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Inflation expectations and regime shifts in the euro area

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Suomen Pankki
Bank of Finland
P.O.Box 160
FI-00101 HELSINKI
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The views expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

* Monetary Policy and Research Department, Bank of Finland, B.O. Box 160, FIN-00101 Helsinki, Finland and Department of Economics, FIN-20014 University of Turku, Finland. E-mail: matti.viren@bof.fi.

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Matti Virén
Monetary Policy and Research Department

Abstract

This paper focuses on the determination of inflation expectations. The following two questions are examined: How much do inflation expectations reflect different economic and institutional regime shifts and in which way do inflation expectations adjust to past inflation? The basic idea in the analysis is an assumption that inflation expectations do not mechanically reflect past inflation as may econometric specification de facto assume but rather they depend on the relevant economic regime. Also the adjustment of expectations to past inflation is different in different inflation regimes. The regime analysis is based on panel data from EMU/EU countries for the period 1973–2004, while the inflation adjustment analysis mainly uses the Kalman filter technique for individual countries for the same period. Expectations (forecasts) are derived from OECD data. Empirical results strongly favour the regime-sensitivity hypothesis and provide an explanation for the poor performance of conventional estimation procedures in the context of Phillips curves.

Key words: inflation expectations, Kalman filter, stability

JEL classification numbers: E32, E37

Inflaatio-odotukset ja regiiminmuutokset euroalueella

Suomen Pankin tutkimus
Keskustelualoitteita 25/2005

Matti Virén
Rahapolitiikka- ja tutkimusosasto

Tiivistelmä

Tämä tutkimus koskee inflaatio-odotusten määräytymistä. Tarkasteltavana ovat kysymykset, miten paljon inflaatio-odotukset heijastavat erilaisia taloudellisten ja institutionaalisten regiimien muutoksia ja miten inflaatio-odotukset sopeutuvat aiempaan inflaatioon. Analyysin kantavana ajatuksena on oletus, että inflaatio-odotukset eivät mekaanisesti heijasta aiempaa inflaatiota, niin kuin useimmat ekonometriset täsmennykset itse asiassa olettavat, vaan ne riippuvat kulloisestakin taloudellisesta regiimistä. Myös inflaatio-odotusten sopeutuminen toteutuneeseen inflaatioon on erilaista erilaisissa inflaatio-oloissa. Regiimianalyysit perustuvat EMU- ja EU-maita koskevaan paneeliaineistoon, joka kattaa ajanjakson 1973–2004, kun taas inflaatio-odotusten sopeutumista koskevat analyysit tukeutuvat pääasiassa Kalmanin suodatintekniikkaan, jossa tarkastelun kohteena ovat yksittäiset EU-maat. Odotukset (ennusteet) perustuvat OECD:n tilastoihin. Empiiriset tulokset tukevat voimakkaasti regiimisensisitiivisyyshypoteesia ja tarjoavat selityksen tavanomaisen estimointimenettelyn huonolle toimivuudelle Phillipsin käyrien tapauksessa.

Avainsanat: inflaatio-odotukset, Kalmanin suodatin, stabiilisuus

JEL-luokittelu: E32, E37

Contents

1 Introduction

This paper deals with inflation expectations. Put very simply we want to examine the question of how sensitive inflation expectations are in terms of different economic regimes. For regimes, we consider some basic institutional regimes like the EMU membership. But above all, we are interested in the role of different inflation regimes. Then relevant question is whether inflation expectations are invariant to these regimes (or more precisely, whether the way in which inflation expectations respond to past inflation stays the same in different inflation regimes).

The role of inflation expectation is crucial in modelling and explaining changes in actual inflation. Concretely this shows up in the context of Phillips curves. The problem is that in this context we have not been very successful and this is true both in general and in particular concerning the role of inflation expectations (see eg Zhu (2005) and Linzert (2005) and Tillman (2005)). When we deal with inflation expectations we usually mean expected future values of inflation that is constructed by means of the (orthogonality conditions of) GMM. This way of constructing inflation expectations has its obvious shortcomings, especially because it postulates a quite mechanical relationship between expected inflation and past inflation and, in addition, past values of some (usually quite few) other variables. Thinking about other relevant variables which may characterize the inflationary environment and the Central Bank's ability and willingness to control inflation this approach might well be quite deficient and that in turn might explain the relatively poor performance of Phillips curves.

This is why we in this paper try shed some light on question of how much measured inflation expectations or forecasts seem to reflect things other that past inflation, and to the extent they just reflect past inflation, in which this relationship has (possibly) changed over time. "The other things" here mean various policy regimes or environments such as the EMU membership. When we focus on the "inflation regimes" and the possible variance of expected inflation past actual inflation relationship we mainly think about the high inflation regime in the 1970s and the subsequent steps towards lower inflation in the 1980s and 1990s. As a practical tool we use the time-variant adaptive expectations rule originally proposed by Stephen Turnovsky in 1969 which easily allows for time-variant parameter estimates with the Kalman filter technique.

The whole analysis makes use of inflation (and output) forecasts made by the OECD. Although some alternative sources of inflation forecasts do exist (see eg Mankiw, Reis and Wolfers (2003) and Adam and Padula (2004)) OECD forecasts are superior in the sense that they cover all industrialized countries in the same way and, moreover, they also facilitate the follow-up the inflation up-dating procedure. In other words, we can instead of the most recent (2005) inflation

numbers use the so-called real-time data which corresponds the most recent inflation estimate of actual inflation that forecasters have had in making assessments on future inflation.

