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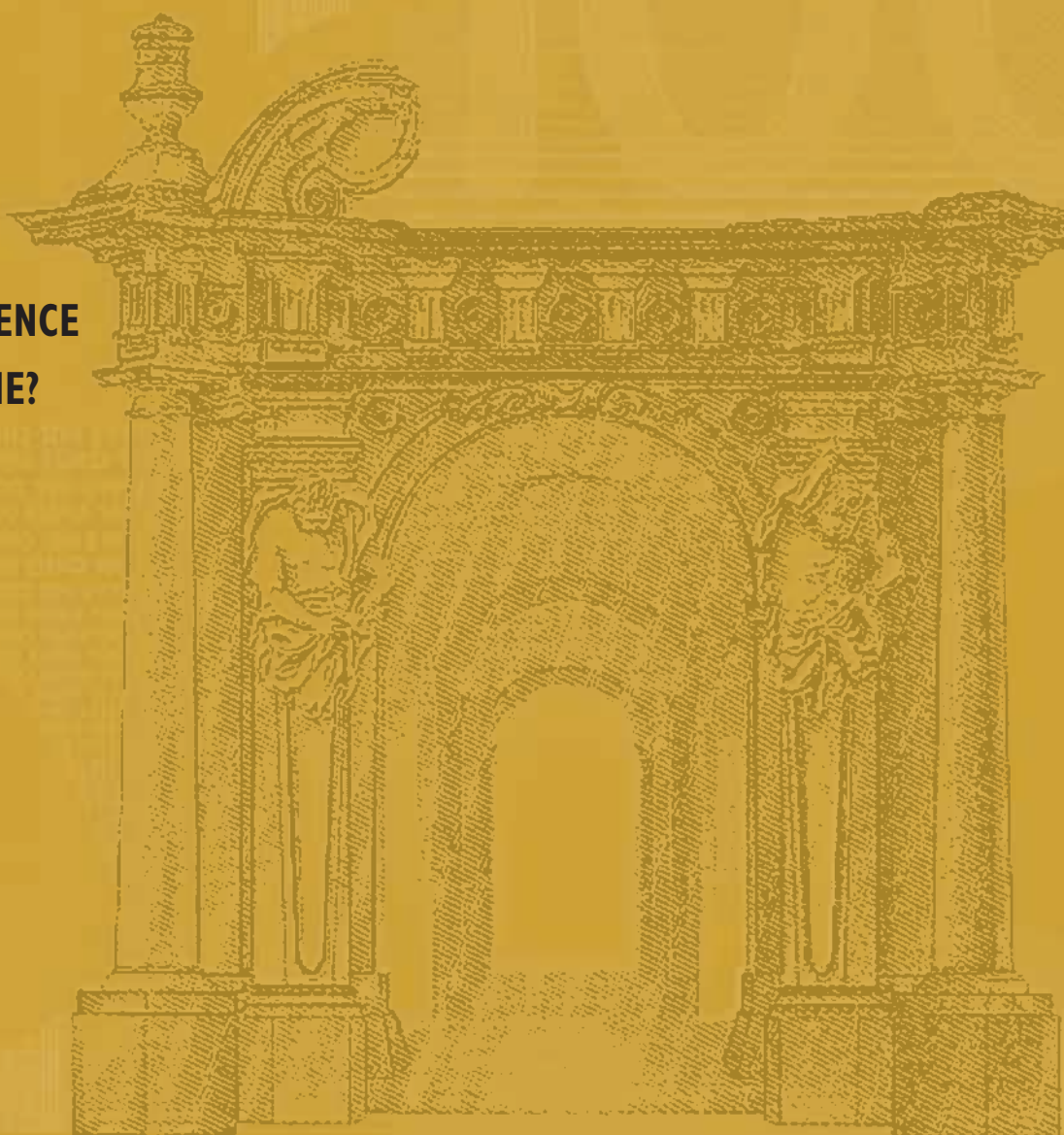
## WORKING PAPER SERIES

NO. 335 / APRIL 2004

**EUROSYSTEM INFLATION  
PERSISTENCE NETWORK**

### **HAS EURO-AREA INFLATION PERSISTENCE CHANGED OVER TIME?**

by Gerard O'Reilly and  
Karl Whelan





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Karl Whelan³



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¹ The views expressed in this paper are our own, and do not necessarily reflect the views of the Central Bank and Financial Services Authority of Ireland or the ESCB. We wish to thank Jerome Henry for generously providing us with the data used in this study.

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## **The Eurosystem Inflation Persistence Network**

This paper reflects research conducted within the Inflation Persistence Network (IPN), a team of Eurosystem economists undertaking joint research on inflation persistence in the euro area and in its member countries. The research of the IPN combines theoretical and empirical analyses using three data sources: individual consumer and producer prices; surveys on firms' price-setting practices; aggregated sectoral, national and area-wide price indices. Patterns, causes and policy implications of inflation persistence are addressed.

The IPN is chaired by Ignazio Angeloni; Jordi Galí (CREI, Universitat Pompeu Fabra) and Andrew Levin (Board of Governors of the Federal Reserve System) act as external consultants and Michael Ehrmann as Secretary.

The refereeing process is co-ordinated by a team composed of Vítor Gaspar (Chairman), Silvia Fabiani, Carsten Folkertsma, Jordi Galí, Andrew Levin, and Philip Vermeulen. The paper is released in order to make the results of IPN research generally available, in preliminary form, to encourage comments and suggestions prior to final publication. The views expressed in the paper are the author's own and do not necessarily reflect those of the Eurosystem.

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### **Abstract**

This paper analyzes the stability over time of the econometric process for Euro-area inflation since 1970, focusing in particular on the behaviour of the so-called persistence parameter (the sum of the coefficients on the lagged dependent variables). Perhaps surprisingly, in light of the Lucas critique, our principal finding is that there appears to be relatively little instability in the parameters of the Euro-area inflation process. Full-sample estimates of the persistence parameter are generally close to one, and we fail to reject the hypothesis that this parameter has been stable over time. We discuss how these results provide some indirect evidence against rational expectations models with strong forward-looking elements, such as the New-Keynesian Phillips curve.

JEL Codes: E31, E52

Keywords: Inflation Persistence, Euro Area, Lucas Critique

## Non-Technical Summary

This paper analyses the stability over time of some simple econometric representations of the Euro-area inflation process since 1970, focusing in particular on the behaviour of the so-called *persistence parameter*, which is defined as the sum of the coefficients on the lagged dependent variables. The paper adds to a recent literature that has been devoted to documenting the facts in relation to structural changes over time in the persistence of various inflation processes.

The motivation for this literature has been the idea that reduced-form inflation regressions may be subject to the Lucas critique. In other words, given the sequence of shifts in monetary policy regimes that have occurred since the early 1970s, it would hardly be surprising if inflation regressions exhibited substantial parameter instability, rendering them of dubious usefulness for forecasting or policy analysis. A particular concern about these regressions that has emerged in recent years as researchers have increasingly used forward-looking rational expectations models of inflation such as the New-Keynesian Phillips curve, is the idea that the importance of lagged dependent variable terms should decline as the credibility of a central bank's commitment to low inflation increases. This concern appears likely to be particularly relevant for the Euro area.

Our principal finding is that there appears to be relatively little instability in the parameters of the Euro-area inflation process. Our full-sample estimates of the persistence parameter are generally close to one, and results from unknown-breakpoint tests for structural change are consistent with the null of no change over time in this coefficient. Implemented using the standard procedures—which involve checking test statistics against asymptotic critical values derived by Donald Andrews (1993)—these tests do appear to detect a structural break in the intercept term, and conditioning on such a break produces somewhat lower estimates of the persistence parameter. However, we show that tests based on the Andrews critical values have poor properties when the true value of the persistence parameter is close to or equal to one. We also show that once this factor is corrected for, there is no significant evidence of an intercept break.

The failure to formally reject a null hypothesis of parameter stability does not, on its own, rule out the potential existence of some important structural changes. In light of this possibility, we also report results from rolling regressions, which allow for separate parameters for the inflation process over a sequence of moving windows. These exercises show that estimates of the persistence parameter are relatively stable throughout the estimation

period, with our preferred point estimates usually being very close to one. It is also worth noting that while most of our exercises follow the existing literature in focusing on univariate regressions, our conclusions concerning the persistence parameter are also robust to specifications that include an output gap. Overall, our results are consistent with a stable reduced-form representation for inflation and a high level of inflation persistence.

This finding of a high and stable persistence parameter may be somewhat surprising given the obvious theoretical relevance of the Lucas critique for our exercise. However, it is consistent with a number of recent papers that have questioned the critique's empirical relevance. For example, Glenn Rudebusch (2003) has used an estimated New-Keynesian-style macroeconomic model to show that the parameters of reduced-form regressions will tend to be relatively stable even in the presence of realistic changes in monetary policy rules. Rudebusch also shows that if the underlying structural equations of such models place relatively low weights on forward-looking expectational variables, then the inflation persistence parameter in reduced-form models will be close to one. Thus, we interpret our results as providing some indirect evidence against pricing models with strong forward-looking elements, such as the New-Keynesian Phillips curve.

# 1 Introduction

The European Central Bank has an explicit mandate for the maintenance of low inflation as its overriding objective. In light of this mandate, an obvious goal for macroeconomists wishing to analyse European monetary policy is the development of statistically adequate econometric models of the Euro-area inflation process. However, while such a goal is clear in principle, the task may be complicated by a number of practical problems. Firstly, there are the potential problems due to modelling a series that aggregates the inflation processes of various countries that have historically pursued independent monetary policies. In addition, the substantial changes over time in monetary regimes may leave any econometric model of Euro-area inflation open to the Lucas critique. In other words, given the sequence of shifts in monetary policy regimes that have occurred since the early 1970s, it would hardly be surprising if Euro-area inflation regressions exhibited substantial parameter instability, rendering them of dubious usefulness for forecasting or policy analysis. A particular concern about these regressions that has emerged in recent years as researchers have increasingly used forward-looking rational expectations models of inflation such as the New-Keynesian Phillips curve, is the idea that the importance of lagged dependent variable terms should decline as the credibility of a central bank's commitment to low inflation increases; this theme has been emphasised by John Taylor (1998), Thomas Sargent (1999) and others.

