An Empirical Study of Interest Rate Determination Rules

Keshab Bhattarai
Lecturer in Economics, Business School
University of Hull
K.R.Bhattarai@hull.ac.uk.

Abstract

This paper finds empirical support for Taylor (1993) type interest rate determination rule. The model is solved analytically, estimated and used for simulation, impulse response analyses and forecasting with quarterly time series data for the UK and annual time series data for Germany, France, Japan, UK and the US. Results support that such rules implicitly exists during the period of analysis.

Key words: Inflation gap, output gap, interest rate

JEL Classification: E37 and E43

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I. Introduction

Changes in the interest rates have profound impacts on saving and consumption behaviours of households, on investment and capital accumulation decisions of firms, and on portfolio allocation of domestic and foreign traders in the financial and exchange rate markets. It is generally agreed that these changes affect the aggregate demand and aggregate supply positions in an economy that may occur immediately or over a lag of up to two years ((Keynes (1936), Hicks (1937), Phillips (1958), Friedman (1968), Phelps (1968), Tobin (1969), Kydland and Prescott (1977), Laidler and Parkin (1975), Taylor (1987), Nickell (1990), Taylor (1993)). They also influence the expectations and plans of economic agents about their own future and their perceptions about welfare and redistribution of income and about the prospects of the economy. As public fears that the policy makers may react unpredictably even violating promises they might have made for dynamic time consistency and credibility of policy the process of determination of interest requires transparency and co-ordination at national and international levels. UK, Europe and the majority of industrial economies have tried to solve these time inconsistency and credibility problems by making their central banks independent from the whims of the policy makers and initiated a rule based monetary policies aimed to achieve a pre-set inflation target. The short term interest rates have become key instruments to be determined by economic realities rather than by the discretion of the policy makers. When the interest rate policy is based on rules like this it is possible to trace out the potential effects of interest rates on market rates on various types of financial transactions and subsequent impacts on asset prices, expectations of households and firms and the exchange rates and ultimately through these prices into the aggregate demand, inflation and the rate of unemployment systematically with minimum errors.
How could macroeconomic stability and higher growth rate of output be achieved under such policy rules is explained sufficiently in non-technical terms in MPC (1999) and Bernanke and Mishkin (1997). Taylor (1993) uses a small scale model which shows how the interest rate can be systematically determined looking at the output gaps and inflation gaps to insure internal and external stability and to reduce the degree of fluctuations in aggregate economic activities. Woodford (2001) has shown how even a small Taylor type model can be consistent to detailed optimisation in more elaborate general equilibrium models though more detailed analyses of consequences of the interest rates by a central bank is often analysed using more comprehensive econometric and general equilibrium models, as discussed in Altig, Carlstrom and Lansing (1995) or in Holly and Weale (2000) or in HM Treasury (2002).

Given the strengths of a small scale model in explaining changes in the interest rate and its contribution in reducing the fluctuations in an economy, this paper aims to investigate how Taylor (1993) model fits to the interest rate series of the UK and five major industrial economies over last three decades. It complements to applied economic studies on this topics that have appeared in recent years; particularly those relating to the interdependency of real interest rates among G7 economies (Cheung and Westerman (2002), Ghazali and Ramlee (2003)) or to G3 economies (Yamada (2002)) or to Fisher hypothesis (Berument and Jelashi (2002), Sil vapulle and Hewarathna (2002)). Model discussed in this paper neither directly derives the interest rate rules using optimising models with non-negativity constraints on the interest rate as found in Sugo and Teranishi (2005) nor uses predominance of the majority vote rule over the consensus in setting policy as discussed in Gerlack-Kristen (2005). The empirical results emerging from single equation or simultaneous equations or panel
data or VAR-cointegration models generate results that are comparable to findings seen in studies by Asimakopoulos, Goddard and Siriopoulos (2000), Brooks and Skinner (2000), Castelnouvo (2003), Camarero, Ordonez and Tamarit (2002), Bacchetta and Ballabriga (2000) Lee (2002), Butter and Jenson (2004), Ferris and Galbraith (2003), Valente (2003), Ghazali and Ramlee (2003), Wetherilt (2003), Buch (2004), Staikouras (2004), Mills and Wood (2002). Some details on issues, methods and major findings of these various studies are given in the appendix. Study reported here also focuses on the long run relationship of the determinants of interest rate and its impacts on output and prices based on cointegration analyses for long run relationship between the interest rate and time series of output gap and inflation gaps in the UK and G7 economies. A simultaneous equation model is used to investigate the interdependency among these variables and a VAR impulse response model is used for analysing the impacts of unit shocks in output, inflation and the interest rate and for forecasting future values of these variables using information contained in their time series. Determinants of the interest rate in this paper are based analytically on the solutions of a second order difference equation for interest determination rule similar to that of Taylor (1993) in section II. A brief discussion of data set used for study is in section III. Empirical relevance of this model is tested with quarterly macro economic time series data for the UK and annual data for five major industrial economies during last three decades in section IV and conclusions and references are in section V.

