

## **The Relevance of International Spillovers and Asymmetric Effects in the Taylor Rule**

**Joscha Beckmann, Ansgar Belke  
and Christian Dreger**

**No. 403 / February 2015**

---

### **Abstract**

Deviations of policy interest rates from the levels implied by the Taylor rule have been persistent before the financial crisis and increased especially after the turn of the century. Compared to the Taylor benchmark, policy rates were often too low. This paper provides evidence that both international spillovers, for instance international dependencies in the interest rate-setting of central banks, and nonlinear reaction patterns can offer a more realistic specification of the Taylor rule in the main industrial countries. The inclusion of international spillovers and, even more, nonlinear dynamics improves the explanatory power of standard Taylor reaction functions. Deviations from Taylor rates tend to be smaller and their negative trend can be eliminated.

**JEL-Codes:** E43, F36, C22

**Keywords:** Taylor rule, international spillovers, monetary policy interaction, smooth transition models

**CEPS Working Documents are intended to give an indication of work being conducted within CEPS' research programmes and to stimulate reactions from other experts in the field. The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of CEPS.**

ISBN 978-94-6138-447-8

Available for free downloading from the CEPS website (<http://www.ceps.eu>)

© CEPS 2015

## Contents

---

1. Introduction.....	1
2. Deviations from the Taylor rule.....	3
3. Linear specifications of Taylor rules.....	4
4. Nonlinear specifications of Taylor rules.....	6
4.1 Exponential and logistic smooth transition models.....	6
4.2 Choice of the transition variable.....	8
5. Empirical results.....	8
6. Conclusion.....	13
References.....	14

### List of Figures and Tables

Figure 1. Deviations from a linear Taylor rule .....	5
Figure 2. Deviations from a linear Taylor rule including the foreign interest rate.....	6
Figure 3. Deviations from a nonlinear Taylor rule including foreign interest rate.....	10
Table 1. Linear Estimations .....	4
Table 2. Linear Estimations including foreign interest rate.....	6
Table 3. Teräsvirta test for nonlinearity excluding foreign interest rates.....	9
Table 4. Teräsvirta test for nonlinearity including foreign interest rates .....	9
Table 5. Nonlinear estimates based on lagged interest rate changes as transition variable.....	10
Table 6. Nonlinear estimates based on change of the oil price as transition variable .....	11
Table 7. Nonlinear estimates based on the lagged interest rate differential as transition variable.....	12



# The Relevance of International Spillovers and Asymmetric Effects in the Taylor Rule

Joscha Beckmann, Ansgar Belke and Christian Dreger\*

CEPS Working Document No. 403 / February 2015

---

## 1. Introduction

Since the 1980s, central banks switched to policies based on rules, with strong emphasis on price stability. The Taylor rule has become popular to describe the monetary policy stance in both advanced and developing countries (Taylor, 1993). It links policy interest rates to deviations of inflation from its target and real output from its potential. According to the Taylor principle, the central bank should raise the nominal interest rate by more than one percentage point for each 1% increase in inflation. Taylor (1993) emphasised the importance of rule-like behaviour on part of central banks as a key framework to ensure time-consistency, monetary transparency, and independence.

While policy rates have been broadly in line with the Taylor rule during the Great Moderation, they have been persistently moving below it in both advanced and developing countries since the turn of the century. The monetary accommodation implied by these deviations have been blamed as a potential factor in the build-up of imbalances in the period before the financial crisis (Kahn, 2010). Therefore, their explanation is of high academic and policy relevance.

A straightforward extension of the traditional Taylor rule is based on the idea of accounting for *international spillovers*. There are several reasons why international linkages have become more important. On the one hand, declining real interest rates may have introduced an upward bias in the Taylor rule, i.e. an overestimation of nominal interest rates implied by the Taylor rate. Capital inflows from emerging markets to the industrial countries might have led to lower real interest rates, as stated by the savings glut hypothesis. In general, the savings glut was in large part a result of policies that emerging market economies put in place when the global economy started to recover from the 2000-01 recession (Bernanke 2005 and 2007)<sup>1</sup>. Underdeveloped financial markets in the emerging countries restricted the ability of their citizens to borrow against future income and redirected their savings to industrial countries, in particular to the US. Asset shortages triggered a reduction of the equilibrium real interest rates at a global scale (Caballero, Fahri and Gourinchas, 2008). This development might also reflect secular demographic trends in the industrial countries, specifically strong asset demand exerted by the baby boomer generation. A further explanation refers to an increase in the perceived riskiness of capital assets in the wake of asset price booms and busts after the turn

---

\* Belke (Corresponding Author, University of Duisburg-Essen and Centre for European Policy Studies (CEPS Brussels), [ansgar.belke@uni-due.de](mailto:ansgar.belke@uni-due.de). Beckmann: University of Duisburg-Essen and Kiel Institute for the World Economy. Dreger: German Institute for Economic Research (DIW Berlin). We would like to thank the participants of the 2014 annual conference of the German Economic Association (VfS) in Hamburg for their valuable comments.

<sup>1</sup> The argument posits that an excess supply of savings - particularly in emerging Asian countries - helped to generate a US current account deficit as savings had to flow somewhere. The US was the main destination and - due to its huge and non-fragmented bond market - also a capable recipient of the savings. See also Belke and Gros (2014).

of the century. Therefore, *policy interest rates fell below the Taylor rule levels in close synchronisation* across countries. For example, Hofmann and Bogdanova (2012) have argued that deviations from the Taylor rule can be best interpreted as a change in the global equilibrium real interest rate.

A further transmission channel for international spillovers stems from the fact that central banks no longer decide on policy rates in an independent way (Taylor, 2013). While interest rates have been set according to national conditions up to the turn of the century, policy reactions have been increasingly affected by the international environment since then. Hence, the deviations might indicate a substantial shift in the monetary policy regime. Among others, Kim (2000) demonstrated that US monetary policy shocks can affect other countries. Belke and Gros (2005) provided evidence that the ECB followed the Fed in its interest rate decisions. In fact, low US interest rates can increase risk-taking in other countries, and one option to react is to lower interest rates, see Bruno and Shin (2012). In addition, central banks tend to resist large exchange rate appreciations, and adjust their interest rates according to the behaviour of other central banks. Most importantly, the actions of the Federal Reserve Bank have been magnified due to the mimicking responses of other central banks (Gray, 2012). Overall, deviations from a Taylor rule can amplify due to international spillovers (Taylor, 2013).

