Monetary Policy in a Markov-Switching VECM: Implications for the Cost of Disinflation in Ghana

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Abstract: Monetary policy assessment in Ghana has been conducted using vector auto-regression. This however, presumes stability of long run outcomes and particularly ignores monetary policy regime changes that has characterized the economy overtime. This study thus introduced the possibility of switches in the long run equilibrium in co-integrated vector auto-regression by allowing both the covariance and weighting matrix in the error-correction term to switch. The study did not find any significant difference in monetary response in the different states. However, significant difference was obtained for the cost of disinflation across states. Though, disinflation cost has declined as the Bank of Ghana shifts from monetary targeting to inflation-targeting regime, overall cost is still high. This has implication on disinflation policy given the development agenda pursue by the country.

Keywords: Monetary Policy, Markov-Switching, Sacrifice Ratio JEL Classification: E31 E52

Introduction

Monetary policy has been the main tool used for macroeconomic stabilization in Ghana. Over the years, the monetary framework has undergone important changes regarding implementation (shocks) and policy (regime) framework. The policy regimes involve switches in the policy rule (i.e., from credits to interest rate instruments) to reflect monetary authorities' reaction to target inflation and output. Emerging from a direct control approach, monetary policy has evolved via monetary targeting approach (an indirect approach under the requirement of structural adjustment program) to its current state of inflation targeting.

These evolution processes aim to enhance the impact of monetary actions on the aggregate economy. Though, monetary policy objectives compose of wide range of aggregates (including growth, exchange rate stability, interest rate and among others), its paramount effort is to curtail the high prices that have bedeviled the economy through disinflationary strategies. This is predominantly motivated by the high cost associated with high and volatile prices.

However, following from Okun (1978), there is potential loss in output or employment associated with disinflationary policy. Given that Ghana is a developing country and desires to accelerate growth in its development path, knowledge about the cost of disinflationary policies is worthwhile. This will guide monetary policy implementation because policy makers will be guided by the economic cost of their actions in terms of output loss.

Also, the regime changes can potentially have a large effect on the volatility of money, interest rates, outputs and prices. This study thus investigates monetary shocks by exploring the cost implication of regime changes on the disinflation strategy adopted by Ghana. The investigation is conducted within the periods 1960 to 2013. We conduct this study for Ghana because no literature has been identified on this theme. Secondly, since the focus of the Bank of Ghana is price stability, it is important to understand the economic effect of this policy directions in terms of output loss. This is because a fore knowledge of the economic cost associated with the disinflation policy will aid monetary authorities in implementing monetary policy.

The study adopted the modelling approach based on multivariate Markov-Switching vector error correction model (hereafter MS-VECM). This strategy explicitly allows for regime changes in the variables since Ghana overtime has been characterized by different monetary and policy regime. The regime changes might have potential stochastic effects on both the short and long run dynamic impacts of monetary policy. MS-VECM modelling approach can account for the long run properties in this
Policy regimes engage switches in the policy rule that mirror changes in the policy maker's reaction to deviations from the target inflation rate and or output growth. Switching monetary policy studies are also able to account for unrelenting adjustments in policy which result from changes in central bank leadership or transparency which also affect the volatility of money, output and interest rates (Clarida et al., 2000; Dennis, 2001; Hanson, 2002). For instance, Dennis (2001) argues that a change in policy maker preferences has shifted after 1979 inflation target from around 7% to a value below 2%.

Other studies have examined both the regime changes (objectives of policy) and policy shocks (policy implementations). To these studies, monetary policy is relevant not only to the policy maker's response to the exogenous economic shocks but also to the contemporaneous effects of the monetary policy innovations (Owyang, 2002; Sims and Zha, 2002). These papers however, failed to address the long-run objectives and impacts of monetary policy. The paper, like Neville and Owyang (2004) incorporates these long-run impacts. Regime switches in the long run relationship through the weighting matrix of the error correction term is also taken care off.