II. A simple Interest Rate Determination Model

A simple interest rate determination model, originally proposed by Taylor (1993) for the Federal Reserves in the US, can be constructed using three equations.
First equation states the current output gap \(y_t - y_t^*\), the actual output relative to the trend output, as a function of the deviation of the interest rate one period earlier from the target interest rate of the monetary authority \(i_{t-1} - i_t^*\). This relationship is expected to be negative one as the higher interest rate is expected to slow down expenses by consumers and firms and generate contractionary impacts in the economy such as:

\[
y_t - y_t^* = -d(i_{t-1} - i_t^*) \quad \text{where} \quad d > 0
\]

where \(y_t\) and \(y_t^*\) are actual and natural level of output, \(i_t\) is the actual rate of interest in period \(t\), \(i_t^*\) is the target or the natural rate of interest for the monetary authority. This is similar to the equation for the investment-saving equilibrium relation (IS curve) in Woodford (2001), particularly when trends and targets are treated as expectations. More than one period lag can be assumed between the periods of the decisions of the interest rate and the changes in the output, though it was found not necessary for the current study.

The next equation shows how the price level in this economy responds to the level of economic activities, the aggregate supply. The expectation augmented Phillips curve in terms of output is given by:

\[
\pi_t = \pi_t^* + c(y_{t-1} - y_{t-1}^*) \quad \text{where} \quad c > 0
\]

where \(\pi_t\) and \(\pi_t^*\) are actual and target rates of inflation. When the output is above the trend in the last period, it creates an upward pressure in the labour market which raises the wage rate. Increase in the wage rate translates into higher prices and higher rates of inflation. Again this is similar to equation (3) in Woodford (2001) when target inflation rate is treated as expected rate of inflation. A simple interest rate rule is derived by combining (1) and (2) to show how the policy makers like to reduce
interest rate when both output and inflation rates are higher relative to their natural rates as:

\[ i_t = i_t^* + a(y_t - y_t^*) + b(\pi_t - \pi_t^*) \quad a > 0 ; b > 0 \quad (3) \]

If the output gap from (1) and inflation rate gap from (2) are substituted in the interest rate rule in (3) it generates autoregressive reduced form single equation of interest that can explain the cycles of interest rate in terms of reduced form parameters as :

\[ i_t = i_t^* - ad(i_{t-1} - i_{t-1}^*) - bcd(i_{t-2} - i_{t-2}^*) \]

\[ i_t + adi_{t-1} + bcdi_{t-2} = i_t^* + adi_{t-1}^* + bcdi_{t-2}^* \quad (4) \]

The stability or convergence properties of the second order difference equation (4) essentially depends upon values of the parameters \( a, b, c \) and \( d \) and two initial conditions for \( i_0 \) and \( i_1 \). For simplicity define \( \beta_0 = (i_t^* + adi_{t-1}^* + bcdi_{t-2}^*) \), and \( \beta_1 = ad \) and \( \beta_2 = bcd \). Then equation (4) can be written as:

\[ i_t + \beta_1i_{t-1} + \beta_2i_{t-2} = \beta_0 \quad (5) \]

The general solution to the reduced form difference equation (5) has complementary and particular parts. The particular solution refers to the steady state and the complementary solution shows a dynamic adjustment towards that steady state when the interest rate is above or below its natural rate. It explains the dynamics of the interest rate series. The convergence or divergence from the steady state or the natural rate of interest rate depend on this part of the equation.