With this background in mind, this paper analyses the stability over time of some simple econometric representations of the Euro-area inflation process since 1970, focusing in particular on the behaviour of the so-called *persistence parameter*, which is defined as the sum of the coefficients on the lagged dependent variables. In this sense, our paper adds to a recent literature that has been devoted to documenting the facts in relation to structural changes over time in the persistence of various inflation processes, with Cogley and Sargent (2001), Stock (2001), and Pivetta and Reis (2003) studying this issue for the US, and Levin and Piger (2003) conducting a multi-country study. More generally, because the Euro area inflation process provides a clear example of a region and a series for which the Lucas critique is most likely to apply, we believe our analysis provides some useful evidence for assessing the empirical importance of changes in policy regimes for the parameters of reduced-form macroeconometric processes.

Perhaps surprisingly, given the theoretical priors just outlined, our principal finding is that there appears to be relatively little instability in the parameters of the Euro-area inflation process. Our full-sample estimates of the persistence parameter are generally



close to one, and results from Andrews-Ploberger unknown-breakpoint tests for structural change are consistent with the null of no change over time in this coefficient. These tests do appear to detect a structural break in the intercept term, and conditioning on such a break produces somewhat lower estimates of the persistence parameter. However, we show below that the standard asymptotic  $p$ -values used to implement these unknown-breakpoint tests turn out to be poor approximations to the correct finite-sample distributions when the true value of the persistence parameter is close to or equal to one. We also show that once this factor is corrected for, there is no significant evidence of an intercept break. That said, even if a break in the intercept is allowed for, there is still no evidence of a break in the persistence parameter.

Of course, the failure to formally reject a null hypothesis of parameter stability does not, on its own, rule out the potential existence of some important structural changes. For instance, one possibility is that the form of the structural change is gradual over time and unlike the simple once-off breaks that our formal hypothesis tests look for. In light of this possibility, we also report results from rolling regressions, which allow for separate parameters for the inflation process over a sequence of moving windows. These exercises show that estimates of the persistence parameter are relatively stable throughout the estimation period, with our preferred point estimates usually being very close to one. It is also worth noting that while most of our exercises follow the existing literature in focusing on univariate regressions, our conclusions concerning the persistence parameter are also robust to specifications that include an output gap. This result is relevant because, as we discuss below, theoretical models such as the New-Keynesian Phillips curve may be consistent with a substantial level of persistence in univariate regressions and low levels of persistence once autocorrelated driving variables have been controlled for.

Overall, then we view our results as consistent with a stable and relatively high level of inflation persistence in the Euro area since 1970. This finding may be somewhat surprising given the obvious potential relevance of the Lucas critique for our exercise. However, it is consistent with recent evidence for the US presented by Rudebusch (2003), who uses an estimated New-Keynesian-style macroeconomic model to show that the parameters of reduced-form regressions will tend to be relatively stable even in the presence of realistic changes in monetary policy rules. Rudebusch also shows that if the underlying structural equations of such models place relatively low weights on forward-looking expectational variables, then the inflation persistence parameter in reduced-form models will be close to

one. Thus, one possible interpretation of our results is that they provide some indirect evidence against pricing models with strong forward-looking elements, such as the New-Keynesian Phillips curve.

## 2 Theoretical Background and Policy Implications

Since the seminal works of Friedman (1968) and Lucas (1972a), it has become widely accepted that the behaviour of the aggregate inflation process depends crucially on those factors that influence the expectations of private agents. As a result, almost all brands of theorizing about inflation now emphasise the important role played by expectations. For example, textbook treatments of inflation such as in Blanchard (2000) focus on the role played in wage and price-setting by workers' prior expectations of price inflation, implying a specification of the form

$$\pi_t = E_{t-1}\pi_t + \eta y_t + \epsilon_t, \quad (1)$$

where  $\pi_t$  and  $y_t$  represent the inflation rate and output gap respectively. The modern “New Keynesian” Phillips curve also emphasises the importance of expectations, although the mechanisms through which this operates are somewhat different. For example, Calvo-style models feature rational price-setters whose concern about their future margins requires them to consider future inflation when setting prices that may be fixed for a number of periods. This results in an inflation equation of the form

$$\pi_t = \beta E_t \pi_{t+1} + \gamma y_t, \quad (2)$$

where  $\beta$  is a discount rate close to one.<sup>1</sup>

Crucial differences emerge, however, once one turns to the empirical modelling of these expectations. Reduced-form Phillips curves are commonly estimated as

$$\pi_t = \alpha + \rho \pi_{t-1} + \sum_{k=1}^n \psi_k \Delta \pi_{t-k} + \delta Z_t + \epsilon_t, \quad (3)$$

where  $Z_t$  is a vector of other variables that may affect inflation. The motivation for this specification is that agents extrapolate from past inflation rates to formulate the expectation used in current-period wage and price setting. Frequently, the value of  $\rho$  is restricted to equal one, implying that agents formulate rule-of-thumb expectations based on a weighted

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<sup>1</sup>The New Keynesian Phillips curve can also be derived from other micro-foundations, such as models featuring costly price adjustment or staggered wages. See Roberts (1995).

average of past inflation rates; this specification is often motivated by a desire to rule out a long-run tradeoff between the levels of inflation and output.

If econometric equations such as (3) are relatively stable over time, then the lagged dependent variable terms are of great importance for the design of monetary policy. In this case, these terms describe how shocks to inflation today—including those that originate from policy actions—are propagated over time. In particular, the persistence parameter  $\rho$  is a crucial determinant of the impulse response patterns over time to shocks.<sup>2</sup> These considerations suggest that it is crucial that central banks take the estimated persistence parameter into account when setting policy. However, despite their continuing empirical popularity, the theoretical underpinnings of reduced-form Phillips curve regressions have been in question ever since the early 1970s saw the advent of the rational expectations approach to macroeconomics. Advocates of this approach emphasised that the type of weighted-average “adaptive” expectation formation underlying these specifications was not necessarily consistent with optimal behaviour.<sup>3</sup>

For our analysis of the Euro-area inflation process, a particular concern posed by the assumption of rule-of-thumb expectations is that this type of model may work poorly in a world in which central bank behaviour changes over time, as stressed in Lucas’s (1976) famous critique of econometric modelling.<sup>4</sup> The extrapolation of expected inflation based only on past values may be reasonable if a central bank allows its target rate of inflation to drift over time, but a switch to a credible low-inflation target may make such a rule less sensible. For example, if it is known that a central bank has a credible commitment to a two percent target for inflation each period, then it may be rational for agents to always expect inflation to be around two percent, implying a reduced-form inflation process approximately of the form

$$\pi_t = 2 + \delta Z_t + \epsilon_t. \quad (4)$$

This type of process rules out a role for the lagged inflation terms altogether.

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<sup>2</sup>Andrews and Chen (1994) discuss this issue and compare the sum of the coefficients on lagged dependent variables favourably with other popular measures of persistence such as the largest autoregressive root and the half-life.

<sup>3</sup>For example, Sargent (1971) argued that the US inflation process appeared to be stationary and so the econometric specifications with  $\rho = 1$  were at odds with an expectations formation process based on available data at the time. Lucas (1972b) also questioned whether tests of  $\rho = 1$  in this equation could correctly be interpreted as tests for monetary neutrality.

<sup>4</sup>Indeed, the effect of changes in monetary policy on inflation expectations was a specific example discussed in Lucas’s paper.

With the rational-expectations-based New Keynesian Phillips curve playing an increased role in monetary policy analysis in recent years, this particular idea—that a credible commitment to low inflation will lead to a reduction in the estimated  $\rho$  parameter—has been quite widely discussed of late.<sup>5</sup> This conjecture, of course, has substantial implications for monetary policy: If reduced-form estimates of the  $\rho$  parameter are indeed spuriously high or unstable over time, then many of the results from econometric exercises based on such regressions could be spurious, and policy must rely on other, more structural, models that are capable of explaining the shifting reduced-form dynamics. And the Euro area provides a particularly relevant testing ground for these ideas, given the series of regime changes seen since 1970: The break-up of the Bretton Woods framework, the formulation and gradual hardening of the EMS system, and the run-up to and introduction of EMU with its strict low-inflation mandate.

### 3 Full-Sample Results

The data source for our analysis is an updated version of the ECB's Area Wide Model (AWM) quarterly database described in Fagan, Henry and Mestre (2001). The sample for this dataset is 1970:1-2002:4. Our principal inflation measure is the annualised quarterly log-difference of the GDP deflator. We also report some results for the Harmonized Index of Consumer Prices (HICP), the annual change in which is cited in the ECB's official inflation mandate. Importantly, while the AWM series for the GDP deflator is seasonally adjusted, the HICP series is not. These two inflation series are plotted on Figure 1.

For our first set of calculations, we follow the approach taken in some other recent studies such as Pivetta and Reis (2003) and Levin and Piger (2003) in focusing on the estimation of the parameter  $\rho$  in univariate regressions of the form:

$$\pi_t = \alpha + \rho\pi_{t-1} + \sum_{k=1}^n \psi_k \Delta\pi_{t-k} + \epsilon_t. \quad (5)$$

We set  $n = 3$  (consistent with four lags of the level of inflation) on the basis of lag selection tests, but none of the substantive results that we report were sensitive to this choice. Moreover, because the HICP series is not seasonally adjusted, the inclusion of four lags in

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<sup>5</sup>See Taylor (1998), Sargent (1999), Cogley and Sargent (2001), and Levin and Piger (2003) for discussions of the likely effect that a credible commitment to a low inflation target has on the  $\rho$  parameter. See Clarida, Galí and Gertler (1999) for an example of monetary policy analysis from the perspective of the New Keynesian Phillips curve.



the levels specification is appropriate as this allows us to capture average seasonal patterns in this series.

