



BANCO CENTRAL DE VENEZUELA

Investigating the Differential Impact of Real Interest Rates and Credit Availability on Private Investment: Evidence from Venezuela

Omar A. Mendoza Lugo

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Resumen

La teoría de la liberalización o represión financiera establece que la relación entre la inversión privada y las variables financieras (la tasa de interés real y el crédito bancario) es no lineal. Para indagar sobre esta relación y cuantificar sus efectos, se utilizó data trimestral para Venezuela del período 1983:2 – 2000:4. El instrumento econométrico utilizado es un vector con corrección de errores que admite una transición suave entre los diferentes estados de la economía (contracción y expansión de crédito). Las impulso-respuestas estimadas muestran evidencias de efectos no lineales o asimétricos, sin embargo, estos no están totalmente en línea con la teoría de la liberalización financiera. También se obtiene que cuando un choque negativo en el crédito ocurre en períodos de contracción de crédito, la tasa de crecimiento de la inversión privada es más sensible al crédito bancario (resultado en línea con la teoría de la liberalización financiera).

Abstract

The theory of financial repression or liberalization establishes that the relationship between private investment and financial variables -real interest rates and credit availability- is nonlinear. We investigate this issue using a logistic smooth transition vector error correction (LSTVEC) model in which private investment, public investment, bank lending real interest rates, gross domestic product generated by the private sector and bank loans to the private sector are considered as endogenous variables. We use data from Venezuela for a period that coincides with administrative controls and liberalization of nominal interest rates. Despite the fact that we found evidence of asymmetries between the growth rate of private investment and financial variables, we did not find evidence of a positive effect of positive shocks to changes in the real interest rate on private investment even in periods of credit contraction. In addition, when the economy faces a credit constraint, a negative shock to our indicator for credit availability causes a higher contractionary effect on the growth rate of private investment. Thus, our findings are not totally in line with the predictions of the financial liberalization theory.

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Omar A. Mendoza Lugo*

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Introduction

Private spending on fixed capital goods has been an important topic of discussion among economists and policy makers. The influence of investment on growth and its volatility contributing to business cycles justify this focus. Recent empirical research has evaluated the effects of economic reforms, especially financial reforms, on capital formation and growth in developing countries. This issue sheds light on the link between financial and real variables. In traditional theory, this link is given by means of the real interest rate. However, credit may also have a direct effect on real variables by affecting consumption and investment when asymmetric information and/or excessive government intervention characterize the financial market.

In the 1970's, some economists, led by McKinnon (1973) and Shaw (1973), began to argue in favor of financial liberalization as a medium of promoting saving, investment and growth. This was based on the argument that real interest rates are frequently negative in developing countries due to administrative controls on the nominal interest rates and heavy regulation in the financial market. This argument implies that real interest rates have a net positive effect on private investment, contradicting the traditional view of a negative relationship between private investment and real interest rates. Nevertheless, the financial liberalization literature argues in favor of higher interest rates due to what was observed in developing economies at the time and the possibility of a negative relationship between investment and interest rates was not ruled out. McKinnon (1973) argued that in those countries where self-finance is very important and the interest rate is negative or very low, an increase in real deposit rates encourages saving (the substitution effect dominates the income effect) and substitution from goods to bank deposits. Both have positive effects on private investment because self-financed investment rises and because there is a rise in the availability of funds to finance any profitable investment project. However, at higher rates, economic agents would prefer to hold deposits that yield a higher return than investment in physical capital. Therefore, at high rates, investment and real bank rates are expected to be negatively related. Hence, McKinnon's arguments

imply a nonlinear relationship between real interest rates and private investment.

Furthermore, private investment can be nonlinear in credit availability (Günçavdi, *et al.*, 1998). That is, if we expect that credit constraints are present at all levels of interest rates, then when the effect of an increase in the real interest rates in the loan supply is higher than the costs brought about by higher rates due to asymmetric information problems, a decrease in the sensitivity of private investment on credit availability at higher rates should be expected as well.

Investigating the effects of financial factors on private investment, especially the role of interest rates, constitutes an important issue for developing countries where economic authorities in general believe that real interest rates play an important role in investment decisions and therefore on growth. In particular, the current Venezuelan government emphasizes the need to lower interest rates to encourage private investment. However, Venezuela is one of the countries that has maintained, on average, low real interest rates in recent years (see Mendoza Lugo, 2001, Appendix A, Tables A.1 and A.2), with long periods of negative real rates and with periods of administrative control and liberalization on the nominal interest rates.

To investigate the non-linear relationship and, therefore, the differential impact of real interest rates and credit availability on private investment, we use Venezuelan quarterly data for the period 1983:1-2000:4. The variables used in this study, besides private investment, are bank lending real interest rates, bank loans to the private sector as an indicator of credit availability, public investment and real gross domestic output generated by the private sector or private GDP. All these variables are, in principle, treated as endogenous but the main focus is given to private investment spending. In addition to the mentioned variables, some dummies variables are taken into account to control for special events, structural economic reform and seasonality. Since we are interested in a model specification where the variable defining the states of the economy is known, the proposed econometric model is a logistic smooth transition vector error correction (LSTVEC) model, which

is a generalization of the smooth transition regressive (STR) models proposed by Granger and Teräsvirta (1993)¹.

We estimate a LSTVEC model for private investment and its determinants with lagged values of DLCREDIT explaining the states of the economy in four of the five equations considered in this study². To estimate the LSTVEC model, we use as a benchmark a linear specification, this is a subset or restricted in coefficients VEC model and follow, with some modifications, the procedure recommended by Granger and Teräsvirta (1993) to estimate a STR model. From the LSTVEC model, generalized impulse response functions are constructed (Koop, *et al.*, 1996 and Weise, 1999) to explore, especially, the effects of positive and negative shocks to the real interest rate and credit availability on private investment when facing credit contractions or expansions. The impulse responses show evidences of asymmetric effects of financial variables growth rate shocks to the growth rate of private investment. However, these asymmetries are not totally in line with the predictions of the financial liberalization theory.

Section I summarizes some theoretical issues and empirical evidence reported in the literature with special focus on developing countries. However, it is not our purpose to present an exhaustive survey of the literature, but merely present a review of results of previous research that allows for comparison and supports the results of this research. Section II presents the data. Section III introduces a smooth transition specification for a VEC model with special emphasis in the modeling of a nonlinear private investment function. Section IV is related to the estimation procedure and presents the results. Section V shows the impulse response functions the growth rate of private investment (DLPRIVINV) to shocks on the five endogenous variables considered in the study. Finally, Section VI presents the conclusions.

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- 1 The STR models belong to the category of régime-switching models. Among the régime-switching models, two general categories can be distinguished. They are (1) the smooth transition regressive (STR) models (The threshold models are a particular case of this category). The STR models assume that the variable defining a régime or state of the world process is observable. And (2) the switching regression models, which assume that the régime is not known with certainty but some probabilities of its occurrence can be assigned. Franses and van Dijk (2000) discuss the properties and applications of these two categories in modeling financial variables.
 - 2 Even though the linearity test indicates that the equation for the growth rate of private GDP is nonlinear when the transition variable is the growth rate of public investment lagged four periods, a satisfactory nonlinear equation was not found. Therefore, the specification of this equation is assumed linear.

I. On the determinants of private investment in developing countries

Some economists argue that when studying investment in developing countries special features not accounted for in traditional theories of investment should be considered. Agénor and Montiel (1999, pp. 97-99) list six of those factors. First, financial variables may influence private investment because of underdeveloped financial systems and financial repression. Second, foreign exchange rationing and the exchange rate in the free market may influence investment decisions because of the importance of imported capital goods. Third, due to their importance in the production process in developing countries, imported intermediate goods should be taken into account in the specification of relative prices. Fourth, debt overhang inhibits investment because of the possibility of higher taxes to finance future debt service. Fifth, public investment has played an important role in the process of capital formation in developing countries. It may have a positive or negative effect on private investment depending on whether public investment is complementary to or a substitute for private investment. And sixth, macroeconomic instability and its resulting uncertainty, which have characterized developing countries, may have an important effect on private investment. Despite the understanding that all these elements may be important determinants of investment, the present study focuses on the first and fifth issues; that is, this research is basically limited to the role of financial factors, credit availability and interest rates as determinants of private investment. Public investment is considered in the analysis because it may affect private investment through its effects on financial variables as well as through a direct positive externality effect of enhancing private sector productivity. In addition, gross domestic product and economic reform policies are taken into account because they have been found in previous research to be important determinants of private investment. Further, these two variables might play an important role in understanding private investment spending in the presence of asymmetric information and the transition from a heavily regulated economy to a more market-oriented economy.