Deviations can also occur due to *asymmetric behaviour* by the central banks. For example, interest rate reaction functions can be different in expansionary and restrictive periods of monetary policy. This distinction may hold independently of an impact of international spillovers. Asymmetric responses lead to nonlinear Taylor rules as recently proposed by Riedl and Brüggemann (2011), among others. Such explanations might be better able to capture the evolution of policy rates. Expansionary and contractionary monetary decisions might be based on a different set of determinants. In this vein, Alcidi et al. (2009) show that linear Taylor rules fail to detect policy decisions driven by policy-makers' judgment while smooth transition models are well-suited to improve linear Taylor reaction functions.

This paper examines the causes for the deviations from the standard Taylor rule by analysing the *importance of both international spillovers and nonlinearities* for monetary policy decisions in the main industrial countries, i.e. the US, the Euro Area, the UK and Japan. A simple linear benchmark model is chosen as a point of departure and extended step by step. After incorporating international spillovers via foreign interest rates, nonlinear dynamics are examined through a smooth transition approach. Several variables steering the transition between the regimes are considered, such as lagged interest rate changes, the output gap, oil prices and lagged differentials between domestic and foreign interest rates. Our empirical results suggest that both incorporating international spillovers and, even more important, *allowing for nonlinear dynamics* are important to improve the Taylor reaction function to explain actual monetary policy behaviour. International spillovers seem to be more important in periods of increasing interest rates, with the exception of the euro area. This appears consistent with recent evidence by the IMF in its spillover reports in the context of the envisaged Fed's exit from unconventional monetary policies (IMF, 2013).

The remainder of the paper is organised as follows. The next section (Section 2) reviews the Taylor rule specification. Section 3 documents the deviations from the linear model and discusses the extension of the Taylor principle by international spillovers. In Section 4 nonlinear specifications are presented. Section 5 holds the empirical results. Finally, Section 6 concludes with some policy implications.

## 2. Deviations from the Taylor rule

The Taylor rule establishes a linear relationship between the nominal interest rate, inflation and the output gap. In its *standard* form

$$(1) \quad i_t = r^* + \pi^* + \alpha_1(\pi_t - \pi^*) + \alpha_2 y_t + \varepsilon_t$$

$i$  is the nominal policy determined interest rate,  $r^*$  is the long-run equilibrium real interest rate,  $\pi^*$  stands for the central bank's inflation objective,  $\pi$  represents the actual inflation rate, and  $y$  is the output gap, i.e. the deviation of actual and potential output, expressed as a percentage of the latter. The error  $\varepsilon$  fulfils the white noise properties and the index  $t$  denotes time. The parameters describe how strong the policy interest rate should respond to deviations of inflation from its target and of output from its potential. The Taylor rule implies that central banks aim to stabilise inflation around its target and output around its potential. Positive (negative) deviations of the two variables from the respective levels would be associated with a tightening (loosening) of the monetary policy stance. An inflation reaction coefficient ( $\alpha_1$ ) above one ensures that real interest rates respond to inflationary pressures (Taylor, 1993, 1998). In that case an increase in inflation triggers a rise in the real interest rate.

Central banks often prefer to adjust policy rates not instantaneously, but gradually with small, distinct steps in a particular direction. If they partially adjust towards desired levels, *interest rate smoothing* can be incorporated through the inclusion of the lagged policy rate (Judd and Rudebusch, 1998).

$$(2) \quad i_t = \rho i_{t-1} + (1 - \rho)(r^* + \pi^* + \alpha_1(\pi_t - \pi^*) + \alpha_2 y_t) + \varepsilon_t$$

The higher the weight of the lagged policy rate, the slower is the adjustment to intended interest rate levels.<sup>2</sup> The lagged interest rate could be also seen as a proxy of further determinants of the policy rate which are less important and therefore excluded from the specification. Equations (1) and (2) are *ex post* specifications of the Taylor rule, i.e. setting of interest rates is conditional to contemporaneous inflation and the output gap. If monetary policy acts with a delay of  $k$  periods, a forward-looking (ex-ante) specification

$$(3) \quad i_t = \rho i_{t-1} + (1 - \rho)(r^* + \pi^* + \alpha_1(E_t \pi_{t+k} - \pi^*) + \alpha_2 E_t y_{t+k}) + \varepsilon_t$$

may be more appropriate, where  $E$  denotes the rational expectations operator (Clarida, Galí and Gertler, 2000). Nominal interest rates depend on their past levels, the expected deviations of inflation from its target and output from its long run potential. Expectations exploit all information available at time when the prediction is made. Nominal interest rates fluctuate around a constant equilibrium level, the latter defined as the sum of the real interest rate and the inflation target. It should be noted, that the Taylor rule acts as a rule of thumb and leaves out many factors that might be actually relevant for monetary policy, for example, the risk that the policy rate hits the zero lower bound.

Many empirical studies demonstrated that monetary policy of advanced countries can, to a lesser or larger extent, be explained by this kind of reaction function. Despite of the persistence of policy rates, the reaction coefficient of the inflation gap tends to be larger than unity and to exceed the coefficient of the output gap, especially in more recent periods of monetary history.

<sup>2</sup> In contrast, nominal interest rates have been cut aggressively towards the zero lower bound during the global financial crisis to avoid output losses, especially after the Lehman collapse (see Gerlach and Lewis, 2011).

Moreover, forward-looking models seem to fit the actual behaviour of central banks slightly better than contemporaneous versions. For example, Orphanides (2001, 2003) used real-time instead of ex-post revised data. As the main interest in the relevance of international spillovers and nonlinearities, a distinction between real time and revised estimates is less important in this paper, as these issues are relevant in both datasets.

Since the turn of the century, however, deviations of actual policy rates from the Taylor rule increased. In particular, actual nominal interest rates fell persistently below the levels implied by the Taylor rule, suggesting a loose stance of monetary policy in the period before the financial crisis. According to Clarida (2012), the differences turn out to be slightly smaller if ex ante rates are considered. But the deviations might have also been caused by the omission of explanatory factors, such as international spillovers and asymmetric policy responses (Taylor, 2013). Note in this context that an exclusion of relevant variables might erroneously be interpreted as a change in the reaction coefficients with regard to the other variables, i.e. inflation and the output gap. Hence, we have to look at international spillovers and nonlinearities.