The particular or steady state solution is easy, as interest rate in each period equals the steady state interest rate which can be also considered a natural rate of interest, i.e. \( i_t = i_{t+1} = i_{t+2} = \ldots = i_{t+n} \). Thus with some manipulation the steady state or the natural rate of interest rate for the above model can be expressed as:
\[ \tilde{i} = \frac{i_t^* + adi_{t-1}^* + bcdi_{t-2}^*}{1 + \beta_1 + \beta_2} \quad \text{or} \quad \tilde{i} = \frac{i_t^* + adi_{t-1}^* + bcdi_{t-2}^*}{1 + ad + bcd} \]

in terms of the original model parameters with flexible targets \( i_{t-2}^* \), \( i_{t-1}^* \) and \( i_t^* \) and as \( \tilde{i} = \frac{i_t^*(1 + ad + bcd)}{1 + ad + bcd} \) with fixed targets \( i_t^* \). \( \text{(6)} \)

Any short run disturbances from this natural rate should ultimately return to it due to forces of demand and supply in the financial markets and is represented by a homogeneous part of the solution.

\[ i_t + \beta_1 i_{t-1} + \beta_2 i_{t-2} = 0 \quad \text{(7)} \]

Theoretically the complementary solutions of (7) can have three different cases depending on the values of parameters \( \beta_0 \), \( \beta_1 \) and \( \beta_2 \):

(a) real and distinct root, when \( \beta_1^2 - 4\beta_2 > 0 \), guarantees convergence to the steady state.

(b) real and equal roots case, \( \beta_1^2 - 4\beta_2 = 0 \), generates repeated cycles and

(c) complex roots case with \( \beta_1^2 - 4\beta_2 < 0 \) gives a cyclical pattern which may converge or diverge from the steady state rate depending the absolute values of parameters.

The general solutions of the model in these three different cases are:

\[ i_t = A_1 \lambda_1^t + A_2 \lambda_2^t + \tilde{i} \quad \text{(8)} \]

where \( A_1 \) and \( A_2 \) are arbitrary constants and \( \lambda_1^t \) and \( \lambda_2^t \) are the characteristic roots.

In case (a) the value of \( \lambda_1^t = \frac{-\beta_1 + \sqrt{\beta_1^2 - 4\beta_2}}{2} \) and \( \lambda_2^t = \frac{-\beta_1 - \sqrt{\beta_1^2 - 4\beta_2}}{2} \).

Therefore the general solution (8) can be written as:

\[ i_t = A_1 \left( -\frac{\beta_1 + \sqrt{\beta_1^2 - 4\beta_2}}{2} \right)^t + A_2 \left( -\frac{\beta_1 - \sqrt{\beta_1^2 - 4\beta_2}}{2} \right)^t + \tilde{i} \quad \text{(9)} \]
More specifically using all the parameters of the model this turns to be

\[
i_t = A_1 \left( -ad + \sqrt{(ad)^2 - 4bcd} \right) + A_2 \left( ad - \sqrt{(ad)^2 - 4bcd} \right) + \bar{I}
\]  

(10)

The definite solution requires values of constant terms \( A_1 \) and \( A_2 \), which can be obtained using the two initial conditions, \( i_0 \) and \( i_1 \). Values of \( a, b, c \) and \( d \) parameters can be obtained from an econometric estimation. Literature suggests that interest rate, determined objectively in this manner, can be used to achieve price stability and real growth in the economy (Fisher (1977), Hanson (1980), Barro and Gordon (1983), Sargent (1986), Mankiw (1987), Driffil (1988), Goodhart (1989) Ball and Romer (1990), Alesina and Summers (1993), Nordhaus (1995), Dornbush and Fisher (1993), Lockwood, Miller and Zhang (1998), Vickers (1999), Nelson (2000), Corsetti and Pesenti (2001), Benigno (2002)).

