlinear generalization is not straightforward in this context since the reaction function would be partly linear - in expected inflation and output gap - and partly nonlinear - in asset prices and exchange rates. To the best of the authors' knowledge, no GMM or instrumental variables estimator exists to date for models of this kind (or indeed for any multivariate threshold model), which makes estimation and statistical inference especially cumbersome in this context.

our analysis to the effects of inflation and output disequilibria on the setting of short-term interest rates, but we have explicitly considered the effects of asset prices and exchange rates disequilibria. Further, a subsidiary issue investigated is the extent to which the output gap is correctly measured in this context. Following the argument that the output-gap measure relevant for monetary policy purposes may be different from the one represented by detrended output (Woodford, 2001), we employed in our analysis real marginal costs as a proxy for the output gap.

By estimating monetary policy rules for each of the US, the UK and Japan we find results which provide some evidence in favor of the conjecture that central banks respond to shifts in real marginal costs, rather than to any shock causing deviations of output from its trend. Further, in contrast with previous literature, we find that the parameters in the monetary rules associated with asset prices and exchange rates disequilibria are statistically significant, yet small, for each of the US and the UK, and exchange rates enter significantly the monetary policy reaction function for Japan. However, our results seem to suggest that asset prices and exchange rates may not be key for systematic monetary policy, albeit representing an important aspect of monetary policy design. In other words, we view our empirical results as suggesting that, in consideration of the risks that large misalignments in asset markets pose to macroeconomic stability and to the soundness of the financial sector, while targeting asset prices and exchange rates has not been a policy goal pursued systematically by the Federal Reserve, the Bank of England and the Bank of Japan, these major central banks have reacted to these variables on a few occasions during the sample. More precisely, this is consistent with the view that, while committed to running monetary policy to keep inflationary pressures under control and to bring output growth in line with potential, major central banks do act in response to exchange rates or asset prices on occasions when there is a need to prevent an abrupt correction in asset markets that could be destabilizing for the economy.

Although our baseline results have been shown to be robust to different specifications and proxy variables, several caveats are in order. Throughout the paper, the estimation of monetary policy rules has been carried out by means of the Generalized Method of Moments. The clear non-rejection of the null hypothesis of a valid instrument set in all our estimations, however, does not rule out the possibility that monetary rules may be misspecified. In particular, it might be



the case that the weights assigned to different targets may be linked in a nonlinear fashion to the arguments in the reaction function, which would be in contrast with the implicit assumption of linearity maintained in conventional forward-looking monetary policy rules. Indeed, if our interpretation that asset prices and exchange rates are economically important in central banks's reaction functions when they are substantially misaligned from their fundamental equilibrium values, then a logical extension of this research involves using nonlinear reaction functions which may explicitly capture this behavior (e.g. see Bordo and Jeanne, 2002, for a theoretical rationale of nonlinearity in this context). Investigation of these issues remains on the agenda for future research.

**Table 1. Standard forward-looking Taylor rule: the role of the output gap**

Panel a) *United States*

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{CPI}, x_t = x_t^Q$	1.688 (0.591)	0.021 (0.328)	0.827 (0.267)	0.253
2. $\pi_t = \pi_t^{CPI}, x_t = x_t^{HP}$	1.764 (0.456)	0.624 (1.887)	0.816 (0.285)	0.192
3. $\pi_t = \pi_t^{GDP}, x_t = x_t^Q$	1.720 (0.426)	-0.021 (0.211)	0.746 (0.257)	0.394
4. $\pi_t = \pi_t^{GDP}, x_t = x_t^{HP}$	1.582 (0.324)	-1.169 (2.943)	0.663 (0.215)	0.998
5. $\pi_t = \pi_t^{CPI}, x_t = LS_t$	1.925 (0.285)	-0.855 (0.332)	0.851 (0.08)	0.085
6. $\pi_t = \pi_t^{GDP}, x_t = LS_t$	2.036 (0.125)	-0.723 (0.143)	-0.830 (0.05)	0.258
7. $\pi_t = \pi_t^{CPI}, x_t = \widehat{LS}_t$	2.205 (0.267)	0.869 (0.387)	0.852 (0.126)	0.471
8. $\pi_t = \pi_t^{GDP}, x_t = \widehat{LS}_t$	2.392 (0.389)	1.073 (0.492)	0.844 (0.228)	0.714