### 3. Linear specifications of Taylor rules

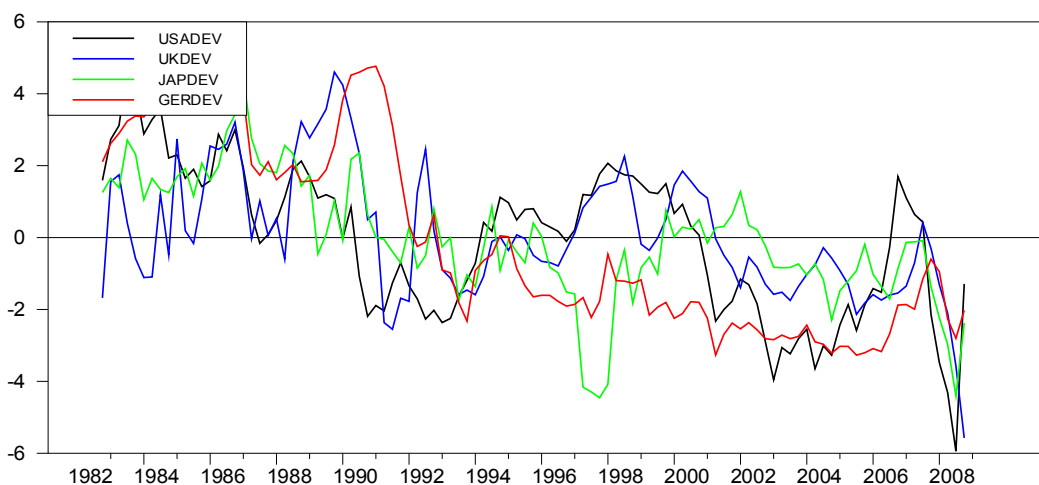
Quarterly data are obtained from the OECD Main Economic indicators and cover the 1982:1 to 2008:4 period. In contrast to, for instance, Belke and Klose (2013), our main aim is to consider the period of conventional monetary policy, as in Taylor (2013). The starting point of our analysis is motivated by the end of the so-called ‘pseudo monetarism’ policy of the Fed (Timberlake, 1993). As said, we exclude the developments during the recent financial crisis as the main interest is in the deviations from the rule prior to the crisis. Three months interbank interest rates are used. Inflation is measured as the percentage of the quarter-on-quarter change of prices inflation, i.e.  $100 \cdot \log(p_t/p_{t-1})$ , where  $p$  denotes the consumer price index. Potential output is obtained by the HP Filter ( $\lambda = 1600$ ) applied to real GDP. The output gap is then determined by the difference between actual and potential GDP, expressed as a percentage of the latter. An output gap beyond (below) 100 percent thus indicates excess (under-) utilization of capacity.

Table 1. Linear Estimations

	Constant	Gap	INFG	$\Delta I_{t-1}$	$\Delta I_{t-2}$
US	3.983*** [10.979]	0.087 [0.460]	1.323*** [5.901]	-0.309 [-0.851]	-0.346 [-0.794]
UK	5.824*** [27.830]	0.063 [0.365]	1.206*** [10.229]	0.220 [0.805]	0.119 [0.496]
Japan	4.767*** [14.912]	0.080 [0.774]	1.761*** [12.297]	-0.561 [-1.208]	-0.388 [-0.838]
Euro area	2.601 [6.745]	-0.043 [-0.29854]	0.807 [2.549]	0.5780 [0.863]	0.5567 [0.876]

Note: \* Statistical significance at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. T-values are given in parentheses.

Figure 1. Deviations from a linear Taylor rule



The analysis is conducted for the US, the euro area, the UK and Japan. As official euro area series are not available before 1999, German data are used instead in the previous period and the series in the following period are denoted as “euro area” data. See also von Hagen and Fratianni (1990) for this strategy. As a starting point, the linear Taylor rule is estimated via OLS and taken as a benchmark. To account for partial adjustment and serial correlation, the first two lagged interest changes are also included (Table 1).

The estimated coefficients are in line with theoretical predictions. Nonetheless, the output gap coefficient can be frequently considered as insignificant because of high standard errors. The inspection of the deviations from the respective country-specific rules shows that the Taylor principle is a reasonable approximation of monetary policy until the turn of the century, more or less (Figure 1). Outliers during the 1990s might be explained by particular events such as the start of the deflationary period in Japan. However, the limitations of the standard model became more pronounced since then. Therefore, explicitly taking into account international spillovers and asymmetric adjustment of central banks might be envisaged to capture monetary policy behaviour.

To control for international spillovers, we extend the Taylor reaction function by adding the foreign interest rate. The latter is proxied by the US rate for the euro area, the UK and Japan. For the US, we employ a linear combination of interest rates in the euro area, UK and Japan. The weights used for this purpose reflect the relevance of the respective currencies in the international reserves held by the US. It should be noted that the evidence exhibited in Table 2 is robust to this choice.<sup>3</sup>

<sup>3</sup> Detailed results are available from the authors upon request.

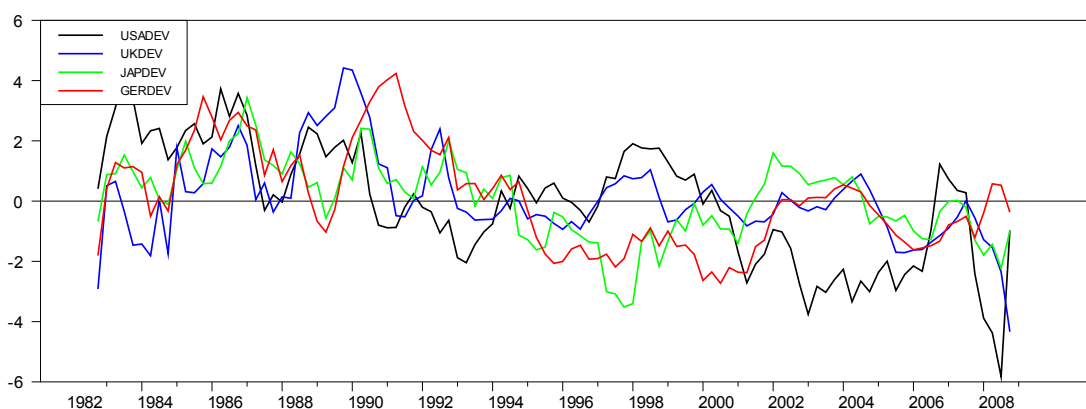


Table 2. Linear Estimations including foreign interest rate

	Constant	Gap	INFG	$\Delta I_{t-1}$	$\Delta I_{t-2}$	$if_{t-1}$
US	4.455*** [13.026]	0.153 [0.798]	1.395*** [6.330]	-0.233 [-0.0756]	-0.315 [-0.816]	0.323*** [3.107]
UK	3.666*** [7.009]	0.158 [1.065]	0.751*** [7.935]	-0.014 [-0.056]	-0.134 [-0.627]	0.467*** [4.641]
Japan	1.227* [1.792]	0.175 [2.293]	1.124*** [5.987]	-0.978** [-2.529]	-0.818 [-2.148]	0.476*** [10.979]
Germany	2.373*** [4,675]	0.019 [0.197]	0.6634* [3.083]	0.5635 [1.429]	-0.3954 [-0.998]	0.368*** [3.931]

Note: \* Statistical significance at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. T-values are given in parentheses.