1.1 Real interest rates as a determinant of private investment

The effect of real interest rates on private investment spending was first formalized in an investment equation by Jorgenson (1963), who derived the desired stock of capital as a function of real output and the opportunity cost of capital. In this approach, known as the neoclassical approach, a representative firm maximizes the present value of its future cash flows. The desired capital stock is directly related to output and inversely related to the cost of capital. A decrease in the real interest rate lowers the opportunity cost of capital and, therefore, raises the desired capital stock and investment spending.

Other literature, emphasizing the role of financial markets on capital formation (McKinnon, 1973; Shaw, 1973; Fry, 1988), includes suggestions that an increase in the real interest rates has a positive effect on the volume and quality of investment in those financially repressed economies³. The former effect is given because self-finance is important and investment is lumpy. Then, the economic agents must accumulate resources before any investment project is executed. An increase in real interest rates thus stimulates both total and financial savings and consequently investment. The latter effect, improvement in the quality of investment, occurs because a higher interest rate will rule out investment projects with low productivity. At the same time, higher rates move resources from less efficient (e.g. goods facing some depreciation) to more efficient forms of accumulation (e.g. bank deposits with a more favorable return)⁴.

In particular, McKinnon (1973), when explaining the link between interest rates, money and investment, suggests a nonlinear relationship between the real interest rates on deposits and the rate of private investment. When the real return to money is lower than the average real return to physical capital, a further increase in money returns induces the accumulation of cash

3 Financial repression is defined as the high intervention of the government on the financial markets by setting ceilings on the nominal interest rates, imposing high legal reserve ratios, and direct intervention on credit allocation.

4 Empirical research in general finds a positive but statistically insignificant effect of real interest rates on savings. Bandeira, *et al.*, (2000) verify that result from previous research in a country by country study for eight developing countries (Chile, Ghana, Indonesia, Korea, Malaysia, Mexico, Turkey and Zimbabwe).

balances to finance a significant number of investment projects. But at higher interest rates, more economic agents may prefer to hold money rather than finance investment projects because money offers a higher return than their investment possibilities in physical capital. Therefore, one expects to find a positive (negative) relationship between these two variables at low (high) returns holding the average return to physical capital constant.

McKinnon's investment equation is given by

$$\frac{I}{Y} = F(r, d) ,$$

with, $\partial F / \partial r > 0$ and $\partial F / \partial d \begin{matrix} > \\ < \end{matrix} 0$ if $d \begin{matrix} < \\ > \end{matrix} r$. Where, I denotes private investment, Y is output, r is the average return on physical capital, d is the real return on money, and the last derivative expresses the nonlinear relationship between real interest rates for money and the rate of investment.

Warman and Thirlwall (1994) study the effects of real interest rates on saving, investment and growth. They use data from Mexico for the period 1960-90 to quantify the level effects of low and high interest rates on private investment. They use the following investment equation.

$$I = a_1 + b_1 r + c_1 [(r - r^e)D] + d_1 C + d_2 \Delta GDP_{-1}$$

where $b_1 > 0$, $c_1 < 0$, $d_1 > 0$, $d_2 > 0$.

They specify investment (I) as a function of the real interest rate (r), credit to the private sector (C), the first difference of GDP (ΔGDP), and a term, $(r - r^e) * D$, to capture the non-linearity between interest rates and private investment. r^e is the threshold rate or the border rate between two regimes in which the interest rate affects investment in different (positive and negative) ways. D is a dummy variable taking values of one when $r - r^e$ is positive and zero otherwise.

Under the above specification, Warman and Thirlwall find that the coefficients for interest rates and for the term measuring non-linearity are very low and statistically insignificant. When a linear relationship is assumed, the

real interest rate has an important negative and statistically significant effect on private investment. However, they may have failed to find a nonlinear relationship between the real interest rate and investment because of a misspecified nonlinear investment equation.

A further study of the nonlinearity of investment in financial factors is provided by Günçavdi, *et al.*, (1998). They argue that after financial liberalization, the investment equation should become more sensitive to the cost of capital and less sensitive to the flow of credit to the private sector because of the relaxation of the credit constraints. Based on the fact that after financial liberalization the real interest rate became positive in Turkey, Günçavdi, *et al.*, test for structural changes in the coefficients for cost of capital and credit availability in an estimated private investment equation for Turkey. They find that the sensitivity of private investment on credit availability decreases after financial liberalization but they do not find evidence for an increase in the sensitivity of investment on the cost of capital⁵.

Furthermore, some economists argue that when analyzing the effect of interest rate policies in developing countries the assumption of perfect competition in the banking system is unrealistic because in these countries the banking sector is characterized by a small number of banks. In addition, credit markets face asymmetric information. For example, Demetriades and Luintel (2001) argue that under imperfect competition, mild repression⁶ in the lending rates has a positive effect on bank loans. That is, under government intervention with an interest rate fixed below the monopoly equilibrium level, it is optimal for bankers to increase the amount of loans. However, repressing interest rate levels below those that would prevail under perfect competition will likely reduce the amount of loans and consequently have a negative effect in the economy.

Data on interest rates is only available since the eighties or early nineties for most developing countries; therefore there is not an abundance of

5 In contrast, Jaramillo, *et al.*, (1996) using data from Ecuador at the firm level do not find support for a relaxing of the credit constraints for small firms after financial reform.

6 Mild repression may be understood as interventions in the capital market leading to fixing the interest rate between the equilibrium level of monopoly and that of under perfect competition.

empirical work testing the effects of interest rates or the cost of capital on private investment for developing countries. Previous work for developing countries is not only sparse but also shows mixed results for the effect of interest rates on investment spending. For instance, Warman and Thirlwall (1994) show a negative and significant relationship using data for Mexico. De Melo and Tybout (1986) report a negative but statistically insignificant effect using data for Uruguay. Laumas (1990) and Athukorala (1998) find a positive relationship between real interest on deposits and private investment in India. With respect to the relationship between the cost of capital and investment, the relation is found to be negative in Athukorala (1998) but positive in Günçavdi, *et al.*, (1998) for Turkey.

1.2 Bank lending as a determinant of private investment

When studying developing countries, bank lending to the private sector is an important determinant of private investment due to the banking system's importance as a source of external finance in those countries. That is, bank loans do not have close substitutes. Therefore, a contraction in the bank supply of credit may limit spending financed by credit. If the supply of bank credit is limited by the size of deposits, then a contraction of deposits will contract the supply of credit.

The financial repression literature, or the literature in favor of financial liberalization, takes the special role of the banking system as a source of finance in developing countries into account. When administrative controls are imposed on interest rates, credit is not allocated according to the expected return on the projects, but according to the quality of collateral, loan size, political pressure and covert benefits to loan officers. With interest rate ceilings, financial institutions do not take risk because higher interest rates cannot be charged. Consequently, many high yielding projects may face credit rationing (Fry, 1988, page 18). An increase in the real interest rates encourages deposits and, hence, increases the availability of funds to the private sector to finance investment projects while deterring low-yield projects.

In contrast, the theory emphasizing the role of asymmetric information in financial markets predicts that an increase in interest rates causes credit rationing because the lenders' expected profitability is not monotonically increasing in interest rates. At higher rates, lenders may experience a decrease in profits due to adverse selection, moral hazard, and monitoring costs. Therefore, lenders are not willing to lend at a rate higher than that which maximizes their expected profits, even though there are agents willing to borrow at that higher rate (see, for instance, Walsh, 1998, chapter 7)⁷.

The opposite predictions of these two literatures do not imply that they exclude each other. If we interpret the type of constraint predicted by the financial liberalization theory as more closely related to price rationing than a credit constraint, then both effects might be present in an economy. That is, higher interest rates may lead to higher credit availability but, for a given amount of credit, some firms may have access to bank loans and others may not. This would imply that credit constraints might be present not only at low interest rates, but also at high interest rates. If both causes of credit constraints exist, then it is expected that credit availability will have a direct effect on private investment at both high and low interest rates. At the empirical level, if the finding is that credit availability affects investment only when interest rates are low, this will be an indicator of financial restraints and shed light in favor of higher interest rates to encourage investment. If credit availability also enters in the investment equation at high interest rates, then the sensitivity of investment to credit availability would depend on the net effect of interest rates on credit. That is, lenders may be willing to lend more if the effect of an increase of interest rates on deposits is higher than the cost brought about by the asymmetric information problem. If this were the case, we would expect a decrease in the sensitivity of investment on credit availability at higher interest rates. This suggests a nonlinear relationship between credit allocated to the private sector and private investment.

⁷ A more recent development in this area emphasizes that credit rationing could be a consequence of the weakness of the legal system to enforce contracts (see for instance, La Porta, *et al.*, 1998, and Levine, *et al.*, 2000). Thus, credit market imperfections may have large impacts on financial markets in developing countries due to the weakness of their legal institutions enforcing contracts.

