

IMPACT OF INTERNATIONAL MONETARY POLICY IN URUGUAY: A FAVAR APPROACH

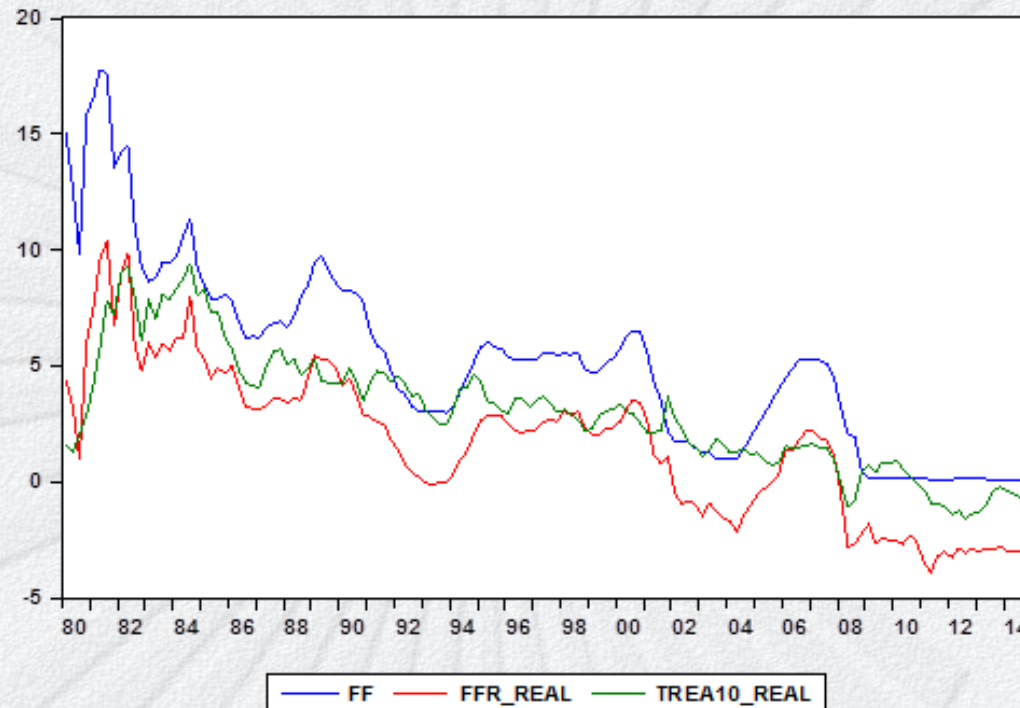
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¹ The opinions herein do not affect the institutional position of Banco Central del Uruguay.

- Motivation
- Methodology
- Data
- Results
- Future agenda

- There are many channels through which monetary policy may affect the real economy.



- In a highly interconnected world, foreign monetary policy changes may affect domestic variables.

- On May 22th, 2013, the chairman of the Federal Reserve (FED) announced the possibility of a decrease in security purchases:
 - This statement re-initiated a debate regarding the impact of US monetary policy in emerging markets (EM).
 - The importance of the issue is reflected in the movements in exchange rates and stock prices observed in EM following the announcements.
- Would it be the same for Uruguay?

- For a small open and dollarized economy that guess seems plausible, despite its shallow financial market.



- Small open economy: 40% openness ratio
- Dollarization
 - Deposits: almost 80%
 - Credits: more than 50%
 - Mismatches are the true problem: 87% of firms
- Uruguayan public sector debt: around 50% is foreign-currency denominated, dollarization has been declining and time of maturity has been increasing.
- A tighter FED monetary policy = bad news for Uruguay:
 - Debt burden increase, 10-year sustained growth put to a hold
 - Local currency depreciation may fuel inflation
 - Higher inflation may reduce investment projects

- Shallow financial market may oneself wonder the very existence of a response:
 - real assets: the biggest component in households' net wealth
 - households: intensive in their use of cash (70%)
 - low and stable use of credit (22%) and debit cards (8%)
- A reasonable way to think how shocks reach Uruguay: *first* FFR changes; *second*, it affects commodity prices; *then*, the effect hits the external demand from the developed world; *next*, it reaches Uruguayan relevant region and *finally*, Uruguayan economic activity.

- A Factor-Augmented Vector Autoregressive (FAVAR) model is used in two stages:
 - In the *first stage*, the impact of foreign monetary policy is assessed on commodity prices, foreign output and regional output.
 - In the *second one*, the effects on real exchange rate, domestic assets (as housing prices) and on domestic output are analyzed.

- Structural **factor models** rest on the idea that a large number of observable economic variables can be described by a relatively small number of unobserved factors. These factors, in turn, can be affected by a few shocks which can be understood as macroeconomic disturbances.
- Macroeconomic data set x_{it} is composed of two mutually orthogonal unobservable components: the common component χ_{it} and the idiosyncratic component ξ_{it}

$$x_{it} = \chi_{it} + \xi_{it}$$

- The *idiosyncratic component* ξ_{it} arise from shocks that affect a specific variable or a small group of variables and may reflect sector specific variations, variations to foreign countries, or measurement errors.

- The *common components* are the ones responsible for most of the co-movements between macroeconomic variables and are represented by a linear combination of a relatively small number ($r \ll n$) of unobserved factors (these are also called *static factors* in the literature):

$$x_{it} = a_{1i}f_{1t} + a_{2i}f_{2t} + \cdots + a_{ri}f_{rt} = a_i f_i$$

- When allowing a VAR model for vector f_t components, dynamic relations among macroeconomic variables show up:

$$f_t = D_1 f_{t-1} + D_2 f_{t-2} + \cdots + D_p f_{t-p} + \varepsilon_t$$
$$\varepsilon_t = R u_t$$

- **Vector autoregressive (VAR) models** are very useful in handling multiequation time-series models because the econometrician not always knows if the time path of a series designated to be the “independent” variable has been unaffected by the time path of the “dependent” variables. The most basic form of a VAR treats all variables symmetrically without analyzing the issue of independence.

$$O_t = \sum_{i=1}^p A_i O_{t-i} + u_t^O \quad (1)$$

- GC, IRFs, VD: can give some light for the understanding of their relationship and guidance into the formulation of more structured models.

- **Factor-augmented VAR (FAVAR) models** combine factor models and VAR models at the same time.

$$\begin{pmatrix} F_t \\ O_t \end{pmatrix} = \begin{bmatrix} \phi_{11}(L) & \phi_{12}(L) \\ \phi_{21}(L) & \phi_{22}(L) \end{bmatrix} \begin{pmatrix} F_{t-1} \\ O_{t-1} \end{pmatrix} + \begin{pmatrix} u_t^F \\ u_t^O \end{pmatrix} \quad (2)$$

where O_t is the $(M \times 1)$ vector of observable variables and F_t is the $(k \times 1)$ vector of unobserved factors that captures additional economic information relevant to model the dynamics of O_t .

- Let us assume that informational time series X_t are related to the unobservable factors F_t by the following observation equation

$$X_t = \Lambda^f F_t + \Lambda^o O_t + e_t$$

where F_t is a $(k \times 1)$ vector of common factors, Λ^f is a $(N \times k)$ matrix of factor loadings, Λ^o is $(N \times M)$, and e_t are mean zero and normal, and assumed a small cross-correlation, which vanishes as N goes to infinity.

