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Changing Effects of Monetary Policy in the U.S. $\hat{\square}$ Evidence from a Time-Varying Coefficient VAR

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Changing Effects of Monetary Policy in the U.S. – Evidence from a Time-Varying Coefficient VAR

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Changing Effects of Monetary Policy in the U.S. – Evidence from a Time-Varying Coefficient VAR

Abstract: We estimate a time-varying coefficient VAR model for the U.S. economy to analyse (i) if the effect of monetary policy on output has been changing systematically over time, and (ii) if monetary policy has asymmetric effects over the business cycle. We find that the impact of monetary policy shocks has been gradually declining over the sample period (1962-2002), as some theories of the monetary transmission mechanism imply. In addition, our results indicate that the effects of monetary policy are greater in a recession than in a boom.

JEL classification: E52, E32, C52

Keywords: vector autoregression, monetary transmission, non-linear time series models,
time-varying coefficients

1 Introduction

Has the impact of U.S. monetary policy on output changed systematically over time? Moreover, are the effects of monetary policy symmetric or asymmetric over the business cycle? These issues have received increasing interest in the recent macroeconomic literature. By applying a time-varying coefficient vector autoregressive model (TVC-VAR) in the present paper we are able to tackle both these issues within one econometric framework. In comparison to other non-linear empirical models that have been used to study time-varying effects of monetary policy (e.g., the Markov-Switching model or the smooth-transition VAR model), the TVC-VAR constitutes an interesting alternative. It is comparatively flexible and it imposes as few as possible restrictions on the data. The empirical model is thereby well suited for a - to a certain extent - “unprejudiced” look at the data, which lies in the VAR-tradition of analysing the effects of policy shocks. Some papers such as Cogley and Sargent (2001) and Cicarelli and Rebucci (2002) recently adopted Bayesian frameworks for TVC-VAR analysis of monetary policy that are related to our approach. Our results suggest a decreasing impact of U.S. monetary policy over time as well as considerable asymmetries over the business cycle, with stronger effects of monetary policy during a recession.

At least two theories of the monetary transmission suggest changing effects of monetary policy over time. The ‘cost channel’ presented by, e.g., Barth and Ramey (2001) claims that monetary policy effects are transmitted through the supply side of the economy by affecting the working capital of enterprises. They develop three factors that may account for a weakening of the real effects of monetary policy through this channel: (i) Financial innovations and deregulation in the U.S. financial system increased the availability of working capital. (ii) The change to a floating exchange rate system after the breakdown of the Bretton Woods system. This counterbalances the directly increasing costs of working capital after a monetary tightening by a reduction in costs of imported materials. (iii) The Federal Reserve monetary policy

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3 actions in the 1960s and 1970s were often accompanied with credit control actions leading to
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5 a non-price rationing of working capital.
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8 In addition to the cost channel, systematic changes of monetary policy effects over time can
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10 be derived from the ‘credit channel’, which is typically divided into the ‘bank lending chan-
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12 nel’ and the ‘balance sheet channel’.¹ Both channels point to changes in the private sector's
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14 financial structure as potential sources of changing effects of monetary policy. In particular, as
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16 financial innovations and the integration of financial markets make it easier to raise funds on
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18 capital markets, the dependence of the private sector on bank credit decreases and the bank
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20 lending channel likely becomes less effective.
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24 Besides theories of monetary transmission, changes in the way monetary policy is conducted
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26 can alter the real effects of monetary policy shocks. Boivin and Gianonni (2002) employ a
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28 stylized model to argue that a decline in the real effects of monetary policy can be explained
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30 by a central bank that has an increasing preference for output stabilization in the face of sup-
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32 ply and demand shocks and therefore makes more efficiently and more rigorously use of its
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34 own instruments.²
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38 The second issue to be addressed in the empirical analysis are potential asymmetries of mone-
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40 tary policy over the business cycle. On the one hand, business cycle dependent effects of
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42 monetary policy can be motivated from a convex aggregate supply curve. In the flat part of
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44 the supply curve where output is relatively low as for example in a recession, a shift in the
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46 demand curve has a larger impact on output and a smaller on prices in contrast to the steeper
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48 part of the supply curve, where output is relatively high.³ On the other hand, asymmetric
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50 effects of monetary policy can be explained by the ‘balance sheet channel’ focussing on the
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57 ¹ See, e.g., Hubbard (1995) for an overview over the credit channel. Bernanke and Blinder (1988) present a
58 model of the bank lending channel, whereas Bernanke et al. (1996) model the balance sheet channel. For em-
59 pirical evidence on the bank lending channel in the U.S. see, e.g., Gertler and Gilchrist (1994), Kashyap and
60 Stein (2000) and Nilsen (2002).