Panel b) *United Kingdom*

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{CPI}, x_t = x_t^Q$	1.039 (0.203)	0.241 (0.185)	0.786 (0.038)	0.067
2. $\pi_t = \pi_t^{CPI}, x_t = x_t^{HP}$	0.984 (0.155)	0.232 (1.653)	0.906 (0.017)	0.412
3. $\pi_t = \pi_t^{GDP}, x_t = x_t^Q$	1.054 (0.228)	0.315 (0.208)	0.738 (0.097)	0.079
4. $\pi_t = \pi_t^{GDP}, x_t = x_t^{HP}$	1.019 (0.253)	0.360 (1.518)	0.814 (0.071)	0.354
5. $\pi_t = \pi_t^{CPI}, x_t = LS_t$	1.457 (0.459)	-0.586 (0.299)	0.790 (0.026)	0.117
6. $\pi_t = \pi_t^{GDP}, x_t = LS_t$	1.271 (0.124)	-0.613 (0.281)	0.846 (0.024)	0.163
7. $\pi_t = \pi_t^{CPI}, x_t = \widehat{LS}_t$	1.086 (0.100)	0.448 (0.174)	0.894 (0.007)	0.999
8. $\pi_t = \pi_t^{GDP}, x_t = \widehat{LS}_t$	1.208 (0.080)	0.596 (0.213)	0.866 (0.012)	0.999

(continued ...)

(... Table 1 continued)

Panel c) Japan

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{CPI}, x_t = x_t^Q$	1.737 (0.259)	0.050 (0.020)	0.972 (0.003)	0.991
2. $\pi_t = \pi_t^{CPI}, x_t = x_t^{HP}$	1.504 (0.182)	0.025 (0.008)	0.970 (0.003)	0.986
3. $\pi_t = \pi_t^{GDP}, x_t = x_t^Q$	1.328 (0.174)	0.005 (0.001)	0.892 (0.028)	0.853
4. $\pi_t = \pi_t^{GDP}, x_t = x_t^{HP}$	1.102 (0.082)	0.014 (0.005)	0.963 (0.003)	0.993
5. $\pi_t = \pi_t^{CPI}, x_t = LS_t$	1.473 (0.549)	-0.023 (0.006)	0.903 (0.035)	0.998
6. $\pi_t = \pi_t^{GDP}, x_t = LS_t$	1.259 (0.196)	-0.009 (0.003)	0.850 (0.029)	0.769
7. $\pi_t = \pi_t^{CPI}, x_t = \widehat{LS}_t$	2.366 (0.389)	0.034 (0.015)	0.946 (0.019)	0.828
8. $\pi_t = \pi_t^{GDP}, x_t = \widehat{LS}_t$	1.854 (0.186)	0.018 (0.008)	0.877 (0.037)	0.921

**Notes:** The estimated parameters refer to equation (2). The interest rates target used are the Federal funds rate, the Bank of England base rate and the call money rate for Japan respectively. The sample period is September 1979-December 2000. The instruments set includes a constant, lagged output gap, inflation, the interest rate and the log-difference of a world commodity price index. Estimates are obtained by GMM with a correction for moving average autocorrelation obtained by two-step nonlinear two-stage least square (Hansen, 1982). The optimal weighting matrix obtained from first step two-stages least square parameter estimates.  $\pi_t^{CPI}$  and  $\pi_t^{GDP}$  are inflation rates measured using the CPI and GDP deflator respectively.  $x_t^Q$  and  $x_t^{HP}$  are measures of the output gap (calculated over the period 1960-2000) obtained by means of quadratic-trend regression and Hodrick-Prescott filter (smoothing parameter set to 1,600) respectively.  $LS_t$  and  $\widehat{LS}_t$  are the labor share (calculated as in the text) and the labor share adjusted for the wage markup respectively. J-test is the test for overidentifying restrictions (Hansen, 1982), which is distributed as  $\chi^2$  under the null. For this test only  $p$ -values are reported.  $\tilde{\rho}$  denotes the sum of the autoregressive parameters associated with the lagged interest rate instrument. Standard errors are reported in parentheses.