2 Analytical framework

When analyzing the role different regimes we follow a quite straightforward way in tracking the regime effects. That is, we fit the following simple dummy regression into the data.

$$p^{e}_{t+1} = a_t + \sum_j a_j D_{ijt} + u_{it} \tag{2.1}$$

where i is the index for the country, j for the regime (dummy) and t for the time period. The dummies represent such things as: adoption of formal inflation target, change in Central Banks legislation, depreciation or appreciation of currency, (major) change in financial markets which in practice means various steps in liberalizating credit (and foreign exchange) controls, (major) fiscal stabilization efforts (packages) and various institution regime indicators (EU membership, EMS and ERM membership and, finally, the EMU membership). The corresponding data are collected from the OECD Economic Outlook, from the OECD country surveys, and from various policy reviews from individual countries (published by the ministries of finance and the central banks). The model is estimated from panel data which cover the period 1972–2004 and using OECD forecasts for p^{e}_{t} (Table 1).

In addition to regime dummies, we use some ex-post data for fiscal balances and import prices to assess their importance as indicators of different fiscal and inflation regimes (Table 2). This is partly motivated by the fact that in the analysis of regime indicators (dummies) it clearly shows up that these variables cannot really explain the change of inflation expectations during the two oil crises in 1974 and 1979/1980. As for the fiscal indicators, we want to use also actual data in distinguishing (possible) fiscal regimes. The data which we otherwise have are (non-quantitative) data for pronounced fiscal stabilization programs which may obviously tell more on fiscal stabilization problems than successful fiscal policy. It might be tempting to think that the performance fiscal variables might also shed some light on the relevance of the "fiscal theory of inflation" but obviously this is not way the theory could be tested.

As a separate exercise we scrutinize the relationship between OECD inflation and output growth forecasts. More precisely, we want to see whether the corresponding forecast errors reflect some form of Phillips curve. In practice, this

analysis boils down in estimating the following relationship in a panel data set- up for 15 EU countries for the sample period 1973–2004

$$p - p^e = \alpha * (y - y^e) + u \tag{2.2}$$

The corresponding results are reported in Table 3 and in Figure 2.

As for the inflation regime analysis, we proceed as follows. We examine the relationship between inflation forecasts and past (observed) inflation using the following adaptive expectations formula as a starting point

$$\Delta p^e = \theta(p_{-1} - p^e_{-1}) \tag{2.3}$$

where p denotes the rate of inflation p^e being the corresponding forecast value.

In an old (classical) paper Turnovsky (1969) shows that it is now point of assuming θ constant. Instead, one may use the idea of Bayesian "learning" in a cross-section setting to derive the following expression for it

$$\theta = \left(1 - \frac{\omega_{t+1}}{\omega_t}\right) \tag{2.4}$$

where ω denotes the subjective variance associated to the average price level. It can be shown that $\frac{1}{\omega_{t+1}} = \frac{1}{\omega_t} + \frac{n_t}{\sigma_t^2}$, where σ^2 is the variance of individual prices and n the number of markets (goods).

Clearly, the coefficient of "adaptive expectations" parameter does not stay constant unless the sampling procedure of the decision maker (forecaster) satisfies some quite strict (unrealistic) assumptions (cf Turnovsky (1969) for details). Clearly if $\frac{1}{\omega_t} = 0$, ie the precision of the estimate of the price level is extremely low, we end up with simple static expectations' rule where $p^e_t = p_{t-1}$. By contrast, full inertia in expectations results when $\sigma^2 = \infty$ and one cannot improve the initial estimate of ω (except for investing infinite amount of resources to the sampling procedure).

Now if one just focuses prices and inflation (and ignores all other relevant information) we may expect that that expected inflation react to past inflation quite differently in different regimes (which basically differ in terms of the relative variances of relative and aggregate prices). Thus, in the high-inflation regime of the 1970s θ may we be close to 1 while in the current "no inflation" regime θ is zero.

Technically, the problem could be solved by using the Kalman filter in estimating the adaptive expectations scheme (2.1) and acknowledging that the evolvement of θ depends on the respective signal-noise ratio.

Then the estimating model is of the following form

$$\begin{aligned} \Delta p^e &= g * (p_{-1} - p^e_{-1}) + \mu \\ g &= g_{-1} + \varepsilon \end{aligned} \tag{2.5}$$

where change in the (expected) inflation now represents the signal and the coefficient of the forecast error the state. μ and ε are both assumed Gaussian and contemporaneously uncorrelated. μ represent a shock on inflation expectations while ε represent a shock on the prediction formula. Assume that we (ie agents) know the signal-to-noise ratio $\frac{\delta^2\varepsilon}{\delta^2\mu}$, we can compute the filter. Here, in the same way is in Edge, Laubach and Williams (2004), we use not only the actual data but also the real-time data, in computing the forecast errors.

Time-variant θ parameter can estimated more easily in a panel-data context by just fitting the "adaptive expectations" formula $\Delta p^e = \theta_i (p_{-1} - p^e_{-1})$, i = 1973,…,2004, into the data. Results from these analyses are reported in Figures 3–4. Kalman filter estimates are reported in Table 4 and Figures 5–9. They represent both average values for all EU countries and individual country results. As for individual country results, the results for Germany are analyzed separately (Figure 7).

3 Results

Turn first to the result with regime dummies. The results in Table 1 quite clearly show that they can in a reasonable way explain the changes in inflation expectations. This is true even in the case the models include annual dummies which presumably take into account changes in overall inflationary environment. The dummies seem mainly to reflect two oil shocks and subsequent high inflation periods (see Figure 1) which obviously cannot be controlled by our regime dummies.