² See the Appendix for a presentation of the model by Boivin and Gianonni (2002).

³ Ball and Mankiw (1994) use a hybrid framework of time and state-contingent price adjustment rules under the assumption of menu costs to derive a convex supply curve, see also Caballero and Engel (1992).

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3 borrower's net worth.⁴ A decline in net worth following a contractionary monetary policy im-
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5 plies that borrowers have fewer internal funds and less collateral to acquire external funds.
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7 This enhances the problems created by informational asymmetries. In a boom, when firms
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9 and households have a relatively high net worth, policy actions are less effective than in a
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11 recession when the net worth is relatively low.
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15 As has been noted above, so far empirical studies have focussed on one of the two issues
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17 alone. Barth and Ramey (2001) and Boivin and Giannoni (2002, 2003), for example, estimate
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19 VARs for different sub-samples and find the average effect of monetary policy on output to
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21 decrease in the U.S. Moreover, concerning potential business cycle asymmetries, recent em-
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23 pirical evidence for the U.S. by Weise (1999), Garcia and Schaller (2002) and Lo and Piger
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25 (2003), among others, suggests stronger effects of monetary policy in a recession than in a
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27 boom.
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31 In the present paper, we take up both issues raised and analyse them in a unifying empirical
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33 framework. We use a standard VAR framework and following Neumann (2001), we allow for
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35 time-varying coefficients following a random walk. This introduces an empirical framework
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37 referred to as TVC-VAR which is able to capture a potentially changing structure of the
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39 economy over time. In particular, time-varying impulse responses are generated that visualise
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41 the nature of this structural change over time. From time-varying impulse response estimates
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43 new insights can be gained concerning the evolution of monetary policy effects over time as
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45 well as potential asymmetries over the business cycle. Section 2 introduces the empirical
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47 framework. Section 3 presents our empirical findings and Section 4 concludes.
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⁴ See Hubbard (1995) and Bernanke et al. (1996).

2 Empirical Methodology – The TVC-VAR Framework

In recent years, a huge amount of empirical models have been developed to account for structural breaks and potential non-linearities including regime-switching models, threshold autoregressive models as well as state-space models with time-varying coefficients.⁵ Essential for the choice of the appropriate modelling framework thereby is the type of coefficient variation that is most likely for the phenomenon under investigation. Empirical findings based on simulated data from Neumann (2003) suggest that time-varying coefficient models with random walk coefficients dominate alternative approaches to time-varying estimation. Moreover, a model with random-walk coefficients may be appropriate even in the presence of time-invariant coefficients because model estimates turn out to be comparatively stable in this case. In this paper we follow Jiang and Kitagawa (1993) and Neumann (2001) and extend univariate time-varying estimation to VAR analysis. Time-varying impulse responses derived from our model estimates allow us to investigate the real effects of monetary policy shocks over time. In the following, a brief sketch of the methodology is presented, see Neumann (2001) for a more detailed exposition.