**III. Data Set**

Interest rates have changed significantly over the years as shown in Figures 1a-1c. In general they were low and helped to generate unprecedented rate of economic growth in major industrial economies till late 1960s; increased and varied significantly and unpredictably in 1970s and 1980s characterising economic problems and have started changing systematically in a predictable manner as many western economies adopted rule based policy of determining these rates after mid 1990. Interest rates have become major tool for stabilising prices and the markets activities more in recent years.
Quarterly fluctuations in the series for the retail price index, growth rate of the real GDP and the Treasury bill rates, which represent the whole varieties of interest rate, from 1970:q2 to 1999:q4 are as presented in Figure 2. These series were obtained from the macro time series data archive in Essex (http://www.data-archive.ac.uk).

The fluctuations in the rate of interest, inflation and the growth of output were more serious in 1980s than in 1990. The UK economy has been stabilised and moving more towards its natural rate after 1995 particularly after the adoption of inflation targeting rule in 1997 (see Nelson (2000) for more division between sub periods). Similar pattern can be obtained from analysis of the annual data on growth rates output, rates of inflation and interest for Germany, France, Japan, and USA from 1978 to 2000 as shown in Figure 3. Quarterly time series shown in Figures 2 and annual series in Figure 3 are used for estimation of the interest rule model explained in the previous sections.
IV. Analysis of Results

Many factors other than the output gap and inflation gap influence the rate of interest in an economy. The econometric models incorporate these missing elements in the model given by equations (1)-(3) including error terms to each equation to represent the influence of these unknown factors. Some of these omitted factors have positive effect and others have negative effects. In aggregate the influences of omitted
variables or specification bias elements tend to cancel out each other making their mean to be zero. Further they are assumed to have constant variance to express no systematic relation among the errors. Technically speaking these errors are distributed normally, identically and independently. These assumptions imply that those errors are homoscedastic and have no autocorrelation and there is no multi-collinearity among the explanatory variables.

\[ y_t - y_t^* = d(t_{t-1} - t_{t-1}^*) + \epsilon_{1,t} \]  
\[ \pi_t = \pi_t^* + c(y_{t-1} - y_{t-1}^*) + \epsilon_{2,t} \]  
\[ i_t = i_t^* + a(y_t - y_t^*) + b(\pi_t - \pi_t^*) + \epsilon_{3,t} \]

Even if relations may be perfect there is still chance of regressions being spurious as the relation may be between nonstationary variables. We follow Dickey-Fuller (1976) Engle and Granger (1987) and Johansen and Juselius (1990) procedures to determine existence or absence of unit roots of a variable or cointegration among variable in the model.

Unit root test suggests that the interest rate variable is integrated of order one, \(I(1)\), and becomes stationary after differencing once. Both output gap and inflation gaps are stationary. The critical and estimated values of coefficients of the unit root for equation of these three variables (from the PC-Give outputs) are as shown in Table 1, along with significant lag lengths.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Stationarity of variables in the model</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADF tests (T=116, Constant; 5%=-2.89 1%=-3.49)</td>
<td></td>
</tr>
<tr>
<td>Interest rate</td>
<td>1\textsuperscript{st} Difference of the interest rate</td>
</tr>
<tr>
<td>Lags</td>
<td>2</td>
</tr>
</tbody>
</table>
Next it is shown how the Engle and Granger (1987) or Johansen (1988) procedure can be used to obtain a non-spurious regression between the interest rate and output and inflation gaps even if the interest rate series is non-stationary.

The basic relation between the interest rate and inflation gap and output gap for the UK is as given below.

\[
i_t = 9.446 - 0.183(y_t - y_t^*) + 0.370(\pi_t - \pi_t^*)
\]

\[
t (32.2) \quad (-1.1) \quad (2.84)
\]

\[
(S) (0.29) \quad (0.13) \quad (0.181)
\]

Normality test: \( \chi^2(2) = 11.279 \) \([0.0036]\)**

Interest rate rises with an increase in inflation and the coefficient is significant. The coefficient in the output gap does not have expected positive sign and it is also statistically insignificant. Above result also suggests that interest rate is more responsive to the inflation rate than to the output gap since the coefficient on output is not significant. These test results are comparable to that of Berument and Jelashi (2002), Silvapulle and Hewarathna (2002).

Figure 3:

**Interest Rate Determination Model: Actual and Predicted Series**

In addition the normality test in line with the Engel and Granger (EG) method of cointegration test suggests that residuals from the above regression of the interest rate
on output gap and inflation gap are non-stationary and hence this is a spurious regression.