Figure 2. Deviations from a linear Taylor rule including the foreign interest rate



Compared to the standard model, the coefficients of inflation and output are largely unchanged except for the euro area where the output gap becomes significant, although with a wrong sign. The foreign interest rate is highly relevant for each economy, except for the US where the coefficient is significant but of small size. Hence, the US monetary policy might matter for other countries, but not vice versa. The deviations from the rule displayed in Figure 2 have declined, but they are still pronounced even in the extended model. Hence, the inclusion of international spillovers is not sufficient to solve the puzzle. Therefore, nonlinear dynamics are considered as a further improvement.

## 4. Nonlinear specifications of Taylor rules

### 4.1 Exponential and logistic smooth transition models

Smooth regression models suggested by Teräsvirta (1994, 1998) provide a convenient framework to capture nonlinear dynamics in the Taylor reaction function (see Alcidi et al., 2009 and Brüggemann and Riedel, 2012). Compared to specifications with discrete structural

breaks, these models allow for gradual change between two regimes. In the extended Taylor rule specification

$$(4) \quad i_{t=}[ \alpha_1 + \beta_1(y_t) + \beta_2(\pi_t - \pi_t^*) + \beta_3(i_{t-1}^*) ] + [ \beta_1'(y_t) + \beta_2'(\pi_t - \pi_t^*) + \beta_3'(i_{t-1}^*) ] F(z_t, \gamma, c) + u_{t+k},$$

$F(z_t, \gamma, c)$  is a transition function which ascertains the speed of adjustment between the regimes and can have either a logistic or an exponential shape. The coefficients  $\alpha_1$  and  $\beta_i$  correspond to the lower regime, and  $(\alpha_1 + \alpha_1')$  and  $(\beta_i + \beta_i')$  to the upper regime (van Dijk et al., 2002). An exponential and a logistic transition function are close substitutes and relate to distinct patterns of nonlinearity. A logistic transition allows for different parameters above and below a threshold, while an exponential transition accounts for a distinction between small and large deviations from a threshold. The choice between the alternatives can be made according to economic arguments. For example, if the aim is to distinguish between regimes of increasing and decreasing interest rates, a logistic transition could be adopted. Brüggemann and Riedl (2011) and Alcidi et al. (2009) have provided evidence that the logistic smooth transition approach is a viable alternative to linear monetary policy reaction functions. However, exponential specifications might be preferred if the transition between the regimes relies on some kind of interest rate differential.

To explain the underlying dynamics, consider the case where  $F(z_t, \gamma, c)$  is a continuous *logistic* transition function bounded between 0 and 1:

$$(5) \quad F(z_t, \gamma, c) = [1 + \exp(-\gamma(z_t - c)/\sigma_{z_t})]^{-1} \quad \text{with } \gamma > 0.$$

It implies that the lower (upper) regime is associated with negative (positive) values of the transition variable  $z_t$  relative to the location parameter  $c$ . The logistic function rises monotonically from 0 to 1 as the transition variable increases, i.e.  $F(z_t, \gamma, c) \rightarrow 0$  as  $z_t \rightarrow -\infty$  and  $F(z_t, \gamma, c) \rightarrow 1$  as  $z_t \rightarrow +\infty$ , while it is equal to 0.5 if  $z_t = c$ . The location parameter can be interpreted as a threshold dividing equation (4) into three different extreme regimes corresponding to  $\lim_{z_t \rightarrow -\infty} F(z_t, \gamma, c)$ ,  $\lim_{z_t \rightarrow +\infty} F(z_t, \gamma, c)$  and  $z_t = c$ . In the case of  $z_t = c$ , equation (4) reduces to the linear model (3), where  $\alpha = \alpha_1 + 0.5\alpha_2$  and  $\beta = \beta_i + 0.5\beta_i'$ . Moreover, the smoothness parameter  $\gamma$  controls the speed of transition between the extreme regimes (Baillie and Kilic, 2006).

The second possibility we consider for some specifications corresponds to  $F(z_t, \gamma, c)$  as a bounded continuous *exponential* transition function which lies between 0 and 1 and thus has the following functional form:

$$F(z_t, \gamma, c) = 1 - \exp(-\gamma(z_t - c)^2/\sigma_{z_t}) \quad \text{with } \gamma > 0 \quad (6)$$

where  $z_t$  indicates the transition variable,  $\sigma_{z_t}$  represents its standard deviation,  $\gamma$  denotes a slope parameter and  $c$  is a location parameter. The transition function given by Equation (6) is symmetrically U-shaped as  $F(z_t, \gamma, c) \rightarrow 1$  for  $z_t \rightarrow \pm\infty$  and  $F(z_t, \gamma, c) \rightarrow 0$  for  $z_t = c$ . Hence, the adjustment for deviations of the transition variable  $z_t$  above and below  $c$ , which can be interpreted as a threshold value, is symmetric, as opposed to the logistic case mentioned below. The slope parameter  $\gamma$  determines the speed of the transition between the extreme regimes, with lower absolute values implying slower transition.

## 4.2 Choice of the transition variable

By modelling the dynamics in a nonlinear form, transition variables need to be specified in advance. As the results might depend on this selection, different transition variables should be considered to assess the robustness of the results. A straightforward choice is the *lagged change of the interest rate* compared to the threshold  $c$  which is restricted to be zero. In this case, the different regimes correspond to periods of declining or rising interest rates, i.e. to different stances of the business cycle and/or different stances of monetary policy (negative change for expansionary and positive change for contractionary policy). As an alternative, the *lagged output gap* is selected to control for the possibility that monetary policy might be influenced by different phases of the business cycle. To account for potential determinants related to international spillovers due to, for example, the uncovered interest rate parity, the *lagged differential between the domestic and the foreign interest rate* is considered. In this case we take into account that central banks (such as the ECB most recently) may be interested in exchange rate stabilization by setting their policy rates. Finally, *lagged oil price changes* might – according to the savings glut hypothesis – steer the transition between the regimes (Belke and Gros, 2014). Revenues of oil exporters increase in case of rising oil prices. The recycling of petrodollars by purchases of US Bonds might drive US and worldwide interest rates down, resulting in international monetary policy coordination.<sup>4</sup> To assess the robustness of the results, we consider all choices of transition variables in the analysis.