The Model Set-Up Consider the following reduced form of a VAR with p lags and n endogenous variables:

$$Y_t = A_{0,t} + A_{1,t}Y_{t-1} + \dots + A_{p,t}Y_{t-p} + U_t. \quad (1)$$

In this set-up, for every t of the sample coefficient matrices $A_{0,t}, A_{1,t}, \dots, A_{p,t}$ and a variance-covariance matrix $\Sigma_{U,t}$ are estimated, where U_t is distributed as $U_t \sim N(0, \Sigma_{U,t})$. Collecting the coefficient matrices in matrix $A_t = (A_{0,t}, A_{1,t}, \dots, A_{p,t})$, and defining $B_t = \text{vec}(A_t)$ and $X_t = (1 \otimes I_k, Y'_{t-1} \otimes I_k, \dots, Y'_{t-p} \otimes I_k)$, the model can be written as

$$Y_t = B_t X_t + U_t. \quad (2)$$

⁵ See, e.g., Granger and Teräsvirta (1993) for a comprehensive survey.

In order to get reasonable estimates of the coefficients from the limited amount of data points available, stochastic constraints are imposed. More specifically, the time variation of the coefficients is specified by assuming that the elements of B_t follow independent random walks,

$$B_t = B_{t-1} + W_t \quad (3)$$

with $W_t \sim N(0, \Sigma_W)$ and Σ_W being diagonal. This restriction constitutes the Gaussian ‘smoothness prior’ distribution on the time history of the VAR coefficients.⁶

In order to enable estimation of the n -dimensional system with time-varying coefficients, following Jiang and Kitagawa (1993) and Neumann (2001), a Cholesky recursive structure is imposed on the system, allowing to estimate the VAR equation by equation. Assuming that the structural form of the VAR follows a recursive structure, equation (1) can be written as

$$\Gamma_t Y_t = C_{0,t} + C_{1,t} Y_{t-1} + \dots + C_{p,t} Y_{t-p} + V_t, \quad (4)$$

where the structural residuals are distributed as $V_t \sim N(0, \Sigma_V)$, and Σ_V being diagonal. The lower triangular matrix Γ_t captures the recursive contemporaneous interactions of the endogenous variables. As Σ_V is a diagonal matrix, the equations of model (4) can be estimated equation by equation yielding estimates of the structural coefficient matrices $C_{0,t}, C_{1,t}, \dots, C_{p,t}$ as well as Γ_t , and the variance-covariance matrix Σ_V .

⁶ Alternatively an autoregressive structure like $B_t = \alpha B_{t-1} + W_t$ could have been imposed, where $0 < \alpha < 1$. Simulations however show that the random walk model as a general specification captures several potential time paths of gradual coefficient changes quite well. Note, however, that the specification by construction imposes a smooth path for the coefficients. As a consequence, the model behaves badly when the underlying coefficient process exhibits discrete single shifts. An appropriate model to capture discrete stochastic shifts may be the Markov-Switching model, see, e.g., Garcia and Schaller (2002).

The matrices $A_{i,t}$ and $\Sigma_{U,t}$ as well as the residuals U_t of the reduced form can be recovered using the following equations:

$$\begin{aligned} A_{i,t} &= \Gamma_t^{-1} C_{i,t}, \\ \Sigma_{U_t} &= \Gamma_t^{-1} \Sigma_V (\Gamma_t^{-1})', \quad i = 1, \dots, p \\ U_t &= \Gamma_t^{-1} V_t. \end{aligned}$$

Estimating and Analyzing the Model For estimating (4) equation by equation each equation of the model is written as

$$y_t = x_t' \beta_t + v_t, \quad (5)$$

where y_t is the dependent variable and x_t and β_t are vectors collecting the variables and the coefficients of a single equation of model (4). (5) constitutes the measurement equation of the state-space representation of the model, where the respective transition equation is given by

$$\beta_t = \beta_{t-1} + w_t, \quad (6)$$

with $w_t \sim N(0, \sigma_w^2)$.