Previous empirical studies have generally found a positive and statistically significant effect of credit availability (net flow of credit to the private sector) on private investment. Oshikoya (1994) finds that credit to the private sector has a significant positive effect on private investment in middle and low-income African countries⁸. Shafik (1992) reports both short term and long-term positive and significant relationships between private investment and credit allocated to the private sector using data for Egypt. Leff and Sato (1988), using data for 21 Latin American countries, found in general a positive relationship between private investment and the change in total real credit. Ramirez (2000) also found a positive coefficient for lagged ratio of credit to the private sector to gross domestic product (GDP) in an equation for private investment-GDP ratio for eight Latin American countries⁹.

There is also evidence of financial development causing investment and growth. For instance, Bell and Rousseau (2001) using data for India find that credit allocated to the private sector, and other two broader financial indicators¹⁰, Granger causes aggregate investment and output without evidence of feedback.

1.3 Public investment as a determinant of private investment

In developing countries, the government has played an important role in capital formation. That is, public investment constitutes an important portion of total investment. Thus, evaluating the effect of this expenditure on private investment decisions may be worthwhile.

According to theory, the effect of public investment on private investment is indeterminate. Public investment can act as a substitute (negative effect on private investment) to or a complement (positive effect) to private investment. The sign of the effect depends on the area in which the govern-

8 In this study, the middle-income countries considered for the estimation of the private investment equation are Cameroon, Mauritius, Morocco and Tunisia. The low-income countries are Kenya, Malawi and Tanzania.

9 See also, for instance, Warman and Thirlwall (1994), Günçavdi, *et al.*, (1998) and Athukorala (1998).

10 These two indicators are domestic assets of deposit money banks and total domestic credit excluding credit to money banks.

ment executes the investment projects. Public investment may encourage private investment when such expenditure contributes to increasing private-owned firms' productivity. On the other hand, it may crowd out private investment when: (i) the government invests in inefficient state-owner firms, (ii) private investors expect higher taxes to finance such expenditures, and/or (iii) the public sector competes with the private sector for domestic loanable funds¹¹.

Empirical studies on this issue report contrasting results for both developing and developed countries¹². Oshikoya (1994) finds a positive and statistically significant relationship between private and public investment in middle-income African countries. Paradoxically, this effect is weak or negative in low-income countries. Recently, Apergis (2000) evaluated the effect of public spending (consumption and investment) on Greece for the period 1948-96. He found that for early years both variables are positively cointegrated. However, for a more recent subperiod, 1981-96, the cointegration relationship between those variables is negative. Ramirez (2000) finds a positive relationship between public and private investment in eight Latin American countries (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru and Uruguay) for the period 1980-95. Cardoso (1993) found a similar result with data for six Latin American countries (Argentina, Brazil, Colombia, Chile, Mexico and Venezuela) using a panel comprising information for three subperiods between 1970 and 1985¹³.

Separating public investment in infrastructure and non-infrastructure investment, some empirical studies have found evidence of a positive relationship between public investment on infrastructure and private investment. By contrast, the effect of government spending on non-infrastructure has a negative effect on private investment (see for instance, Blejer and Mohsin, 1984). Pereira (2000) reports that five types of total public investment have a positive effect on private investment and output in the USA for the period 1956-97 using a four variable VAR in first difference¹⁴. Due to the type of

11 See Apergis, 2000, for references on each of these possibilities.

12 For early references on this issue see Agénor and Montiel (1999, page 101).

13 Another study reporting complementarity between public investment and private investment is Athukorala (1998) for India.

14 The VAR contains the first difference of the logarithm of private investment, private employment, private GDP and one of six indicators of public investment.

spending considered¹⁵, the result is consistent with the view that public investment in infrastructure tends to encourage private activity by means of a rise in private sector productivity¹⁶.

1.4 On the other determinants of private investment¹⁷

In addition to the determinants mentioned above, private investment spending depends on output, economic reform policy, and on its own lagged values. Since the early study of Clark (1917), the change in output is considered as a determinant of investment spending. This effect is the well known "accelerator effect". Output also plays an important role in the neoclassical approach of investment introduced by Jorgenson (1963), although the central feature of this theory is to evaluate the effects of relative prices on the demand for capital. Output affects investment decisions due to its effect on firms' profitability and also by means of the output-saving-aggregate investment channel¹⁸. Empirical results usually confirm a strong and positive effect of changes in GDP on private investment or GDP growth on the investment-GDP ratio.

Moreover, recent empirical studies for developing countries have found evidence for important changes in the investment equation due to economic reform. For instance, Fielding (1997) evaluates the impacts of policy reform in six African countries (Kenya, Nigeria, Zimbabwe, Côte d'Ivoire, Cameroon and Mauritius), and found evidence for economic reform altering the investment equation. Also, Athukorala (1998) finds that market oriented

15 Infrastructure: classified in three groups, buildings for the provision of quasi-public goods (health, education, etc.) and conservation structures, among others.

16 See also Rioja (1999) and Feltenstein and Ha (1999). Both studies, using a general equilibrium framework, conclude that investment in infrastructure is not always welfare improving. Rioja argues that Latin American countries need an additional 4% of GDP to dedicate to investment in infrastructure to optimize their welfare gains from this type of investment. Feltenstein and Ha use data for 16 sectors of the Mexican economy and conclude that only small increases in public infrastructure have a positive impact in the real economy.

17 Due to the large number of variables that economists consider when studying developing countries, the term "other determinants of private investment" should be understood as the other variable considered in this research.

18 In the Q-theory of investment, future output stream affects the market value of the firm and consequently the firm's investment decisions.

reforms positively affected the private investment function in India. Other empirical researchers have found evidence of the impact of financial reforms on private investment. In general, this line of research tests for structural changes in the parameters of the investment function. For example, Günçavdi, *et al.*, (1998) and De Melo and Tybout (1986) test for structural breaks in the investment equation after financial liberalization policies were implemented in Turkey and Uruguay.

II. Data

The data covers the period 1983:1-1999:4. In section 2, we discussed the determinants of private investment considered in this research. For empirical implementation those variables, except for the real interest rate, are transformed into natural logarithms. These variables are denoted as follows:

$v = \text{LPRIVINV}$ or the logarithm of real private investment spending,

$w = \text{DLCREDIT}$ or first difference of logarithm of real stock of credit to the private sector,

$x = \text{RIQ}$ or the real bank lending interest rate,

$y = \text{LPRIVGDP}$ or logarithm of private GDP

$z = \text{LPUBINV}$ or logarithm of public investment, and

Data for gross domestic product (GDP) and investment have been provided by the econometrics department (Departamento de Apoyo Cuantitativo) of the Central Bank of Venezuela (BCV). Data on the nominal stock of credit to the private sector is obtained from the IMF, International financial statistics, CD-R, April 2001. The real stock of credit is the nominal stock of credit deflated by the consumer price index (CPI). Investment (total, public and private), GDP and the real stock of credit are expressed in billions of Bolivares and in 1984 prices. The natural logarithm transformation is applied to those variables as well.

What matters for investment spending in period t is the amount of funds available in that period rather than the credit stock. Credit allocated to the private sector in real term should be measured by means of the first difference of the nominal stock of credit deflated by the price index. This takes into account not only the change in the real stock of credit but also the replacement of the stock due to inflation. However, when the series are transformed into logarithms there is an important loss of information because the logarithm is

not defined for negative numbers. Nevertheless, in this research, the indicator for credit availability is obtained as the first difference of the logarithm of real stock of credit.

Furthermore, the real interest rate in quarterly terms is constructed from monthly data on nominal lending interest rates from the six most important banks and the CPI is provided by the BCV. See Mendoza Lugo (2001, appendix A) for details on the procedures used in the calculation of the real interest rate series. In Venezuela, the public sector constitutes an important proportion of total GDP. It represents the 37.5 percent of total GDP throughout the period under analysis. Therefore, it seems better to use GDP generated by the private sector rather than total GDP as a determinant of private investment. Private GDP for 1983:1-1990:3 is calculated by interpolation based on proportions of private GDP to total GDP using annual data obtained from Antivero (1992) tables II-8 and II-9 and the quarterly total GDP for the same period obtained from the BCV. That is, the proportion of private GDP to total GDP is obtained from annual data and the four observations of quarterly total GDP for each year are multiplied by this proportion. The computed new series is used as the indicator of private GDP.

The series used in this research are intentionally left seasonally unadjusted. Even though much empirical work uses seasonally adjusted data, some time series analysts suggest working with seasonally unadjusted data because: (i) seasonally adjusted data may lead to misleading inferences about the relationship among the variables; and (ii) seasonal adjustments imply a loss of important information when seasonal fluctuations explain an important part of the behavior of the variables in analysis (See for instance, Lee, 1992, Lee and Siklos, 1997, and Bohl, 2000). Thus, the data is tested for unit roots at all frequencies (seasonal and long run) using the HEGY (Hylleberg, Engle, Granger and Yoo) test for unit roots, which allows discrimination of unit roots at long-run, semiannual and annual frequencies. Also, the augmented Dickey-Fuller (ADF) test and the Phillips and Perron (PP) test are performed for comparison purposes. The PP test is applied in this research only when the residuals from the ADF regression are heteroskedastic as reported by the Q statistic on the square of the residuals. The HEGY test indicates that the Venezuelan data in this research does not have seasonal unit roots. While at the long-run frequency, unit root is found for LPRIVGDP, LPRIVINV and LPUBINV. Results and discussion about unit root tests are reported in Mendoza Lugo (2001, appendix B).