**Table 2. Augmented forward-looking Taylor rule: baseline estimates**

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\delta}$	$\tilde{\phi}$	$\tilde{\rho}$	J-test
United States	1.252 (0.195) [0.246]	0.719 (0.229) [0.192]	0.073 (0.009) [0.221]	0.015 (0.005) [0.188]	0.767 (0.040) [0.147]	0.935
United Kingdom	1.034 (0.026) [0.160]	0.542 (0.037) [0.104]	0.056 (0.006) [0.175]	0.007 (0.003) [0.173]	0.889 (0.001) [0.136]	0.999
Japan	1.115 (0.440) [0.122]	0.013 (0.003) [0.386]	0.002 (0.0008) [0.160]	0.0002 (0.0005) [0.179]	0.895 (0.034) [0.332]	0.745

**Notes:** See Notes to Table 1. The estimated parameters refer to equation (3). The sample period is September 1979-December 2000. The baseline specification was estimated using the CPI to measure inflation and the adjusted labor share to measure the output gap. The forward looking horizon for inflation and the output gap is one quarter ( $k_\pi = 1, k_x = 1$ ). The instruments set includes a constant plus four lags of output gap, inflation, the interest rate, log difference of a world commodity price index, real effective exchange rate and dividend-price ratio. Values in brackets are  $p$ -values from executing the Hansen (1992) test statistic for the null hypothesis of parameter stability.

**Table 3. Augmented forward-looking Taylor rule: robustness analysis**

*Panel a) United States*

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\delta}$	$\tilde{\phi}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{GDP}, k_\pi = 1, k_x = 1$	1.226 (0.209)	0.817 (0.135)	0.065 (0.010)	0.011 (0.005)	0.721 (0.069)	0.961
2. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 1$	1.289 (0.215)	0.981 (0.337)	0.075 (0.013)	0.017 (0.007)	0.785 (0.064)	0.946
3. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 1$	1.562 (0.267)	0.824 (0.385)	0.064 (0.014)	0.008 (0.004)	0.719 (0.078)	0.935
4. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 2$	1.048 (0.210)	0.907 (0.278)	0.049 (0.017)	0.022 (0.006)	0.788 (0.069)	0.995
5. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 2$	1.752 (0.116)	0.890 (0.109)	0.046 (0.005)	0.008 (0.004)	0.779 (0.042)	0.999
6. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^C$	2.035 (0.049)	0.796 (0.106)	0.076 (0.008)	0.037 (0.015)	0.765 (0.052)	0.994
7. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^{BG}$	1.561 (0.099)	0.593 (0.139)	0.081 (0.009)	0.036 (0.019)	0.822 (0.037)	0.999

*Panel b) United Kingdom*

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\delta}$	$\tilde{\phi}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{GDP}, k_\pi = 1, k_x = 1$	0.925 (0.013)	0.778 (0.040)	0.075 (0.006)	0.008 (0.002)	0.886 (0.002)	0.998
2. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 1$	1.439 (0.211)	0.423 (0.09)	0.098 (0.013)	0.007 (0.003)	0.892 (0.004)	0.867
3. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 1$	1.553 (0.388)	0.462 (0.014)	0.034 (0.008)	0.006 (0.003)	0.813 (0.003)	0.913
4. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 2$	1.462 (0.343)	0.284 (0.046)	0.036 (0.006)	0.009 (0.005)	0.863 (0.002)	0.999
5. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 2$	1.531 (0.355)	0.269 (0.017)	0.032 (0.008)	0.011 (0.003)	0.816 (0.003)	0.905
6. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^C$	1.041 (0.020)	0.535 (0.034)	0.064 (0.004)	0.023 (0.001)	0.891 (0.001)	0.999
7. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^{BG}$	1.079 (0.044)	0.713 (0.093)	0.028 (0.011)	0.018 (0.002)	0.903 (0.003)	0.998

(continued ...)

(... Table 3 continued)

Panel c) Japan

	$\tilde{\beta}$	$\tilde{\gamma}$	$\tilde{\delta}$	$\tilde{\phi}$	$\tilde{\rho}$	J-test
1. $\pi_t = \pi_t^{GDP}, k_\pi = 1, k_x = 1$	1.094 (0.434)	0.014 (0.001)	0.0012 (0.0005)	0.0001 (0.0006)	0.901 (0.051)	0.811
2. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 1$	1.378 (0.541)	0.012 (0.002)	0.0015 (0.0006)	0.0001 (0.0005)	0.940 (0.049)	0.751
3. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 1$	1.548 (0.543)	0.011 (0.002)	0.003 (0.0012)	0.0001 (0.0004)	0.859 (0.058)	0.765
4. $\pi_t = \pi_t^{CPI}, k_\pi = 4, k_x = 2$	1.277 (0.374)	0.010 (0.002)	0.007 (0.0017)	0.0002 (0.0008)	0.926 (0.051)	0.825
5. $\pi_t = \pi_t^{GDP}, k_\pi = 4, k_x = 2$	1.670 (0.318)	0.010 (0.001)	0.007 (0.0019)	0.0001 (0.0006)	0.894 (0.032)	0.788
6. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^C$	1.564 (0.227)	0.012 (0.001)	0.0012 (0.0005)	0.0003 (0.0014)	0.928 (0.038)	0.825
7. $\pi_t = \pi_t^{CPI}, k_\pi = 1, k_x = 1, s_t = s_t^{BG}$	1.343 (0.441)	0.011 (0.001)	0.009 (0.0035)	0.0003 (0.0018)	0.967 (0.029)	0.827