As for individual dummies, we find that all perform in a meaningful way irrespectively of the estimation method and data transformations. Thus, inflation targeting and strengthening of central bank position in control of inflation seem to lower inflation expectations. Developments in exchange rates seem to be even more important in this respect. Obviously this may simply reflect the direct pass-through of import prices as a consequence of depreciation/appreciation of

exchange rates. But equally well it may reflect the changes in monetary policy credibility. In the environment in which exchange rate targeting represented the dominating policy rule failures in preserving the target must have had some effect in anticipations on future monetary policy developments.

Financial market reforms do not seem to affect very strongly on inflation expectations, or maybe the effect is a sum some conflicting tendencies. Reforms have created more efficient and transparent markets but also, at least in the short run, created some inflationary pressure due to asset price increase (which was often characterized as bubbles).

As for different "membership" dummies, we find that membership in the European Union has not been particularly important although it has a quite systematically negative effect on inflation expectations. In this respect, memberships in the EMS/ERM and EMU have been more important – at least in the sense their effects can be estimated more precisely.

Finally, turn to the effects of so-called fiscal stabilization programs. At face value, one might imagine they affect inflation expectations in "a correct way" (lower expected inflation"). The data tells a different story. An obvious explanation is a "sample selection bias" type effect which is due to the fact that fiscal stabilizations were needed only in the case fiscal balance had either been lost or there has been a great danger of loosing the balance. Of course, fiscal stabilization efforts could have been useful from the perspective of inflation control (in the case fiscal problems do exist) compared with the alternative of "do nothing". Still the (overall) effect which obtained here may tell that the fiscal programs have not been very effective in general.

The considerations give a good reason to look the effects of (measured) true fiscal balance on inflation expectations. Results form this analysis are reported in Table 2. In the estimating equation we have also import prices mainly to control the development in oil prices. The results represent really no surprise; better fiscal balance seems lower expectations on future inflation.

Before we turn to analysis on the role of past inflation we shortly scrutinize the relationship between expected inflation and expected output growth. The results from this analysis which in precise terms concerns the relationship between the respective forecast errors (with different time horizons) are reported in Table 3 and Figure 2. The somewhat surprising result is the fact these two forecast errors seem to negative correlated (except for a long – two years' – time horizon). The result is somewhat puzzling from the Phillips curve point of view and cannot be simply explained. One important point is the fact that correlation between the forecast errors is after all relative small (of the magnitude of 0.01–0.04 measured by the R^2 of the estimated equation) which suggests that forecast errors are to large extent variable-specific and reflect difference sources of effects.

Next we turn to the analysis of inflation regimes which in practice means estimating the adaptive expectations formulas (2.2) and (2.3). (2.2) was estimated

panel data using time-variant coefficients of lagged inflation forecast errors (see Figures 3 and 4). Equation (2.3), in turn, is estimated in a single country equation framework using the simple Kalman filter representation.

The results of both analyses point to same direction: parameter θ has clearly decreased over time.[1] Thus, while in the mid 1970 the coefficient seems to have been close to one now it is decreased, if not to zero, but to 0.5, or below that. In the 1970s the mechanism of inflation expectations was close to regressive expectations in which expected inflation is just a reflection of past inflation. Now we have turn to system in which past inflation is less important, and in some cases even of zero importance. Basically this is no surprise; if inflation settles down to the proximity of the inflation target level variations of past inflation are not very informative in predicting future developments.[2] For the sake of future developments, other things, like overall policy credibility, or policy uncertainty are more important.

4 Concluding remarks

This analysis has showed that one should careful in treating inflation expectations in mechanical way as reflections of past values of typical set of macro variables. The formation of inflation expectations is probably sensitive to different policy regimes and there identification of these regimes becomes important. As for the main analytical tool, the Phillips curve, this means that efforts in rescuing the currently standard New Keynesian Phillips curve by, for instance, introducing more dynamics, may not be very successful. Irrespectively of question what is the right remedy it seems well-founded to put more effort in examining the propagation mechanism of inflation expectations because after expectations are instrumental in the whole process of inflation.

[1] The decline of the θ parameter is not monotonic as can be seen from figures 7–9. Thus, for instance, in the case of Germany the parameter starts to increase again in about 1990. This may be explained by German unification but it is not all clear whether this is the (whole) explanation. Similar changes appear in many other countries as well and also Figure 1 indicates that at this point of data inflation expectations in the whole EU experience a sudden increase (which by the way cannot be explained by exchange rate depreciation and appreciation dummies).

[2] This is a bit similar thing than the gold standard before the first Wold War. Then price level was more or less stationary and inflation could not be properly forecast. Accordingly, the Fisher equation does not seem to perform very well. See eg Barsky (1987) for details).