What about estimating the interest rule in terms of the reduced autoregressive second order difference equation equivalent to that given in equation (5)? This gives reasonable results as:

\[ i_t = 1.630 + 0.582i_{t-1} + 0.244i_{t-2} \]

\[ t \text{-ratios (2.71) (6.42) (6.69)} \]

\[ r \text{-square } = 0.62 \quad \text{Durbin-Watson } = 2.0104 \]

All coefficients of the reduced form equation of interest for the UK have expected signs. It is however, difficult to retrieve the structural parameters of the original model from the estimates of the reduced form equation.

Alternative is to use a recursive estimation method where the output gap is estimated as a function of the lagged interest rate and then the inflation gap estimated on the lagged output gap and finally the interest rate rule equation estimated with the predicted values of the output gap and inflation gaps. The output gap is influenced by the interest rate, and the inflation gap is determined by the output gap and then that is determined by the interest rate. The recursive simultaneous equation estimation from UK time series that removes the simultaneity bias looks as following:

\[
\begin{align*}
\text{Interest rate: } & i = 4.969(y-y^*) -5.182 (p-p^*) \\
& (7.74) \quad (-7.27) \\
\text{Output gap: } & y-y^* = 0.08i + 0.504 (p-p^*) \\
& (7.75) \quad (5.21) \\
\text{Inflation: } & p-p^* = -0.071i + 0.421 (y-y^*) \\
& (-7.27) \quad (5.21) \\
\end{align*}
\]

\[ \text{System R-Square } = 0.8637 \]

The result of the simultaneous equation model has better overall fit even that of the results from the autoregressive model given above. Now the model explains about 86 percent of variation in the interest rate.
The above model can be estimated following Johansen and Juselius (1990) procedure for a cointegrated VAR model. The validity of this approach is based on the rank of the cointegration matrix of the structural coefficients that is crucial for determining the number of cointegration vectors in the model. Consider a VAR model for above three variables.

\[ Y_t = A_1 Y_{t-1} + \varepsilon_t \]

where \( Y_t \) is vector of interest rate, output gap and inflation gap and \( \varepsilon_t \) is the vector of normally and identically distributed random error terms. By subtracting \( Y_{t-1} \) from both sides

\[ \Delta Y_t = (A_1 - I) Y_{t-1} + \varepsilon_t \]

\[ \Delta Y_t = \Pi Y_{t-1} + \varepsilon_t \quad \text{where} \quad \Pi = (A_1 - I) \]

Here \( \Pi \) is the matrix of parameters showing the total long run relationship among variables. By using the cointegration procedure this matrix can further be decomposed into adjustment coefficients \( (\alpha) \) and cointegrating vectors \( (\beta) \) as \( \Pi = \alpha \beta' \). The matrix \( \beta \) denotes the long run steady state relationship among variables and \( \alpha \) is the dynamic process of adjustment towards that equilibrium. The estimation on interest rate, output gap and inflation gap for the UK for 1972:2 to 1999:4 obtained using the PcGive (Doornik and Hendry (2001)) yields following results.

\[
\Pi = \begin{bmatrix}
-0.03654 & -0.12011 & 0.18569 \\
0.02982 & -0.24185 & -0.08453 \\
-0.09433 & -0.07224 & -0.53655
\end{bmatrix}
\]

\[
\alpha = \begin{bmatrix}
0.01810 & 0.09100 & 0.01089 \\
0.01667 & -0.00346 & -0.00208 \\
-0.00793 & -0.20723 & 0.00692
\end{bmatrix}
\]
\[
\beta = \begin{bmatrix}
1.0000 & 0.19498 & -6.6460 \\
-13.850 & 1.0000 & 3.6355 \\
-4.3680 & 2.7897 & 1.0000
\end{bmatrix}
\]

The number of co-integrating vectors in the Johansen procedure is determined by
\[
\lambda_{\text{trace}(r)} = -T \sum_{i=r+1}^{n} \ln(1 - \hat{\lambda}_i) \quad \text{and} \quad \lambda_{\text{max}(r,r+1)} = -T \ln(1 - \hat{\lambda}_{r+1})
\]
statistics, where \( \hat{\lambda}_i \) denotes the eigenvalues of the characteristic matrix \( \Pi = (A_i - I) \) and \( r \) is an indicator for a reduced rank in \((k-r)\) for \( k \) number of explanatory variables. The calculated values of these statistics are compared with the theoretical critical values from Johansen and Juselius (1990) to ascertain the number of cointegrating ranks as following.