- Unobservable factors in FAVAR do not have exact meanings. Forni, Gambetti (2010) model is different from FAVAR in that they tried to give the factors themselves a structural interpretation.

- Estimation strategy (following Bernanke et al. (2005)): a FAVAR model in a two-step procedure.
- In the **first step**, factors are consistently estimated by the first r principles of components of X (Stock and Watson, (2002)). For this result to hold, it is important that the estimated number of factors, k , is larger than or equal to the number, r . Because N is sufficiently large, the factors are estimated precisely enough to be treated as data in subsequent regressions.
- In the **second step**, I estimate the FAVAR equation, replacing F_t by \hat{F}_t .

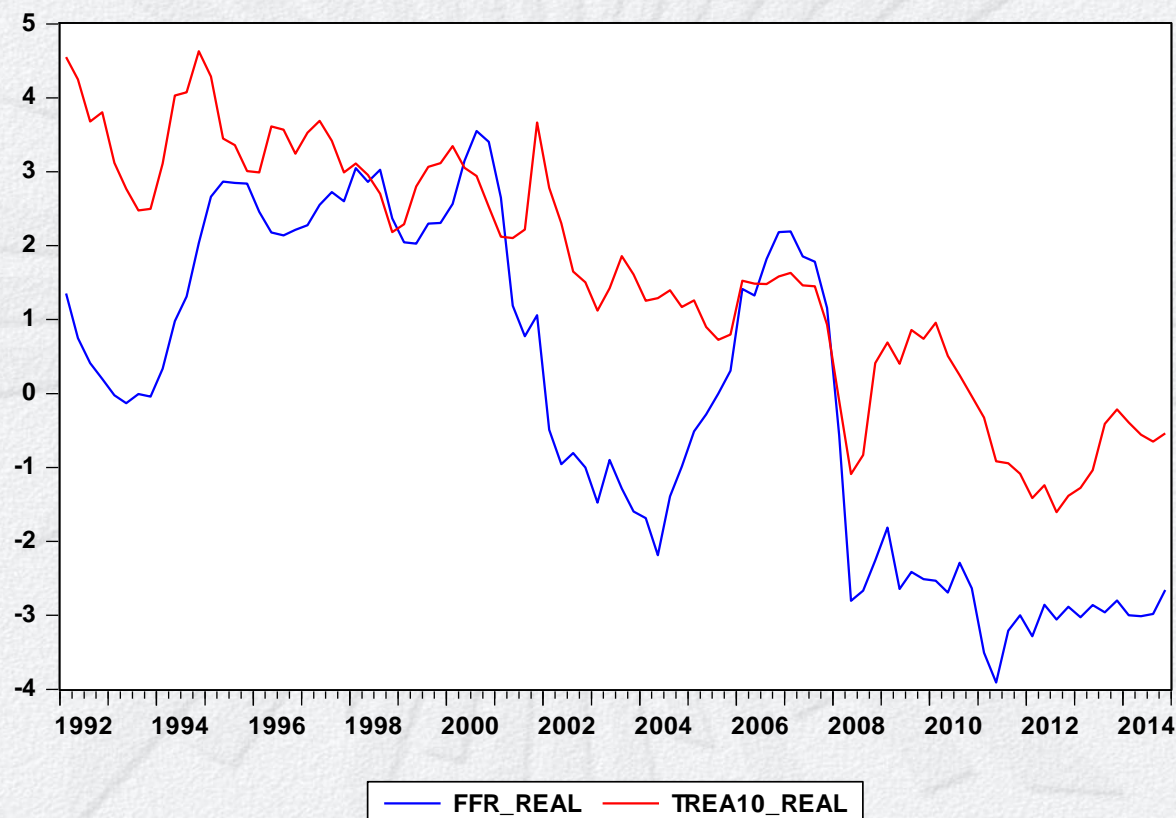
- FAVAR models are a mixture of a factor model and a VAR model.
- Advantages:
 - Factors can alleviate omitted variable problems in empirical analysis using traditional small-scale models. (Bernanke and Boivin (2003)).
 - Factors may help to generate a more general specification (Bernanke, Boivin and Elias (2005))
 - Factors help in keeping the number of parameters to estimate under control without losing relevant information (Chudik and Pesaran (2007)).
- Disadvantages:
 - Unobservable factors do not have an exact meaning but some researchers try to give them a structural interpretation. (Forni and Gambetti (2010)).

- A balanced set of 36 quarterly macroeconomic TS.
- Expressed in real terms and in log levels (except ratios and interest rates) and whenever necessary, series are transformed in order to leave them stationary.
- 1996Q1-2014Q4, 76 observations after adjustments
- **Observable variables Y:** Federal funds rate (*FFR*), 10-year bond rate (*T10*), real exchange rate (*rer*), country risk (*UBI*), domestic passive real interest rate (*i_p*), housing prices (*p_h*), domestic output (*y*), and primary fiscal result (*pb*).
- **Other informational variables:** several commodity prices (wheat, soybean, food, oil), foreign output (from Argentina, Brazil, USA, China, UK, Italy, Spain, Germany, Mexico), US debt to GDP ratio, Uruguayan country risk indicator, domestic investment ratio (total, public and private), trade (exports and imports), real domestic wages, unemployment, public debt to gdp ratio (total, foreign, domestic, in foreign currency, in domestic currency), public assets to GDP ratio.

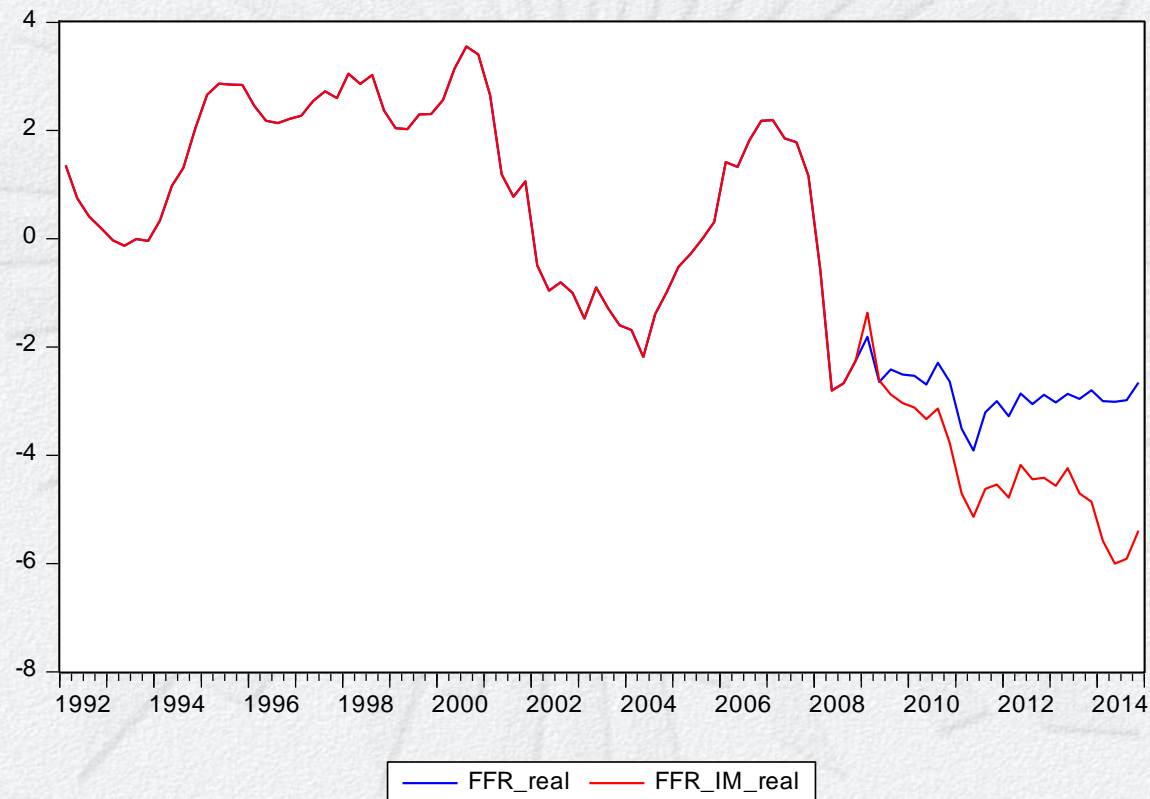
- **FFR:** has been the measure for the Fed's monetary policy stance in the economic literature and has been used as the link between monetary policy and the economy.
- Since the end of 2008 the FFR has been at the zero lower bound (ZLB), damping its historical correlation with economic variables like real gross domestic product (GDP), the unemployment rate, and inflation.
- Federal Open Market Committee (FOMC): Unconventional forms of monetary policy (a mix of forward guidance and large-scale asset purchases), to boost the economy.
- Attempts to summarize current policy have led some researchers to create a "**virtual**" fed funds rate.