## 5. Empirical results

To establish the presence of nonlinear effects in the Taylor rule we conduct a Lagrange multiplier test (Luukonen et al., 1988). Under the null hypothesis a linear model is assumed. If the linear specification in terms of the transition variable

$$(6) \Delta i_{t+k} = \varphi_0 + \varphi_1(c_t) + \varphi_2(c_t)z_t + \varphi_3(c_t)z_t^2 + \varphi_4(c_t)z_t^3 + \epsilon_{t+k}$$

is valid, the coefficients  $\varphi_i$  should be equal to 0 for  $i=2,3,4$ . Linearity is rejected if at least  $\varphi_i$  is different from 0 implying that the higher order terms are significant. The test statistic is distributed as Chi-squared with 3 degrees of freedom. Our findings for the two Taylor-rule specifications, excluding or including foreign interest rates, are shown in Tables 3 and 4.

The *linear* specifications are *rejected* if lagged interest rate changes, the interest rate differential and oil price changes are chosen as transition variables. Note that these results are obtained for both specifications in most of the cases. Hence, spillovers are relevant. Since nonlinear effects are, however, less visible for the output gap if the foreign interest rate is included (Table 4), the output gap is no longer considered as a potential transition variable. We have gained substantial evidence of non-linearity, because linearity has been rejected. The true transition variable is not known; the output gap is, however, not suitable for that. Nonlinear effects are important to explain monetary policy behaviour for all economies.

<sup>4</sup> Lagged transition variables are preferred. In case of contemporary values the central bank would not be able to react to, for instance, change in oil prices in the same period.

Table 3. *Teräsvirta test for nonlinearity excluding foreign interest rates*

<b>j</b>	<b>UK</b>	<b>US</b>	<b>Japan</b>	<b>Germany/Eurozone</b>
<i>di</i> ( <i>t</i> - 1)	(0.000) **	(0.000) ***	(0.002) ***	(0.000) ***
<i>di</i> ( <i>t</i> - 2)	(0.003) ***	(0.000) ***	(0.000) ***	(0.046) ***
<i>gap</i> ( <i>t</i> - 1)	(0.031) **	(0.000) ***	(0.028) **	(0.000) ***
<i>gap</i> ( <i>t</i> - 2)	(0.009) ***	(0.004) **	(0.084) *	(0.000) ***
<i>doil</i> ( <i>t</i> - 1)	(0.517)	(0.001) **	(0.008) ***	(0.086) *
<i>doil</i> ( <i>t</i> - 2)	(0.192)	(0.014) **	(0.015) **	(0.288) ***
<i>id</i> ( <i>t</i> - 1)	(0.541)	(0.000) ***	(0.076) *	(0.002) ***
<i>id</i> ( <i>t</i> - 2)	(0.693)	(0.000) ***	(0.168)	(0.009) ***

*Note:* The table displays the p-Values of the LM test for nonlinearity as described in Section 3.3 for the lagged changes in interest rates, the lagged output gap, the lagged change in oil prices and the lagged interest rate differential. The test is distributed as  $\chi^2$  with three degrees of freedom. For details, see Teräsvirta (1998). \*/\*\*/\*\* implies rejection of the null hypothesis at the 10/5/1% significance level.

Table 4. *Teräsvirta test for nonlinearity including foreign interest rates*

<b>j</b>	<b>UK</b>	<b>US</b>	<b>Japan</b>	<b>Germany/Eurozone</b>
<i>di</i> ( <i>t</i> - 1)	(0.034) **	(0.000) ***	(0.001) ***	(0.007) ***
<i>di</i> ( <i>t</i> - 2)	(0.000) ***	(0.000) ***	(0.001) ***	(0.001) ***
<i>gap</i> ( <i>t</i> - 1)	(0.508)	(0.000) ***	(0.061) *	(0.386)
<i>gap</i> ( <i>t</i> - 2)	(0.678)	(0.000) ***	(0.031) ***	(0.087) *
<i>doil</i> ( <i>t</i> - 1)	(0.007) ***	(0.014) **	(0.076) *	(0.000) ***
<i>doil</i> ( <i>t</i> - 2)	(0.000) ***	(0.009) ***	(0.025) **	(0.000) ***
<i>id</i> ( <i>t</i> - 1)	(0.000) ***	(0.000) ***	(0.000) ***	(0.000) ***
<i>id</i> ( <i>t</i> - 2)	(0.000) ***	(0.000) ***	(0.000) ***	(0.000) ***

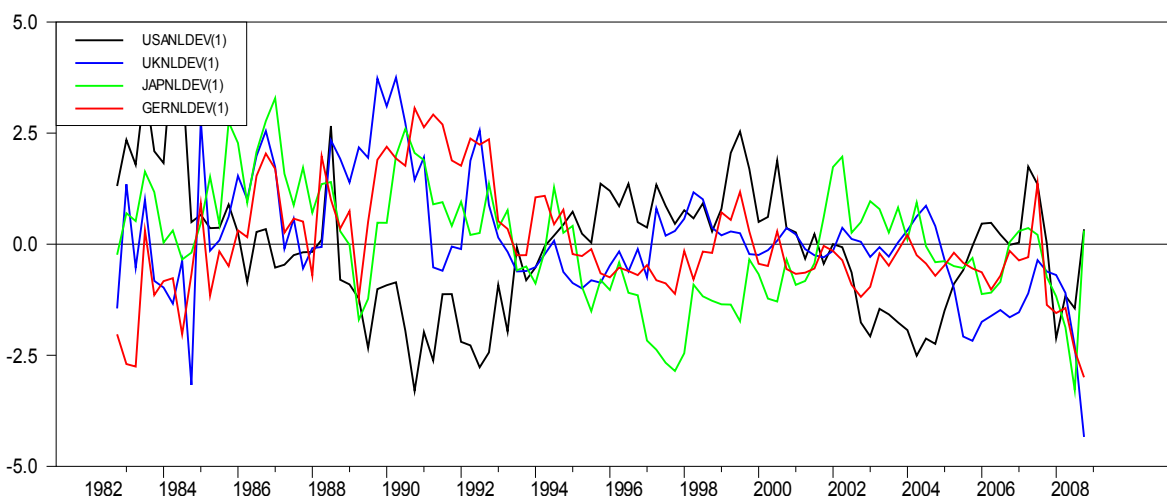
*Note:* The table displays the p-Values of the LM test for nonlinearity as described in Section 3.3 for the lagged changes in interest rates, the lagged output gap, the lagged change in oil prices and the lagged interest rate differential. The test is distributed as  $\chi^2$  with three degrees of freedom. For details, see Teräsvirta (1998). \*/\*\*/\*\* implies rejection of the null hypothesis at the 10/5/1% significance level.