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Tables 1–4

Tae 1. **Testing the impact of regime-change dummies**

	1	2	3	4	5	6
Constant	4,868	6.055	8.917	9.316	8.543	
	(13.541)	(26.67)	(19.25)	(15.79)	(19.53)	
Inflation target	-.301	-3.503	-1.331	-1.189	.127	-.513
	(0.68)	(3.61)	(5.87)	(3.95)	(0.73)	(2.29)
Devaluation of currency	.590	2.060	.725	2.413	1.284	.022
	(1.45)	(2.53)	(2.02)	(2.48)	(2.06)	(0.08)
Revaluation of currency	-.650	.184	-.845	-1.291	-2.987	-.089
	(2.55)	(0.42)	(2.12)	(2.72)	(3.41)	(0.53)
Liberalization of financial markets	-.028	-.165	-.128	-1.032	.428	.432
	(0.09)	(0.23)	(0.36)	(1.25)	(0.50)	(1.95)
Change in Central Bank position	-.195	-1.909	.212	-1.046	.370	.308
	(0.80)	(32.85)	(0.81)	(2.77)	(0.80)	(2.09)
EU membership	.562	-.951	-.198	-.894	-.169	-1.220
	(0.98)	(0.58)	(0.89)	(1.40)	(0.52)	(2.63)
EMS membership	.649	1.627	-3.331	-4.422	-3.776	.700
	(1.55)	(2.02)	(16.03)	(8.14)	(6.08)	(1.71)
EMU membership	-2.017	-2.324	-1.892	-1.512	-.029	-.300
	(2.22)	(4.16)	(4.87)	(4.87)	(0.14)	(2.23)
Major stabilization package	3.210	4.894	2.293	3.785	4.681	1.518
	(3.39)	(2.37)	(2.38)	(1.94)	(3.02)	(1.92)
R^2/SEE	0.213	0.129	0.634	0.430	0.549	0.054
	0.825	4.361	0.902	4.015	3.282	0.977
DW	1.07	0.47	1.33	0.68	0.55	2.01
Estimator	SUR	GLS, CSFE	SUR	GLS	GLS,TSFE	SUR
Dummies	impulse	impulse	permanent	permanent	permanent	impulse

The dependent variable in equations 1–5 is the OECD forecast for next year's inflation. In equation 6, it is the difference between inflation forecasts for the current year (published in this year's December and the previous year's December). Equations 1 and 3 are estimated by SUR and equation 2 with GLS using the fixed effects specification. The number of data points is 335. Numbers inside parentheses are corrected t-values. The dummies are either expressed as impulse (0, 1) dummies or permanent (1) values from certain period until the end of the sample period. This formulation applies to all membership dummies and the inflation targeting dummy.

Table 2. **Testing the impact of government deficits and import prices**

Dependent variables	1	2	3	4
Actual (lagged) inflation	.688	.160		
	(33.32)	(3.22)		
Forecast for current year's inflation			.846	.477
			(55.49)	(9.49)
Deficit/trend GDP	-.037	-.084	-.009	-.054
	(1.96)	(3.28)	(0.78)	(2.33)
Change rate of import prices	.147	.090	.028	.050
	(8.98)	(8.59)	(2.52)	(4.34)
R^2/SEE	0.834	0.275	0.957	0.490
	0.921	0.937	0.942	0.936
DW	1.47	2.18	1.88	2.58
Form of data	level	difference	level	difference

Positive values of deficit represents surplus. The dependent variable is (the difference of OECD December) inflation forecast for the next year. The number of data points is 189. All estimates are (cross-section) SUR estimates (with no fixed effects).

Table 3. **Relationship between inflation and output growth forecast errors**

Forecast horizon	Data	OLS	GLS	SUR
S1	actual	-.112	-.095	-.077
		(2.39)	(3.29)	(3.93)
S1	real time	-.004	-.011	-.005
		(0.21)	(0.55)	(0.45)
K1	actual	-.117	-.058	-.078
		(2.19)	(1.93)	(4.13)
K1	real time	-.067	-.032	-.021
		(1.72)	(1.15)	(1.01)
S2	actual	-.097	-.066	-.080
		(1.65)	(1.52)	(3.16)
S2	real time	-.070	-.063	-.060
		(1.23)	(1.51)	(1.86)
K2	actual	-.030	-.020	-.065
		(0.72)	(0.67)	(4.23)
K2	real time	-.046	-.026	-.070
		(0.98)	(0.85)	(4.28)
S3	actual	.017	.061	.023
		(0.38)	(2.10)	(2.97)
S3	real time	.017	.058	.012
		(0.36)	(2.29)	(1.49)

Numbers are the coefficient estimates of output growth forecast errors (with different time horizons). The data consist of 423 observations for D1, J2 and S2, 314 for J2 and 228 for D3. Corrected t-values are inside parentheses. S1 denotes the forecast published in OECD December Economic Outlook the current year, S2 forecast for the next and S3 forecast for two years ahead. Similarly K1 and K2 correspond to forecasts published in OECD June Economic Outlook.

Table 4. **Results from Kalman filter estimation**

		Dec, R	Dec, H	June, R	June, H	Dec, D
AUT	Var(μ)	0.84	0.33	0.56	0.38	0.54
		3.53	*2.93*	*2.66*	*3.52*	*3.81*
	g_T	0.32	0.96	0.14	0.56	0.75
		0.78	*2.47*	*0.39*	*1.54*	*1.97*
BEL	Var(μ)	0.38	0.49	0.33	0.83	0.42
		4.08	*5.82*	*5.16*	*4.83*	*3.77*
	g_T	0.57	0.51	0.60	0.75	0.63
		1.59	*1.40*	*1.76*	*1.93*	*1.77*
DEN	Var(μ)	2.06	1.54	0.76	0.65	1.97
		4.75	*4.94*	*4.41*	*4.19*	*5.21*
	g_T	0.79	0.71	0.24	0.25	0.87
		1.72	*1.65*	*0.67*	*0.70*	*1.84*
FIN	Var(μ)	2.58	2.45	0.54	0.51	1.99
		5.25	*6.08*	*3.14*	*3.09*	*4.82*
	g_T	0.66	0.62	0.40	0.41	0.90
		1.75	*1.55*	*1.42*	*1.40*	*2.36*
FRA	Var(μ)	0.74	0.83	0.42	0.54	0.80
		3.95	*3.26*	*3.78*	*3.75*	*4.62*
	g_T	1.07	0.98	0.88	0.72	1.12
		2.50	*2.30*	*2.18*	*1.81*	*2.55*
GER	Var(μ)	0.59	0.56	0.43	0.43	0.46
		3.33	*3.40*	*2.74*	*3.01*	*2.81*
	g_T	0.44	0.41	0.54	0.56	0.51
		1.10	*1.11*	*1.57*	*1.67*	*1.35*
GRE	Var(μ)	5.39	4.57			5.62
		7.03	*4.75*			*6.26*
	g_T	0.76	1.18			0.60
		1.66	*2.51*			*1.29*
IRL	Var(μ)	3.17	1.91	1.51	0.88	3.14
		4.71	*4.15*	*4.27*	*5.50*	*4.72*
	g_T	0.45	0.75	0.26	0.69	0.61
		1.18	*1.83*	*0.85*	*1.92*	*1.59*
ITA	Var(μ)	3.95	2.65	2.12	1.66	4.29
		5.10	*4.44*	*3.59*	*2.85*	*5.26*
	g_T	0.84	0.86	0.74	0.81	0.95
		1.87	*2.01*	*1.75*	*2.04*	*2.00*