- **Wu and Xia** (2014) construct a new policy rate “by splicing together the effective federal funds rate before 2009 and the estimated (*by them*) shadow rate since 2009.
- **Bauer and Rudebusch** (2015): *“the sensitivity of estimated shadow short rates raises a warning flag about their use as a measure of monetary policy. Our findings show that such estimates are not robust and strongly suggest that their use as indicators of monetary policy at the ZLB is problematic.”*
- **Lombardi and Zhu** (2014), infer a shadow short rate that is consistent with other observed indicators of monetary policy and financial conditions.
- **Krippner** (2015), *considers the area between shadow rates and their long-term level.*

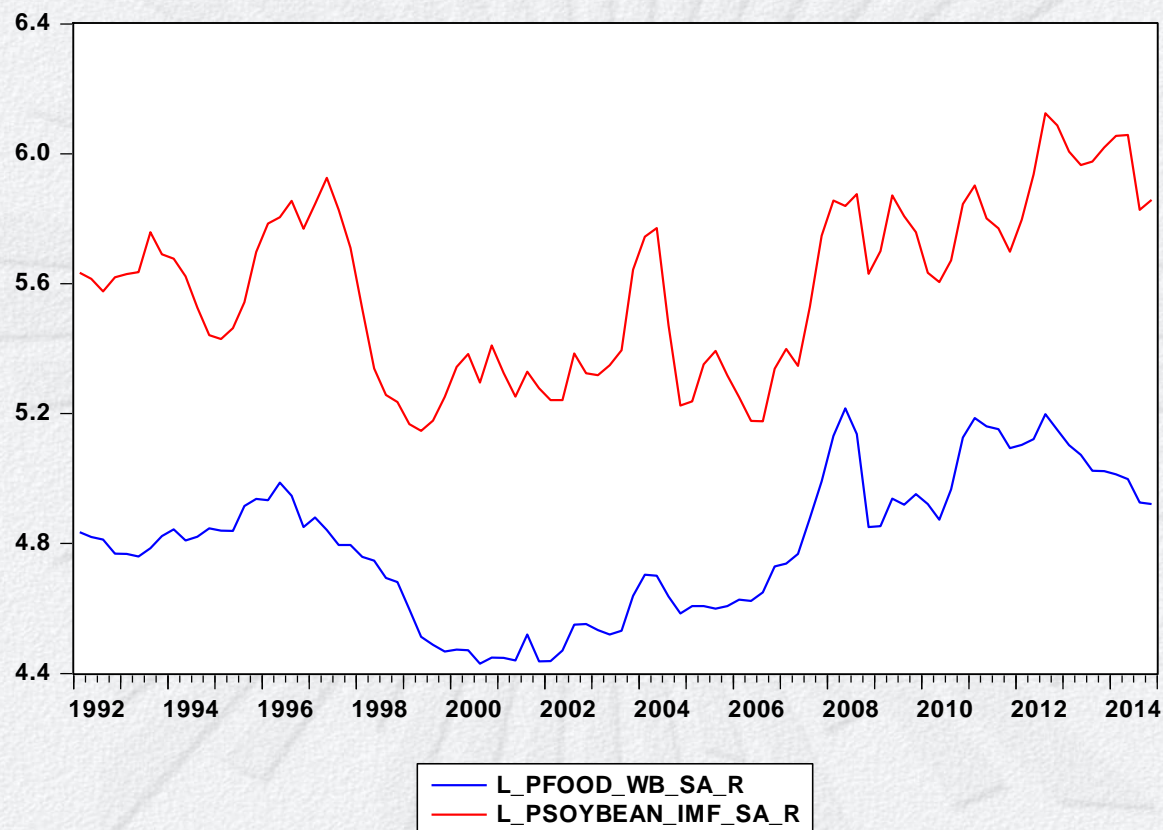
- Federal funds rate and 10-year Treasury interest rate



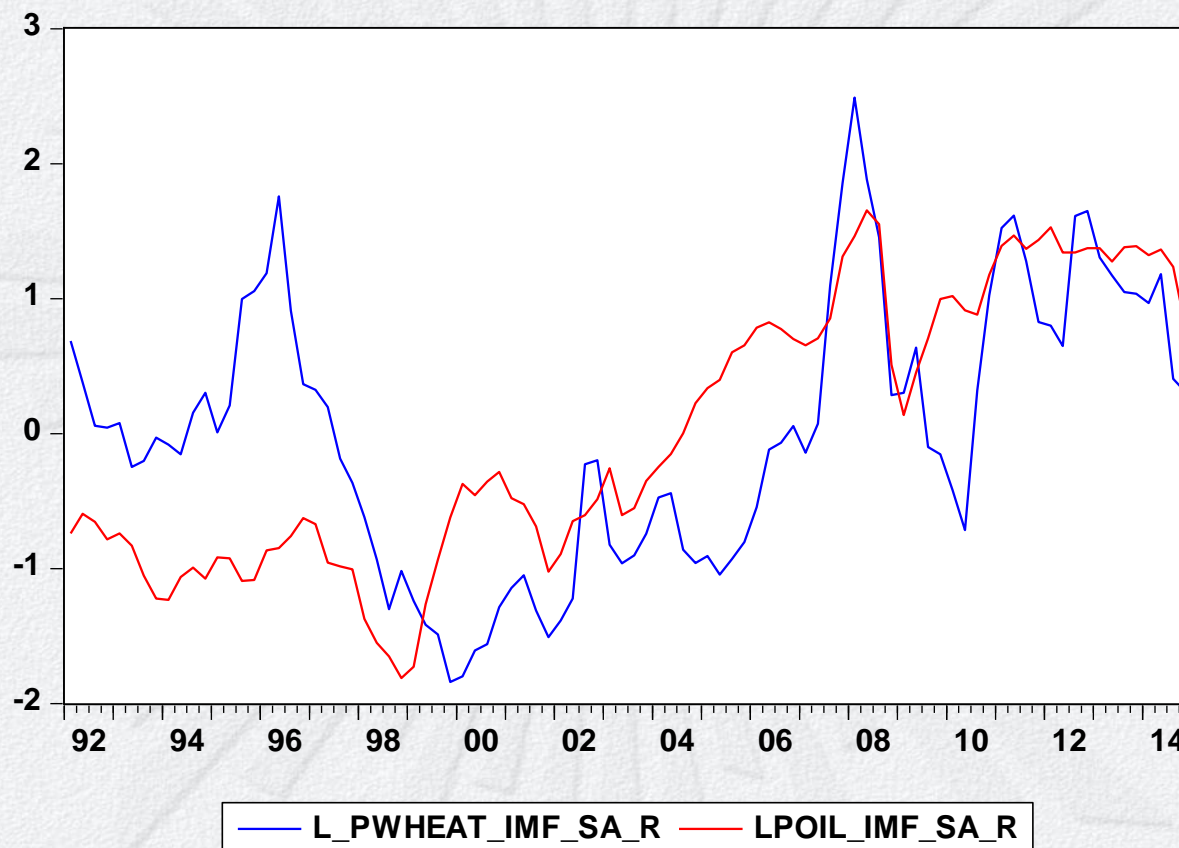
- Federal funds rate and Wu-Xia virtual effective federal funds rate