The nonlinear findings for the three transition variables (the lagged change of the interest rate, the lagged differential between the domestic and the foreign interest rate, and the lagged oil price changes) are reported in Tables 5 to 7. They are based on nonlinear least squares (NLS). Note that we pre-select a logistic transition function for each transition variable except for the interest rate differential where an exponential function can be more appropriate. We feel legitimised to do so because bigger interest rate differentials influence carry trades and Japan's interest differential has been negative since the 1990s.<sup>5</sup> In line with the results from the nonlinearity tests, the Taylor coefficients frequently differ between the regimes. Overall,

<sup>5</sup> The results of the logistic specification are available on request.

Figure 3 reveals that the inclusion of international spillovers and, even more, nonlinear dynamics improves the explanatory power of the standard Taylor reaction function. This can be inferred from smaller deviations of the interest rates from the Taylor levels. In comparison both Figures 1 and 2 seem to include a negative trend that can be eliminated by taking nonlinearities into account.

Figure 3. Deviations from a nonlinear Taylor rule including foreign interest rate



Note: Logistic specification based on lagged interest rate change as a transition variable.

Table 5. Nonlinear estimates based on lagged interest rate changes as transition variable

Country	$\alpha_0$	$\alpha_1$	$\beta_1$	$\beta_1'$	$\beta_2$	$\beta_2'$	$\beta_3$	$\beta_3'$	$\gamma_1$
UK	3.858*** [5.055]	-0.261 [-0.504]	0.506*** [3.759]	0.577** [-2.556]	1.027*** [15.336]	-0.386 [-1.552]	0.257** [2.514]	0.361** [2.478]	3.014 [1.144]
US	0.372 [0.312]	1.237 [1.176]	0.411*** [0.637]	0.712** [-1.275]	-0.513 [0.994]	-0.159 [-0.540]	0.513*** [2.790]	0.100 [0.835]	5.048 [1.489]
Japan	2.885*** [5.665]	-3.167*** [-4.127]	0.046 [0.485]	0.146 [1.466]	1.326*** [7.789]	-0.352 [-1.080]	0.330*** [6.945]	0.292*** [3.617]	46.656* [1.671]
Eurozone	3.431*** [4.546]	-3.448*** [-5.468]	-0.181** [-2.154]	0.373*** [6.188]	0.633*** [5.070]	0.398* [1.947]	0.024 [0.419]	0.915*** [9.014]	1.490*** [2.935]

Note: \* Statistical significance at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. The coefficients are estimated by nonlinear least squares. T-values are given in parentheses. Logistic specification of the transition function. Coefficients refer to eq. (4).

We now elaborate on the results for the different specifications with respect to the choice of the transition variable. We start with the case of lagged interest rate changes as the transition variable (case 1). The first regime corresponds to decreasing interest rates while the second

corresponds to increasing interest rates. In the first regime, the output gap is positively signed for the US and the UK (coefficient  $\beta_1$  in Table 5, 3rd column).<sup>6</sup> While the output gap is not significant for Japan, a negative impact of this variable is found for the euro area, which is striking. The inflation coefficient  $\beta_2$  turns out to be significant and positive for the UK, the euro area and Japan, but insignificant for the US (Table 5, 5th column). The coefficient  $\beta_3$  of the lagged foreign interest rate is estimated with a positive sign and turns out to be significant in all cases except for the euro area (Table 5, 7th column). More or less, the signs of the estimated parameters are in line with theoretical predictions except for the euro area. The results imply that the Fed, and the Bank of England are guided by business cycle considerations even if the interest rates have decreased over the previous quarter.

In a regime of increasing interest rates ( $\beta_1 + \beta_1'$ , Table 5, 3rd plus 4th column), the impact of the output gap becomes negative for the UK and the US while the variable is still not important for Japan. An interesting result is that the output gap coefficient for the euro area turns out to be positive now, as expected from theory. For Japan, the euro area and the UK, the lagged US interest rate becomes increasingly significant ( $\beta_3 + \beta_3'$ , Table 5, 7th and 8th column). In contrast no difference is observed for the US. Overall, these findings show that periods of decreasing interest rates are more influenced by output developments, while the importance of international spillovers increases in periods of rising interest rates.

The result suggests that coordination of monetary policy is closer in periods of rising interest rates. It appears consistent with recent evidence by the IMF in its spillover reports in the context of the envisaged Fed's exit from unconventional monetary policies (IMF, 2013). The pattern that the monetary policy reaction in the euro area is only linked to domestic developments in times of increasing interesting rates might be traced back to the period after the German unification when the Bundesbank raised interest rates to fight inflationary pressure as a result of accelerating capacity rates. As outlined above, the Bundesbank was a leading example for monetary policy guided by price stability within the sample until 1999.

Table 6. Nonlinear estimates based on change of the oil price as transition variable

Country	$a_0$	$a_1$	$\beta_1$	$\beta_1'$	$\beta_2$	$\beta_2'$	$\beta_3$	$\beta_3'$	$\gamma_1$
UK	4.392*** [4.008]	-1.079 [-0.561]	0.959 [1.483]	-1.592 [-1.202]	0.746*** [9.264]	0.117 [0.565]	0.394** [2.449]	0.060 [0.210]	2.574 [0.953]
US	1.954*** [2.473]	-0.571 [-1.087]	0.332 [0.824]	-0.621* [1.966]	1.022** [3.547]	0.675** [-4.245]	0.385*** [3.107]	0.106* [1.529]	74.012 [0.779]
Japan	2.026*** [3.924]	-0.708 [-1.381]	0.0514 [0.403]	0.138 [0.832]	1.0285*** [6.782]	0.337* [1.750]	0.3705*** [7.006]	0.146** [2.387]	19.848 [0.737]
Eurozone	3.528*** [3.716]	-1.900*** [-5.173]	0.146*** [2.680]	-0.167 [-1.450]	0.724*** [4.502]	-0.164 [-0.808]	0.177 [1.645]	0.330*** [5.076]	20.561 [1.279]

Note: \* Statistical significance at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. The coefficients are estimated by nonlinear least squares. T-values are given in parentheses. Logistic specification of the transition function. Coefficients refer to eq. (4).

