Are monetary policy regime switches endogenous? Insights from an estimated Markov-Switching DSGE model.

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Abstract

We investigate whether changes in the conduct of monetary policy have been *exogenous* – reflecting a deliberate choice of the monetary authority –or *endogenous*, dictated by the evolution of the economic environment. We explore this issue by solving and estimating a Markov-switching new-Keynesian DSGE model with (synchronized or desynchronized) regime changes in the variance of shocks and in the coefficients of the monetary policy rule. Applying our methodology to U.S. and Euro Area data, we find strong evidence for both economies of regimes switches affecting both shock variance and monetary policy. Yet, we find significant differences in the way monetary policy was conducted in each economy: while monetary policy regimes in the U.S. are found to be closely connected to the personality of the Fed chairman in office (so that regimes changes usually occur when a new chairman is appointed), regime switches in the Euro Area have been much more correlated with changes in the economic environment, at least during the 70s to the early 90s. During this period, shifts from a passive to a more aggressive regime typically occurred when the variance of the structural shocks switched from a high to a low volatility regime, and vice versa.

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