		Dec, R	Dec, H	June, R	June, H	Dec, D
LUX	Var(μ)	0.34	0.30	0.50	0.37	0.31
		3.14	*2.34*	*4.91*	*4.97*	*3.40*
	g_T	0.56	0.68	0.42	0.52	0.71
		1.69	*1.99*	*1.34*	*1.59*	*2.16*
NET	Var(μ)	0.91	0.66	0.58	0.44	0.95
		3.87	*3.99*	*3.10*	*3.84*	*3.88*
	g_T	0.76	0.81	0.32	0.38	0.78
		1.71	*2.10*	*0.91*	*1.22*	*1.79*
POR	Var(μ)	3.93	2.21	2.68	2.52	3.94
		4.19	*3.38*	*4.17*	*4.80*	*4.51*
	g_T	0.75	1.00	0.56	0.70	0.77
		1.75	*2.39*	*1.46*	*1.75*	*1.80*
SPA	Var(μ)	3.62	1.84	1.01	1.05	3.46
		6.01	*4.90*	*4.33*	*4.80*	*6.25*
	g_T	0.87	1.09	0.13	0.26	0.84
		1.85	*2.46*	*0.33*	*0.64*	*1.83*
SWE	Var(μ)	4.14	4.52	2.71	2.64	4.01
		5.73	*5.49*	*6.01*	*6.25*	*5.99*
	g_T	0.73	0.80	0.18	0.28	0.85
		1.57	*1.66*	*0.44*	*0.69*	*1.79*
UK	Var(μ)	5.10	4.17	0.38	0.35	3.97
		6.50	*6.71*	*2.94*	*3.50*	*6.42*
	g_T	0.61	0.58	0.28	0.28	0.86
		1.31	*1.36*	*1.07*	*1.05*	*1.85*

Var(p) denotes the estimated variance of the signal equation and g_T the final estimate of the state variable. t-ratios are below the parameter estimates. The actual rate of inflation is computed either by using the historical ex-post (H) rate of inflation or the corresponding real-time (R) rate which corresponds to the December estimate of the previous year's inflation. The estimates in the last column refer to the signal equation in which is the actual rate is replaced OECD December forecast for the current year's rate of inflation (D).

Figures 1–9

Figure 1. **Time variant constant term from the regime dummy panel regression**

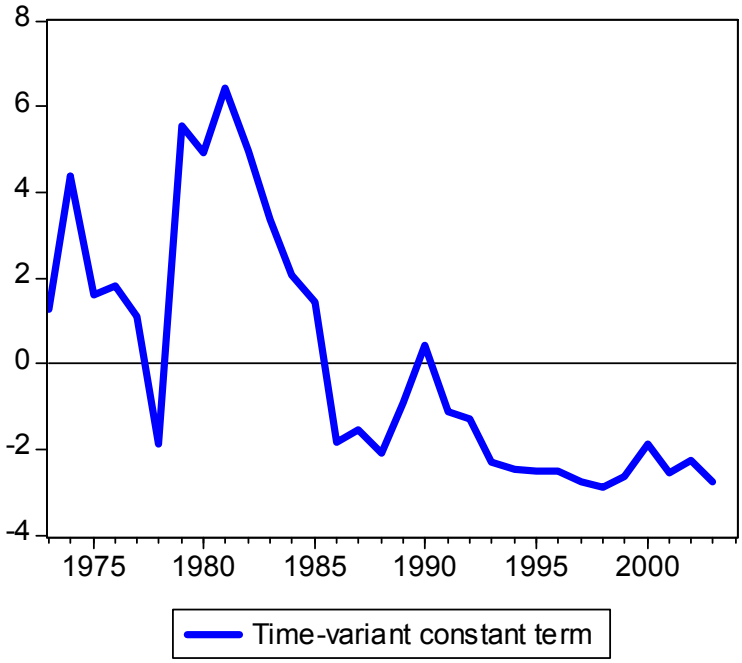
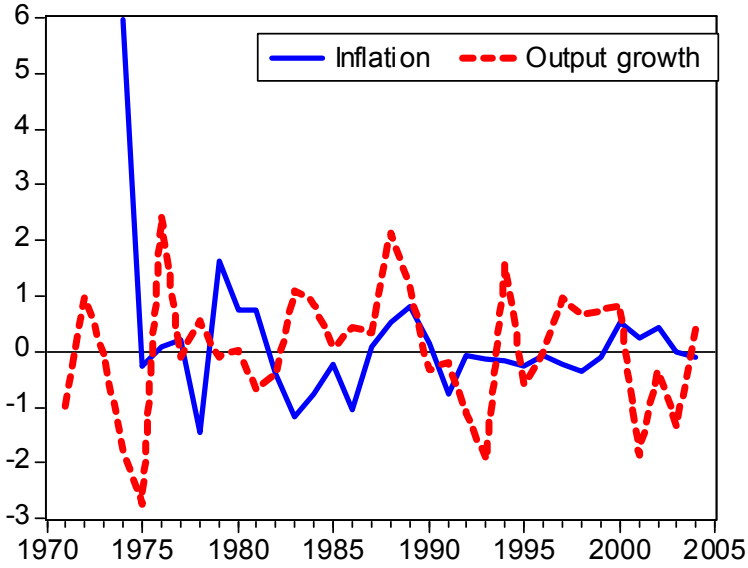
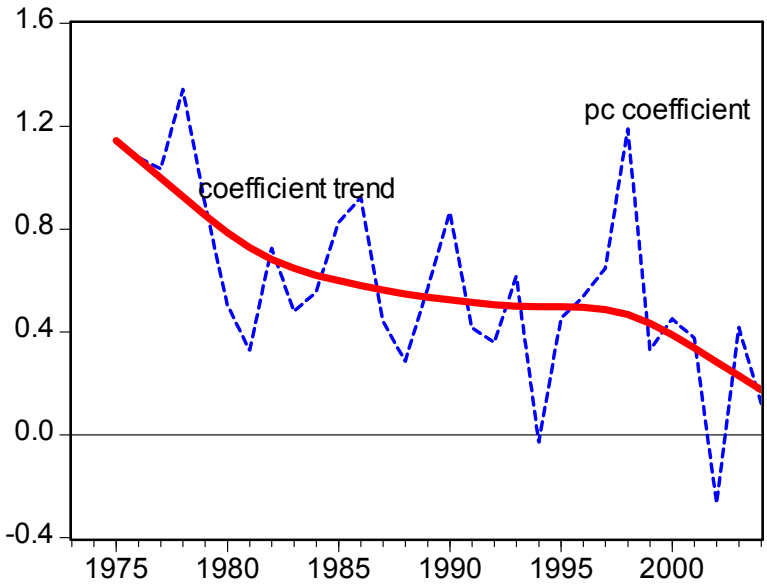