Although a lot of studies have used the Markov Switching in an error correction framework (Clarida et al., 2003; Paap and Van Dijk, 2003; Hanson, 2002 and among others) around the world, Monetary policy studies in Ghana has been based on Vector innovations to a Vector Auto regression (VAR) (Abradu-Otoo et al., 2003; Epstein and Heintz, 2006; Atta-Mensah and Bawumia, 2003). Such studies are unable to represent many non-linear dynamic patterns. Also, these studies ignored monetary policy regime changes that has characterized the Ghanaian economy overtime. This study thus comes handy to address such issues.

### Econometric Modelling

The aim of the study is to explore monetary policy implementation in regime switching. Hence the study adopted a vector error-correction model that allows for different states of the economy. The regime switching can either be modelled to allow all or part of the coefficient matrix to switch independently or with the error-correction term. However, this study allows the switch with the error term. This approach thus, assumes a stable long-run relationship i.e., regime invariant co integrating vector whereas the short run dynamics are analyzed in a Markov-Switching framework which allows the error correction to respond to regimes. By this, the study can examine the state dependent responses to monetary policy shocks.

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The study by specifying a Markov-Switching Vector Error Correction Model (MSVECM) of:

$$\Delta Y_t = \alpha + \sum_{i=1}^{r} \sigma_i \Delta Y_{t-i} + \omega_s Y_{t-1} + \epsilon_t$$  (3.1)

Where:

- $\Delta Y_t$ = An n dimensional vector of differenced variables of interest.
- $\alpha$ = A vector of intercepts.
- $\sigma_i$ = nXn parameter matrices.
- $\omega_s$ = The state-dependent long run impact matrices.

The long run state dependent matrix comprises of rXn matrix of co integrating vector $\beta$ and nXr state-dependent weighting matrix $\tau_s$. Therefore:

$$\omega_s = \tau_s \beta$$

Given a two state first order Markov process $S_t \in \{0, 1\}$ with its associated transition kernel $P$, where $P_{ij} = Pr[S_t = i| S_{t-1} = j]$, then Equation 3.1 can be re-written as:

$$\Delta Y_t = \alpha + \sum_{i=1}^{r} \sigma_i \Delta Y_{t-i} + \tau_s \beta Y_{t-1} + \epsilon_t$$  (3.2)

Though, the long run state-dependent matrix can either switch in the co integrating vector, the weighing matrix or both, this study allows only switches in the error-correction term which implies a single set of long run relationship. This means that the correction mechanism depends on the state. By implication, switches in this framework are interpreted as differences in the rate at which the common long run relation is obtained. Allowing switches only in the error term is predominantly motivated by some potential interpretations. Given a regime-invariant long run relationship between the variables, the state-dependent coefficient assign weights to each relationship which implies that any perturbation to the system could have different long run effects across states (though the long run relationship is unchanged). For example, monetary perturbation has different long run effects depending on the monetary objective (targets). The study adopts the Cholesky ordering which places the policy instrument last in the system ordering. In this three-variable system comprising price, output and policy instrument, the study assumes that monetary authorities observe prices and output before determining the level of the instrument. By this identification, it is assumed that policy does not contemporaneously impact on prices and output.

**Empirical Results**

**Data**

Annual data ranging between 1964 and 2013 obtained from the World Development Indicator (WDI) were used for the analysis. The variables include consumer price index, gross domestic product at constant local currency unit and broad definition of money (M2). Though the central bank of Ghana in recent times is using interest rate instrument, the study adopted M2 as proxy for policy instruments because the time frame of the study includes periods of monetary targeting regime. To eliminate outliers, all the variables are logged. Figure 1 shows the graph of the series at both level and first differenced.