**Notes:** See Notes to Table 1. The estimated parameters refer to equation (3).  $k_\pi$  and  $k_x$  denotes the forward looking horizon for inflation and the output gap respectively. Standard errors are reported in parentheses.  $s_t^C$  denotes the transitory component calculated as in Cochrane (1994) using *Datastream* stock price indices.  $s_t^{BG}$  denotes the log-differenced changes in the *Datastream* stock price indices (see Bernanke and Gertler, 1999); under  $s_t^{BG}$ , six lags of the log-differences in the stock prices have been used.

## References

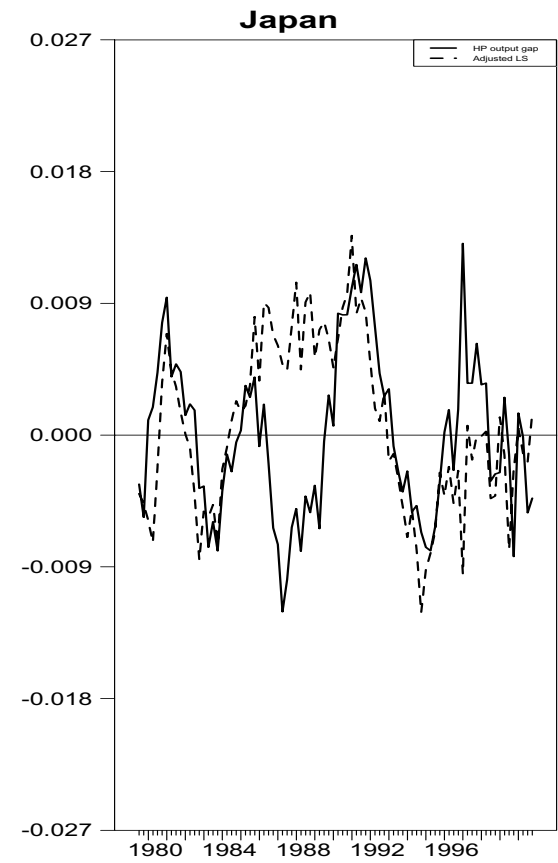
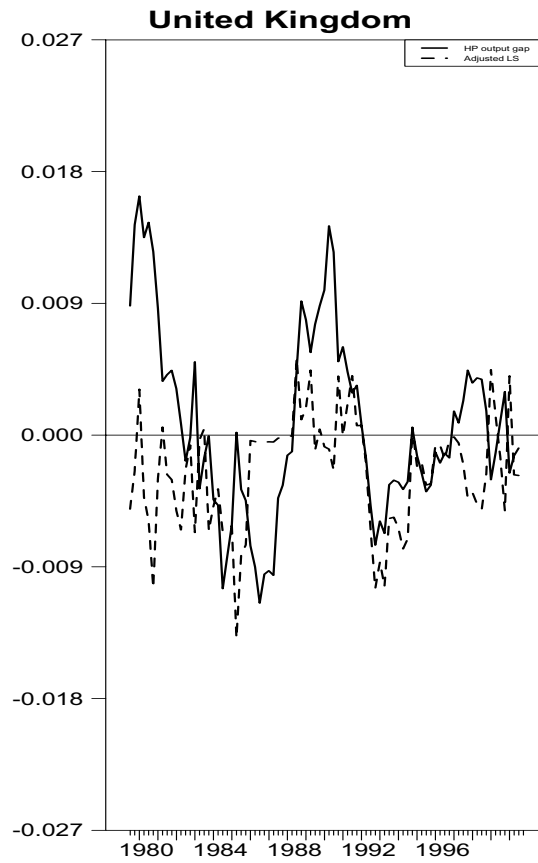
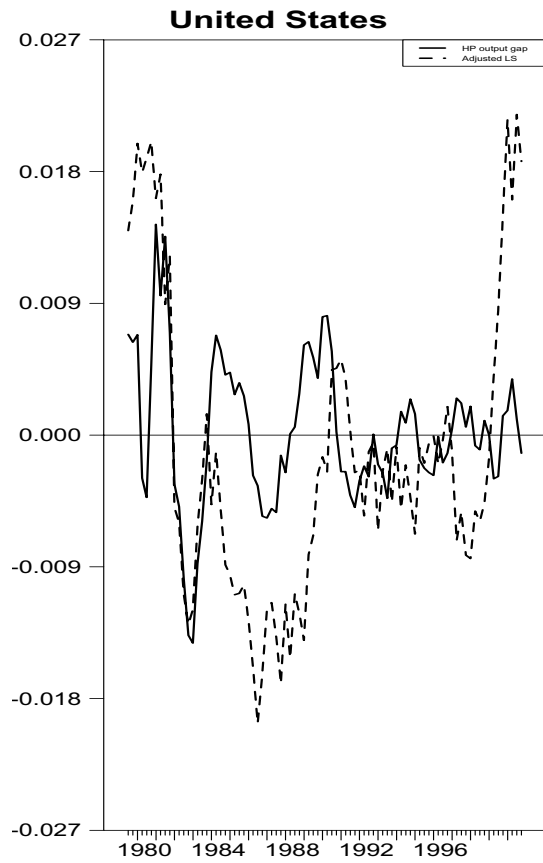
- Batini, N. and Nelson, E. (2000), "When the Bubble Bursts: Monetary Policy Rules and Foreign Exchange Market Behavior," Bank of England, mimeo.
- Baxter, M. and King, R.G. (1999), "Measuring Business Cycles: Approximate Band-Pass Filters for Economic Time Series," *Review of Economics and Statistics*, 81, 575-593.
- Bernanke, B. S. and Gertler, M. (1999), "Monetary Policy and Asset Price Volatility," *Federal Reserve Bank of Kansas City Economic Review*, 84, 17-51.
- Bernanke, B.S. and Gertler, M. (2001), "Should Central Banks Respond to Movements in Asset Prices?," *American Economic Review*, 91, 253-257.
- Bernanke, B.S. and Mihov, I. (1998), "Measuring Monetary Policy," *Quarterly Journal of Economics*, 113, 869-902.
- Bernanke, B.S. and Woodford, M. (1997), "Inflation Forecasts and Monetary Policy," *Journal of Money, Credit, and Banking*, 29, 653-85.