Figure 2. **Median of OECD forecast errors**



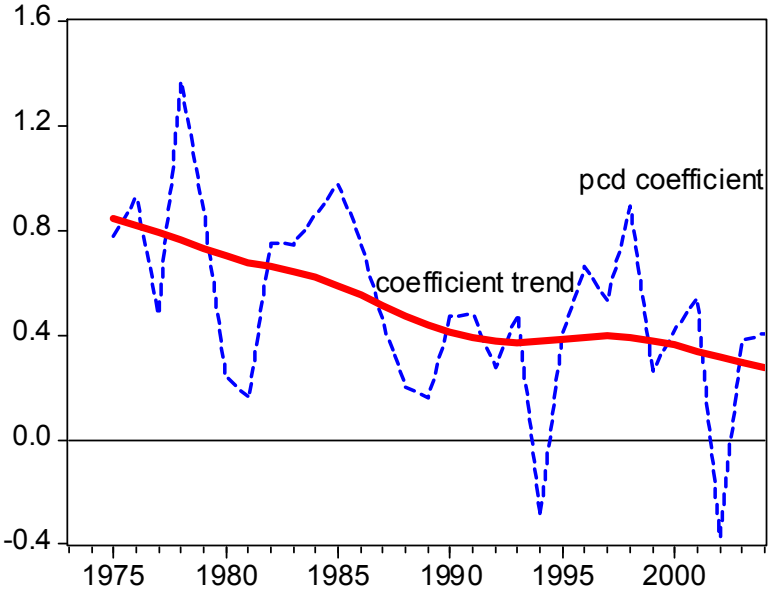
Both errors are related to OECD December forecasts for the next year.

Figure 3. **Time-variant θ-parameter from panel regression with ex-post data**



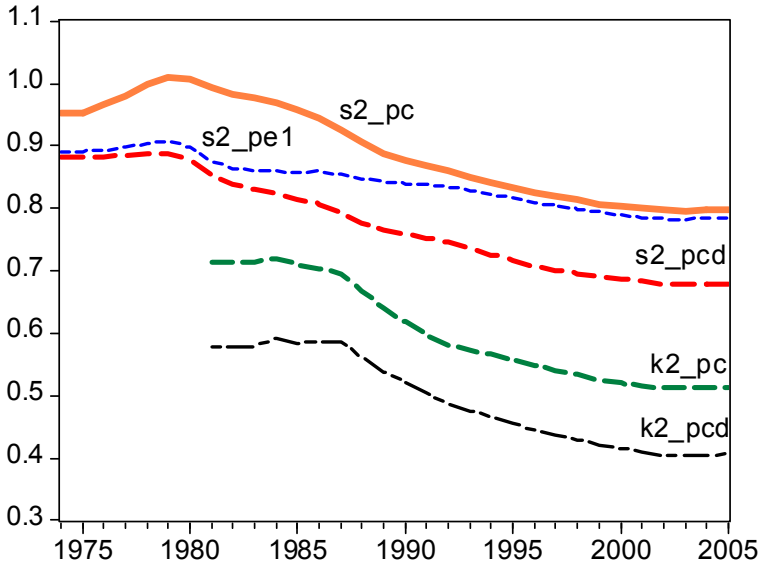
Actual inflation is computed from ex-post (2005) data on consumer prices. Inflation forecasts are OECD December forecasts for the next year.

Figure 4. **Time-variant θ-parameter from panel regression with real-time data**



Actual real-time inflation corresponds to the OECD December data on previous year's consumer price inflation. Inflation forecasts are OECD December forecasts for the next year.