III. Modeling a nonlinear private investment function

The literature offers a wide variety of nonlinear models. Among the nonlinear parametric specifications, the smooth transition regression (STR) models and the threshold regression (TR) models have been increasingly used in modeling economic relationships in recent times. However, since the TR models are a particular case of the STR models, it is convenient to start investigating a nonlinear relationship with the STR models to avoid specification problems.

The smooth transition models belong to the category of regime switching models and are introduced in the literature in its autoregressive (STAR) version by Chan and Tong (1986); Luukkonen, Saikkonen and Teräsvirta (1988); Teräsvirta and Anderson (1992) and Teräsvirta (1994). Granger and Teräsvirta (1993) extend the STAR models to a multivariate context resulting in the STR models¹⁹.

III.1 A smooth transition specification for private investment within a VEC model

We model a nonlinear specification for the private investment within a smooth transition vector error correction (STVEC) model in which private investment depends on its own lagged values and on the lags of other variables determining investment. In other words, it is claimed that if a linear specifica-

¹⁹ The smooth transition models have been applied to explain the dynamic behavior of some macroeconomic variables. For instance, Weise (1999) tests for asymmetric effects of monetary policy in the United States using a logistic smooth transition vector autoregression (LSTVAR) model. Taylor and Peel (2000) find that the exponential smooth transition autoregressive (ESTAR) model explain the behavior of the deviations of the dollar-mark and dollar-sterling exchange rates from the long-run equilibrium rate. Sarantis (1999) find that STAR models approximate the nonlinearity in the effective real exchange rate for eight of the G10 countries. Byers and Peel (2000) model the hyperinflation in Germany, Brazil and Argentina using the ESTAR model. Other recent applications of smooth transition models are in Chen and Wu (2000), Öcal and Osborn (2000), van Dijk and Franses (1999), Lutkepohl, *et al.*, (1999), Leybourne and Mizen (1999), Bradley and Jansen (1998), Greenaway, *et al.*, (1997).

tion for private investment is rejected, then there exists a nonlinear dynamic that is appropriately described by a STR model. The STR models in addition to offering a less restrictive framework are recommended when analyzing aggregates as in the case of private investment spending, Granger and Teräsvirta (1993, page 40). That is, at the micro level the decisions to invest may be constrained to "invest given a state of the economy, say state or regime 1" or "do not invest given state or regime 2". However, at the macro level the lack of coordination among individual decisions may lead to a smooth transition from one regime to the other.

A general STVEC model can be expressed as follows:

$$\Delta X_t = \Pi_{0,1} D_t + \Pi_1 X_{t-1} + \sum_{m=1}^{p-1} \mathbf{q}_{m,1} \Delta X_{t-m} + [\Pi_{0,2} D_t + \Pi_2 X_{t-1} + \sum_{m=1}^{p-1} \mathbf{q}_{m,2} \Delta X_{t-m}] F(TV_{t-d}) + \mathbf{e}_t \quad (3.1)$$

where,

D is a $(n_0 \times 1)$ matrix of deterministic terms, X is a $(n \times 1)$ vector, n is the number of endogenous variables; $\Pi_{0,i}$, $i=1,2$, is a $(n \times n_0)$ vector of coefficients for the i^{th} régime; and Π_i and $\mathbf{q}_{m,i}$ are $(n \times n)$ matrices of coefficients. The rank of $\Pi_{0,i}$, r , is the number of cointegrating vectors. The matrix $\Pi_{0,i}$ can be expressed as $\Pi_{0,i} = \mathbf{g}_i \mathbf{a}_i$, \mathbf{g}_i and \mathbf{a}_i are $(n \times r)$ matrices with rank r . The former is the matrix containing the adjustment coefficients and the latter is the matrix of cointegrating vectors. In the estimation procedure, we assume $\mathbf{a}_1 = \mathbf{a}_2 = \mathbf{a}$, $\mathbf{a} X_t$ is the cointegrating vector (CIV _{t}) for both régimes. $\Pi_{0,2}$ is a matrix of zeros but the coefficient denoting the constant term. That is, the model is linear in all determinist variables except the constant term. In addition, $\Delta X_t = [dv_t, dw_t, dx_t, dy_t, dz_t]'$ and $F(TV_{t-d})$ is the indicator or transition function taking values between zero and one, both extremes, inclusive. When taking intermediate values, it allows a smooth transition between régimes. In general, $F(TV_{t-d})$ is specified by one of the following two forms:

$$F(TV_{t-d}) = \{1 + \text{Exp}[-\mathbf{g}(TV_{t-d} - c)]\}^{-1}, \mathbf{g} > 0 \quad (3.2)$$

or

$$F(TV_{t-d}) = 1 - \text{Exp}\{-[\mathbf{g}(TV_{t-d} - c)]^2\}, \mathbf{g} > 0 \quad (3.3)$$

These are the logistic and the exponential transition or indicator functions. Notice that the indicator function has been restricted to contain only one transition variable. This is equivalent to assuming that the transition variable, TV , and the delay parameter, d , are known. A model combining (3.1) and (3.2) is a logistic smooth transition vector error correction (LSTVEC) model. When using (3.1) and (3.3), the model is the exponential smooth transition vector error correction (ESTVEC) model. The LSTVEC model allows the VEC to behave differently when the transition variable takes low values. That is, two regimes can be defined: the low regime and the high regime. The ESTVEC models, instead, assume that the VEC behaves the same when the transition variable takes extreme values. This behavior differs from when the transition variable takes values located in the middle of its own range of values. In this case the two regimes are called the outer regime and the middle regime.

In the logistic function, when $(TV_{t-d} - c)$ is large and positive, $\text{Exp}[-\mathbf{g}(TV_{t-d} - c)]$ tends to zero and the transition function takes a value of one. In the opposite case, $\text{Exp}[-\mathbf{g}(TV_{t-d} - c)]$ tends to infinity and the transition function goes to zero. Therefore, in the low regime, the estimated regression is given by the set of estimated coefficients in the first and second terms of (3.1). While in the high regime, the whole set of estimated coefficients for all terms in (3.1) describes the dynamics of investment or the variable being analyzed. In the case of the exponential function, when $(TV_{t-d} - c)$ takes either large positive or negative values, $\text{Exp}\{-[\mathbf{g}(TV_{t-d} - c)]^2\}$ tends to zero and the transition function takes a value of one. Thus, this function restricts the dynamics of the equation to be the same when the transition variable takes extreme values. When TV_{t-d} takes values close to c , $\text{Exp}\{-[\mathbf{g}(TV_{t-d} - c)]^2\}$ tends to one and the transition function goes to zero.

Between the logistic and the exponential transition functions, we have chosen the logistic function to investigate nonlinearities in the VEC. This choice is based on the theory discussed previously.

III.2 The choice of transition variable

The search for a transition variable will be done focusing on possible nonlinearities in the VEC model due to nonlinearities in the private investment equation²⁰. We suspect that the investment equation behaves differently when the interest rate takes high as opposed to low values. It could also be that the investment equation behaves differently when there is a credit constraint and when constraints are relaxed. One additional possibility is that whether the economy is expanding or contracting could define the state of the world or régime. That is, the theory of financial constraints states that the severity of agency costs should vary with the general macroeconomic conditions. It is expected that during recessions a firm's internal finance falls and the demand for external funds rises. Since the cost of external finance increases when the firm's balance sheet deteriorates, investment falls and thus intensifies the magnitude of the recession (Bernanke and Gertler, 1989 and Walsh, 1998, pp. 298-302). Consequently, during recessions, the investment equation may be more sensitive to credit than in periods of expansions. This implies a nonlinear relationship between investment and credit with changes in output defining the state of the economy. Finally, public investment can be the transition variable depending on its impact on the credit market.

We have not found a theoretical explanation for using private investment itself as the transition variable. However, we do not rule out this possibility. Provided that the investment function is nonlinear, differential impacts of real interest rates and credit availability on investment can arise from the dynamic interactions of the other variables included in the model. Therefore, all lagged variables explaining investment other than CIV are considered potential transition variables.

²⁰ Weise (1999) shows that in a structural multiple-equation model, with a nonlinear equation in at least one of its coefficients, may lead to a nonlinear representation for all equations in the reduced form of the system.