- Bordo, M.D. and Jeanne, O. (2002), "Monetary Policy and Asset Prices: Does 'Benign Neglect' Make Sense?," *International Finance*, 5, 139-164.
- Borio, C.E.V., Kennedy, N. and Prowse, S.D. (1994), "Exploring Aggregate Asset Price Fluctuations Across Countries: Measurement, Determinants and Monetary Policy Implications," *Bank for International Settlements Economic Papers* No. 40.
- Carare, A. and Stone, M.R. (2003), "Inflation Targeting Regimes," International Monetary Fund, mimeo.
- Cecchetti, S.G., Genberg, H., Lipsky, J. and Wadhvani, S.B. (2000), *Asset Prices and Central Bank Policy*, Geneva Reports on the World Economy 2. London: Centre for Economic Policy Research.
- Clarida, R.H. (2001), "The Empirics of Monetary Policy Rules in Open Economies," *International Journal of Finance and Economics*, 6, 315-23.
- Clarida, R.H., Gali, J. and Gertler, M. (1998), "Monetary Policy Rules in Practice: Some International Evidence," *European Economic Review*, 42, 1033-1067.
- Clarida, R.H., Gali, J. and Gertler, M. (1999), "The Science of Monetary Policy: A New Keynesian Perspective," *Journal of Economic Literature*, 37, 1661-1707.
- Clarida, R.H., Gali, J. and Gertler, M. (2000), "Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory," *Quarterly Journal of Economics*, 115, 147-180.
- Cochrane, J.H. (1994), "Permanent and Transitory Components of GNP and Stock Prices," *Quarterly Journal of Economics*, 241-265.
- Eijffinger, S.C.W. and Huizinga, H. (1999), "Should Monetary Policy be Adjusted Frequently?," *Centre for Economic Policy Research Discussion Paper* No. 2074.