Figure 5. **EU-averages of the smoothed Kalman filter estimates for the θ-parameter**



s2 (k2) denotes the OECD December (June) forecast for the next year. pc denotes the actual ex-post (2005) inflation rate, pcd the OECD real-time estimate of it and pe1 the OECD December forecast for the current year's inflation.

Figure 6. **Median EU values of the smoothed Kalman filter estimates for the θ-parameter**

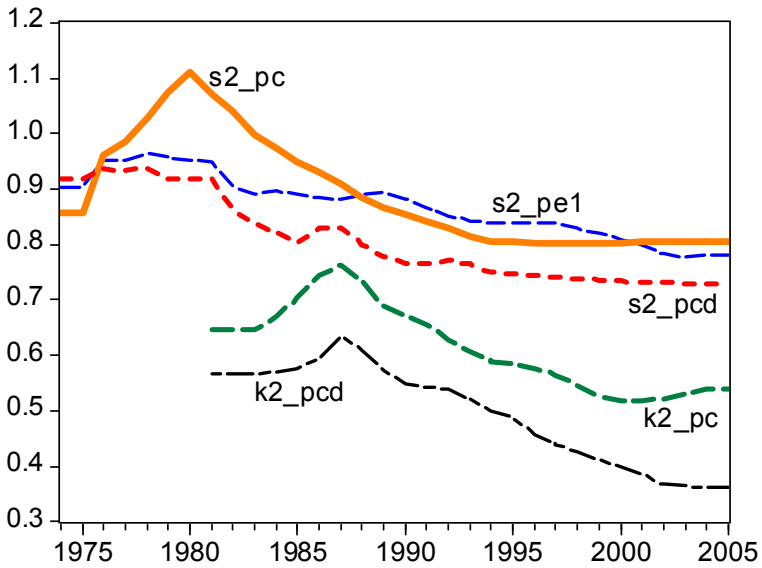
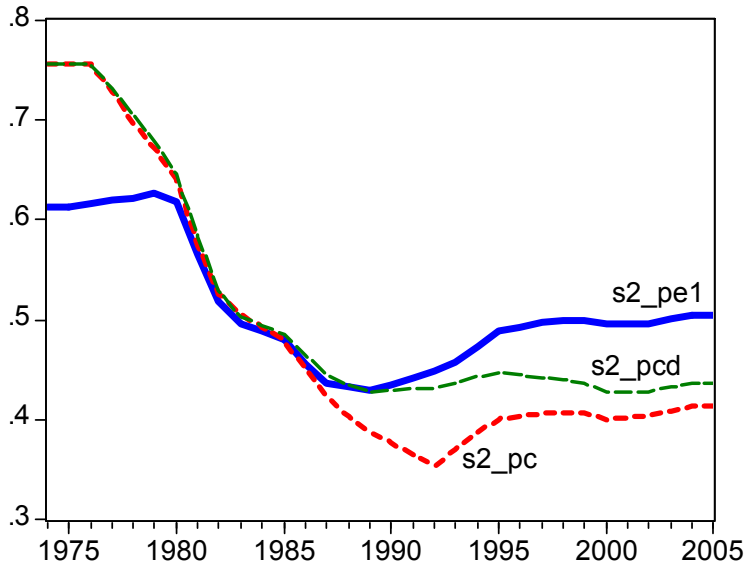


Figure 7. **Smoothed Kalman filter estimates of the θ-parameters for Germany**



Notation is the same as in Figure 5.