<table>
<thead>
<tr>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>( r = 0 )</td>
<td>56.86 [0.000]**</td>
<td>34.38 [0.000]**</td>
<td>55.43 [0.000]**</td>
<td>33.52 [0.000]**</td>
</tr>
<tr>
<td>( r \leq 1 )</td>
<td>22.48 [0.003]**</td>
<td>12.68 [0.087]</td>
<td>21.91 [0.004]**</td>
<td>12.36 [0.097]</td>
</tr>
<tr>
<td>( r \leq 2 )</td>
<td>9.80 [0.002]**</td>
<td>9.80 [0.002]**</td>
<td>9.55 [0.002]**</td>
<td>9.55 [0.002]**</td>
</tr>
</tbody>
</table>

These cointegration results are comparable to those found in other applied works such as Cheung and Westerman (2002), Yamada (2002), Brooks and Skinner (2000), Camarero, Ordonez and Tamarit (2002) and Silvapulle and Hewarathna (2002), Valente (2003), Mills and Wood (2002).

The order of the rank of \( \Pi \) suggests the number of cointegrating vectors in \( \beta \).

Above \( \lambda_{\text{trace}(r)} \) and \( \lambda_{\text{max}(r,r+1)} \) tests suggest that at least there are two cointegrating vectors in the above model. The long run relation among these variables is shown by a very good fit of the predicted and actual series of above three variables.

The fit of the predicted and the actual interest rate is almost perfect as shown in the figures 4.
The model estimated above can be used to analyse the impacts of shocks to each of the above equations in terms of incremental and cumulative impulse responses as shown in Figures 5 and Figure 6.

A unique shock to the interest rate by one standard unit reduces the output gap immediately with a lagged response in the rates of inflation; a similar shock to the output equation reduces the interest rate immediately and has lagged response in the rate of inflation rate as shown by graphs in the second row; an unit shock to inflation reduces the interest rate immediately and has lagged response in output gap as shown by graphs in row 3. Though the model converges to the steady state over periods, each of these shocks has its own patterns of impacts. The cumulative shocks corresponding to each of three unit shocks on treasury bills rate, output and inflation gaps in Figure 5 are shown by cumulative response graphs in respective positions in Figure 6. Dynamic forecasts along with their confidence bands are shown in Figure 7.
Figure 5: Impulse Response Analysis

Figure 6: Cumulative Impulse Response Analysis
Studying the time profiles of these shocks it becomes obvious that it may take from 4 to 24 quarters for economy to realise the impact of a shock to the interest rate. The above shocks can further be divided in real shocks to the output and the nominal sector shocks in terms of the interest rate. More detailed estimates for various sub-periods between 1973-2000 can be found in Nelson (2000) or in Castelnouvo (2003).

The estimation of the interest rule model for one economy can be extended to a group of economies taken together. An attempt is made here to test it for five major industrial economies France, Germany, Japan, UK and the USA using the annual data set on growth rates of output, inflation and interest rates obtained from the World Bank (2002). Three steps are involved in applying this interest determination model to five major industrial economies. First step involves estimation of the current output gap as a function of the actual interest rates in the previous period relative to a trend interest rate, and the estimation of current inflation gap as a function of output gap in
the previous period. These predicted series of output and inflation gaps are used to estimate model generated interest rate for each period in the second step. A comparison is made between the series of the actual interest rates to those predicted by the model in the third stage. Then the quality of predictions of the model are judged using test statistics and studying whether model based prediction can track actual interest rates well and decompose the sources of changes in the interest rate into the real or supply side factors as represented by the output gap and the demand side factors as represented by the inflation gaps.