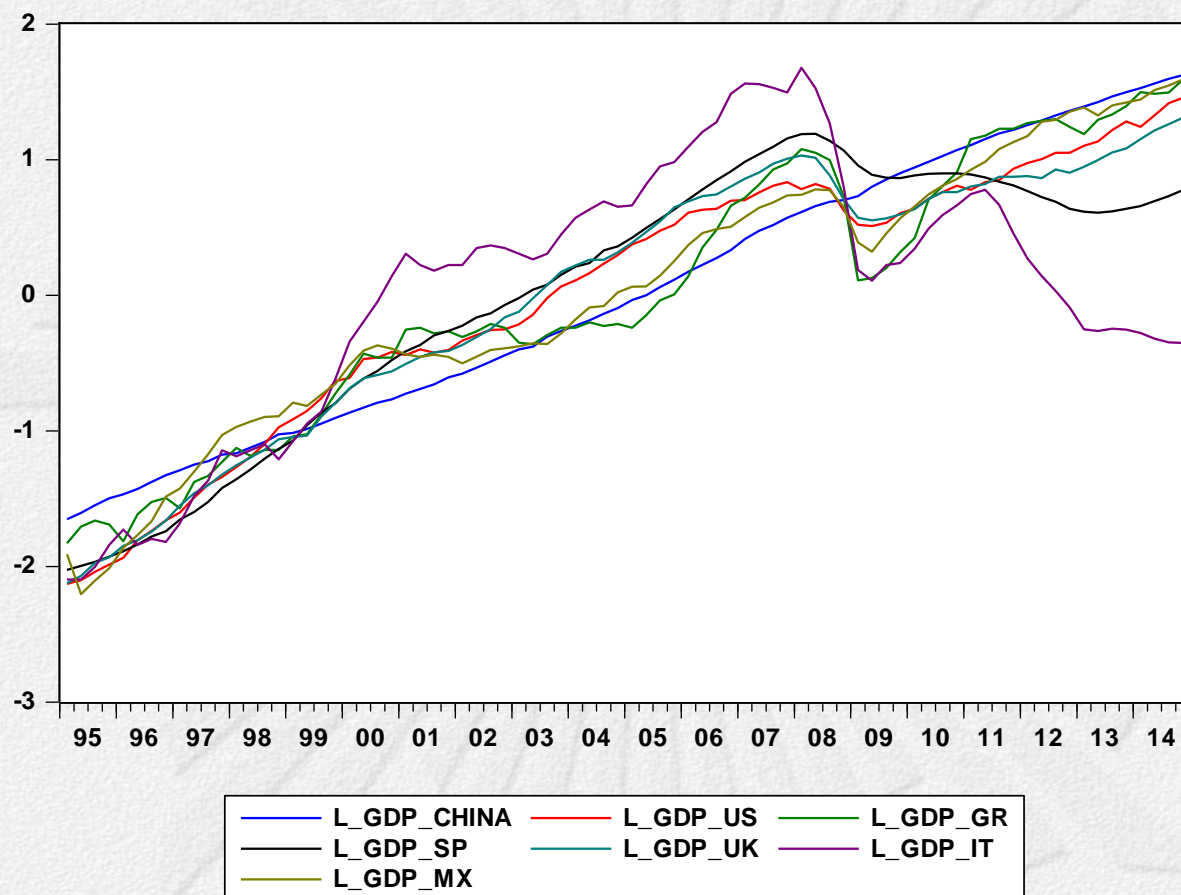
- Commodity prices



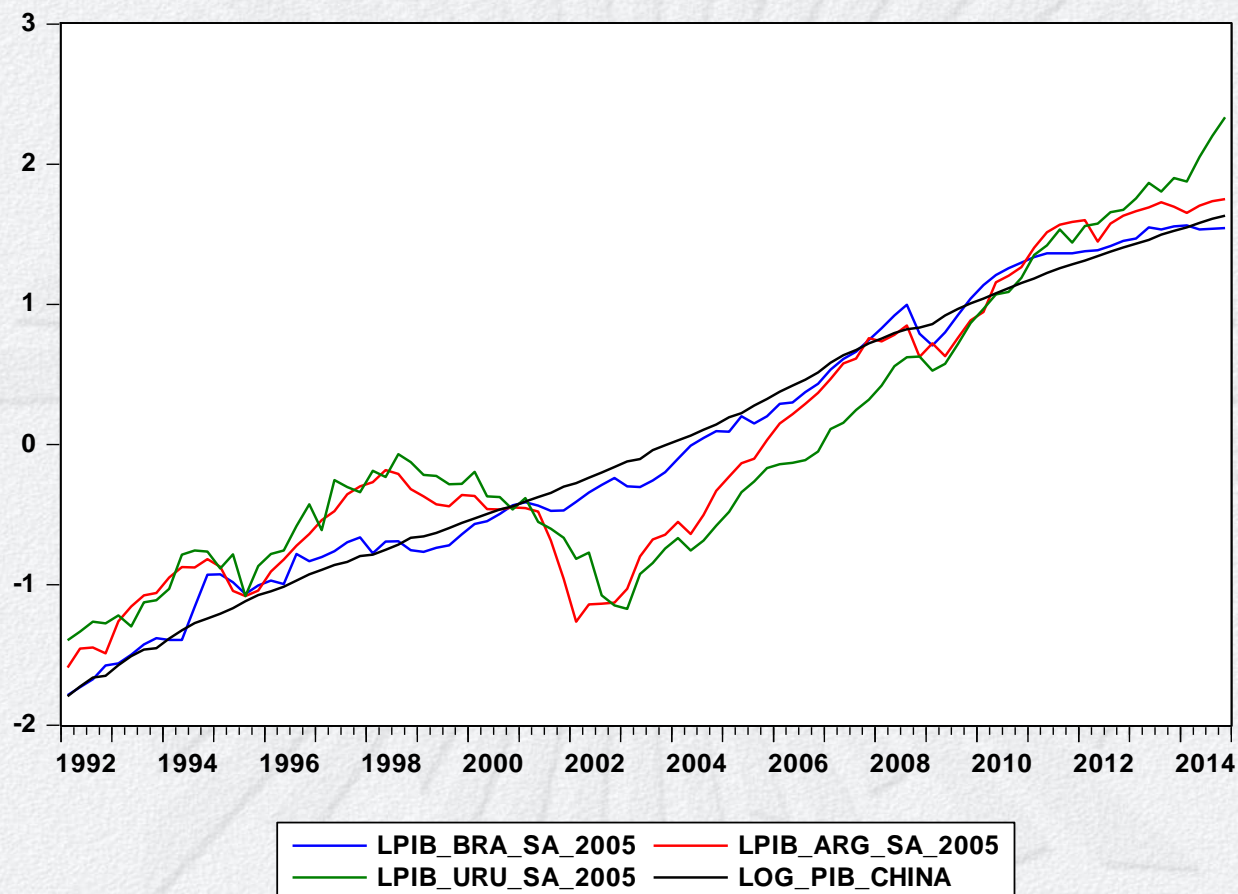
- Commodity prices



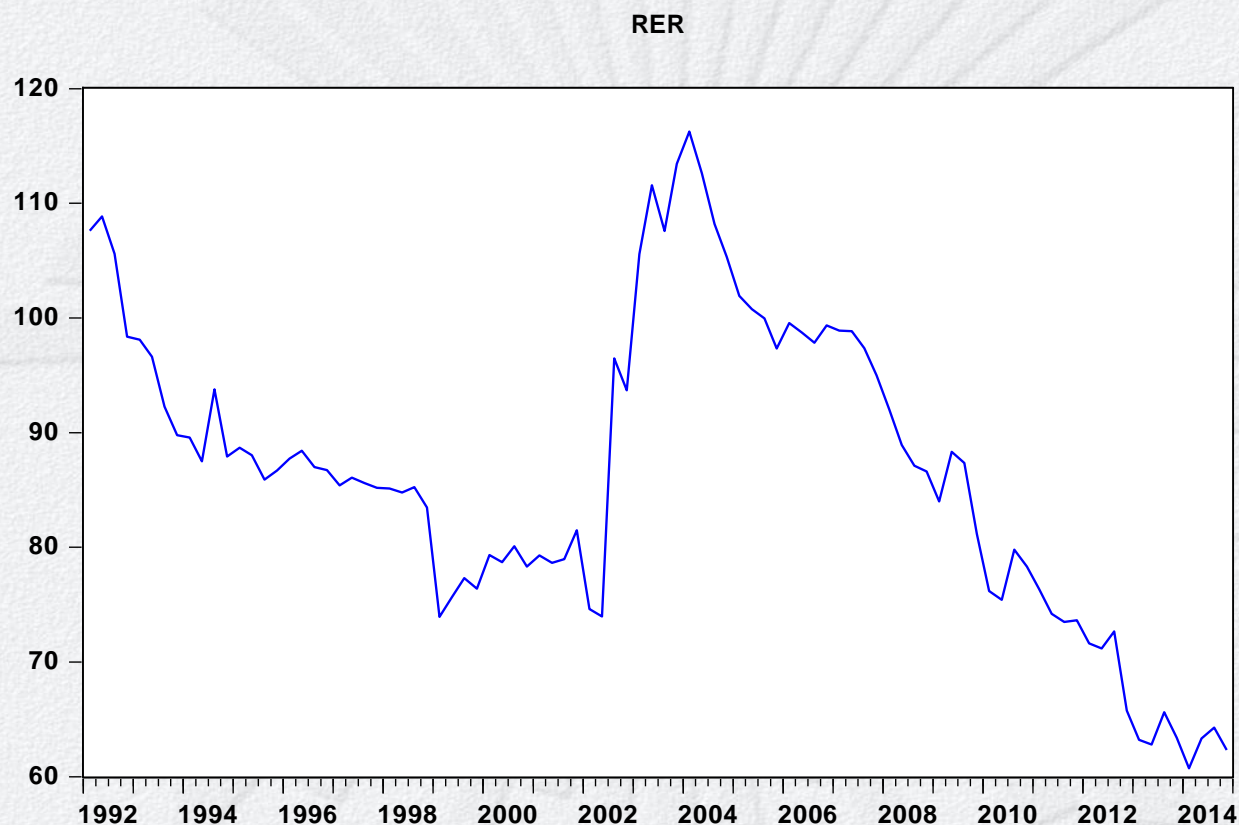
- Developed world



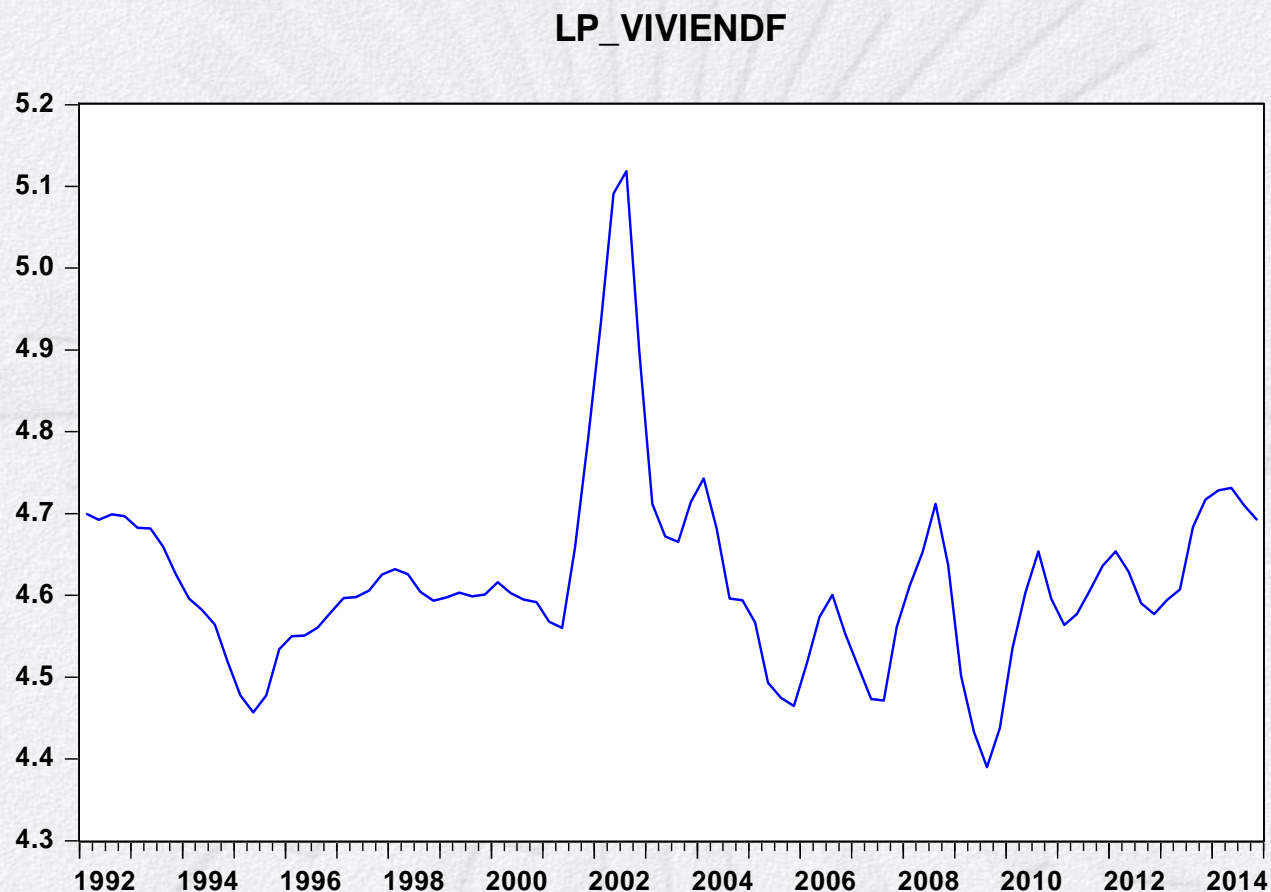
- Relevant region



- URUGUAY: real exchange rate



- URUGUAY: housing prices



- Baseline VAR

$$O_t = \sum_{i=1}^p A_i O_{t-i} + u_t^O$$

Six variables of interest, where