Figure 8. **Individual country estimates of the θ-parameter with ex-post data**

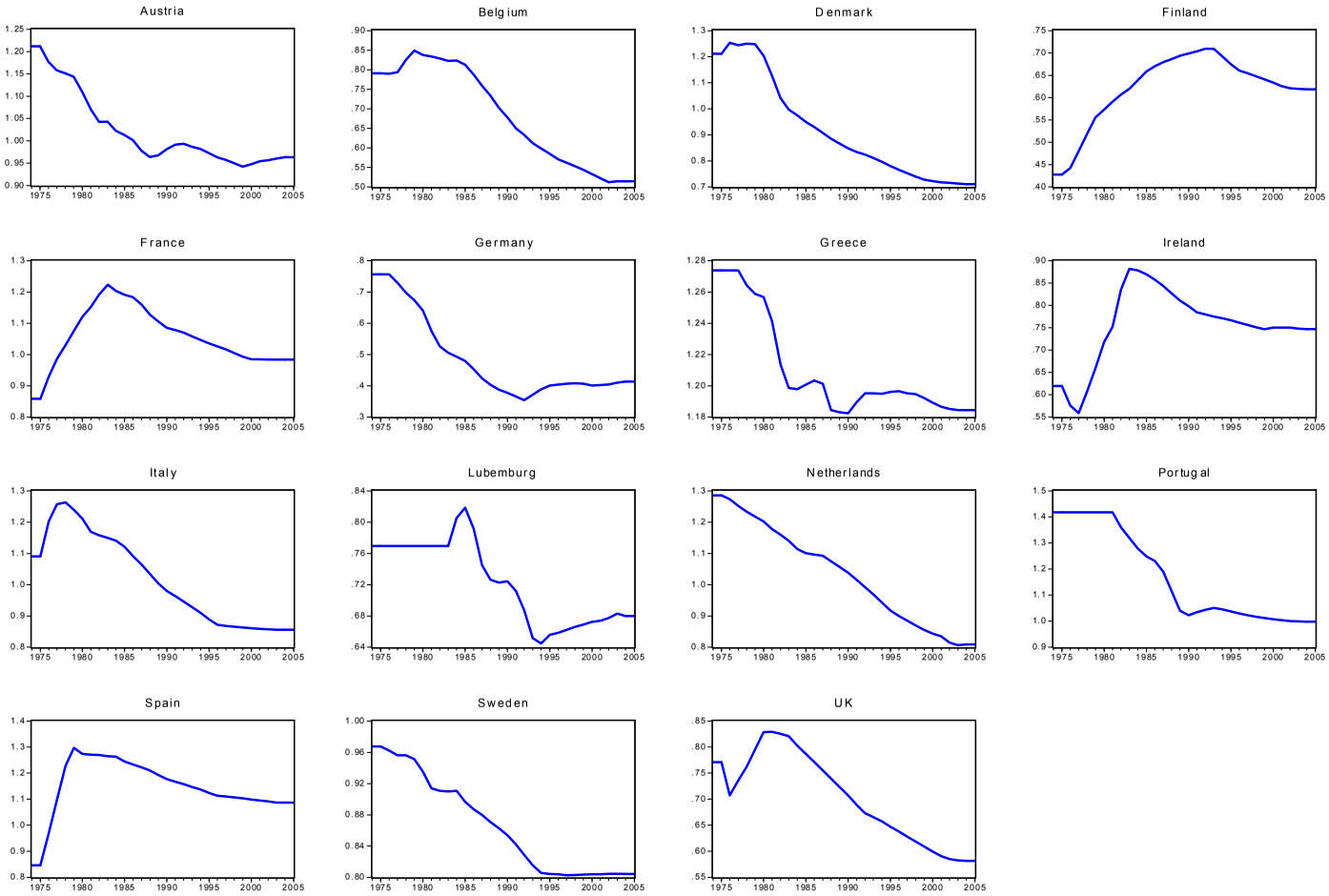
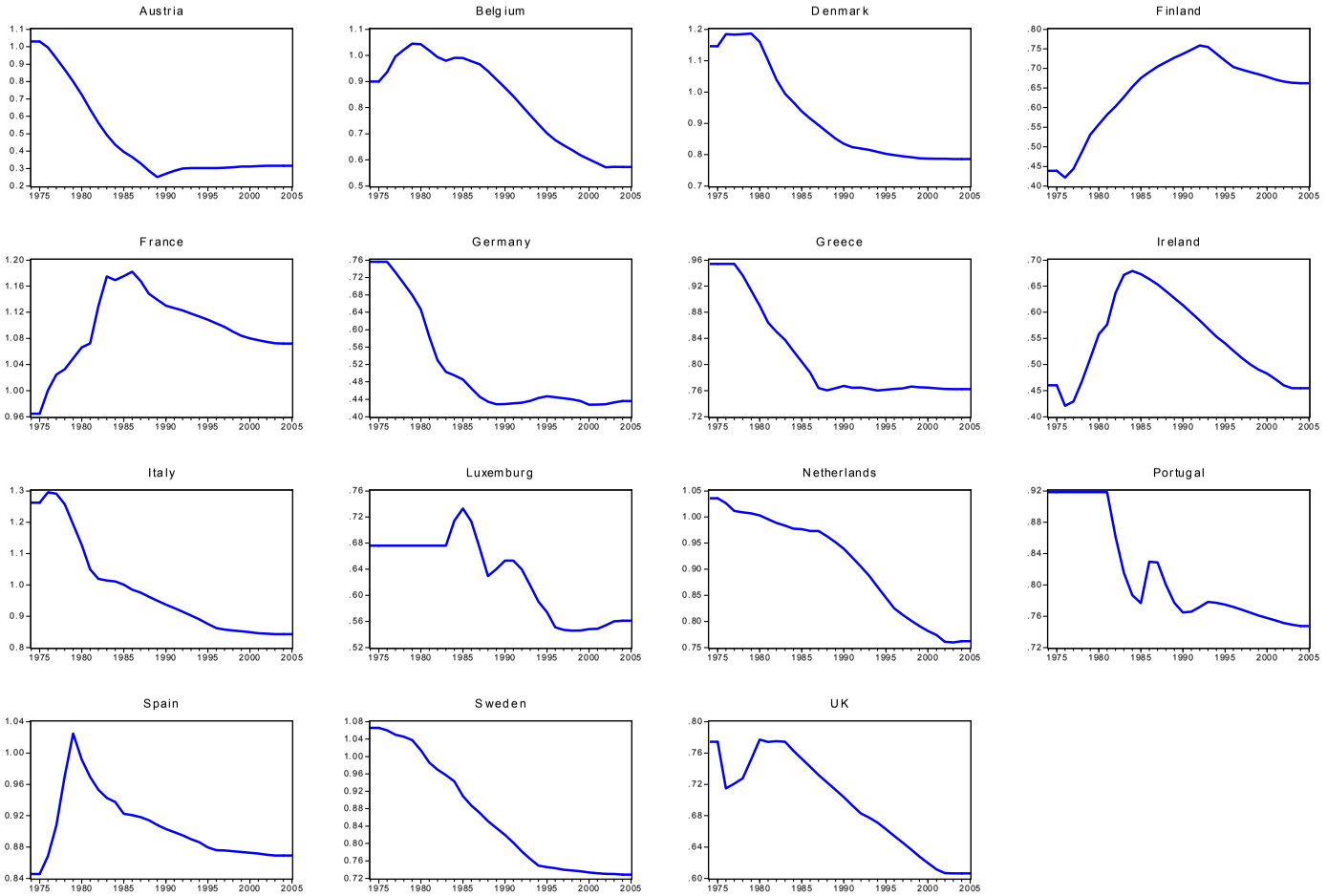


Figure 9. **Individual country estimates of the θ-parameter with real-time data**



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Suomen Pankki
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