<sup>6</sup> Note again that, according to eq. (4), the total effect is  $\beta_1 + \beta_1'$ .

Turning to the *oil prices as the transition variable* (case 2), we now distinguish between decreasing and increasing oil prices (Table 6). In case of decreasing oil prices, the inflation coefficient turns out to be significant for all economies ( $\beta_2$ , Table 6, 5<sup>th</sup> column). Inflation becomes less important for the US and more important for Japan in case of positive oil price changes ( $\beta_2+\beta_2'$ , Table 6, 5<sup>th</sup> plus 6<sup>th</sup> column). For the euro area the inflation impact stays positive. As before, the importance of foreign interest rates increases in periods of rising oil prices for the US, Japan and the euro area ( $\beta_3+\beta_3'$ , Table 6, 7<sup>th</sup> and 8<sup>th</sup> column). The impact of the foreign interest rate for the UK is the same in both regimes.

Finally, we turn to case 3 in which the *lagged (home versus foreign) interest rate differential* is chosen as the *transition variable* (Table 7). Since we rely on an *exponential function*, the *first regime* corresponds to a *small* interest rate differential relative to the US while the *second regime* corresponds to a *large* interest rate differential. For the UK, the coefficients for the output gap and inflation are well signed for a small interest rate differential ( $\beta_1$  and  $\beta_2$ , Table 7, 3<sup>rd</sup> and 5<sup>th</sup> column). However, large interest rate differentials are associated with wrongly signed coefficients ( $\beta_1+\beta_1'$  and  $\beta_2+\beta_2'$ , Table 7, 4<sup>th</sup> and 6<sup>th</sup> column). A similar pattern can be observed for the inflation coefficient of Japan. However, the output gap coefficient of Japan is correctly signed for a large interest rate differential ( $\beta_1+\beta_1'$ , Table 7, columns 3 and 4), it is wrongly signed for a small interest rate differential ( $\beta_1$ , Table 7, 3<sup>rd</sup> column). In addition, international interest rate spillovers appear to be stronger for a large interest rate differential in case of Japan ( $\beta_3+\beta_3'$ , Table 7, 7<sup>th</sup> and 8<sup>th</sup> column). The picture for the euro area is different (Table 7, 4<sup>th</sup> row, a negative coefficient for the output gap and an insignificant inflation coefficient are observed in case of small interest rate differentials ( $\beta_1$  and  $\beta_2$ ). Large interest rate differentials lead to a positive inflation coefficient ( $\beta_2+\beta_2'$ ) while the importance of the US interest rate decreases ( $\beta_3+\beta_3'$ ). In general, US monetary policy shows less evidence of regime switches (Table 7, 2<sup>nd</sup> row). The only coefficient which changes is the impact of the output gap when large interest rate differentials are considered.

Table 7. Nonlinear estimates based on the lagged interest rate differential as transition variable

Country	$\alpha_0$	$\alpha_1$	$\beta_1$	$\beta_1'$	$\beta_2$	$\beta_2'$	$\beta_3$	$\beta_3'$	$\gamma_1$
UK	1.567* [1.797]	3.557** [2.700]	0.147** [3.552]	-0.516** [-4.852]	0.353* [1.753]	-0.626** [-2.055]	0.743*** [5.197]	0.462 [1.588]	0.038*** [3.592]
US	-0.540*** [-3.411]	-6.785*** [-15.432]	-0.153*** [-3.707]	0.844*** [8.912]	0.333** [2.254]	-0.124 [-0.667]	1.012*** [32.698]	-0.028 [-0.482]	0.226*** [14.382]
Japan	0.869*** [2.240]	-9.118*** [-5.719]	-0.221** [-4.008]	0.405*** [3.497]	0.561*** [5.447]	-0.758*** [-3.326]	0.815*** [13.337]	0.261* [1.972]	0.001*** [5.370]
Eurozone	-0.307 [-0.752]	3.207*** [2.380]	-0.170*** [-4.306]	0.199 [1.426]	-0.088 [-0.539]	1.326*** [4.251]	1.068*** [13.334]	-0.860*** [-5.118]	0.994 [6.778]

Note: \* Statistical significance at the 10% level, \*\* at the 5% level, \*\*\* at the 1% level. The coefficients are estimated by nonlinear least squares. T-values are given in parentheses. Exponential specification of the transition function. Coefficients refer to eq. (4).



## 6. Conclusion

This study has allowed for *international spillovers* and various *nonlinear adjustment* patterns when analysing monetary policy decisions against the background of the Taylor rule. Both effects are well-suited to capture actual central bank behaviour. Our approach fits the data reasonably well and reduces deviations compared to standard Taylor reaction functions. We identify several cases where Taylor rule coefficients change their sign between the regimes, suggesting that nonlinear dynamics are important. It is also worthwhile mentioning that the magnitude of spillover effects is always positive and frequently larger compared to the output gap and inflation as traditional determinants.

From a general point of view, our findings suggest that nonlinear patterns in central bank behaviour can be due to several aspects. On the one hand, coefficients of the Taylor rule are different for expansionary and contractionary periods. In general, lagged changes of US interest rates are even more significant in times of increasing domestic interest rates. Hence, expansionary monetary policy decisions by the other central bank under observation have been more frequently related to changes in the US monetary policy stance. International spillovers resulting from interest rate differentials and different oil price pattern also introduce fluctuations in the Taylor reaction function coefficients. In contrast, the output gap turns out to be a less important determinant to model nonlinear dynamics.

Overall, we confirm the main argument of Taylor (2013) that international coordination has become a more important aspect of monetary policy. Our results show that the Taylor rule framework turns out to be useful for the assessment of monetary policy even after the millennium once nonlinear dynamics and international spillovers are included. Future research beyond this framework should for example be able to shed some light on the issue of policy coordination in a zero interest rate environment.