Then, sequential estimates of the coefficients β_1, \dots, β_T can be generated by applying the Kalman filter routine to every single equation given by (5), see Jiang and Kitagawa for an exposition of the Kalman filter for the TVC–VAR application. The model is estimated as outlined in detail in Neumann (2001), using the EM algorithm to find maximum likelihood estimates of the hyperparameters to initialise the Kalman filter. Alternatively Bayesian approaches in the tradition of Doan, Litterman and Sims (1984) could be adopted for model estimation. A number of papers such as Cogley and Sargent (2001) and Cicarelli and Rebucci (2002) applied Bayesian techniques in the context of monetary policy analysis recently. We derive time-varying impulse responses using the Generalised Impulse Response approach of Koop et al. (1996). In contrast to Koop et al. the present analysis assumes that once a shock has occurred there is no feedback of this shock to the coefficients of the model, coefficient variation thus is exogenous.

3 Empirical Results

We apply the TVC-VAR methodology to a standard three variables VAR model of the U.S.-economy, consisting of GDP (deflated with the consumer price index and in logs), consumer prices (in logs) and the federal funds rate. All series are at the quarterly frequency, running from 1962:1 to 2002:2.⁷ The federal funds rate is used as a measure of monetary policy for the whole sample range. This approach is widely used in the empirical literature, for a discussion see, e.g., Bernanke and Mihov (1998).⁸

Unit root tests indicate that output and prices are I(1), whereas the federal funds rate is I(0), see Table 1 for details. Therefore, except for the federal funds rate the model is estimated in first differences. With this specification we follow, among others, Rudebusch and Svensson (1999). No statistical criterion is available yet for the choice of the lag order in the TVC-VAR case. The results, however, are comparatively robust to alternative choices. Hence, we restrict the presentation of estimation results to a lag order of four. Finally, as the estimation and identification of the model relies on the recursive Cholesky structure, we follow the standard procedure to order the monetary policy instrument last in the VAR, after GDP and prices. We choose this ordering because it has the strongest theoretical background given that GDP and prices are unlikely to react simultaneously to interest rate shocks. Nonetheless, we considered alternative orderings in order to check the robustness of reported results. In fact, we found the results to be rather robust to alternative orderings of the monetary policy instrument. This finding indicates that a low degree of simultaneous correlations among the examined variables.

⁷ All data are from the IMF's "International Financial Statistics": Gross Domestic Product, series code 11199b.c. Consumer Price Index, series code 11164. Federal Funds rate, series code 11160b.

⁸ Even though the Federal Reserve changed its operating procedure in the period of 1979-1982, the funds rate was still closely connected with the Federal Reserve monetary strategy, on this see, e.g., Cook (1989), Goodfriend (1991) and Bernanke and Mishkin (1992). Among others Sims (1992) and Clarida et. al (2000) have used the funds rate for comparable sample ranges in a VAR-analysis as monetary policy instrument.