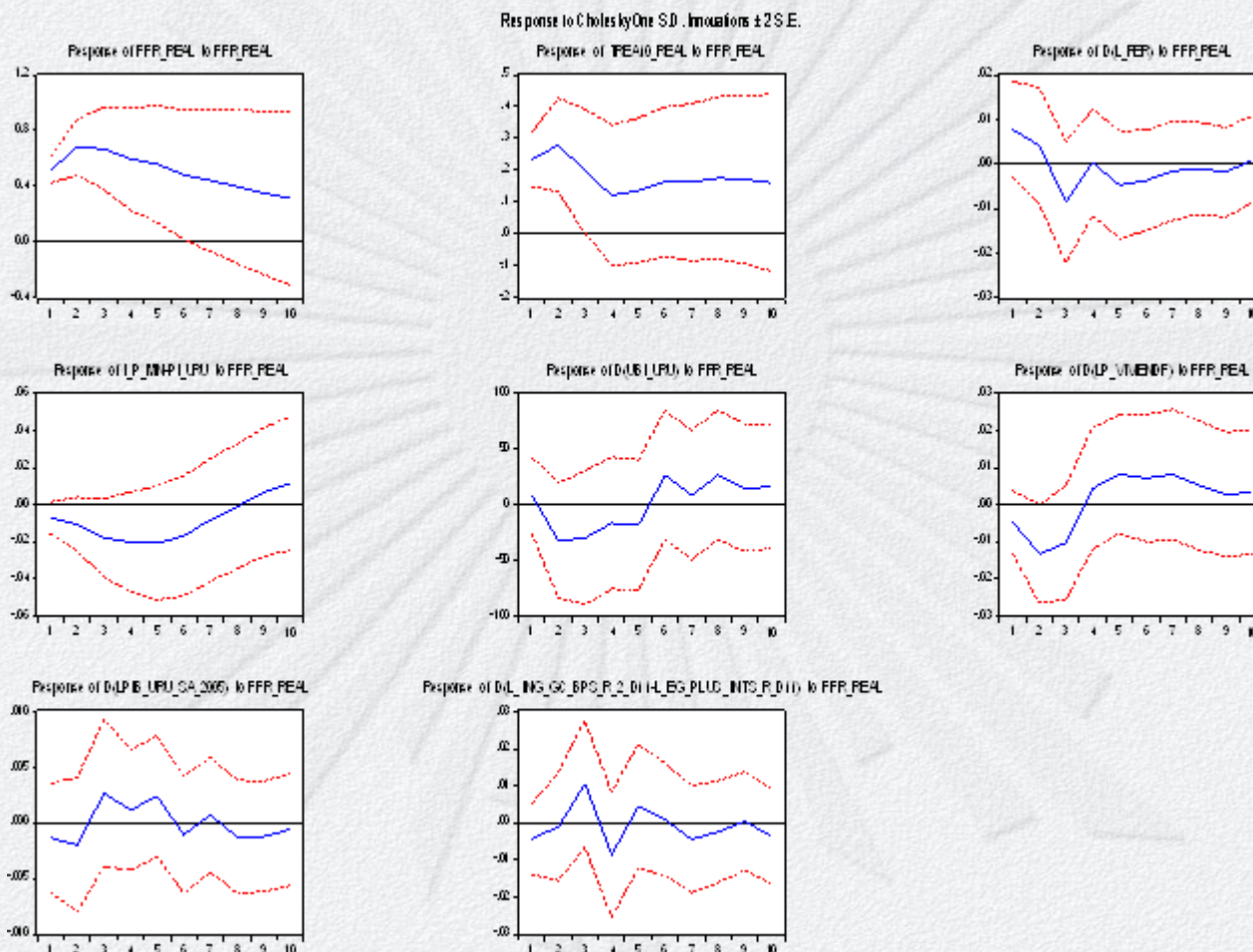
$$O_t = (FFR_t, T10_t, rer_t, UBI_t, i_{p_t}, p_{h_t}, y_t, pb_t)$$

RESULTS – Baseline VAR



BCU

- The results show that a contractionary foreign monetary policy (a one-time rise of FFR) has no clear effects on Uruguayan real output.



- Then, I explore the possibility of being other unobserved variables that may influence the behavior of the observable ones:

$$\begin{bmatrix} O_t^* \\ F_t \\ O_t^d \end{bmatrix} = B(L) \begin{bmatrix} O_{t-1}^* \\ F_{t-1} \\ O_{t-1}^d \end{bmatrix} + u_t$$

where

$$O_t^* = (FFR_t^*, T10_t); \quad O_t^d = (rer_t, UBI_t, i_{p_t}, p_{h_t}, y_t, pb_t)$$

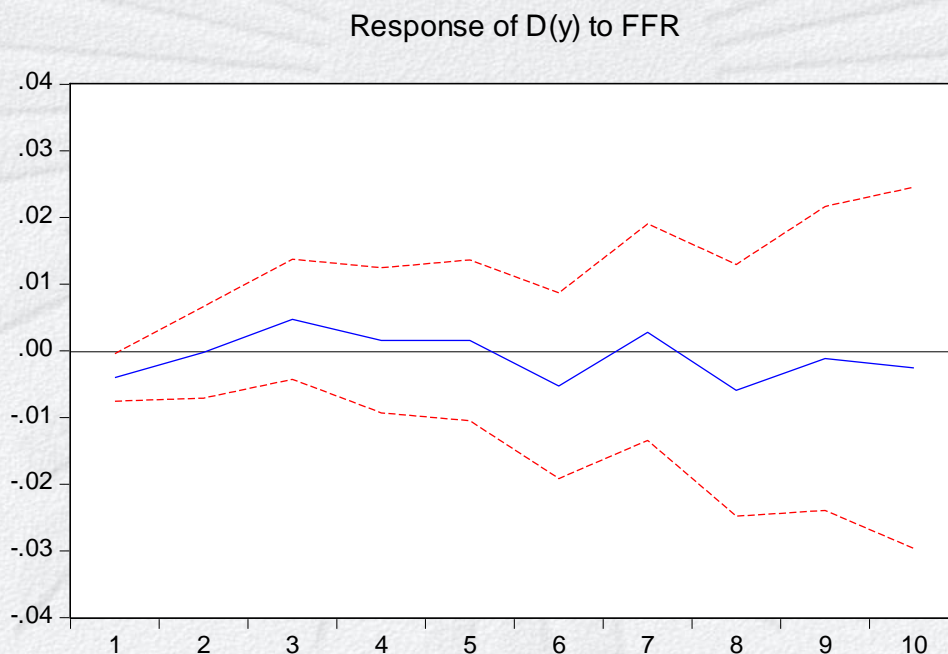
$F_t = (F_{1t}, F_{2t}, F_{3t})$, are the factors estimated in the first part by factor analysis.