Figure 3 and 4 depict non-parametric plots of the series versus their first to fourth lags. The figure reveals a linear approximation for the series. This suggests that a linear approximation for the analysis may not be questionable since the entire series exhibits linear trend with no possibilities of regime shifts. However, the distributional approximation for CPI and GDP in Fig. 5 indicates that the series depict bi-modal distribution suggesting the possibilities of regimes (i.e., the evolution process of the series might differ across periods). Following this, both regime and non-regime unit root test were conducted on the series. Table 1 shows the test results for both regime and non-regime unit root tests. The non-regime unit root tests were conducted using the ADF test, whereas the regime test is conducted on a unit root null hypothesis against stationary SETAR. The test statistic is compared with the bootstrapped critical value 16.181, 18.4 and 23.01 for 10, 5 and 1% respectively. As Table 1 shows, the results from both tests indicate the presence of unit root in the series.
Fig. 1. Series at levels and first differenced

Fig. 2. Series Distribution (CPI)
Fig. 3. Series Distribution (GDP)

Fig. 4. Series distribution (M2)
Table 1. Unit root tests

| Series | Non-regime test | 1st Difference | Regime test |
|--------|-----------------|----------------|-------------|
| CPI    | -1.1035(0.7073) | -3.8250(0.005)** | 32.933      |
| GDP    | 0.8107(0.9933)  | -4.9832(0.000)** | 48.681      |
| M2     | 1.7178(0.9996)  | 4.2401(0.002)**  | 15.616      |

(a) P-Value in parenthesis. *, (**), *** indicate rejection of unit root at 10, 5 and 1 percent respectively. (b) The test is for unit root against stationary SETAR. The test statistic is compared with the bootrapped critical value 16.181, 18.4 and 23.01 for 10, 5 and 1 percent respectively.

Table 2. Co-integration test result

| Test                | H0                          | H1 Linear VAR | No co-integration |
|---------------------|-----------------------------|---------------|-------------------|
| TVAR(1)             | 38.24(0.07)                 | -             |                  |
| TVAR(2)             | 60.641(0.30)                | -             |                  |
| Threshold co-integration | 11.0977(0.44) | 16.548 (0.93) |                  |

NB: P-value in parenthesis

The study further conducted a formal test to investigate the presence of co integration among the series. The formal test result is provided in Table 2. The test was conducted on two hypotheses. First, a test of no co integration against threshold co integration was conducted. A P-value of 0.93 fails to reject no co integration in the series. The second, a test of linear co integration against threshold co integration, supports the presence of linear co integration given a P-value of 0.44. Though, both tests reject threshold co integration, a test of model fit supports a model with one threshold. A P-value of 0.07 associated with the test statistic in the model fit test of linear VAR versus threshold VAR indicate that at 10% critical level, modelling the data in one threshold regime is superior. Based on this, the study proceeds in a Markov switching approach with one regime.

Result and Discussion

Given the study's objective to investigate monetary shocks in regimes, the study estimated a VECM model with extensions to accommodate states. This follows the exploratory analyses which indicate the presence of co-integration among the variables. The VECM is estimated in the presence of state restrictions following a tractable Markov process. The innovation of monetary shocks is estimated within a simple Cholesky specification ordering the policy variable (i.e., M2) last.

Table 3 reports that there is only one co-integrating relationship and provides the weighting matrix for the relation that vary across regimes. The co-integration vector is fixed across regimes.

| States              | Probability estimates | High level of persistence in each state. The probability of transition from one state to another is approximately the same in the arena of about 12%.
|---------------------|-----------------------|------------------------------------------------------------------------------------------------|
| Response to Policy Shocks | The study considered the short run response to a one standard deviation shock to the policy instrument (i.e., money supply). The impulse response function is generated for a horizon up to twelve years. The generated IRF are either conditioned or not conditioned on the state (i.e., when the shock is generated in one state, it is transmitted through that particular state). Figure 6 depicted the IRF in each regime and the average for the entire period. |
Fig. 6. Impulse response function to a standard deviation shock