- Flood, R. and Isard, P. (1989), "Monetary Policy Strategies," *International Monetary Fund Staff Papers*, 36, pp. 612-32.
- Gali, J. and Gertler, M. (1999), "Inflation Dynamics: A Structural Econometric Analysis," *Journal of Monetary Economics*, 44, 195-222.
- Gali, J., Gertler, M. and Lopez-Salido, D. (2001), "European Inflation Dynamics," *European Economic Review*, 45, 1237-70.
- Gertler, M., Goodfriend, M., Issing, O. and Spaventa, L. (1999), *Asset Prices and Monetary Policy: Four Views*, Centre for Economic Policy Research/Bank for International Settlements Conference Report.
- Gilchrist, S. and Leahy, J.V. (2002), "Monetary Policy and Asset Prices," *Journal of Monetary Economics*, 49, 1, 75-97.
- Goodfriend, M. (1987), "Interest Rate Smoothing and Price Level Trend-Stationarity," *Journal of Monetary Economics*, 19, 335-348.
- Goodhart, C. (2000), "What Weight Should be Given to Asset Prices in the Measurement of Inflation?," London School of Economics, mimeo.
- Greenspan, A. (1999), "Monetary Policy and the Economic Outlook," Testimony Before the Joint Economic Committee, US Congress, June.
- Hansen, B.E. (1992), "Testing for Parameter Instability in Linear Models," *Journal of Policy Modeling*, 14, 517-33.
- Hansen, L.P. (1982), "Large Sample Properties of Generalized Method of Moments Estimators," *Econometrica*, 50, 1029-54.
- Hodrick, R.J. and Prescott, E.C. (1997), "Postwar U.S. Business Cycles: An Empirical Investigation," *Journal of Money, Credit, and Banking*, 29, 1-16.
- Hunt, B. and Rebucci, A. (2003), "The U.S. Dollar Real Exchange Rate and Trade Balance: What Accounts for the 1990s?," Research Department, International Monetary Fund, mimeo.
- International Monetary Fund (2000), *World Economic Outlook*, May issue, Washington, D.C.: International Monetary Fund.
- Jinushi, T. Kuroki, Y. and Miyao, R. (2000), "Monetary Policy in Japan Since the Late 1980s: Delayed Policy Actions and Some Explanations," in Mikitami, R. and Posen, A. (eds.), *Japan's Financial Crisis and Its Parallels to U.S. Experience*, Institute for International Economics, Special Report 13, 115-148.
- Kozicki, S. (1999), "How Useful Are Taylor Rules for Monetary Policy?," *Federal Reserve Bank of Kansas City Economic Review*, 84, 5-33.
- McKinnon, R. and Schnabl, G. (2003), "Synchronized Business Cycles in East Asia: Fluctuations in the Yen/Dollar Exchange Rate and China's Stabilizing Role," *World Economy*, forthcoming.



- Newey, W.K. and West, K.D. (1987), "A Simple, Positive Semi-definite, Heteroskedasticity and Autocorrelation Consistent Covariance Matrix," *Econometrica*, 55, 703-8.
- Obstfeld, M. and Rogoff, K. (1995), "The Mirage of Fixed Exchange Rates," *Journal of Economic Perspectives*, 9, 73-96.
- Oliner, S.D., Rudebusch, G.D. and Sichel, D. (1996), "The Lucas Critique Revisited. Assessing the Stability of Empirical Euler Equations for Investment," *Journal of Econometrics*, 70, 291-316.
- Rigobon, R. and Sack, B. (2003), "Measuring the Reaction of Monetary Policy to the Stock Market," *Quarterly Journal of Economics*, 118, 639-69.
- Rotemberg, J.J. and Woodford, M. (1999), "The Cyclical Behavior of Prices and Costs," in Taylor, J. B. and Woodford, M. (eds.) *Handbook of Macroeconomics*, Volume 1B, 1051-1135.
- Rudebusch, G.D. (1998), "Do Measure of Monetary Policy in a VAR Make Sense?," *International Economic Review*, 39, 907-931.
- Rudebusch, G.D. (2001), "Is the Fed too Timid? Monetary Policy in an Uncertain World," *Review of Economics and Statistics*, 83, 203-217.
- Sarno, L. and Taylor, M.P. (2001), "Official Intervention in the Foreign Exchange Market: Is It Effective and, If So, How Does It Work?," *Journal of Economic Literature*, 39, 839-68.
- Sarno, L. and Taylor, M.P. (2002), "Purchasing Power Parity and the Real Exchange Rate," *International Monetary Fund Staff Papers*, 49, 65-105.
- Sbordone, A. (2002), "Prices and Unit Labor Costs: A New Test of Price Stickiness," *Journal of Monetary Economics*, 49, 265-92.
- Shiller, R.J. (2000), *Irrational Exuberance*, Princeton, NJ: Princeton University Press.
- Svensson, L.E.O. (1997), "Inflation Forecast Targeting: Implementing and Monitoring Inflation Targets," *European Economic Review*, 41, 1111-46.
- Taylor, J.B. (1993), "Discretion Versus Policy Rules in Practice," *Carnegie Rochester Conference Series on Public Policy*, 39, 195-214.
- Taylor, J.B. (1999), *Monetary Policy Rules*, National Bureau of Economic Research Conference Report series. Chicago and London: University of Chicago Press.
- Taylor, J.B. (2001), "The Role of the Exchange Rate in Monetary-Policy Rules," *American Economic Review*, 91, 263-67.
- Woodford, M. (2001), "The Taylor Rule and Optimal Monetary Policy," *American Economic Review*, 91, 232-37.