Table 1 reports the OLS estimates of  $\rho$  for both deflators. For both series the point estimates were approximately 0.96, and the augmented Dickey-Fuller (ADF) statistics associated with these regressions do not come close to rejecting the null hypotheses that the inflation series are unit roots without drift. One problem with these estimates is the fact that, in finite samples, the standard asymptotic distributions for OLS coefficients and  $t$ -statistics in autoregressive models are known to become systematically poorer approximations to their true finite-sample distributions as the true value of  $\rho$  increases. In particular, point estimates become increasingly downward-biased and their distribution becomes more skewed to the left as  $\rho$  increases.

To rectify this problem, we also used Bruce Hansen's (1999) grid-bootstrap method to obtain bias-adjusted point estimates and confidence intervals.<sup>6</sup> This method uses a bootstrap technique to simulate the finite-sample distribution of the OLS estimator for a range of possible true values of the parameter  $\rho$  in the model:

$$Y_t = \delta_0 + \delta_1 t + Z_t \quad (6)$$

$$Z_t = \rho Z_{t-1} + \epsilon_t. \quad (7)$$

This approach produces median-unbiased estimates of  $\rho$ ; in other words, it tells us the value of  $\rho$  that would result in the estimated OLS parameter,  $\hat{\rho}$ , being the median of the empirical sampling distribution. This method also allows for the construction of confidence intervals that accurately capture the skewed nature of the finite sample distributions: The grid-bootstrap 95th (5th) percentile estimate is the value of  $\rho$  for which the OLS estimate would be the 5th (95th) percentile of the sampling distribution.

In our implementation, we set the parameter  $\delta_1$  equal to zero as the hypotheses that both inflation series have a unit root with drift can be firmly rejected.<sup>7</sup> Table 2 reports the results from our grid-bootstrap estimation. They show that our OLS estimates are actually consistent with point estimates of  $\rho$  of about 1.02, with the lower end of the 90

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<sup>6</sup>Hansen's paper actually develops two different grid bootstrap estimators that produce very similar answers. We use his preferred method, which he labels the grid- $t$  method. Gauss code to produce these estimates was downloaded from Hansen's website.

<sup>7</sup>In this case, the distribution of the OLS estimate collapses quickly on one, and our point estimates are far too low to be consistent with this hypothesis. Note that this implies that an estimate of  $\rho$  equal to one from the grid bootstrap procedure is not necessarily the same as an estimate of one from equation (5)

percent confidence intervals equalling about 0.94 for both series. These results enforce the picture painted by the OLS estimates of a highly persistent series: The median-unbiased representation of the Euro area inflation process is essentially a unit root without drift, and even the lower ranges of our estimates of  $\rho$  are consistent with a high degree of persistence.

## 4 Tests for Structural Change

Our full-sample univariate estimates suggest a high level of inflation persistence. However, there are a number of potential explanations as to why these high estimates of  $\rho$  may be misleading, or possibly completely spurious. The first potential problem, in light of the Lucas critique, is that the assumption of a constant  $\rho$  parameter throughout the sample may be inappropriate: Our high full-sample estimate could still mask a substantial reduction in persistence over the latter part of the sample.

Another potential problem is the fact that these calculations do not allow for the possibility of a shift in the unconditional mean value of inflation. The fact that inflation was, on average, high in the early part of the sample and low in the later part, implies that allowing for such a shift would improve the fit of the model.<sup>8</sup> Also, it is well known from work such as Perron (1989) that failure to account for structural breaks in an intercept or trend can result in spuriously high estimates of the persistence parameter: Once one accounts for changes over time in the mean, then deviations from this time-varying mean do not seem as persistent. On the other hand, the very fact that inflation was high in one part of the sample and low in another is not, on its own, evidence against a model with a constant unconditional mean. In particular, a constant-mean process with a high value of  $\rho$  is quite capable of generating periods of high inflation followed by periods of low inflation. Ultimately, we need to formally test whether the null hypothesis of parameter stability can be rejected.

### 4.1 Tests Based on Asymptotic Distributions

We are interested in testing the general null hypothesis of parameter stability. Thus, instead of carrying out a traditional Chow test, which posits a specific breakdate, our structural change tests do not assume any prior knowledge about potential breakdates. Two test

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<sup>8</sup>This unconditional mean is estimated as  $\frac{\alpha}{1-\rho}$  in our OLS regression, and as the sample mean inflation rate in the grid-bootstrap estimates.

statistic were calculated. The first is the Andrews-Quandt sup- $F$  statistic, which is the maximum of a sequence of traditional Chow-style  $\chi^2$  tests for structural change each based on a different potential breakpoint. This test statistic was originally introduced by Quandt (1960) and its asymptotic distribution was derived by Andrews (1993).<sup>9</sup> The second test is the exp- $F$  statistic, which is based on a weighted average of the full sequence of  $\chi^2$  tests; this test and its asymptotic distribution were introduced by Andrews and Ploberger (1994). Though less commonly used, the exp- $F$  has been shown to have superior power in distinguishing the null hypothesis relative to local alternatives.<sup>10</sup>

In what follows, we only report results for the GDP deflator, rather than testing for parameter stability with the non-seasonally-adjusted HICP data, which may exhibit instabilities over time due to changing seasonal patterns. The test statistics and their asymptotic  $p$ -values are reported in Table 3. In addition, Figure 2 plots the time series of Chow statistics associated with the various potential breakdates; the left-hand-panel illustrates the results for tests of stability of the persistence parameter, while the right-hand panel shows results for the intercept. The figure also includes the relevant 5 percent critical values for both the traditional  $\chi^2$  distribution and the Andrews asymptotic distribution for the sup- $F$  statistic.<sup>11</sup>

Figure 2 shows that the maximum Chow statistic for a break in the persistence parameter is 6.82 (this occurs at 1982:3). While this break is technically significant at the 5 percent level for the traditional  $\chi^2$  distribution, this is the only breakpoint for which this is true, and this value falls well short of the 5 percent critical value for the Andrews distribution: Using the approximate asymptotic distributions calculated by Hansen (1997), this result has a  $p$ -value of 11 percent. (Results for the exp- $F$  statistic are similar for each case reported here).

The right-hand panel of Figure 2 shows that there is stronger evidence for a break in the intercept term. A number of the potential break points are significant relative to the

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<sup>9</sup>Our analysis in this section uses the Lagrange Multiplier (LM) form of the  $\chi^2$  test, but similar conclusions are reached using the alternative Wald or Likelihood Ratio tests

<sup>10</sup>There are, of course, a number of other possible tests for structural change. For example, Vogelsang (1998) and Altissimo and Corradi (2003) discuss tests for a break in the mean of a time series that do not require modelling the dynamics of the deviation from this mean. However, such tests are not appropriate for our exercise because we are interested in modelling these dynamics and assessing whether they have changed over time.

<sup>11</sup>We followed the usual convention and eliminated the first and last 15 percent of the observations from consideration as potential breakpoints.

traditional  $\chi^2$  distribution, and the sup- $F$  statistic (also reached at 1982:3) is 10.47, which is significant at the 2 percent level of the Andrews distribution. One unsurprising pattern in light of earlier discussions is that conditioning on the break in the intercept reduces the estimated persistence parameter. Allowing for this break, the OLS estimate drops to  $\rho = 0.80$ , the median-unbiased estimate is  $\rho = 0.86$  and the fifth and ninety-fifth percentile estimates are 0.75 and 1.00. Importantly, however, allowing for a break in the intercept has no effect on our conclusions regarding the *stability* of the persistence parameter: The asymptotic  $p$ -value for such a test is 0.19.

## 4.2 Problems with the Asymptotic Distributions

These results show that one cannot formally reject the hypothesis of no break over time in the persistence parameter, but the 11 percent  $p$ -value at least suggests the possibility that there may be such a break. And the results also point to the possibility that the correct estimate of  $\rho$  is a good deal lower than our full-sample estimates, once one accounts for a structural break in the intercept.<sup>12</sup> One concern, however, about these test results is their reliance on asymptotic distributions that may not be appropriate in finite samples for the autoregressive processes that we are considering. The results of Diebold and Chen (1996) indicate that these concerns are likely to be important in this case. Their research shows that the asymptotic  $p$ -values for sup- $F$  tests for simultaneous breaks in the intercept and persistence parameters of an AR(1) model become less accurate as  $\rho$  increases, with tests based on these  $p$ -values too often rejecting the hypothesis of no structural change.

Diebold and Chen's paper does not discuss finite-sample distributions for separate tests for breaks in the intercept or the persistence parameter. To illustrate the finite-sample properties of these tests, Figure 3 reports the results from a Monte Carlo analysis of the true sizes of both the intercept and  $\rho$ -break tests using the same number of observations as in our estimating sample ( $T = 127$ ). We simulated a sequence of univariate processes with increasing values of  $\rho$  (ranging from 0.4 to 0.999), and with each process having a unit mean and random shocks drawn from a  $N(0, 0.5)$  distribution; these values were roughly

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<sup>12</sup>One way to measure the change in persistence caused by allowing for an intercept break is to note that the half-life associated with the OLS estimates of 0.96 and 0.80 are 17 quarters and 3 quarters respectively. That said, there are drawbacks to the applicability of the half-life measure in this case. This is because the median-unbiased estimates for these two cases are 1.02 and 0.86, so the half-life is not defined for the best available evidence of the no-break value of  $\rho$ . Also, a value of  $\rho = 1$  is still inside the 90 percent confidence interval even when a break is allowed for.



calibrated to match our estimated process for GDP price inflation, for which the standard deviation of the errors was about half the model's implied long-run average inflation rate.<sup>13</sup> For each value of  $\rho$  considered, we constructed 5000 separate simulated autoregressive series, and for each of these series we performed sup- $F$  tests of the (correct) null hypotheses of parameter stability for the intercept and for the persistence parameter.