IV. Estimation

Teräsvirta (1994) elaborates on the procedure for estimating a smooth transition model in the univariate case. Granger and Teräsvirta (1993) discuss this procedure in the multivariate context. The technique consists of the following three broad stages. First, specify the linear model. Second, apply the test for linearity against STR models following the third order test procedure introduced by Luukkonen, *et al.*, (1988) but using only one transition variable each time for all possible values of d . And third, if linearity is rejected, then choose between the logistic smooth transition regressive (LSTR) and the exponential smooth transition regressive (ESTR) model by testing a sequence of hypotheses.

IV.1 The linear model

Since no evidence for seasonal unit roots are found in the Venezuelan data, cointegration and the number of cointegrating vectors are tested within a linear VEC model from 1 to 4 lags²¹. Cointegration is tested using the maximum likelihood procedure proposed by Johansen (1988, 1991) and well documented in Hamilton (1994). Evidence of cointegration is found for one and three lag specifications with LPRIVINV, LPUBINV and LPRIVGDP as endogenous variables. The CIV for one lag is discarded because its coefficients do not look reasonable. Therefore, the selected CIV comes from a system specification with three lags and it is $LPRIVINV_t = 0.191 - 0.759 * LPUBINV_t + 0.861 * LPRIVGDP_t$. The trace statistic is 33.772, significant at 5%²². As a second step, given the existence of one cointegrating vec-

21 In general, it is recommended the lag length of the VAR in levels should be chosen before testing for cointegration (See for instance, Enders, 1995, page 396). However, when using the Akaike information criterion (AIC) and Schwarz information criterion (SIC) for lag length selection, with the same sample size and up to six lags in the VAR, both criteria indicate one lag in the VAR in levels. This implies zero lags in the VEC model. Since a longer lag is preferable to one that is too short (Banerjee, *et al.*, 1993, page 286), an alternative procedure is followed to test and estimate the cointegrating vector. That is, using the same effective sample size (1984:2-2000:4), cointegration is tested from one up to four lags in the VEC model and the cointegrating vector with more reasonable coefficients is selected.

22 The maximum eigenvalue does not indicate evidence for cointegration.

tor, the term $LPRIVINV_{t-1} + 0.759*LPUBINV_{t-1} - 0.861*LPRIVGDP_{t-1}$ is used to estimate a linear version of (3.1) where dummies for some special events and structural economic reforms are introduced²³. The VEC lag length is set arbitrarily equal to 4²⁴. Furthermore, insignificant coefficients are eliminated using the modified version of the likelihood ratio test suggested by Sims (1980). This second step is performed using generalized least squares or seemingly unrelated regressions (SUR). As we can observe, the procedure applied differs from the two-step Engle and Granger (1987) method only in the method of estimation applied in each step. The resulting estimated subset VEC model is shown in Table 5.1²⁵.

IV.2 Linearity test

Linearity test is performed using its one equation and system version. For the multivariable equation setup, we use the augmented first order test proposed by Luukkonen, *et al.*, (1988), which is more suitable for small samples and has

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- 23 The dummy variables are DC and DPC, which pretend to control for structural economic reform as specified in section 3. The dummies to control for special events (See Mendoza Lugo, 2001, section 2.3) are introduced only after an initial estimation evidences the need to control for some outliers in those periods. These dummies are D891 and D942 in the real interest rate equation, D944, D962 in the credit equation, and D861 in the public investment equation. D891 is defined as +1 in 1989:1, -1 in 1989:2 and 0 otherwise. D944 take value of +1 in 1994:4, -1 in 1995:1 and 0 otherwise. D962 is specified as +1 in 1996:2, -1 in 1996:3 and 0 otherwise. And finally, D861 is defined as +1 in 1986:1, -1 in 1986:2 and 0 otherwise. D942 is specified as 1 in 1994:2 and 0 otherwise. After the introduction of these dummies, all equations pass the diagnostic check in terms of normality, serial correlation and heteroskedasticity. The subset VEC model is re-estimated, starting from a full coefficient or unrestricted VEC model accounting for those especial events that the new dummies attempt to control for.
- 24 One problem encountered when specifying an unrestricted VEC model using the Venezuelan data is related to the lag length selection. Both SIC and AIC suggest a VAR in levels with one lag or its corresponding VEC with no lags. However, it is observed that when estimating the unrestricted VEC with higher number of lags that significant coefficients are not uniform with respect to the lag length for the lagged values of each variable in each regression in the VEC model. The main problem in continuing with an unrestricted VEC with lag length selected arbitrarily, say four lags, is the presence of too many insignificant coefficients. The price of too many insignificant coefficients is higher variance and consequently imprecise impulse response functions. But proceeding with too short a lag specification may lead us to conclude that a variable, or variables, does not affect each other because of a misspecification in the lag order for such variable. Thus, it may be preferable to choose the lag length arbitrarily, which we set equal to 4, and estimate with a restricted-in-coefficients version or subset VEC model. An early proponent of subset VAR is Hsiao (1981), who proposes a procedure for choosing different number of lags for each variable in the VAR based on the final prediction error (FPE) criterion. McMillin (1985) applies a subset VAR to investment in the United States. Lütkepohl (1993, chapter 5), discusses specification procedures, advantages and disadvantages, for restricted VAR, which are also applicable to a VEC.
- 25 E-views is used for all computational procedures but the impulse response functions. In this case, we use GAUSS.

more power under the null hypothesis. This test can be performed using the following auxiliary regression.

$$dv_t = \phi_0 + \phi_1 H + \phi_2 HTV_{t-d} + \psi_d TV_{t-d}^3 + v_t^* \quad (4.1)$$

where,

$$H = [dv_{t-1}, \dots, dv_{t-p}, dw_{t-1}, \dots, dw_{t-q}, dx_{t-1}, \dots, dx_{t-r}, dy_{t-1}, \dots, dy_{t-s}, dz_{t-1}, \dots, dz_{t-k}, CIV_{t-1}]'$$

ϕ_0 and ψ_d are scalars and $\phi_i, i=1,2$ are $1 \times k^*$ vector of coefficients, $k^* = p+q+r+s+k$.

TABLE 4.1
VENEZUELA: ESTIMATED SUBSET VEC MODEL FOR PRIVATE INVESTMENT
AND ITS DETERMINANTS. PERIOD 1984:3-2000:4

	DLPRIVINV _t		DDLREDIT _t		DRIQ _t		DLPRIVGDP _t		DLPUBINV _t	
	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.
C	-0.273	-6.844	-0.004	-0.601	0.008	1.308	-0.115	-8.181	-0.563	-9.858
DS2	0.575	5.722	-	-	-	-	0.175	7.013	0.866	8.197
DS3	-	-	0.028	1.969	0.020	1.750	0.142	8.218	0.804	10.613
DS4	0.422	6.231	-	-	-0.043	-3.720	0.191	8.745	0.737	8.533
D861									0.359	5.705
D891					-0.211	-12.417				
D942					-0.098	-4.124				
D944			-0.246	-7.220						
D962			-0.230	-6.853						
DPC	-	-	-	-	-	-	-	-	-	-
DLPRIVINV _{t-1}	-0.321	-3.669	-	-	-	-	0.043	2.211	-	-
DLPRIVINV _{t-2}	-0.190	-2.157	-	-	-	-	-	-	-	-
DLPRIVINV _{t-3}	-	-	-	-	-	-	0.079	4.528	0.182	2.634
DLPRIVINV _{t-4}	-0.304	-3.591	-	-	-	-	-	-	0.157	2.090
DDLREDIT _{t-1}	0.520	2.881	-0.201	-2.776	-0.103	-2.682	-	-	-0.270	-1.730
DDLREDIT _{t-2}	-	-	-	-	-0.117	-3.041	-	-	-	-
DDLREDIT _{t-3}	-	-	-0.158	-2.230	-0.087	-2.266	-	-	-	-
DDLREDIT _{t-4}	-	-	-	-	-0.069	-1.849	-	-	-	-
DRIQ _{t-1}	-	-	0.294	2.436	-	-	-	-	0.873	3.475
DRIQ _{t-2}	-	-	-	-	-	-	-	-	1.184	4.613
DRIQ _{t-3}	-0.783	-2.581	-	-	-0.184	-2.901	-	-	-0.542	-1.926
DRIQ _{t-4}	-	-	-	-	-	-	-0.151	-2.331	-0.661	-2.524
DLPRIVGDP _{t-1}	1.876	3.800	-	-	-	-	-0.206	-2.141	1.992	5.105
DLPRIVGDP _{t-2}	1.115	2.764	-	-	0.231	2.629	-	-	1.702	4.806
DLPRIVGDP _{t-3}	2.420	5.521	-0.397	-3.377	-0.228	-2.537	-	-	-	-
DLPRIVGDP _{t-4}	-	-	-	-	-	-	-0.189	-1.928	-1.509	-3.999
DLPUBINV _{t-1}	0.172	1.787	-	-	0.045	4.276	0.082	4.098	-0.350	-4.388
DLPUBINV _{t-2}	-0.279	-4.566	-	-	-	-	0.064	3.554	-0.136	-1.917
DLPUBINV _{t-3}	-	-	-	-	-	-	0.085	4.826	-0.178	-2.669
DLPUBINV _{t-4}	-	-	-	-	-	-	-	-	-	-
CIV	-	-					-0.036	-2.841	-0.174	-3.493
R ² adj.		0.482		0.647		0.738		0.763		0.917
Q(1)		0.121		0.474		1.547		1.020		0.346
Q(4)		1.064		2.422		5.489		3.158		3.835
Qsr(1)		1.678		0.416		0.169		0.867		1.517
Qsr(4)		4.032		1.371		0.405		4.866		2.515
Hausman				-0.196						0.756
JB		2.076		2.645		1.652		2.278		0.092