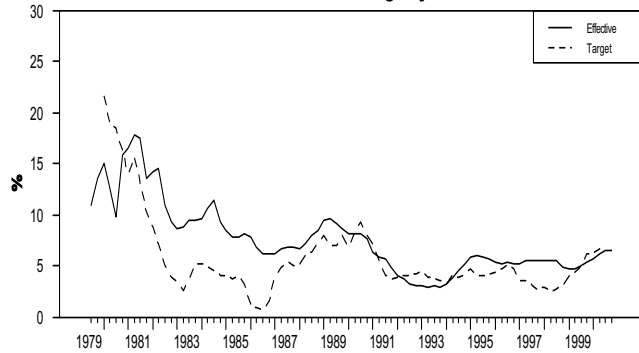
# Figure 1. Output gaps and labor shares



# Figure 2. Interest rates: actual and target

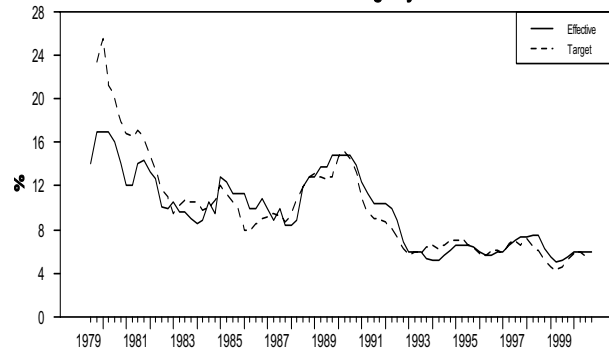
## United States

### Standard forward-looking Taylor rule



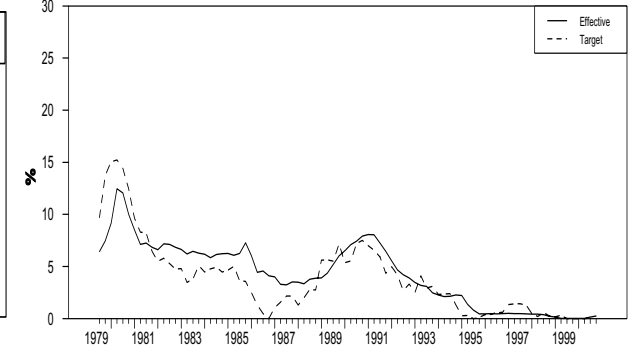
## United Kingdom

### Standard forward-looking Taylor rule

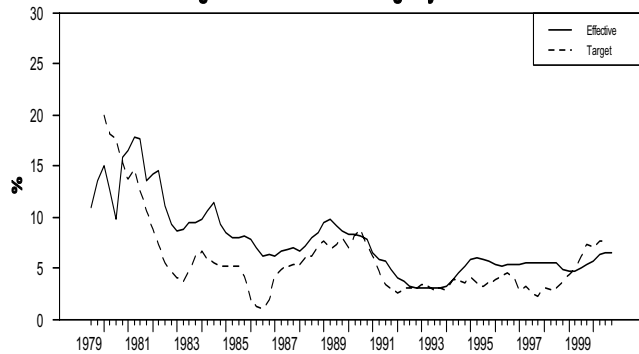


## Japan

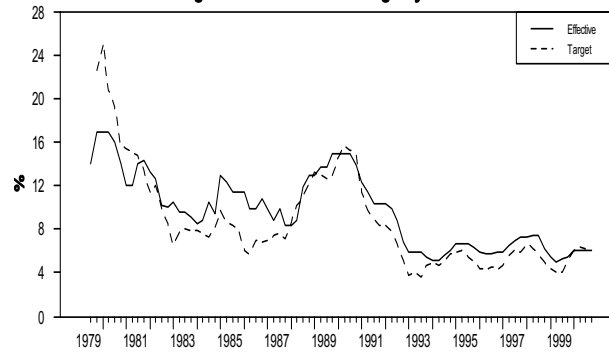
### Standard forward-looking Taylor rule