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3 From TVC-VAR estimates we derive an impulse response function for every point of time
4 over the whole sample period. Figure 1 presents the accumulated impulse response at several
5 horizons of real GDP to a monetary policy shock (one percentage point increase in the federal
6 funds rate) as it evolves over the estimation period. It contains four graphs (a) to (d) that indi-
7 cate how the accumulated impulse responses at a horizon of 4, 8, 12 and 16 quarters evolve
8 over the sample period, respectively. For reasons of an illustrative comparison every graph
9 also plots as a dashed line the accumulated impulse response at the respective horizon from
10 the *linear* VAR specification as well as 10% error bands from the latter specification. This is
11 intended to serve as a rough guideline to judge the degree to which the time-varying specifi-
12 cation departs from the linear one. Yet, it is important to stress that this does not constitute a
13 formal test for non-linearity, as the estimates from the linear specification are biased in the
14 presence of structural change.⁹ Concerning the first issue to be analysed in this paper, namely
15 the stability of monetary policy effects over time, the results suggest that the effects of mone-
16 tary policy shocks have become weaker over time. Most clearly this ‘trend’ is visible in the
17 reaction of GDP to the monetary policy shock after four quarters. The impact today is almost
18 half as strong as it was in the 1970s. While at the beginning of the 1970s a one percentage
19 point increase in the federal funds rate led to a decrease in real GDP after four quarters of
20 roughly 0.5 percent, in the second half of the 1990s this effect was down to around 0.2 per-
21 cent, though increasing again at the end of the sample period. It is also interesting to note that
22 at the four quarter horizon the impulse response moves out of the linear error bands at the
23 beginning of the 1980s. As has been noted above, this may indicate a structural break at the
24 beginning of the 1980s. A linear specification over the whole sample period hence may sys-
25 tematically overestimate the effect of a monetary policy shock on output.
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27 The finding of a declining impact of monetary policy shocks over time supports the cost
28 channel and the credit channel of monetary transmission. Both refer to changes in the finan-
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⁹ Computing error bands for the time-varying impulse responses on the other hand is still an unresolved issue.

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cial structure that translate into a weakening of monetary policy effects. Additionally, our findings support theories that are based on a change in the monetary policy reaction function causing the effects of monetary policy to decline. To differentiate between the various theories is beyond the scope of the TVC-VAR framework. In fact, it requires the use of more structural models that help to disentangle the causes of a declining impact of monetary policy shocks over time. However, the gradual change in the real effects of monetary policy over the last 40 years might tentatively speak in favor for theories of monetary transmission linking the changes over time to gradually changing economic structures, as far as monetary policy seems to be more likely to be subject to abrupt regime shifts rather than to a gradual change.

Empirically our results are consistent with the evidence found in Boivin and Giannoni (2002, 2003) and Barth and Ramey (2001). Boivin and Giannoni (2002, 2003) estimate a linear VAR with different sub-samples and find that the response of output to a monetary policy shock has become weaker since the beginning of the 1980s, similar results at the industry level can be found in Barth and Ramey (2001). Also, the empirical evidence on changes in the Federal Reserve's monetary policy reaction function presented by, e.g., Taylor (1999), Clarida et al. (2000) is consistent with our results. They find an increased preference for output stabilization in the conduct of monetary policy by the Federal Reserve which might cause monetary policy effects to decline as our estimates suggest.¹⁰

The second issue we are interested in is whether there is a business-cycle dependency in the effects of monetary policy. Therefore, we compare our results with the U.S. recession periods. In Figure 1 the shaded areas correspond to the NBER recession periods. It is clearly evident from Figure 1 that monetary policy tends to have stronger effects during recessions. This result is particularly pronounced at the longer impulse response horizons, most strongly during the recessions 1973:4 until 1975:1 and in the early 1980s. In addition, we observe that this

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3 asymmetry became much weaker since the mid 1980s. This observation fits to the available
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5 evidence of an increased efficiency in monetary policy in the sense that the Federal Reserve
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7 gained more experience in steering the economy through the business cycle.
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10 The second part of our empirical findings are again in line with economic theory, namely with
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12 the credit channel and with models of convex supply curves. Moreover, our study confirms
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14 the results of other empirical studies that analyse asymmetries of the effects of monetary pol-
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16 icy. To mention only three important studies, Garcia and Schaller (2002) and Lo and Piger
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18 (2003) find that monetary policy is stronger during recessions using the Markov-Switching
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20 framework introduced by Hamilton (1989), while Weise (1999) finds the same result applying
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22 a non-linear smooth transition VAR framework.
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28 4 Conclusion