Figure 3 shows how, for these parameter values, the empirical size of the sup- $F$  test procedures with nominal size of 10 percent is close to 10 percent until the true  $\rho$  reaches about 0.7. However, after  $\rho$  gets larger than 0.7 the empirical size of the tests increase. The size of the  $\rho$ -break test rises particularly rapidly, reaching values of over 50 percent when  $\rho$  is close to one. In contrast, the size of the intercept-break test rises more slowly until  $\rho$  is about 0.95, after which it increases rapidly to just under 50 percent for values of  $\rho$  that are very close to one. It is also noteworthy that these results relate to the LM version of the sup- $F$  test, and that the size distortions will be even greater than those reported here for the alternative Wald version of the test, which is often used in practice.

Given that our full-sample point estimates for  $\rho$  are so high, these results imply that using asymptotic distributions overstates the evidence for structural breaks in the Euro area inflation process, perhaps by a significant amount. As an alternative, Diebold and Chen suggested calculating bootstrapped  $p$ -values, based on simulating the estimated full-sample process with shock terms drawn randomly from the historical residuals. They show that this technique produces test procedures that have approximately the correct size. We first applied this technique using the OLS point estimates of the GDP inflation process and performing 5000 bootstrap replications; the results are reported on the third and seventh lines of Table 3. The bootstrapped  $p$ -value for a sup- $F$  test statistic of 6.82 (the value for a break in  $\rho$ ) is 34 percent, not the 11 percent value implied by the asymptotic distribution. Similarly, the bootstrapped  $p$ -value for a test statistic of 10.47 (the value for a break in the intercept) is 20 percent, not the 2 percent reported above. Similar results are obtained for the exp- $F$  statistic.

Finally, as we discussed above, once one adjusts for the finite-sample bias in the OLS estimates, the true inflation process is well-described as a unit root without drift. Thus, we also performed bootstrap calculations based on simulating the process obtained by estimating the inflation regression with the restriction  $\rho = 1$  imposed. This resulted in  $p$ -values of 37 percent for the break in the persistence parameter and 24 percent for the break in the intercept.

<sup>13</sup>In other words, we simulated equations (6) and (7) with  $\delta_0 = 1, \delta_1 = 0$  and  $\epsilon_t \sim N(0, 0.5)$ .

We conclude from these calculations that the evidence from formal hypothesis tests for structural breaks in the Euro-area inflation process is quite weak, and the hypothesis that the process has a stable representation with a high level of persistence is hard to reject. In addition, even if one accepts the potential break in the intercept, the value of  $\rho$  obtained after conditioning on this break is still fairly high—recall that median-unbiased estimate of the persistence parameter in this case was 0.86.

## 5 Rolling Regressions

One objection to the tests just presented is that they take the hypothesis of parameter stability as their null. But even if one fails to formally reject this null, that doesn't necessarily imply that such change is not present. In this section, we provide another, more informal, method of assessing whether or not there has been structural change over time in the persistence parameter. Specifically, we follow the approach of Pivetta and Reis (2003) and report estimates from over a sequence of short rolling samples. While the small sample sizes involved in these rolling regressions usually imply substantial variation in parameter estimates and wide confidence intervals, they have the advantage of allowing for greater flexibility in detecting structural changes over time, with each rolling sample allowed to have a completely different estimated inflation process.

This feature of rolling regressions is particularly likely to be an advantage if one views the high full-sample estimates of  $\rho$  as due to a failure to capture time variation in the conditional mean of the inflation process of a more sophisticated type than the once-off breaks considered by the Andrews-Quandt test.<sup>14</sup> For example, although our full-sample estimate of  $\rho$  is high, indicating little tendency of inflation to revert to its full-sample mean, it may be that once one considers a sequence of small samples—each more likely to be associated with a specific stable policy regime—then a form of conditional mean reversion could become more apparent.

Figures 4 to 7 report results from these rolling regression exercises. In each case, we estimated an AR(4) model for a sequence of rolling samples and calculated the median-unbiased estimates of  $\rho$  as well as confidence intervals based on the 5th and 95th percentiles from the grid-bootstrap procedure. Because of the small sample sizes involved in these

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<sup>14</sup>See, for example, the discussion of this position by Marques (2003).

rolling regression calculations, we believe it is particularly important to focus on median-unbiased point estimates rather than the OLS estimates. This is because it is well known that the finite-sample biases for OLS estimates of autoregressive models get larger as the sample size declines: Whereas Tables 1 and 2 report full-sample estimates of the OLS bias for this dataset to be about 0.06, the bias estimates for the rolling regressions were generally much larger and were often in the range of 0.20 to 0.30.

Despite the intuition discussed above, the rolling regressions generally endorse our earlier conclusion of a high and stable value for the persistence parameter. Figure 4 shows the results for the GDP deflator with a rolling window of 12 years. The median-unbiased estimates of the persistence parameter tend to be consistently high: The average value for these estimates is 1.02, while three-quarters of the estimates are greater than 0.89. The 95th percentiles are stable at a high level, and are always above one. And despite a dip in the median-unbiased estimates corresponding to samples ending in the early to mid-1990s, there is little evidence of a trend towards lower levels of persistence over time. Figure 5 shows that roughly the same patterns emerge when we use the HICP.

A potential criticism of these results is that the 12-year sample is still too long to capture the behaviour of inflation over a single stable monetary policy regime, given the frequency of changes in monetary policy regimes seen in Europe over this period. To address this issue, Figures 6 and 7 report results using an 8-year window. As would be expected given the very short estimation windows being used, these results exhibit more volatility than the 12-year results and have wider confidence bands. However, the same overall story emerges with median-unbiased estimates of  $\rho$  still being high in most cases, with no evidence of a tendency towards lower estimates towards the end of the sample. In fact, if anything, these results suggest some increase in persistence after the early 1980s. Consider Figure 6 for GDP price inflation: After a sequence of low values associated with samples ending up to 1983, the average value for the median-unbiased estimate for subsequent samples is 1.02.

One methodological point worth noting about these calculations is that they help to illustrate the value of reporting a sequence of estimates from rolling samples, rather than drawing conclusions based on short individual samples. The variability of the estimates from the 8-year samples is very high and a number of the individual estimates would be quite misleading if presented in isolation. Thus, for example, Kieler (2003) reports an OLS estimate of  $\rho$  of 0.55 for the period 1995-2002 from an AR(4) regression for the Euro-area GDP deflator, and contrasts this with a full-sample estimate of 0.96 to argue that there

has been a sharp decline in inflation persistence in recent years. With our data (which are slightly more up to date), we obtain a very similar OLS estimate for this sample of 0.59. However, as can be seen from the last data points in Figure 6, this sample produces a substantially-higher median-unbiased estimate of 0.72, while the grid-bootstrap estimate of the 95th percentile for this sample is 1.14. And as Figure 6 also clearly illustrates, this final rolling sample produces an estimated persistence parameter that is lower than most of the samples close to it, and there is actually little trend over this period towards systematically lower estimates of  $\rho$ .

## 6 Including the Output Gap

Up to this point, we have followed a number of other recent studies in focusing on measuring the persistence parameter in the univariate inflation process. However, as we noted above, practical implementations of econometric Phillips curves, usually include some proxy for the level of “slack” in the economy, such as an output gap. And, from our perspective of assessing the level of inflation persistence, there are a number of reasons why we might wish to include such a variable. One simple reason is suggested by the model described by equation (1) augmented with the traditional assumption that expected inflation is a weighted average of past realized values. To the extent that there is a negative feedback from inflation to the output gap—for example, because the central bank operates according to an inflation-targeting Taylor rule—univariate exercises will underestimate the true “structural” value of  $\rho$  suggested by this model.

Conversely, it is also possible that the exclusion of an autocorrelated driving variable could result in spurious findings of a high value of  $\rho$ . Although evidence of a value of  $\rho$  close to one might be considered evidence in favour of the “adaptive expectations” approach, models based purely on rational expectations can also predict high values of the persistence parameter in univariate regressions. For example, consider the case in which an output gap follows an AR(1) process

$$y_t = \phi y_{t-1} + u_t. \quad (8)$$

Applying repeated iteration to the New-Keynesian Phillips curve, equation (2), gives us an inflation process of the form

$$\pi_t = \gamma \sum_{k=0}^{\infty} \beta^k E_t y_{t+k}. \quad (9)$$

Combined with the output gap process this implies the following solution for inflation:

$$\pi_t = \frac{\gamma}{1 - \beta\phi} y_t. \quad (10)$$

In this case, the univariate processes for inflation and the output gap will be identical up to a scalar multiple. It is unlikely that this kind of example can fully explain our univariate results—an AR(4) regression for our output gap produces an OLS estimate of 0.76 for its persistence parameter, which is well below our inflation estimate of 0.96. However, this example shows that unless one conditions the inflation regression on appropriate driving variables, it is hard to make any direct link between the estimated value of  $\rho$  and the true effect on current inflation of its own lagged values.

It turns out, though, that the overall pattern of our results concerning the persistence parameter are little changed by the inclusion of a measure of the output gap, which we have constructed using a Hodrick-Prescott filter (see Figure 8). Tables 4 and 5 report the full-sample OLS and grid-bootstrap estimates obtained from estimation of

$$\pi_t = \alpha + \rho\pi_{t-1} + \sum_{k=1}^n \psi_k \Delta\pi_{t-k} + \gamma y_t + \epsilon_t, \quad (11)$$

where  $y_t$  is the output gap. The first result worth noting is that, while admittedly crude, this measure of the output gap plays a statistically significant role in influencing inflation: The gap obtains a  $t$ -statistic of 4.5 in the GDP deflator regression and 4.9 when added to the HICP specification. However, it has essentially no influence on estimates of the persistence parameter: The OLS and grid-bootstrap estimates show very little change from the univariate case.<sup>15</sup>

Figure 9 shows the sequence of Chow statistics obtained from performing the unknown breakpoint tests on the GDP deflator specification including the output gap; Table 6 reports the test results. As before, the hypothesis of no structural change in the persistence parameter cannot be rejected using the standard asymptotic distribution. Again, these tests suggest a break in the intercept that is significant at the 5 percent level, and conditioning on the estimated break (in 1984:1) we obtain the lower estimate of  $\rho = 0.78$ . Again though, adjusting for finite-sample bias by calculating  $p$ -values using bootstrap simulation methods casts considerable doubt on the statistical significance of the estimated intercept break: For example, the (unit-root-based) bootstrap estimate of the  $p$ -value for the intercept-break

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<sup>15</sup>In the grid-bootstrap estimation, the output gap series was treated as a fixed regressor, with the same data series used across all of the bootstrap simulations.

sup- $F$  statistic is 22 percent. Finally, Figure 10 shows that the pattern of results from our rolling regressions is unchanged by the addition of the output gap.