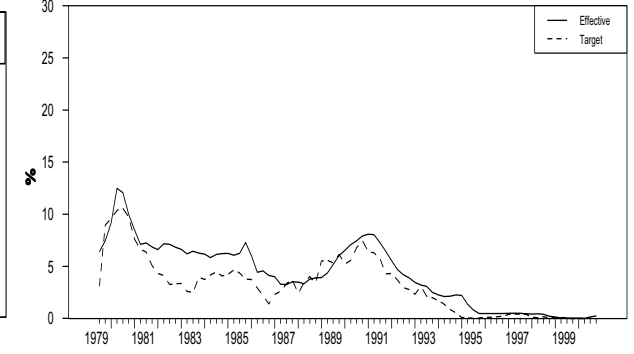
### Augmented forward-looking Taylor rule



### Augmented forward-looking Taylor rule

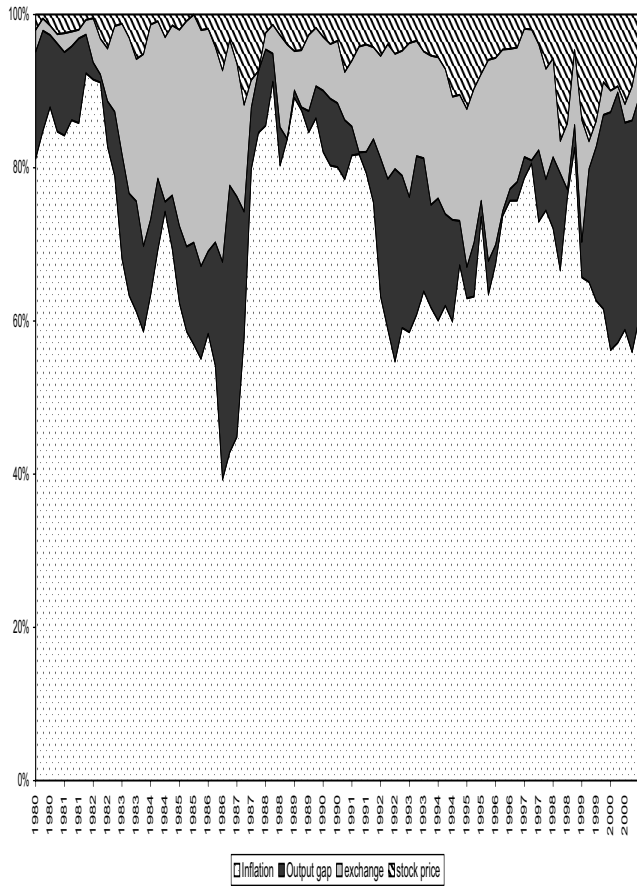


### Augmented forward-looking Taylor rule

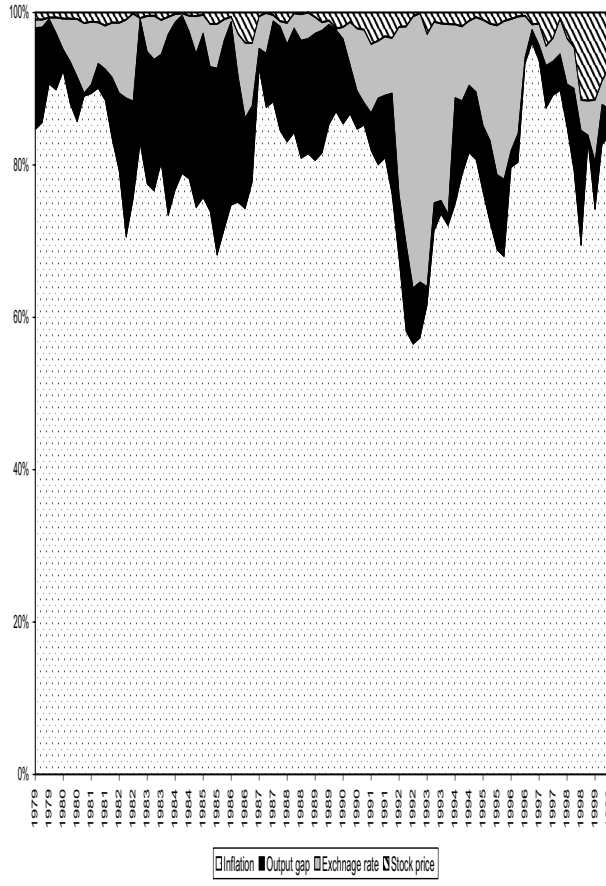


### Figure 3. Interest rates target decomposition

#### United States



#### United Kingdom



#### Japan