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32 In the present paper we address two questions: (i) Have the real effects of US monetary policy
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34 changed over the last 40 years? (ii) Are the real effects of monetary policy asymmetric over
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36 the business cycle? To investigate these two issues, we apply a standard three-variable VAR
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38 while allowing for time-varying coefficients in this model. From this we derive time-varying
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40 impulse responses to investigate the response of output to monetary policy shocks over time.
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44 Two findings emerge from our empirical analysis. First, the impact of monetary policy shocks
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46 steadily decreased since the 1960s. This finding supports the cost channel and the credit
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48 channel of monetary transmission as well as theories pointing to an increased preference to
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50 stabilize output fluctuations by the central bank, leading to a decline in real effects of mone-
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52 tary policy. Second, we find that monetary policy effects are asymmetric over the business
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54 cycle, where monetary policy is stronger during recessions. This is in support of the credit
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¹⁰ The issue of a changing conduct of U.S. monetary policy, i.e. how and if the Federal Reserve's reaction function has changed in the last 40 years is still controversial. See, e.g., Cogley and Sargent (2001), Orphanides (2002, 2004), Söderlind (2004) and Österholm (2005).

channel, but also of models with convex supply curves. Finally, our findings suggest that the asymmetry of monetary policy effects over the business cycle has decreased since the mid 1980s.

Appendix

With the aid of a small stylized model this argument can be illustrated. The model proposed by Boivin and Gianonni (2002) consists of two central equations and is a stripped down version of a standard New Keynesian model as used for the analysis of monetary policy by McCallum and Nelson (1999) and Clarida et al. (1999), to name but a few.¹¹ All variables are expressed in percent deviations from the long-run value and in real-terms. The first equation represents an expectational IS-curve

$$y_t = E_t(y_{t+1}) - \sigma r_t + \delta_t \quad (\text{A.1})$$

with the output gap y_t , the one-period expected output gap $E_t(y_{t+1})$, the current short-term real interest rate r_t and a demand shock δ_t . The expectational IS-curve is a linear approximation to the representative household's Euler condition for optimal consumption. Forward iteration of equation (A.1) leads to equation (A.2) and it is apparent that output depends on the long-term interest rate r_t^L .

$$y_t = \delta_t - \sigma r_t^L \quad (\text{A.2})$$

By the nature of New Keynesian models and according to the expectation theory of the term structure, the long-term interest rate r_t^L is dependent on current and expected short-term interest rates as shown here in equation (A.3).

$$r_t^L = E_t\left(\sum_{j=0}^{\infty} r_{t+j}\right) \quad (\text{A.3})$$

The second central equation of this model represents central bank behavior. This is given in equation (A.4) by a simple Taylor-style interest rate rule.¹² For expository purposes Boivin

¹¹ Usually a third equation is included in these models, providing the inflation adjustment process with inflation adjustment derived from optimizing firms in an environment of monopolistic competition. This equation is omitted to focus on the issue in question.

¹² See Taylor (1993)

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3 and Gianonni (2002) assume that the central bank is able to use the short-term real interest
4 rate r_t as an instrument.
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$$7 \quad r_t = \phi y_t + \varepsilon_t \quad (A.4)$$

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9 The interest rate rule states that the central bank wishes to stabilize output around the steady
10 state with ϕ (and $\phi > 0$) representing the strength of output stabilization. In addition, the pol-
11 icy rule in equation (A.4) includes a disturbance term ε_t representing the unsystematic part of
12 monetary policy. In fact, this disturbance term can be thought of as the monetary shock with
13 which impulse-response analysis in a VAR framework of monetary policy is conducted.
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16 Solving the model for output y_t leads to equation (A.5).
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$$19 \quad y_t = \frac{\delta_t - \varepsilon_t}{1 + \sigma\phi} \quad (A.5)$$