## 7 Interpreting the Results

One obvious interpretation of the results reported here is that they favour the simple backward-looking “rule-of-thumb” model of expectations over models that feature rational expectations. In particular, advocates of a rational expectations approach would likely be surprised by the fact that the persistence parameter has remained stable despite the clear changes over time in monetary policy regimes, and by the fact that this parameter appears to have been high even through the 1990s and early 2000s, when the policy regime for the Euro-area could be argued to have had far more anti-inflationary credibility. In addition, our general finding of parameter stability in a “backward-looking” model for inflation is consistent with Estrella and Fuhrer’s (2003) conclusions based on US data that such models tend to be more stable over time than models featuring rational expectations.

That said, we believe it is worth noting that it may be possible to reconcile our results with a popular class of models that feature *both* forward- and backward-looking expectations. Consider, for example, the recent work of Glenn Rudebusch (2003) on the empirical importance of the Lucas critique in New-Keynesian-style macroeconomic models. Rudebusch examines small multi-equation models such as the following “hybrid” model for inflation, the output gap, and the short-term real interest rate that mixes both backward-looking and forward-looking rational expectations:

$$\pi_t = (1 - \mu_\pi)\pi_{t-1} + \mu_\pi E_t \pi_{t+1} + \alpha_y y_{t-1} + \epsilon_t \quad (12)$$

$$y_t = \beta_y [(1 - \mu_y)y_{t-1} + \mu_y E_t y_{t+1}] - \beta_r r_t + \eta_t \quad (13)$$

$$r_t = (1 - \mu_r)(i_{t-1} - \pi_{t-1}) + \mu_r (i_t - E_t \pi_{t+1}). \quad (14)$$

Rudebusch solves for the reduced-form time series representation implied by this model. Perhaps surprisingly, he finds that the persistence parameter in inflation regressions varies little across a realistic range of values for the monetary policy rule. For example, for a highly forward-looking specification in which the weights on the expectational terms are all 0.8 or above, Rudebusch finds that switching from the estimated pre-Volcker policy rule to the post-Volcker rule (as estimated by Clarida, Galí and Gertler, 2000) produces a change in the estimated persistence parameter from 0.32 to 0.23. The same shift in a more

backward-looking model (in which the weights on expected inflation and output are lower than 0.3) leads to a change in the estimated persistence parameter from 0.99 to 0.95.

These calculations show that the joint existence of both rational expectations and an inflation-targeting policy rule is not, on its own, a sufficient condition to imply a fast rate of convergence to an average value for inflation. Nor do changes in the monetary policy rule necessarily eliminate the usefulness of the full-sample reduced-form estimates for forecasting. Finally, although these calculations show that our finding of a high and stable value of  $\rho$  in reduced-form econometric equations can be reconciled with models featuring some role for rational expectations, they cannot be reconciled with models that feature *only* forward-looking rational expectations, such as the New-Keynesian Phillips curve. Thus, our estimates are consistent with previous work by Rudd and Whelan (2001,2002) who argue that the important role for lagged inflation terms in US regressions cannot be reconciled with the pure New-Keynesian model.

## 8 Conclusions

We have presented evidence on the stability over time of some simple reduced-form Phillips curve equations for inflation in the Euro area. While large shifts in reduced-form coefficient estimates may have been expected as a response of rational agents to the sequence of shifts in monetary policy regimes that have taken place in the Euro area since 1970, the overall message that we take away from our results is one of surprising stability in these coefficients. In particular, while there is some evidence of a potential break in the intercept of the inflation process, the important “persistence parameter” which plays a crucial role in describing the impulse response patterns from inflationary shocks, appears to have been quite stable over the post-1970 period.

Our paper adds to a recent literature that has cast some doubt on the empirical relevance of the Lucas critique of reduced-form models. However, it is important to point out that the evidence presented in this paper cannot be used to rule out the possibility of future structural changes in the Euro-area inflation process. It may indeed be the case—now that a hard and credible EMU has arrived—that inflation will become “anchored” near its target value and that the “lag effect” documented here will cease to play an important role. However, our analysis suggests that there is little historically-based empirical evidence for the idea that the persistence of inflation will alter dramatically in response to these institutional changes.

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Table 1: Full-Sample Univariate OLS Estimates of  $\rho$

(Standard errors in parentheses below the coefficients.)

GDP Deflator	0.960 (0.039)
HICP	0.957 (0.043)

Table 2: Univariate Grid-Bootstrap Confidence Intervals for  $\rho$  (50% $\equiv$  Median Unbiased)

	5%	50%	95%
GDP Deflator	0.938	1.022	1.060
HICP	0.937	1.025	1.065

Note: Estimated by Bruce Hansen's (1999) grid- $t$  bootstrap method using GAUSS code downloaded from Hansen's website.

Table 3: Unknown-Breakpoint Tests for Structural Change

	$\rho$ -Break	Intercept-Break
<hr/>		
Sup- $F$ (Andrews-Quandt) Tests		
Test values	6.82	10.47
Asymptotic $p$ -values	0.11	0.02
Bootstrapped $p$ -values ( $\rho = 0.96$ )	0.34	0.20
Bootstrapped $p$ -values ( $\rho = 1.00$ )	0.37	0.24
<hr/>		
Exp- $F$ (Andrews-Ploberger) Tests		
Test values	1.38	2.58
Asymptotic $p$ -values	0.12	0.03
Bootstrapped $p$ -values ( $\rho = 0.96$ )	0.36	0.21
Bootstrapped $p$ -values ( $\rho = 1.00$ )	0.39	0.24
<hr/>		

Note: Bootstrapped  $p$ -values are based on simulating estimated OLS process (the  $\rho = 0.96$  case) or the estimated process with  $\rho = 1$  imposed; shocks for the simulated processes were based on drawing from the estimated residuals.

Table 4: OLS Estimates of Output Gap Specification

(Standard errors in parentheses below the coefficients.)

	$\rho$	$\gamma$
GDP Deflator	0.960 (0.039)	0.596 (0.132)
HICP	0.947 (0.043)	0.675 (0.137)

Table 5: Grid-Bootstrap Estimates for Output Gap Specification (50%≡ Median Unbiased)

	5%	50%	95%
GDP Deflator	0.932	1.011	1.055
HICP	0.917	0.995	1.051

Note: Output gap treated as a fixed regressor in all bootstrap simulations.

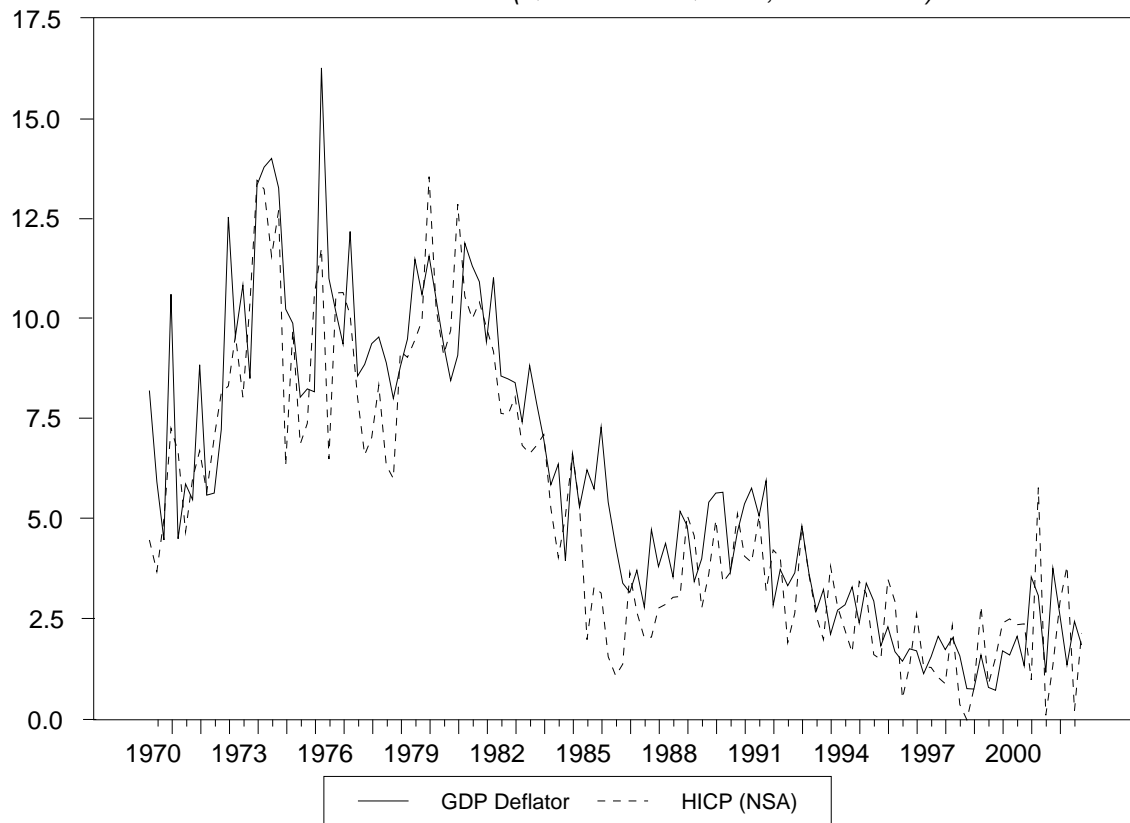
Table 6: Structural Change Tests for Output Gap Specification

	$\rho$ -Break	Intercept-Break
<hr/>		
Sup- $F$ (Andrews-Quandt) Tests		
Test values	6.72	8.65
Asymptotic $p$ -values	0.12	0.05
Bootstrapped $p$ -values ( $\rho = 0.96$ )	0.26	0.19
Bootstrapped $p$ -values ( $\rho = 1.00$ )	0.28	0.22
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Exp- $F$ (Andrews-Ploberger) Tests		
Test values	1.88	2.42
Asymptotic $p$ -values	0.06	0.03
Bootstrapped $p$ -values ( $\rho = 0.96$ )	0.15	0.13
Bootstrapped $p$ -values ( $\rho = 1.00$ )	0.17	0.15
<hr/>		

Note: Bootstrapped  $p$ -values are based on simulating estimated OLS process (the  $\rho = 0.96$  case) or the estimated process with  $\rho = 1$  imposed; shocks for the simulated processes were based on drawing from the estimated residuals.