Notes: The restricted VEC model is estimated using seemingly unrelated regression (SUR). R² adj. Is the adjusted R². Q(i) (Qsr(i)) is the Ljung-Box Q-statistic for the ith lag of the residuals (squared of residuals). JB accounts for the Jarque-Bera statistic for normality. JB is distributed as a X² with two degrees of freedom. The Q-statistics are distributed as X² with "i" degrees of freedom. The critical values for X²(0.05) (X²(i,0.1)), for i=1 and 4 are 3.84 and 9.49 (2.71 and 7.78) respectively. CIV denotes the cointegrating vector. Hausman corresponds to the t-statistics for the Hausman test. The Hausman test is performed for the credit and public investment equations. Due to the way

interest rates are calculated in this research (see Mendoza Lugo (2001, appendix A) RIQ_{t-1} contains information for one month of quarter "t", then there exists the possibility that $DRIQ_{t-1}$, which enters in the credit and public investment equations, is an endogenous variable. For the Hausman test, (i) $DRIQ_{t-1}$ is regressed on the right hand side variables of each of the above-mentioned equations plus the variables in the right hand side of the interest rate equation (all of them lagged one period). Contemporaneous variables to $DRIQ_{t-1}$ are omitted from the regression. (ii) The residuals from the estimated interest rate equation are retrieved and (iii) the credit or public investment equation augmented for the residuals from the previous step is estimated. The Hausman statistic is the t-statistic on the estimated coefficient for the residuals obtained from the interest rate equation. If the estimated coefficient is not statistically different from zero, we must conclude that $DRIQ_{t-1}$ is not an endogenous variable. The test statistics do not indicate evidence for endogeneity in $DRIQ_{t-1}$.

The test consists of a hypothesis contrast, using the F statistic, in which the null for linearity is set as the coefficients of f_2 and y_d are zero I_2, I_3 and I_4 are zeros. This test is performed for each possible TV_{t-d} . With this test we cannot perform nested hypothesis tests for model selection. However, both models can be estimated and the final model can be chosen based on a forecast evaluation. In the particular case of investigating nonlinearities of the investment equation on financial factors, the theory suggests the use of a logistic model. Therefore, we restrict estimation to this kind of model and without any complication for model selection when using the augmented first order linearity test²⁶.

Weise (1999) introduces a linearity test for a multiple-equation framework. This is a likelihood ratio test. Instead of a first order test extended to a multiple-equation framework proposed by Weise, we use a multi-equation version of the augmented first order test and correct for small sample bias²⁷.

26 In general, third order linearity test proposed by Luukkonen, *et al.*, (1988), which is based on the following multivariate auxiliary regression. However, in a multivariate context the auxiliary regression contains $1+4k^*$ parameter estimates, which in small samples implies the use of too many degrees of freedom.

27 Due to the cumbersome joint tests for no cointegration and linearity against cointegration and nonlinear (threshold) specification, where not only nonstationarity and nuisance parameters are present under the null but there is also a large class of nonlinear (threshold) specifications, Balke and Fomby (1997) suggest breaking up this analysis into two parts. These are (i) test for cointegration and (ii) test for nonlinear behavior. An important argument in favor of this separation is that standard time series analysis for linear cointegration is asymptotically valid for the threshold cointegration because the order of integration is not affected by a threshold specification. From a Monte Carlo experiment, they find that no serious problems arise when testing for cointegration using a linear misspecified model. van Dijk and Franses (1995) use the same procedure to estimate a smooth transition vector error correction model. For other references on threshold and smooth transition EC models, see Franses and van Dijk (2000), page 133.

Table 4.2 reports the results of the linearity tests for each equation, the F test, and for the whole system, the LR test. The first ten columns show the linearity test statistics and their respective P-values for each dependent variable described at the top of the table. The last two columns contain information about the LR statistics for each transition variable and their respective P-values. The LR test suggests the use of DLCREDIT as the transition variable. It reports low P-values for delays of 1, 2 and 4 being the lowest one for DLCREDIT_{t-1} . The LR test also reports P-values lower than 5% when DRIQ and DLPRIVGDP are the transition variables with delays of 4 and 1 respectively. On the other hand, the F test does not always suggest using as the transition variable the same variable indicated by the LR test. For instance, the LR test indicates DLCREDIT_{t-2} as a good choice when searching for a common transition variable and delay parameter. However, the F test in the equation for DLPRIVGDP reports a P-value of 0.941, which suggests that the use of DLCREDIT_{t-2} as transition variable may not be a good choice to explain the potential nonlinearity in the output equation even though this equation is estimated in a multi-equation context.

The F test reports evidence against linearity in all five equations. In the private investment equation, linearity is rejected at the 5% of significance level when DLCREDIT_{t-1} and RIQ_{t-4} are the transition variables. For the remaining four equations only in the output equation does the test fail to reject linearity when financial variables are used as transition variables. However, the test rejects linearity in the output equation when DLPUBINV_{t-4} is the transition variable. In addition, the linearity test for each single equation does not report evidence for the use of a unique transition variable and delay parameter in all equations.

Teräsvirta (1994), following Tsay (1989), recommends choosing the delay parameter, d , in the univariate model as the value with the minimum P-value. Generalizing this decision rule to a multivariate context, it should be to choose the transition variable, TV, and the delay parameter d ; that is, TV_{t-d} , as the d^{th} order lagged variable with the minimum P-value. We could also select, among the potential TVs with tests reporting P-values lower than 5 %, each variable with the lowest P-value for each potential TV and proceed to estimate the model for each of these candidates and then make the final selection based on specification tests. We explore this possibility by attempting to estimate the nonlinear model equation by equation using as TV's all

possible candidates with F tests reporting a P-value lower or equal than 5%. We also attempt to estimate the nonlinear model, within a system procedure, using the same transition variable for all equations as suggested by Weise (1999) according to the LR test. The next subsection explains in detail the estimation procedure for the nonlinear model.