Table 3
Test of Interest Determination Rule for Five Major Economies

<table>
<thead>
<tr>
<th></th>
<th>Output gap</th>
<th>Inflation gap</th>
<th>Constant</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>-6.641</td>
<td>0.670</td>
<td>5.900</td>
<td>0.766</td>
</tr>
<tr>
<td></td>
<td>(-14.778)</td>
<td>(1.341)</td>
<td>(1.341)</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>-10.732</td>
<td>4.335</td>
<td>5.339</td>
<td>0.752</td>
</tr>
<tr>
<td></td>
<td>(-15.187)</td>
<td>(4.953)</td>
<td>(11.898)</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>-6.775</td>
<td>-1.794</td>
<td>-1.312</td>
<td>0.641</td>
</tr>
<tr>
<td></td>
<td>(-6.554)</td>
<td>(-7.061)</td>
<td>(-3.487)</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>-2.941</td>
<td>1.006</td>
<td>7.416</td>
<td>0.574</td>
</tr>
<tr>
<td></td>
<td>(-5.885)</td>
<td>(2.848)</td>
<td>(10.203)</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>-1.794</td>
<td>0.360</td>
<td>5.337</td>
<td>0.696</td>
</tr>
<tr>
<td></td>
<td>(-7.061)</td>
<td>(0.408)</td>
<td>(18.955)</td>
<td></td>
</tr>
</tbody>
</table>

Estimates from a 3SLS method, values in the parenthesis represent t-statistics.

Explanatory power of this model in analysing the behaviour of the interest rate in each economy is quite remarkable as shown by significant t-values for coefficients and higher values of R-square statistics. Sizes of the coefficients of output gap vary substantially across these countries reflecting the link between the interest rate and growth rate of the economy comparable to those found in other studies (Cheung and Westerman (2002), Yamada (2002)). These output gap coefficients are significant for each of the above countries at one percent level of significance as shown by the t-statistics. These economies reduce interest rate whenever actual output growth rate is below the trend growth rate and raise it whenever the actual growth rate is above the
trend growth rate in order to avoid inflationary consequences. There is dissimilarity however, regarding the link between the interest rate and inflation gap among these countries both is terms of size of the coefficients and their significance. All countries except Japan have expected sign of the coefficient on the inflation gap but that is not significant for the US. Despite this the predictive power of each equation remarkably suggests for existence of interest rate rule among these economies during the study period.

When we study the interdependence in the interest rate determination among G5 major economies treating them as one by pooling cross section and time series data for entire 1978-2000 period, it generates following result.

\[ i_t = 6.25 - 0.29(y_t - \bar{y}) + 0.115(\pi_t - \pi_t^*) \]

\[ \begin{align*}
  \text{t-ratios} & \quad (0.80) \quad (-3.30) \quad (1.33) \\
  R^2 & = 0.43 \quad F = 5.5; \quad N=100
\end{align*} \]

From economic point of view this result is not very sensible. In theory the interest rate should rise when output is above its trend but here estimated coefficient has a negative sign showing a reverse result. The coefficient on inflation gap has expected positive sign but it is not significant at 5 percent level of significance. These results do not support the hypothesis of interest rate determination rule at aggregate level by G5 countries for this period though it is supposed to be so in the literature (Asimakopoulos, Goddard and Siriopoulos (2000), Lee (2002), Butter and Jenson (2004), Ghazali and Ramlee (2003), Buch (2004)). Each of G5 countries were acting independently in determining its own interest rate. Analyses on how the interest is determined and how it affects other economies requires more detailed specification of demand, production, portfolio allocation and trade structure of the monetary economy in line with Tobin (1969), Altig, Carlstrom and

V. Conclusion

Analytical solution for interest rate rules in a three equation model is found using a second order-difference equation technique in terms of model parameters. Those parameters were estimated using the quarterly time series data on treasury bills rate, growth rate of output and inflation rates for UK, the annual time series during the last three decades for Germany, France, Japan, UK and the US. The evidence suggests existence of an interest rule. This empirical model is then applied for impulse response analysis and forecasting.

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References:


### Appendix

Summary of recent applied studies on the determination and interdependence in the interest rates and their impact among economies

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<td>Brooks and Skinnert (2000)</td>
<td>What will be the risk-free rate and benchmark yield curve following European monetary union?</td>
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<td>Ferris and Galbraith (2003)</td>
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<td>Wetherilt (2003)</td>
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