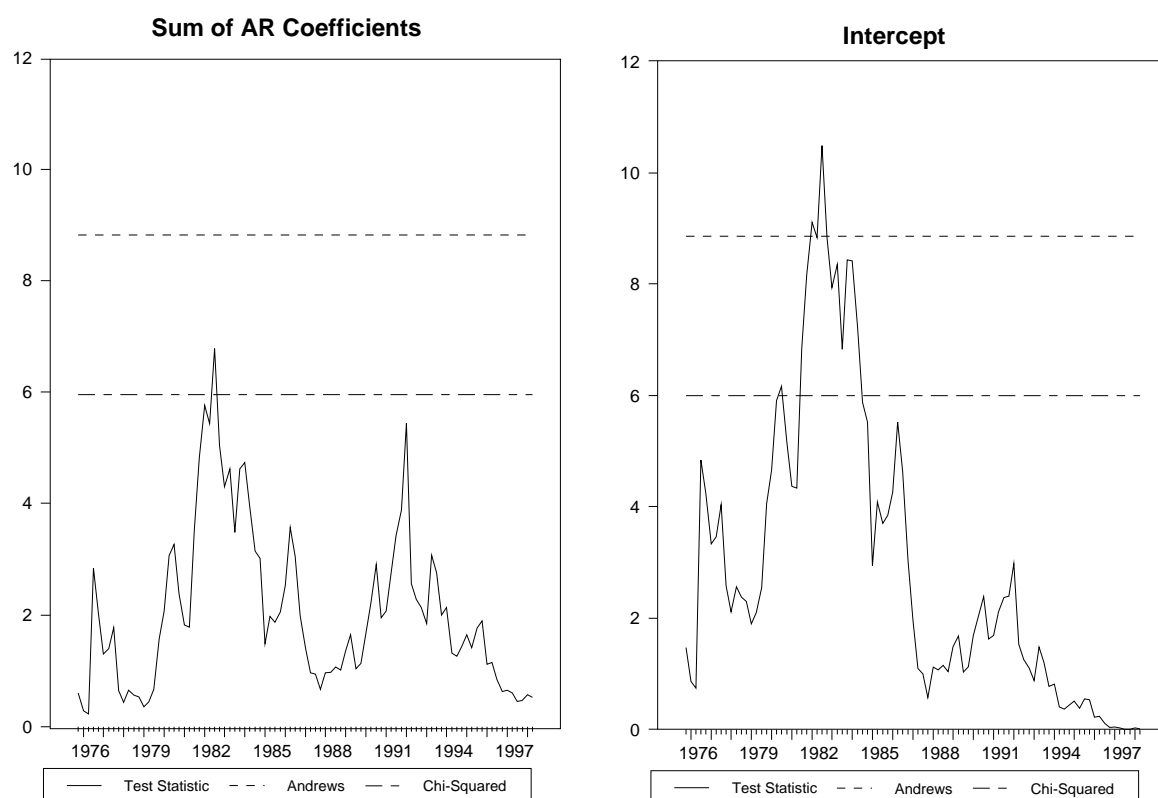
**Figure 1**

*Euro-Area Price Inflation (Quarter-over-Quarter, Annual Rate)*



## Figure 2

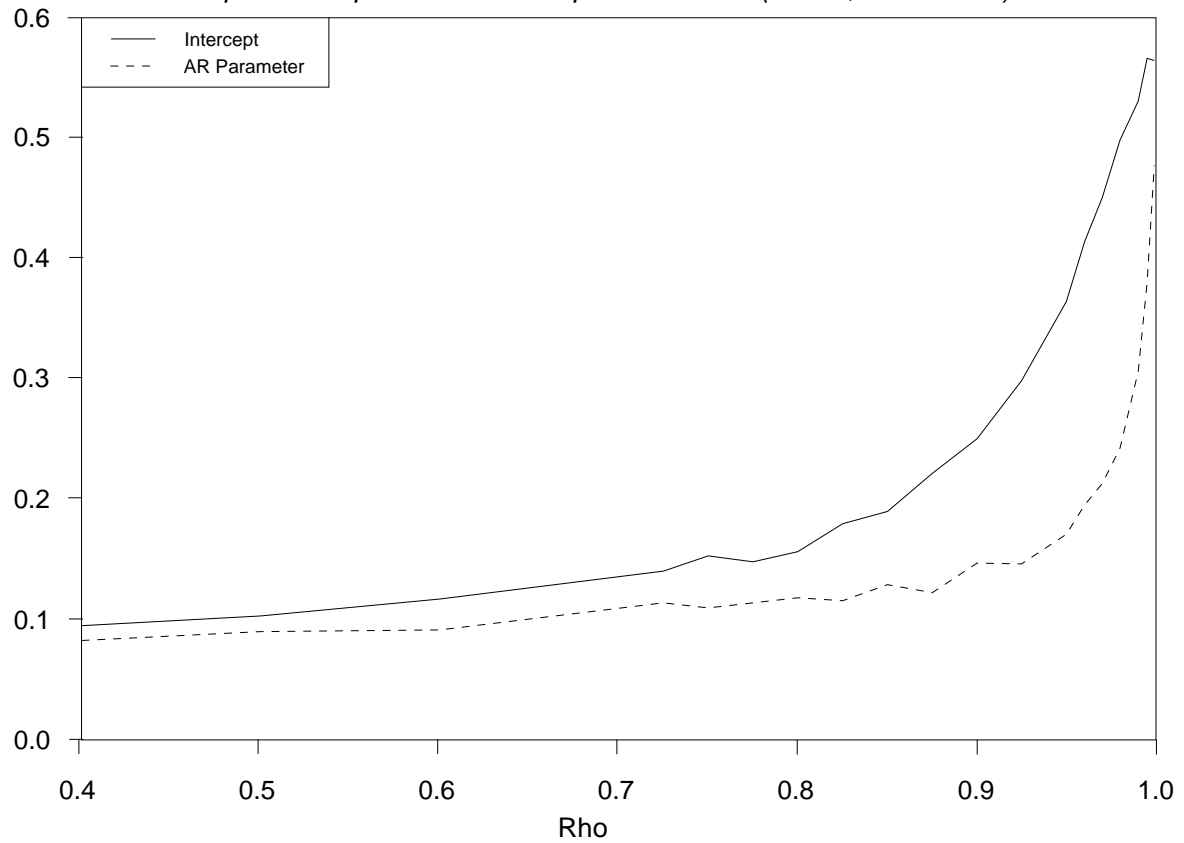
*Chow Test Sequences and 5% Critical Values: Univariate Model*