- The whole data set available is used in order to estimate the factors, although several time series are dropped out (measures of sampling adequacy and goodness of fit criteria).
- Velicer's MAP method has retained three factors, labeled "F1", "F2" and "F3".

- F1: commodity prices (food, wheat and soybean) and real wages. It can be labelled as a measure of commodity prices.
- F2: foreign real output (from US, Germany, Spain, United Kingdom, Italy and probably Mexico) and American debt. It can be labelled as an indicator of foreign demand from developed countries.
- F3: oil price and a relevant regional foreign real output (Argentina, Brazil and China). It can be labelled as an aggregate variable for the regional demand.
- Once the baseline model is expanded into a FAVAR one, dynamics seem more plausible because an undoubtedly response of all the observed variables is reached, especially for domestic output.

- There is a clear and statistically significant impact effect but the following results are uncertain: an increase of one standard deviation of FFR (230 basis points) reduces quarterly output growth by 0.40% on impact but as confidence intervals grow rather fast as time goes by, it is not possible to have credible forecasts.

Response to Cholesky One S.D. Innovations ± 2 S.E.



- The dynamics of the variables in the system depends on the structure imposed on the factor loadings.
- In the *recursive scheme*, the impact matrix A_0 is lower triangular:
 - foreign variables do not respond to Uruguayan performance
 - Uruguayan economy reacts in the same period to changes occurred in the rest of the world, in the relevant Region and in the variables that act as linkages between them.

- In the *recursive scheme (Choleski)*, the restrictions are:

$$\begin{pmatrix} u_{R_t^*} \\ u_{T10_t} \\ F_{1_t} \\ F_{2_t} \\ F_{3_t} \\ u_{rer_t} \\ u_{UBI_t} \\ u_{ipt} \\ u_{ph_t} \\ u_{y_t} \\ u_{pb_t} \end{pmatrix} = \begin{pmatrix} \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & \times & \times & \times & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & \times & \times & \times & \times & 0 & 0 & 0 & 0 \\ \times & \times & \times & \times & \times & \times & \times & \times & 0 & 0 & 0 \\ \times & \times & \times & \times & \times & \times & \times & \times & \times & 0 & 0 \\ \times & \times & \times & \times & \times & \times & \times & \times & \times & \times & 0 \\ \times & \times & \times & \times & \times & \times & \times & \times & \times & \times & \times \end{pmatrix} \begin{pmatrix} e_{R_t^*} \\ e_{T10_t} \\ F_{1_t} \\ F_{2_t} \\ F_{3_t} \\ e_{rer_t} \\ e_{UBI_t} \\ e_{ipt} \\ e_{ph_t} \\ e_{y_t} \\ e_{pb_t} \end{pmatrix}$$

- In the *non-recursive scheme*, the impact matrix A_0 implies
 - different reactions of unobserved factors to foreign interest rates changes.
 - no contemporaneous response of domestic output to a FFR_t^* change because real activity seems to react through a specific pattern: those three unobserved factors canalize the initial change in US monetary policy instrument affecting domestic interest rate directly and through real exchange rate and country-risk, and finally reaching domestic output.

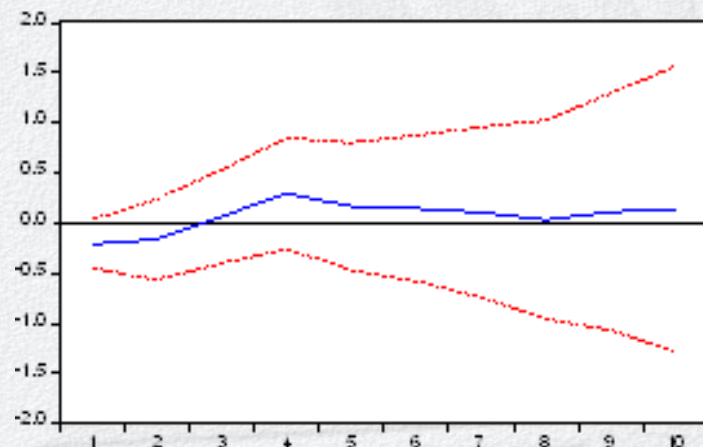
- In the *non-recursive scheme*, the restrictions are:

$$\begin{pmatrix} u_{R_t^*} \\ u_{T10_t} \\ u_{F1_t} \\ u_{F2_t} \\ u_{F3_t} \\ u_{rer_t} \\ u_{UBI_t} \\ u_{ip_t} \\ u_{ph_t} \\ u_{y_t} \\ u_{pb_t} \end{pmatrix} = \begin{pmatrix} \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & 0 & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & \times & \times & 0 & \times & 0 & 0 & 0 & 0 & 0 & 0 \\ \times & 0 & \times & 0 & 0 & \times & \times & 0 & 0 & 0 & 0 \\ 0 & \times & 0 & 0 & \times & 0 & \times & 0 & 0 & 0 & 0 \\ 0 & \times & \times & \times & 0 & \times & \times & \times & 0 & 0 & 0 \\ \times & \times & \times & \times & 0 & \times & \times & \times & \times & 0 & 0 \\ 0 & \times & \times & 0 & 0 & 0 & 0 & \times & 0 & \times & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & \times \end{pmatrix} \begin{pmatrix} e_{R_t^*} \\ e_{T10_t} \\ e_{F1_t} \\ e_{F2_t} \\ e_{F3_t} \\ e_{rer_t} \\ e_{UBI_t} \\ e_{ip_t} \\ e_{ph_t} \\ e_{y_t} \\ e_{pb_t} \end{pmatrix}$$

- There seems to be four **channels** through which a one-time rise in **FFR have real effects in Uruguay**:
 - the commodity price channel
 - the aggregate demand channel
 - OCDE countries
 - relevant region
 - the assets channel (exchange rate and housing prices).

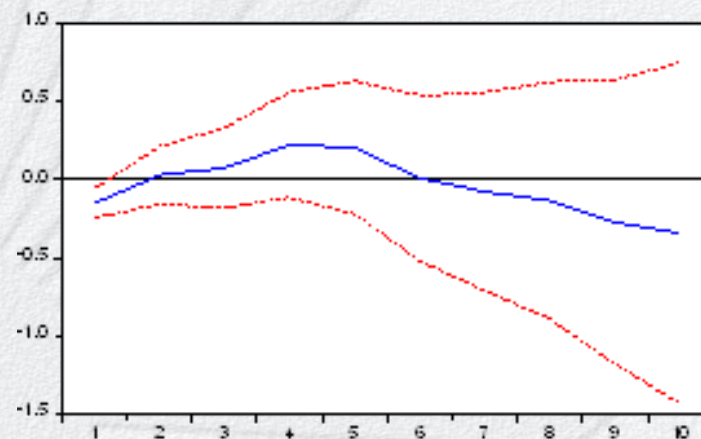
Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of F1 to FFR