TABLE 4.2
VENEZUELA: LINEARITY TEST USING THE ESTIMATED SUBSET VEC
MODEL AS BENCHMARK

Transition Variable	DLPRIVIN _t		DDLCCREDIT _t		DRIQ _t		DLPRIVGDP _t		DLPUBINV _t		SYSTEM	
	F-stat.	P-val.	F-stat.	P-val.	F-stat.	P-val.	F-stat.	P-val.	F-stat.	P-val.	LR-stat.	P-val.
DLPRIVIN _{t-1}	1.277	0.276	0.551	0.737	0.360	0.947	1.326	0.252	1.546	0.157	57.452	0.219
DLPRIVIN _{t-2}	0.735	0.699	0.613	0.691	0.759	0.654	0.996	0.464	1.015	0.470	41.227	0.807
DLPRIVIN _{t-3}	1.650	0.125	1.233	0.308	0.695	0.709	1.947	0.068	0.231	0.998	58.078	0.202
DLPRIVIN _{t-4}	1.164	0.344	1.306	0.277	0.611	0.780	1.996	0.062	0.720	0.745	59.976	0.158
DDLCCREDIT _{t-1}	0.908	0.542	0.609	0.693	1.690	0.124	0.692	0.726	0.920	0.554	43.933	0.714
DDLCCREDIT _{t-2}	0.651	0.773	1.076	0.385	1.452	0.200	0.476	0.895	1.665	0.121	50.648	0.448
DDLCCREDIT _{t-3}	0.782	0.656	0.673	0.646	1.024	0.438	0.740	0.682	0.674	0.786	42.725	0.758
DDLCCREDIT _{t-4}	1.311	0.257	1.257	0.298	0.451	0.898	0.912	0.532	0.549	0.888	45.014	0.673
DRIQ _{t-1}	0.694	0.735	0.176	0.970	1.044	0.424	0.802	0.628	0.853	0.617	43.830	0.718
DRIQ _{t-2}	1.493	0.176	1.253	0.299	1.198	0.324	1.903	0.075	2.153	0.040	66.501	0.059
DRIQ _{t-3}	1.174	0.338	1.062	0.393	3.942	0.001	0.933	0.514	1.046	0.444	64.561	0.081
DRIQ _{t-4}	1.535	0.160	2.127	0.078	1.527	0.173	0.990	0.469	0.729	0.736	68.767	0.040
DLPRIVGDP _{t-1}	1.314	0.255	1.221	0.313	4.340	0.001	1.342	0.244	0.761	0.705	68.972	0.039
DLPRIVGDP _{t-2}	1.288	0.270	1.132	0.356	2.460	0.025	0.660	0.753	1.060	0.432	57.201	0.225
DLPRIVGDP _{t-3}	0.334	0.972	1.043	0.403	1.121	0.371	0.417	0.930	1.325	0.254	53.271	0.350
DLPRIVGDP _{t-4}	0.981	0.481	0.249	0.939	1.622	0.143	1.092	0.393	1.087	0.411	56.573	0.243
DLPUBINV _{t-1}	1.750	0.100	1.020	0.416	4.180	0.001	0.745	0.678	0.914	0.559	56.082	0.257
DLPUBINV _{t-2}	1.016	0.452	0.938	0.465	0.810	0.610	1.204	0.320	0.814	0.655	46.310	0.622
DLPUBINV _{t-3}	0.735	0.698	0.357	0.875	0.721	0.687	1.905	0.075	2.322	0.027	61.843	0.122
DLPUBINV _{t-4}	1.031	0.440	0.112	0.989	4.164	0.001	2.227	0.037	0.492	0.924	64.271	0.084
DLCCREDIT _{t-1}	2.088	0.047	3.919	0.005	1.901	0.081	1.116	0.376	1.372	0.230	87.865	0.001
DLCCREDIT _{t-2}	1.118	0.375	3.169	0.015	3.763	0.002	0.395	0.941	2.146	0.041	76.466	0.009
DLCCREDIT _{t-3}	1.227	0.304	3.438	0.010	2.210	0.042	0.491	0.885	0.458	0.942	61.725	0.124
DLCCREDIT _{t-4}	2.013	0.055	2.777	0.028	1.008	0.451	1.206	0.318	1.031	0.457	75.493	0.011
RIQ _{t-1}	1.836	0.083	1.282	0.287	0.989	0.465	0.926	0.521	0.559	0.880	45.504	0.654
RIQ _{t-2}	0.719	0.713	2.725	0.030	1.187	0.330	1.176	0.336	0.700	0.763	47.885	0.559
RIQ _{t-3}	0.869	0.577	0.859	0.516	2.055	0.059	0.765	0.660	1.528	0.164	65.158	0.073
RIQ _{t-4}	2.532	0.017	1.378	0.249	2.187	0.044	0.949	0.501	0.705	0.758	67.361	0.051

Notes: P-values lower than 5% are reported in dark numbers.

IV.3 Estimation procedure for the logistic STVEC model

Due to the lack of evidence for estimating the logistic STVEC (LSTVEC) model for a single TV_{t-d} , the nonlinear system is estimated equation by equation, the five equations are then put together and the logistic STVEC (LSTVEC) model is re-estimated using SUR. We start the estimation procedure by performing a two-dimensional grid search for the transition parameter, c , and the smooth parameter, \mathbf{g} , using as TV_{t-d} all possibilities in Table 4.3 that are associated with linearity tests having P-values lower than 5%. Previously, the argument of the transition function, $F(TV_{t-d})$, is rescaled downward by dividing by the standard deviation of TV_{t-d} as recommended by the estimation of the logistic model when the smooth parameter is large. This rescaling helps the computing process in the model estimation. See for instance, Granger and Teräsvirta (1993), page 123²⁸.

We arrange the values of TV_{t-d} in ascending order and divide the range of values taken by that variable into 10 intervals, which gives 11 grid values. We assure all intervals contain information by discarding atypical observations from the range of values for TV_{t-d} . The search for the transition parameter, c , is performed for the nine grids located between both extremes. The search for the smooth parameter, \mathbf{g} , consists of 25 values from 1 to 49 augmenting two by two. For those cases where \mathbf{g} is located in the upper extreme, a new search is made for higher values of \mathbf{g} . Thus, there are at least 225 combinations for c and \mathbf{g} in each two-dimensional grid search. We select that combination of c and \mathbf{g} reporting the maximum log-likelihood²⁹.

28 In previous work, we tried to estimate the nonlinear model performing a grid search for the transition parameter, c , fixing the standardized smooth parameter, \mathbf{g} , equal to the standard deviation of TV_{t-d} . However, in most of the cases the value of c maximizing the log-likelihood was located at the extremes of the range of values taken by the transition variable. Such a result suggests that the equation is linear or the value given to \mathbf{g} is not the most adequate.

29 Other alternative measures of fit are AIC, SIC and R^2 , obtaining similar results.

Those cases where the log-likelihood takes the maximum value for c located in any of the extremes of the range of values for the transition variable are ruled out³⁰. We proceed using only those cases where the value of c maximizing the log-likelihood is located between the third and eight grid values. The best value of c should be a value of TV_{t-d} located in some part within the middle of its observed range of values such that it guarantees both regimes contain enough observations for reliable estimates of the coefficients.

With starting values from the two-dimensional grid search, the parameter \mathbf{g} is allowed to vary while c is fixed to the value obtained in the previous step. Once \mathbf{g} is estimated, a new grid search is performed; this time only for the parameter c . Next, with starting values from the previous step, \mathbf{g} is allowed to vary again. Finally, we allow all parameters to vary setting initial values from the previous step. In each step involving the estimation of \mathbf{g} or the joint estimation of \mathbf{g} and c , each equation is estimated using nonlinear least squares (NLS). The estimated coefficients $\hat{\mathbf{g}}$ and \hat{c} for each equation are reported in Table 4.3³¹.

Fixing the parameters c and \mathbf{g} to those values obtained from the single equation procedure, the LSTVEC model is estimated, using SUR. To alleviate computing problems, insignificant coefficients on lagged variables are eliminated. As a second step, in theory, all coefficients are allowed to vary using the estimated coefficients from the previous step as initial values. However, some computing problems, which may be associated with the es-

30 Within a two-dimensional grid search, a transition parameter taking values in any of the extremes of the range of values of the transition variable, it is probably a consequence of the presence of outliers. A problem facing the linearity tests for smooth transition models is that it may be biased toward rejecting the null hypothesis due to the presence of outliers. See for instance, Franses and van Dijk (2000), page 105. In the present study, some alternatives for TV_{t-d} are discarded when the transition parameter is found in the extreme values of the range of TV_{t-d} when performing the two-dimensional grid search. The discarded choices for TV_{t-d} , in the credit equation, are all lagged DLCREDIT, but DLCREDIT_{t-3}. In addition, RIQ_{t-4}, DRIQ_{t-2} and DLPUBINV_{t-4} are rejected as TV_{t-d} in the equations for DRIQ, DLPUBINV and DLPRIVGDP. Since the linearity test does not indicate other possible TV for the output growth equation, then this equation is treated as linear. Moreover, information for the estimated equation for DDLCCREDIT under the assumption that RIQ_{t-2} is TV_{t-d} are not reported in Table 4.3 since a unique solution for this alternative was not found.

31 Teräsvirta (1998), page 527, recommends the use of a two dimensional grid search to get reasonable starting values for the NLS estimation and to reduce the size of the model by imposing exclusion restrictions.

timization of logistic models in small samples and large adjustment parameters as is the case in general for the logistic smooth transition (LSTR) models, lead us to seek the maximum number of smooth and transition parameters that can be jointly estimated while fixing the remaining ones to those values obtained from the estimation for each single nonlinear equation.

We evaluate three combinations of transition variables and delay parameters in order to proceed to the estimation of the LSTVEC model. These three options are illustrated in Table 4.4. In Option 1 we allow for the same transition variable. In this case it is DLCREDIT but allowing for different delay parameters. Option 2 is selected according to the TV_{t-d} associated with the higher log-likelihood value for each nonlinear equation. Finally, Option 3 differs from Option 2 only in the TV_{t-d} chosen for the private

TABLE 4.3
VENEZUELA: SUMMARY OF THE ESTIMATION OF EACH SINGLE NONLINEAR EQUATION FOR EACH POTENTIAL TV

	$\hat{\gamma}$	T-stat.	\hat{c}	T-stat.	P-value, F-test ($\theta_2 = 0$)	Loglk
TV for DLPRIVINV Equation						
DLCREDIT _{t-1}	37.543	0.560	0.006	1.228	0.094	66.056
RIQ _{t-4}	44.156	1.122	0.034	19.040	0.400	65.956
TV for DDLCREDIT Equation						
DLCREDIT _{t-3}	65.438	0.236	0.036	5.374	0.000	120.467
TV for DRIQ Equation						
DRIQ _{t-3}	33.127	0.679	0.036	5.141	0.036	173.960
DLPRIVGDP _{t-1}	33.102	0.955	0.014	2.313	0.004	175.100
DLPRIVGDP _{t-2}	-3.046	-0.944	0.021	0.897	0.937	167.577
DLPUBINV _{t-1}	6.963	0.530	-0.076	-0.563	0.045	172.317
DLPUBINV _{t-4}	92.768	0.188	0.132	12.437	0.001	178.846
DLCREDIT _{t-2}	60.176	0.467	-0.013	-4.341	0.438	162.068
DLCREDIT _{t-3}	84.711	0.308	-0.049	-1.911	0.074	167.728
TV for DLPUBINV Equation						
DLPUBINV _{t-3}	10.672	0.944	-0.046	-0.978	0.020	97.364
DLCREDIT _{t-2}	3.221	1.992	-0.053	-2.068	0.368	92.275