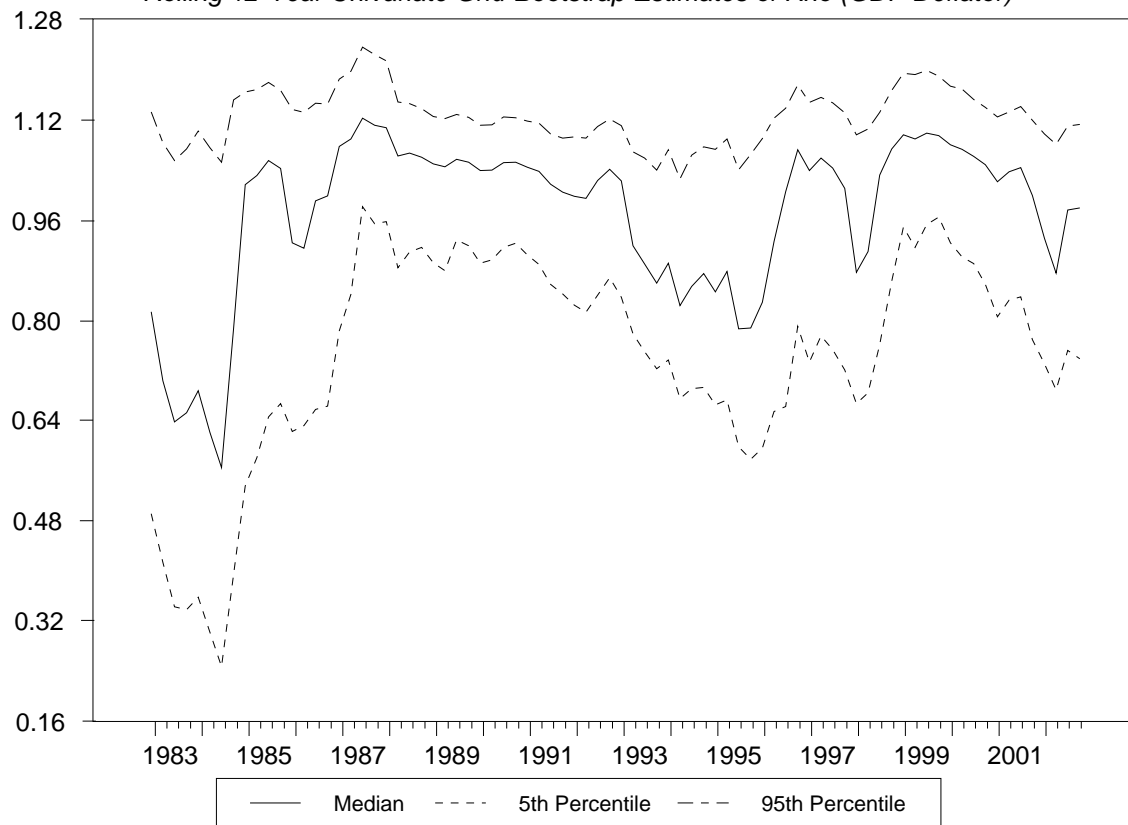
**Figure 3**

*Examples of Empirical Sizes of Sup-F 10% Tests ( $T=127,5000$  Draws)*

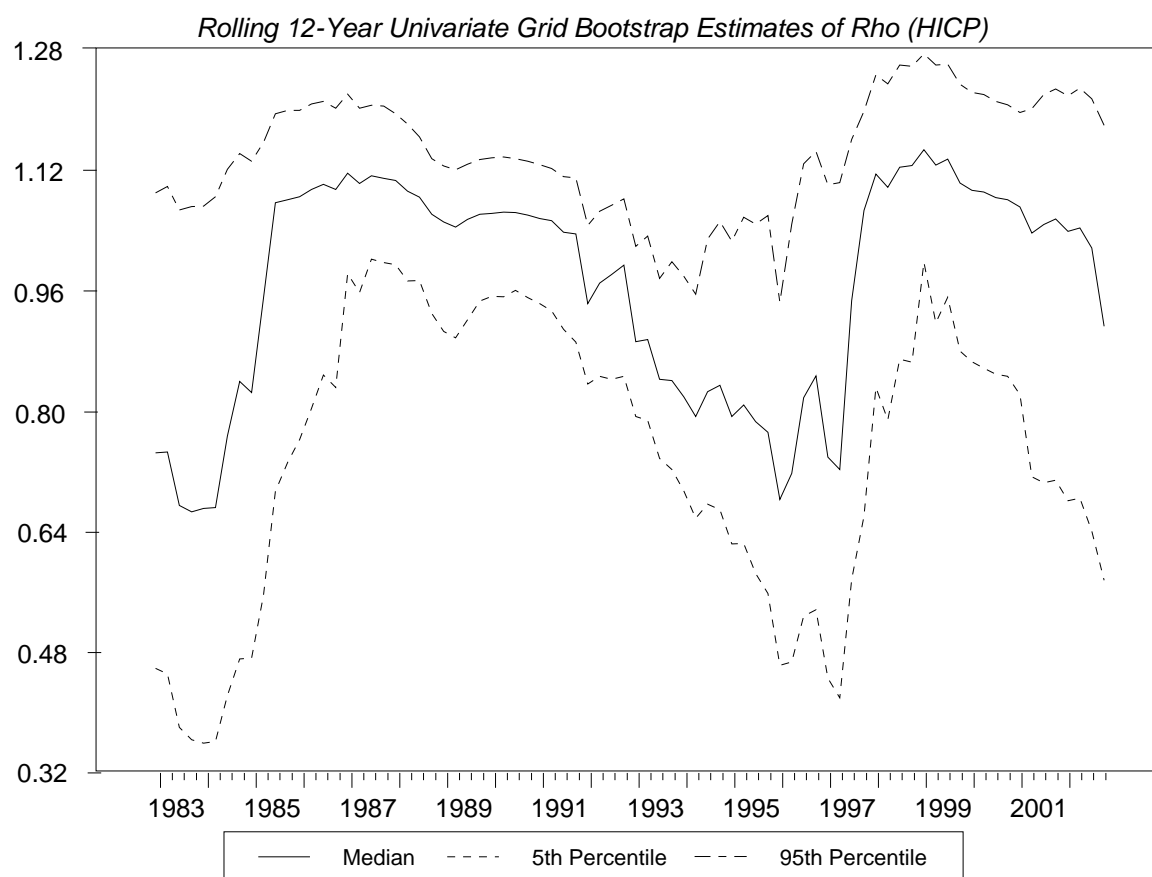


**Figure 4**

*Rolling 12-Year Univariate Grid-Bootstrap Estimates of Rho (GDP Deflator)*

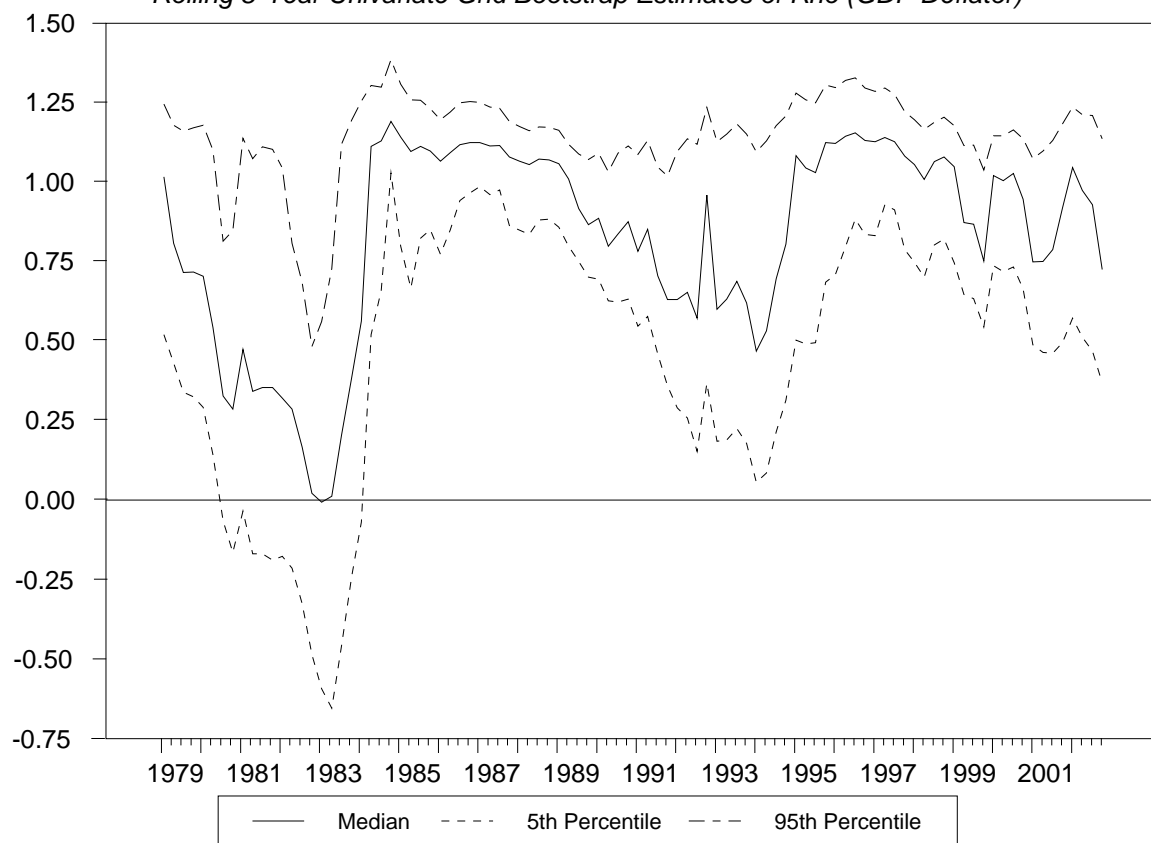


**Figure 5**



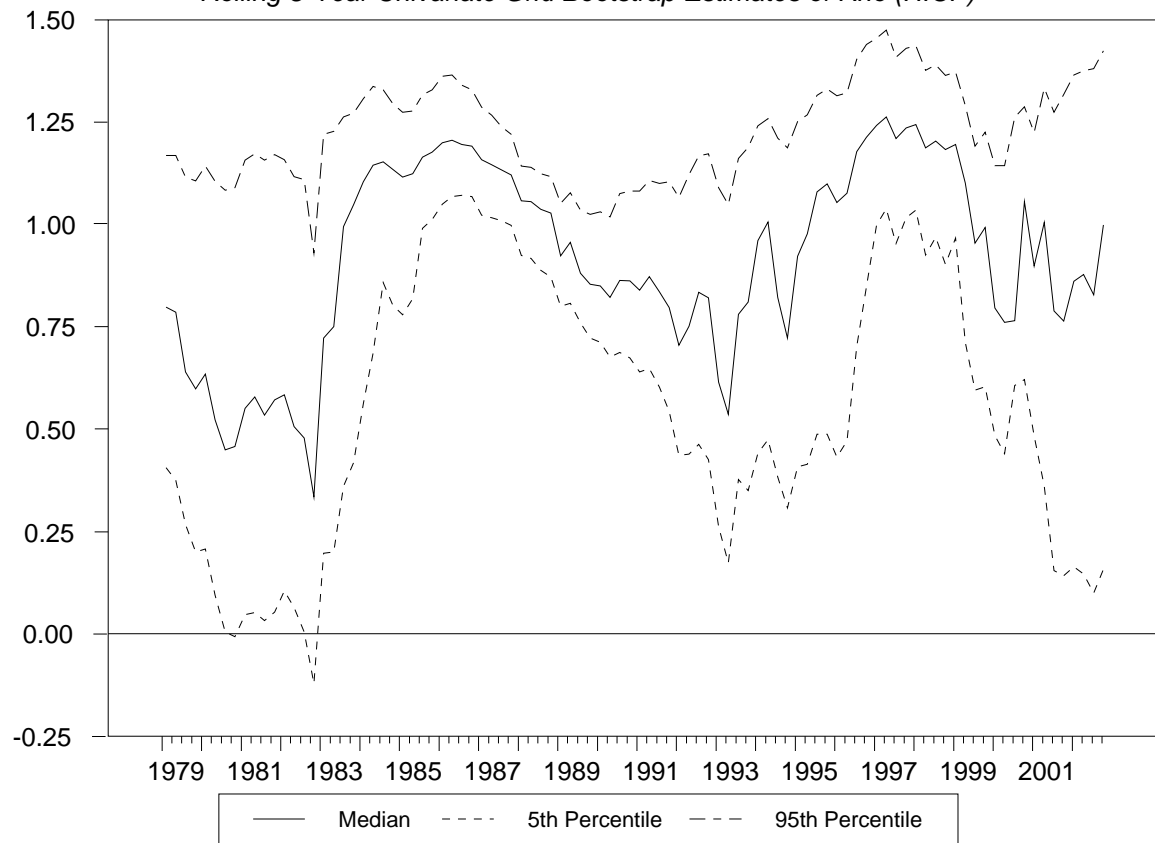
**Figure 6**

*Rolling 8-Year Univariate Grid Bootstrap Estimates of Rho (GDP Deflator)*



