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.
Uruguay is a small and dollarized open emerging economy, with a shallow financial sector.

The aim of this study is to analyze the vulnerability of the Uruguayan economy to US monetary policy normalization.

The approach consists of implementing a Factor-Augmented Vector Autoregressive (FAVAR) model on a quarterly balanced panel that span from 1996Q1 to 2014Q4.

FAVAR models enable the researcher to incorporate more information without adding more variables and allow a better identification of structural shocks.

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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 and housing prices (as domestic assets) and on domestic output are analyzed.

Despite of the uncertainty surrounded the responses, preliminary results indicate that Uruguay may be negatively affected by an increase in the FFR.

Those effects seem to be mild and short-lived.
PLAN

- Motivation
- Methodology
- Data
- Results
- Future agenda

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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?
MOTIVATION

Liz Bucacos (2019)  A FAVAR approach
MOTIVATION

- A small and dollarized open economy, shallow financial market.

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MOTIVATION

- 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

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MOTIVATION

- 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 is: 
  - 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 reacts.

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MOTIVATION

FACTORS

FFR

p_commodities
y_dev’ed
y_region

rer
p_housing
y
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 \( \chi_{it} \) and the idiosyncratic component \( \xi_{it} \):

\[
x_{it} = \chi_{it} + \xi_{it}
\]
The *idiosyncratic component* $\xi_{it}$ 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):

\[
\chi_{it} = a_1 f_{1t} + a_2 f_{2t} + \cdots + a_r f_{rt} = a_i f_i
\]

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

\[
f_t = D_1 f_{t-1} + D_2 f_{t-2} + \cdots + D_p f_{t-p} + \varepsilon_t
\]

\[
\varepsilon_t = Ru_t
\]
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.

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

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

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

\[
\begin{pmatrix}
F_t \\
O_t
\end{pmatrix} = \begin{bmatrix}
\phi_{11}(L) & \phi_{12}(L) \\
\phi_{21}(L) & \phi_{22}(L)
\end{bmatrix} \begin{pmatrix}
F_{t-1} \\
O_{t-1}
\end{pmatrix} + \begin{pmatrix}
u_t^F \\
\nu_t^O
\end{pmatrix}
\] (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, $\Lambda^f$ is a $(N \times k)$ matrix of factor loadings, $\Lambda^O$ 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.
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 Eliasz (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)).

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A FAVAR approach
Estimation strategy for a FAVAR model: a two-step procedure.

In the **first step**, factors are estimated. Some authors suggest to extract them by the first of principal components (PCA) of the series involved (Bernanke et al. (2005), Boivin (2009)); others, suggest to apply a ML method following a factor analysis (FA).

In the **second step**, the FAVAR equation is estimated by OLS, replacing \( F_t \) by \( \hat{F}_t \).
Factor Analysis vs. Principal Components

- Common factors are extracted from a large group of variables. Both approaches create variables that are linear combination of original series.

- On the Principal Component approach (PCA) these common factors account a maximal amount of variance in the variables.

- On the Factor Analysis (FA) approach these common factors capture common variance in the variables.

- FA is generally used when the research purpose is to detect data structure (i.e. latent construct or factors).

- PCA is generally preferred for purposes of data reduction (i.e. translating variable space into optimal factor space) but not when the goal is to detect latent factors.

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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.

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DATA – policy rate

Factor 1
- p_wheat
- p_soybean
- p_food
- p_oil

Factor 2
- y_USA
- y_UK
- y_I Italy
- y_Spain
- y_Germany
- y_Mexico

Factor 3
- y_Argentina
- y_Brazil
- y_China

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**DATA – policy rate**

- **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.

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A FAVAR approach
DATA – policy 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 Wu-Xia virtual effective federal funds rate

Liz Bucacos (2019) A FAVAR approach
RESULTS – Baseline VAR

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

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A FAVAR approach
Then, I explore that other unobserved variables may influence the behavior of the observable variables:

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

where

\[
O_t^* = (FFR_t^*, T10_t); \quad O_t^d = (rer_t, UBI_t, i_p_t, p_ht, y_t, p_b_t)
\]

\[F_t = (F_{1t}, F_{2t}, F_{3t})\], are the factors estimated in the first part by ML

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”.

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RESULTS - FAVAR

- 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.

Liz Bucacos (2019)                                      A FAVAR approach
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.