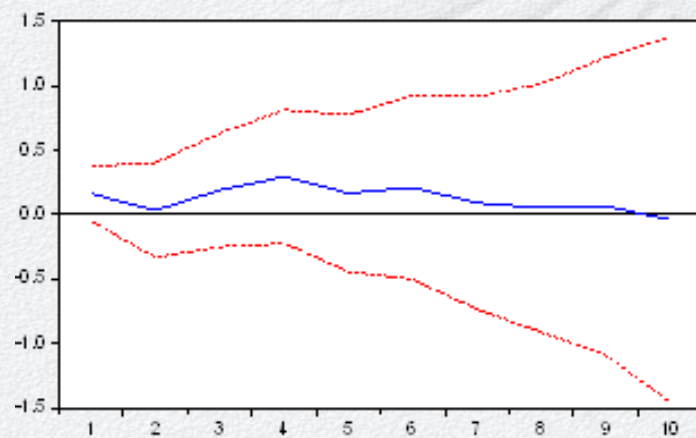
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Response of F2 to FFR



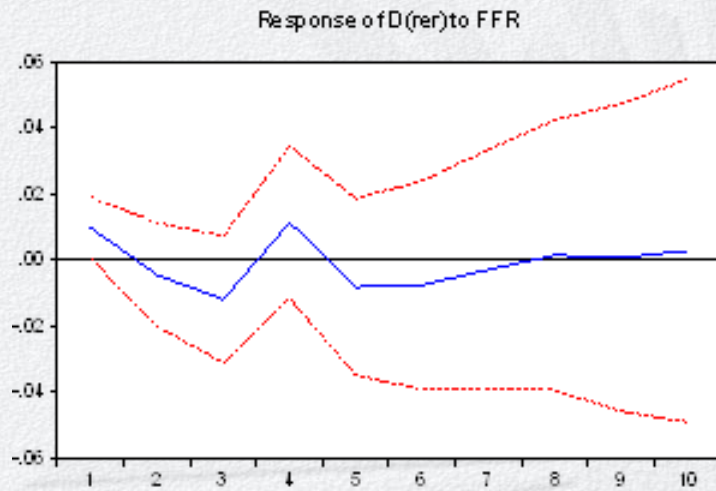
Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of F3 to FFR

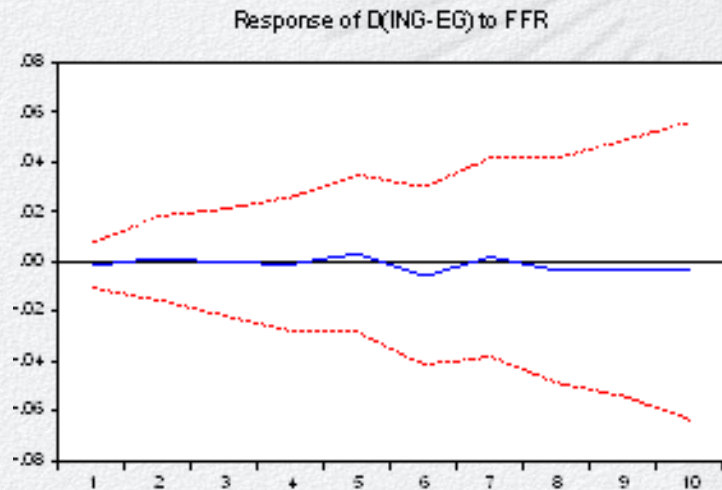


RESULTS - FAVAR

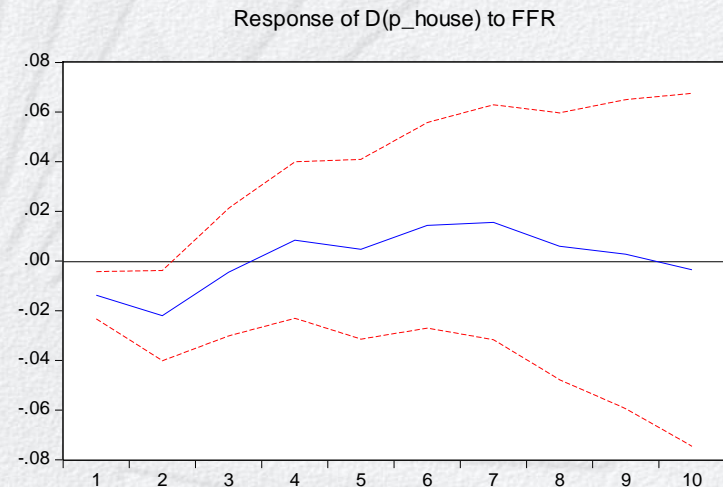
Response to Cholesky One S.D. Innovations ± 2 S.E.



Response to Cholesky One S.D. Innovations ± 2 S.E.



Response to Cholesky One S.D. Innovations ± 2 S.E.



VD

- Domestic output fluctuations
 - In the first period:
 - around 9% by foreign interest rate (both FFR and T10)
 - 6% by commodity prices (F1).
 - As time goes by, the relative importance of foreign interest rate, commodity prices and regional demand are almost the same (12%)

Robustness

- The previous results are robust to different orderings of the shocks, beginning always by FFR.
- There is a slight change in the results, however, when country-specific risk (measured by UBI) is handled either as an exogenous or an endogenous variable (0.47% decrease on impact).

- I proceed to substitute the effective federal funds rate (FFR) by the **Wu-Xia virtual effective federal funds rate** (FFR_im) in the FAVAR estimation:

FIR : same dynamic responses are found but more uncertainty

- I also applied **block restrictions** on the FAVAR equation in order to prevent feedbacks from the observed domestic variables to the foreign interest rate and the unobserved factors blocks:

$$\begin{pmatrix} O_t^* \\ F_t \\ O_t \end{pmatrix} = \begin{bmatrix} \phi_{11}(L) & 0 & 0 \\ \phi_{21}(L) & \phi_{22}(L) & 0 \\ \phi_{31}(L) & \phi_{32}(L) & \phi_{33}(L) \end{bmatrix} \begin{pmatrix} O_{t-1}^* \\ F_{t-1} \\ O_{t-1} \end{pmatrix} + \begin{pmatrix} u_t^{O^*} \\ u_t^F \\ u_t^O \end{pmatrix}$$

FIR: unanticipated MP shock affects the real economy by the same channels found in previous exercises in this study regardless of the foreign interest rate used.

- The aim of this study is to analyze the vulnerability of the Uruguayan economy to US monetary policy.
- A Factor-Augmented VectorAutoregressive (FAVAR) model is implemented on a quarterly balanced panel that span from 1996Q1 to 2014Q4, for the first time.
- FAVAR models enable the researcher to incorporate more information without adding more variables and allow a better identification of structural shocks.
- In this paper, FAVAR models are used in two stages. In the first stage, the impact of foreign monetary policy is assessed on commodity prices, foreign output and regional output. In the second one, the effects on real exchange rate, domestic assets (as housing prices) and on domestic output are analyzed.

- According to the exercise done, Uruguay seems to be reachable.
A rise of 230 basis points in the Federal fund rate (in real terms) drops Uruguayan output growth rate by 0.40% at once; nevertheless, what happens afterwards is uncertain. These results only suggest the need to deep into the transmission mechanism of a particular shock.
- No formal test for structural breaks were performed despite of the presence of breaks in individual TS. Stationarity of the estimated FAVAR model, may suggest co-breaking.
- An important limitation of this study is the time span of the sample.
- Future research on this topic should include a broader data set, analyze possible breaks and apply a dynamic factor model approach.



Thank you!