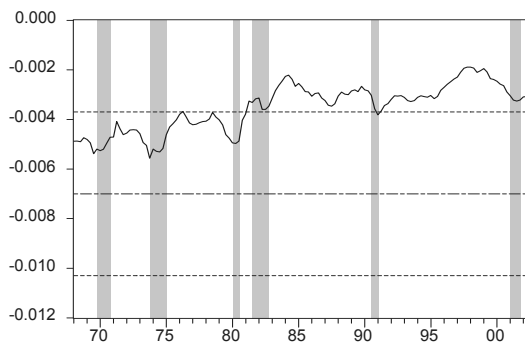
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28 At this point it is now possible to illustrate how changes in the conduct of monetary policy
29 lead to a change in the real effects of monetary policy. If the preference of the central bank for
30 output stabilization increases, i.e. ϕ is increasing, then a standardized positive monetary shock
31 ε_t (raising the interest rate to the same level as before the preference change in the degree of
32 output stabilization) now leads to a smaller contractionary output response.
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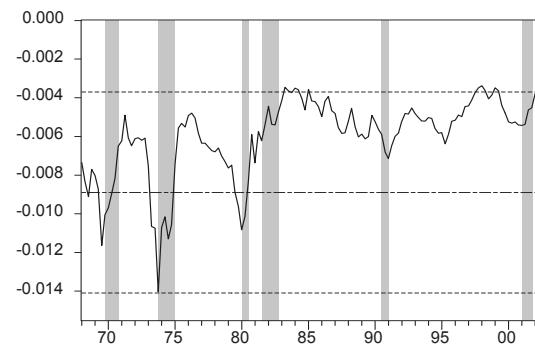
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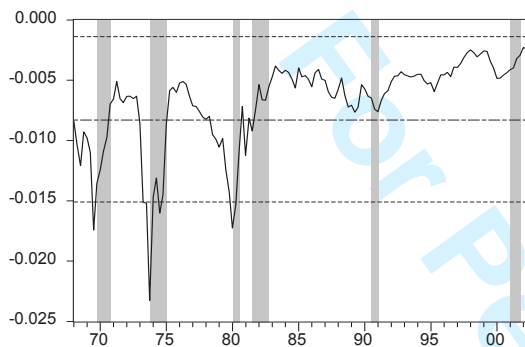
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Figure 1: Accumulated Impulse Responses of GDP to a Monetary Policy Shock

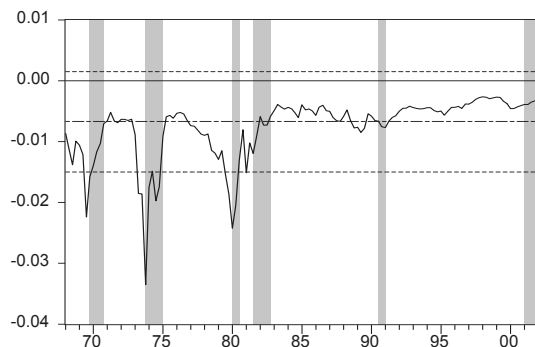
(a) Response over time after 4 quarters



(b) Response over time after 8 quarters



(c) Response over time after 12 quarters



(d) Response over time after 16 quarters

Note: Graphs (a) to (d) are profiles along the time axis of Figure 1. Shaded areas are NBER recessions.

The y-axis gives the percentage impact on output of a one unit shock.

Table 1: Unit Root tests

Variable	ADF Test ^a	KPSS Test ^b
	Test statistic (Specification ^c)	Test statistic (Specification ^c)
GDP	-3.436* (c,t)	0.159** (c,t)
ΔGDP	-8.585*** (c)	0.216 (c)
CPI	-1.618 (c, t)	0.290*** (c,t)
ΔCPI	-2.189 (c)	0.326 (c)
Interest rate	-2.654* (c)	0.264 (c)
	H₀ : Existence of a unit root	H₀ : Stationarity
	* denotes significance at 10% - level	
	** denotes significance at 5% - level	
	*** denotes significance at 1% - level	

^a Augmented Dickey-Fuller Test with lag selection according to the Schwartz criterion; ^b Kwiatkowski-Phillips-Schmidt-Shin Test; ^c c =constant, t = trend.