Table 3. Estimation results

|         | P     | Y     | M     |
|---------|-------|-------|-------|
| Cointegrating vector | β     | 1.000 | 4.6498| 1.3789|
| Adjusting vector (S1 = 1) | α(S1 – 1) | -0.2377 | -0.0513 | 0.17978|
| Adjusting vector (S1 = 2) | α(S1 – 2) | -0.7670 | -0.2842 | 0.5048|

Table 4. Transition matrix

| Regime 1 | Regime 2 |
|----------|----------|
| Regime 1 | 0.8815   | 0.1185   |
| Regime 2 | 0.1191   | 0.8809   |

The graph shows that there are no significant differences in how prices and output respond to the policy instrument. The effect of policy changes on prices and output is very minimal with coefficient ranging the same in both state 1 and state 2. The effect of policy instrument hits prices and output respectively from the 11 months and 8 months onwards in state 1. Similar evidence is found in state 2.

Cost of Disinflation

High inflation has bedeviled the economy of Ghana for long. However, in recent times inflation has showed a downward trend over the past few decades. In comparing the developments in the current monetary regime (inflation-targeting) to the control regimes and the monetary targeting regimes, the inflation rate has been quite stable. It averaged 50.0% per annum during the 1970s, 44.5% during the 1980s and was 27.9% during the 1990s and further down to 16.2% in the early six years of 2000s. Within the period 2009 and 2010, the rate has been stable at single-digit, though the trend has reverted upward in recent years. The favorable downward trend in the inflation rate together with the gains in the general macroeconomic trends raise issues in the short run tradeoff between stability and growth particularly given that Ghana is a developing country and desires to accelerate growth for development purposes. Thus, this study estimated the cost of disinflationary policy for Ghana.
To calculate the sacrifice ratio, this study adopted Cecchetti and Rich (2001) VAR approach to access the output cost of disinflation occurring because of switches between regimes. Various methods for estimating the sacrifices ratio has been suggested in the literature (Ball, 1994; Zhang, 2001; Cecchetti and Rich, 2001). To calculate the sacrifice ratio, this study adopted Cecchetti and Rich (2001) VAR approach to access the output cost of disinflationary monetary shock within a single regime. As argued by Neville and Owyang (2004), this modelling approach can measure the cost of disinflation occurring because of switches between regimes.

Following Neville and Owyang (2004), this study posits two distinct disinflationary episodes to include disinflationary periods driven by a policy shock and one driven by change in regime. Aside using the Markov process for the states, the study experimented to investigate the credibility of monetary authorities as policy switched from monetary targeting to inflation targeting framework. The aim is to identify if the credibility is enhanced given that credibility underscore inflation targeting. The estimated sacrifice ratios for both within and across states are reported for both the Markov process and pre-specified regimes in Table 5.

| Regimes          | Markov process | Pre-specified |
|------------------|----------------|--------------|
| Within state 1   | 1.46           | 0.59         |
| Within state 2   | 1.90           | 0.43         |
| From 1 to 2      | 0.44           | -            |
| From 2 to 1      | 1.02           | -            |
| Pooled sample    | 1.42           |              |

NB: The cost is calculated at 10 years’ horizon

The tradeoff between output and inflation has been a popular area of research for years. Though, there are consensus among economists that high inflation is inimical to the economy, disinflationary policies on the other hand result in some short-run costs in terms of loss in output. As identified by (Okun 1978), disinflationary monetary policy result in output or employment loss (See among others Cecchetti and Rich, 2001; Fuhrer, 1994; 1995) a one percentage point fall in inflation.

The finding of this study has some policy implication for the conduct of monetary policy in Ghana. The sacrifice ratio obtained indicate that monetary policy should be conducted with care in order not to erode output growth given the state of economic development in the country. Further, the study suggests that cost of disinflation is low within inflation targeting period because agents can forecast better due to enhanced credibility. By implication, policy makers should be more transparent and credible in their actions to help minimize associated cost.

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### Author’s Contributions

Richard Kwabi Ayisi  
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### Ethics

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