The rise and fall of the British monetary policy rule*

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Abstract

We provide new evidence on which historical changes in the institutions that govern UK monetary policy effectively translated into a shift of the systematic way the policy instrument were set. To this aim we use a recently-developed technique that specifically addresses two econometric issues that undermine the estimation of structural changes in the parameters of forward-looking models, that is the presence of endogenous regressors and potential changes in their marginal distribution. Without imposing any prior information on the timing of these changes we find six distinct regimes, but overall a coherent evolution where the adoption of inflation targeting appears only a refinement of a change in paradigm started far earlier. Moreover, trying to understand the sources of the observed movements in the policy interest rate, we conclude that it is the occasional, but not so sporadic, policy regime change that explains most of the variation in the official interest rate, far more than simply the response to the dynamics of the main indicators of the state of the economy or the persistent deviations from the policy rule due to other secondary factors influencing the policy decisions in specific historical periods. Finally, we highlight how neglecting the shifts in policy coefficients can generate substantial autocorrelation, which can spuriously be attributed to, or at least overstate the importance of, policy inertia.

Keywords: Monetary policy rules; structural change; endogenous regressors.
JEL classification: *E43; E51; E58.*

*Comments from John Driffill, Alastair Hall, Haris Psaradakis, Ron Smith and Paolo Surico are gratefully acknowledged.