## References

- Alcidi, C., Alessandro, F., Fracasso, A. (2009), "Policy regime changes, judgment and Taylor rules in the Greenspan era", *Economica*, 78(309), 89-107.
- Baillie, R.T., Kilic, R. (2006), "Do asymmetric and nonlinear adjustments explain the forward premium anomaly?", *Journal of International Money and Finance*, 25(1), 22-47.
- Belke, A., Gros, D. (2005), "Asymmetries in Transatlantic monetary policy making: Does the ECB follow the Fed?", *Journal of Common Market Studies*, 43, 921-946.
- Belke, A., Cui, Y. (2010), "US-Euro area monetary policy interdependence - New evidence from Taylor rule based VECMs", *The World Economy*, 33/5, 778-797.
- Belke, A., Gros, D. (2014), "A simple model of an oil based global savings glut - The "China factor" and the OPEC cartel", *International Economics and Economic Policy*, 11/3, 413-430.
- Bernanke, B. (2005), "The global saving glut and the US current account", Remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March.
- Bernanke, B. (2007), "Global imbalances: recent developments and prospects", Bundesbank Lecture, Berlin.
- Bruno, V., Shin, H.S. (2012), "Capital flows and the risk-taking channel of monetary policy", Paper presented at the 11th BIS Annual Conference, Basle.
- Caballero, R., Farhi, E., Gourinchas, P. (2008), "An equilibrium model of global imbalances and low interest rates", *American Economic Review*, 58, 358-93.
- Clarida, R., Galí, J., Gertler, M. (2000), "Monetary policy rules and macroeconomic stability: Evidence and some theory", *Quarterly Journal of Economics*, 115, 147-180.
- Clarida, R. (2012), "What has and has not been learned about monetary policy in a low-inflation environment? A review of the 2000s", *Journal of Money, Credit and Banking*, 44, 123-140.
- Dijk, D. van, Teräsvirta, T., Franses, P.H. (2002), "Smooth transition autoregressive models - A survey of recent developments", *Econometric Reviews*, 21(1), 1-47.
- Franses, P.H., van Dijk, D. (2000), *Nonlinear time series models in empirical finance*, Cambridge: Cambridge University Press.
- Gerlach, S., Lewis, J. (2010), "The zero lower bound, ECB interest rate policy and the financial crisis", CEPR Discussion Papers 7933.
- Gray, C. (2012), "Responding to a monetary superpower: Investigating the behavioral spillovers of US monetary policy", *Atlantic Economic Journal*, DOI 10.1007/s11293-012-9352-0.
- Hofmann, B., Bogdanova, B. (2012), "Taylor rules and monetary policy: A global great deviation?", *BIS Quarterly Review*, September.
- International Monetary Fund (2013), "IMF multilateral issues report - spillover report", Washington, DC, August.
- Judd, J.P., Rudebusch G.D. (1998), "Taylor rules and the fed: 1970-1997", Federal Reserve Board San Francisco, *Economic Review* 3, 3-16.

- Kahn, G.A. (2010), "Taylor rule deviations and financial imbalances", *Economic Review*, Federal Reserve Bank of Kansas City, 63-99.
- Kim, S. (2000), "International transmission of US monetary policy shocks: Evidence from VARs", *Journal of Monetary Economics*, 48, 339-372.
- Luukkonen, R., Saikkonen, P., Teräsvirta, T. (1988), "Testing linearity against smooth transition autoregressive models", *Biometrika*, 75(3), 491-499.
- Orphanides, A. (2001), "Monetary policy rules based on real-time data", *American Economic Review* 91, 964-985.
- Orphanides, A. (2003), "Historical monetary policy analysis and the Taylor rule", *Journal of Monetary Economics*, 50, 983-1022.
- Taylor, J.B. (1993), "Discretion versus policy rules in practice", *Carnegie Rochester Conference Series in Public Policy*, 39, 195-214.
- Taylor, J.B. (1998), "A historical analysis of monetary policy rules", in J.B. Taylor (ed.), *Monetary policy rules*, Chicago, IL: University of Chicago Press, 319-348.
- Taylor, J.B. (2013), "International monetary coordination and the great deviation", Paper prepared for the Session on International Policy Coordination, American Economic Association Annual Meetings, San Diego, California, January.
- Teräsvirta, T. (1994), "Specification, estimation and evaluation of smooth transition autoregressive models", *Journal of the American Statistical Association*, 89(425), 208-218.
- Teräsvirta, T. (1998), "Modelling economic relationships with smooth transition regressions" in D.E.A. Giles and A. Ullah (eds), *Handbook of Applied Economic Statistics*. New York, NY: Marcel Dekker, 507-552.
- Timberlake, R.H. (1993), *Monetary policy in the United States - An intellectual and institutional history*, Chicago, IL: University of Chicago Press.
- von Hagen, J., Fratianni, M. (1990), "German dominance in the European Monetary System: Evidence from Interest Rates", *Journal of International Money and Finance*, 9, 358-375.



## ABOUT CEPS

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is widely recognised as the most experienced and authoritative think tank operating in the European Union today. CEPS acts as a leading forum for debate on EU affairs, distinguished by its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

### Goals

- Carry out state-of-the-art policy research leading to innovative solutions to the challenges facing Europe today,
- Maintain the highest standards of academic excellence and unqualified independence
- Act as a forum for discussion among all stakeholders in the European policy process, and
- Provide a regular flow of authoritative publications offering policy analysis and recommendations,

### Assets

- Multidisciplinary, multinational & multicultural research team of knowledgeable analysts,
- Participation in several research networks, comprising other highly reputable research institutes from throughout Europe, to complement and consolidate CEPS' research expertise and to extend its outreach,
- An extensive membership base of some 132 Corporate Members and 118 Institutional Members, which provide expertise and practical experience and act as a sounding board for the feasibility of CEPS policy proposals.

## Programme Structure

### **In-house Research Programmes**

Economic and Social Welfare Policies  
Financial Institutions and Markets  
Energy and Climate Change  
EU Foreign, Security and Neighbourhood Policy  
Justice and Home Affairs  
Politics and Institutions  
Regulatory Affairs  
Agricultural and Rural Policy

### **Independent Research Institutes managed by CEPS**

European Capital Markets Institute (ECMI)  
European Credit Research Institute (ECRI)

### **Research Networks organised by CEPS**

European Climate Platform (ECP)  
European Network for Better Regulation (ENBR)  
European Network of Economic Policy  
Research Institutes (ENEPRI)  
European Policy Institutes Network (EPIN)