Response of D(y) to FFR
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 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 $\text{FFR}_t^*$ 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.
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).
RESULTS – FAVAR

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A FAVAR approach
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.

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A FAVAR approach
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 ($\text{FFR}_{im}$) 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.

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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.

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According to the exercise done, Uruguay seems to be reachable. A rise of 230 basis points in the Federal funds 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.

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Thank you!
It is common that several variables are dropped out of the data set, according to measures of sampling adequacy (MSA) and goodness-of-fit criteria. Only TS whose MSA value are greater or very close to Kaiser’s MSA (Kaiser and Rice (1974)), remain:

- MSA value > 0.90: marvelous
- MSA value in the 80s: meritorious
- MSA value in the 70s: middling
- MSA value in the 60s: mediocre
- MSA value in the 50s: miserable
- MSA value < 0.50: unacceptable
There are various methods to determine the number of factors.

**Velicer’s (1976)** minimum partial map (MAP) method computes the average of the squared partial correlations after m components have been partialized out (for m=0, ..., p-1). The number of factors retained is the number that minimizes this average. The intuition here is that the average squared partial correlation is minimized where the residual matrix is closest to being the identity matrix.

There is evidence that the MAP method outperforms a number of other methods under a variety of conditions.
Federal funds rate and 10-year Treasury interest rate
DATA

- Commodity prices

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Commodity prices

DATA

P_wheat

P_oil
“Developed” world

Liz Bucacos (2019)  A FAVAR approach
DATA

Relevant region

GDP_BRA  GDP_Arg  GDP_Uru  GDP_China

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URUGUAY: real exchange rate
DATA

URUGUAY: housing prices

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

\[
\begin{pmatrix}
    u_{R_t^*} \\
    u_{T10_t} \\
    F_{1_t} \\
    F_{2_t} \\
    F_{3_t} \\
    u_{rer_t} \\
    u_{UBI_t} \\
    u_{ipt_t} \\
    u_{pht_t} \\
    u_{yt_t} \\
    u_{pbt_t}
\end{pmatrix}
= 
\begin{pmatrix}
    \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & \times & \times & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & \times & \times & \times & 0 & 0 & 0 & 0 \\
    \times & \times & \times & \times & \times & \times & \times & 0 & 0 & 0 \\
    \times & \times & \times & \times & \times & \times & \times & \times & 0 & 0 \\
    \times & \times & \times & \times & \times & \times & \times & \times & \times & 0 \\
    \times & \times & \times & \times & \times & \times & \times & \times & \times & \times \\
\end{pmatrix}
\begin{pmatrix}
    e_{R_t^*} \\
    e_{T10_t} \\
    F_{1_t} \\
    F_{2_t} \\
    F_{3_t} \\
    e_{rer_t} \\
    e_{UBI_t} \\
    e_{ipt_t} \\
    e_{pht_t} \\
    e_{yt_t} \\
    e_{pbt_t}
\end{pmatrix}
\]
In the *non-recursive scheme*, the restrictions are:

\[
\begin{bmatrix}
    u_{R^*_t} \\
    u_{T10_t} \\
    u_{F1_t} \\
    u_{F2_t} \\
    u_{F3_t} \\
    u_{rer_t} \\
    u_{UBI_t} \\
    u_{ipt} \\
    u_{pht} \\
    u_{yt} \\
    u_{pbt}
\end{bmatrix}
= 
\begin{bmatrix}
    \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    0 & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & \times & \times & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
    \times & 0 & \times & 0 & 0 & \times & \times & 0 & 0 & 0 & 0 \\
    0 & \times & 0 & 0 & \times & \times & \times & 0 & 0 & 0 & 0 \\
    \times & \times & \times & \times & 0 & \times & \times & \times & 0 & 0 & 0 \\
    0 & \times & \times & 0 & 0 & \times & 0 & \times & 0 & 0 & \times \\
    0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & \times
\end{bmatrix}
\begin{bmatrix}
    e_{R^*_t} \\
    e_{T10_t} \\
    e_{F1_t} \\
    e_{F2_t} \\
    e_{F3_t} \\
    e_{rer_t} \\
    e_{UBI_t} \\
    e_{ipt} \\
    e_{pht} \\
    e_{yt} \\
    e_{pbt}
\end{bmatrix}
\]