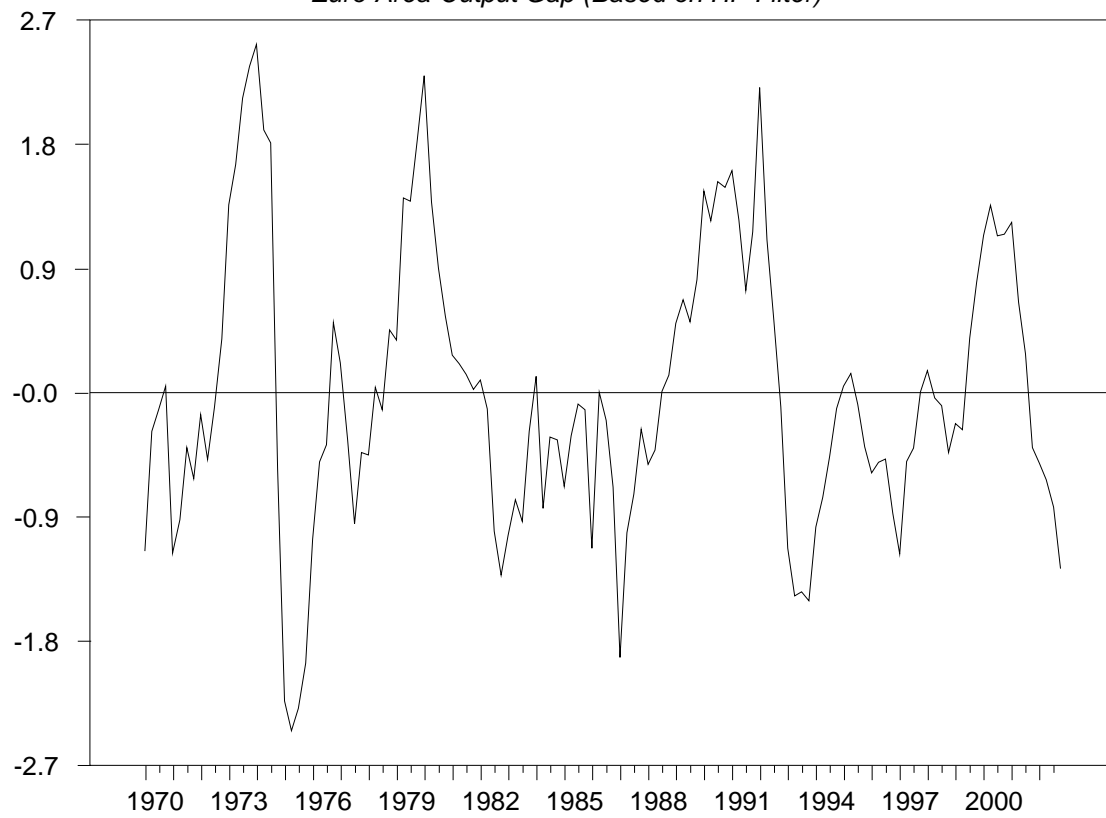
**Figure 7**

*Rolling 8-Year Univariate Grid Bootstrap Estimates of Rho (HICP)*



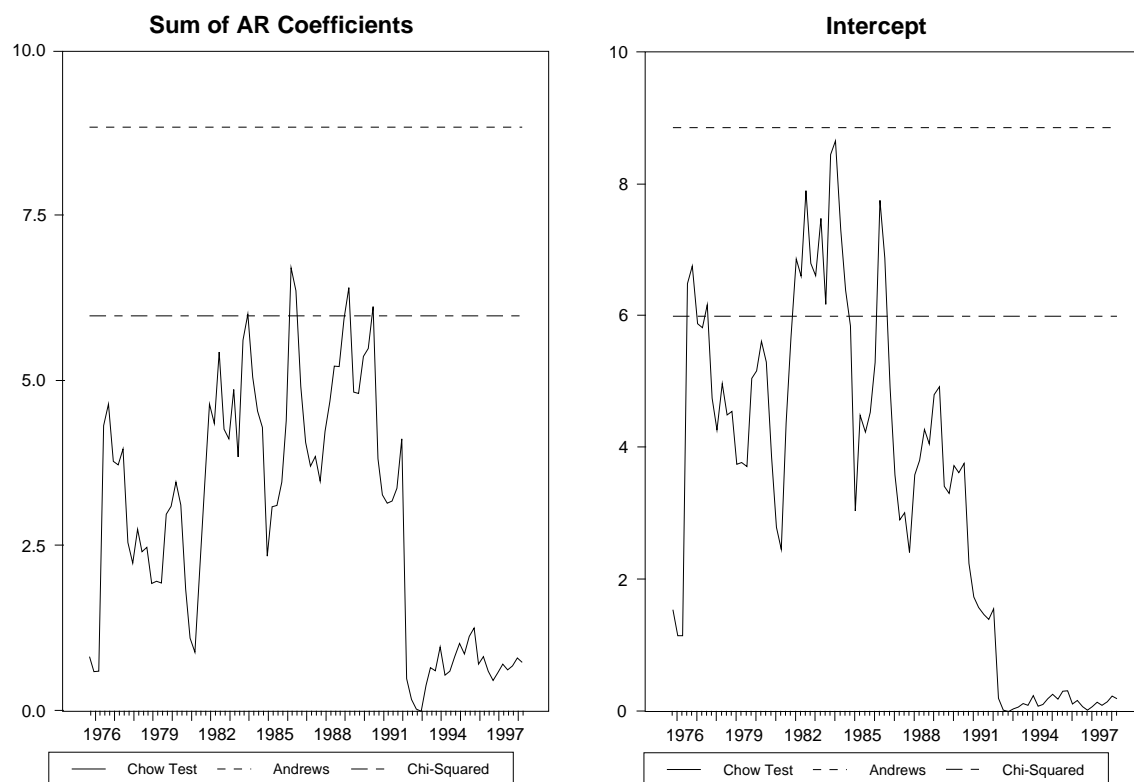
**Figure 8**

*Euro-Area Output Gap (Based on HP Filter)*



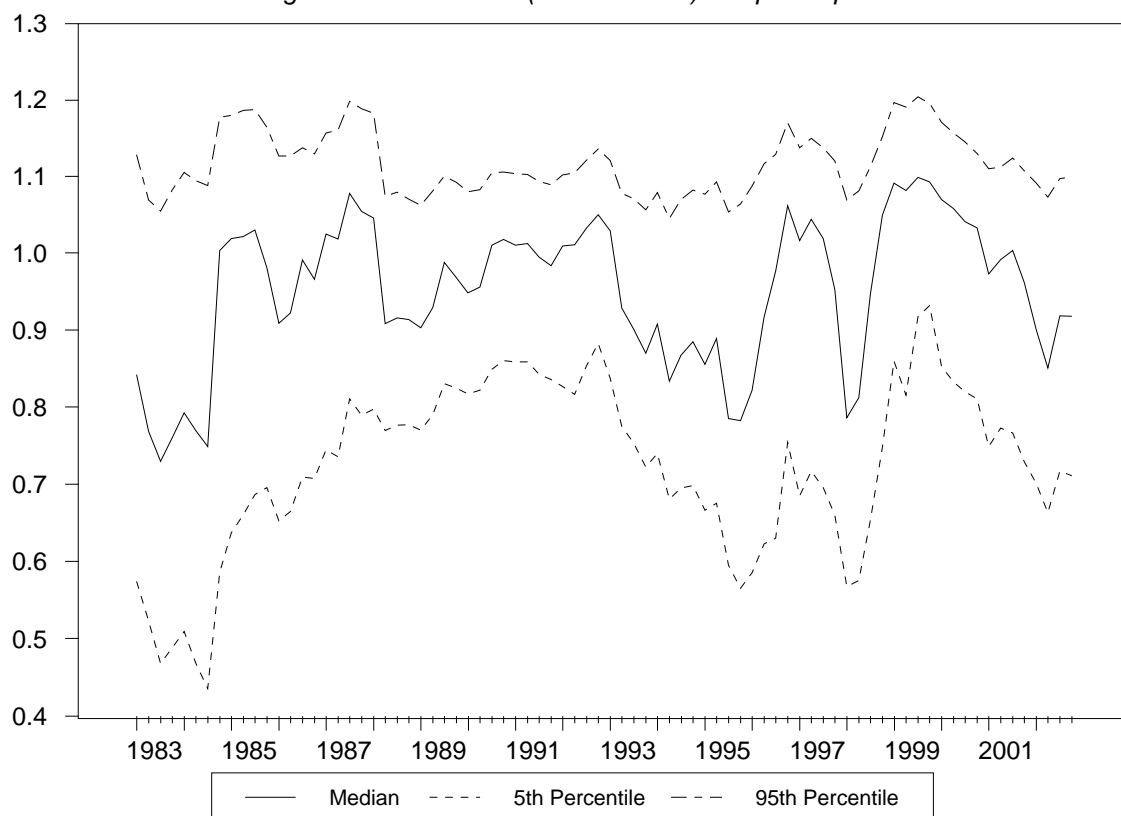
# Figure 9

*Chow Test Sequences and 5% Critical Values: Output Gap Model*



**Figure 10**

*Rolling 12-Year Estimates (GDP Deflator): Output Gap Model*





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