Notes: Loglk denotes log-likelihood. F-test ($\theta_2 = 0$) is the test on whether the estimated coefficients accompanying the transition function in each single equation are jointly equal to zero. It tests for the specification of the LSTR models against a linear specification. However, when the equations are estimated in a system, in particular for DLPRIVINV and DLPUBINV equations with RIQ_{t-4} and $DLCREDIT_{t-2}$ as TV_{t-d} , and insignificant coefficients are dropped from the system applying a LR test, there is no evidence that all those coefficients are equal to zero. Even though, the t-statistics for the estimated coefficients c and \mathbf{g} are reported in this table, the lowest t-statistics cannot be interpreted as evidence for linearity. A precise estimation of \mathbf{g} needs many observations around c and becomes more difficult when this parameter is large. See for instance, Franses and van Dijk (2000), page 91 and Granger and Teräsvirta (1993), page 123. Another element we should consider is that these parameters are not identified under the null hypothesis of linearity (Davies problem), so they do not follow the standard distribution.

investment equation. In this case, RIQ_{t-4} is used as TV_{t-d} . This Option is taken into account because the log-likelihood values are only slightly different from the case when $DLCREDIT_{t-1}$ is TV_{t-d} (see Table 4.3). The final specification(s) for the LSTVEC model will be chosen based on diagnostic tests on the residuals and long-run dynamic evaluation.

TABLE 4.4
VENEZUELA: ESTIMATION OPTIONS FOR THE NONLINEAR SYSTEM ACCORDING
TO THE SELECTION OF TRANSITION VARIABLES

Equation for:	Transition Variables		
	Option 1	Option 2	Option 3
$DLPRIVINV_t$	$DLCREDIT_{t-1}$	$DLCREDIT_{t-1}$	RIQ_{t-4}
$DDLACREDIT_t$	$DLCREDIT_{t-3}$	$DLCREDIT_{t-3}$	$DLCREDIT_{t-3}$
$DRIQ_t$	$DLCREDIT_{t-3}$	$DLPUBINV_{t-4}$	$DLPUBINV_{t-4}$
$DLPUBINV_t$	$DLCREDIT_{t-2}$	$DLPUBINV_{t-3}$	$DLPUBINV_{t-3}$

After estimation, we evaluate each of the three specifications. For such purposes, we use diagnostic tests on the residuals and evaluate the long run properties while computing impulse response functions³². Only in Option 1 convergence is achieved. Options 2 and 3 are discarded because they are globally unstable. How the impulse response functions are computed is the subject of the next section. A diagnostic test is performed on the residuals of Option 1. We apply the F test version of the LM serial correlation test proposed by Eitrheim and Teräsvirta (1996) in the four nonlinear equations. This test can be seen as a generalization of the Breusch and Pagan LM test for autocorrelation for linear specifications (Franses and van Dijk, 2000, page 110). In addition, the Jarque-Bera normality test and the Engle's ARCH-LM test are applied to all five equations³³. All equations passed diagnostic tests

32 The evaluation of the long-run dynamic of smooth transition models cannot be done analytically. A numerical solution is instead recommended. See Teräsvirta, *et al.*, (1994), page 2.945 and Granger and Teräsvirta (1993), page 128. Also, we can evaluate the dynamic properties of the model when computing the impulse responses. That is, if the effects of a shock dye out, this implies the model is stationary.

33 Eitrheim and Teräsvirta (1996) do not recommend using the Ljung-Box Q-statistic to analyze the residuals of smooth transition models because its distribution is unknown under the null. Eitrheim and Teräsvirta (1996) also propose a test for remaining nonlinearity and parameter constancy for smooth transition models. However, because of data limitations and the important number of additional parameters to be estimated in this research, their application is impractical.

except the credit equation, which presented serial correlation. Adding own lag values omitted in the linear specification, $DDL\CREDIT_{t-2}$ and $DDL\CREDIT_{t-4}$ solves serial correlation, in the credit equation. The residuals of this equation also present an important outlier in 1989:1, the period of implementation of the structural reform program. Thus, D891 was included to control for this effect. Under the new specification all equations pass diagnostic test. The statistics for these tests are reported in the bottom of Table 4.5.

TABLE 4.5
VENEZUELA: ESTIMATED LOGISTIC SMOOTH TRANSITION SUBSET VECTOR ERROR CORRECTION (LSTVEC) MODEL FOR PRIVATE INVESTMENT AND ITS DETERMINANTS WITH LAGGED RATE OF GROWTH OF REAL STOCK OF CREDIT USED AS TRANSITION VARIABLE (OPTION 1). PERIOD, 1984:3-2000:4

	DLPRIVINV _t		DDL\CREDIT _t		DRIQ _t		DLPRIVGDP _t		DLPUBINV _t	
	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.
C1	-0.300	-8.719	-0.002	-0.385	0.013	2.281	-0.112	-7.798	-0.515	-14.110
DS2	0.582	6.843	-	-	-	-	0.171	6.755	0.897	13.401
DS3	-	-	0.026	2.347	0.041	3.495	0.141	8.001	0.917	14.237
DS4	0.481	8.110	-	-	-0.036	-3.078	0.185	8.277	0.666	13.768
D861	-	-	-	-	-	-	-	-	0.346	7.159
D891	-	-	-0.089	-3.635	-0.220	-13.853	-	-	-	-
D942	-	-	-	-	-0.077	-3.388	-	-	-	-
D944	-	-	-0.237	-9.846	-	-	-	-	-	-
D962	-	-	-0.296	-10.003	-	-	-	-	-	-
DLPRIVINV _{t-1}	-0.500	-4.644	-	-	-	-	0.043	2.190	-	-
DLPRIVINV _{t-2}	-	-	-	-	-	-	-	-	-	-
DLPRIVINV _{t-3}	-	-	-	-	-	-	0.080	4.446	0.832	4.853
DLPRIVINV _{t-4}	-0.194	-2.253	-	-	-	-	-	-	0.170	3.167
DDL\CREDIT _{t-1}	0.523	3.213	-0.147	-2.362	-	-	-	-	-	-
DDL\CREDIT _{t-2}	-	-	-0.088	-1.547	-0.085	-2.081	-	-	-	-
DDL\CREDIT _{t-3}	-	-	-0.240	-3.597	-	-	-	-	-	-
DDL\CREDIT _{t-4}	-	-	-0.074	-1.007	0.203	2.360	-	-	-	-
DRIQ _{t-1}	-	-	0.367	4.046	-	-	-	-	2.251	5.926
DRIQ _{t-2}	-	-	-	-	-	-	-	-	2.839	9.431
DRIQ _{t-3}	-0.706	-2.770	-	-	-0.150	-2.403	-	-	-	-
DRIQ _{t-4}	-	-	-	-	-	-	-0.149	-2.242	2.099	3.667
DLPRIVGDP _{t-1}	1.680	3.878	-	-	-	-	-0.220	-2.258	-	-
DLPRIVGDP _{t-2}	1.331	3.270	-	-	0.292	2.480	-	-	-	-
DLPRIVGDP _{t-3}	2.321	5.183	-0.201	-2.265	-0.153	-1.712	-	-	-	-
DLPRIVGDP _{t-4}	-	-	-	-	-	-	-0.167	-1.666	-	-
DLPUBINV _{t-1}	0.182	2.262	-	-	0.097	5.458	0.080	3.925	-	-
DLPUBINV _{t-2}	-0.389	-6.672	-	-	-	-	0.062	3.397	0.781	5.689
DLPUBINV _{t-3}	-	-	-	-	-	-	0.079	4.394	-	-
DLPUBINV _{t-4}	-	-	-	-	-	-	-	-	-	-
CIV	-	-	-	-	-	-	-0.038	-2.924	-0.452	-4.790

Table 4.5 Continued

	DLPRIVINV _t		DDLREDIT _t		DRIQ _t		DLPRIVGDP _t		DLPUBINV _t	
	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.	Coeff.	T-stat.
C2 F(.)	-	-	-0.055	-2.936	-0.021	-2.687	-	-	-0.074	-1.741
DLPRIVINV _{t-1} F(.)	0.471	2.940	-	-	-	-	-	-	-	-
DLPRIVINV _{t-2} F(.)	-	-	-	-	-	-	-	-	-	-
DLPRIVINV _{t-3} F(.)	-	-	-	-	-	-	-	-	-0.770	-3.823
DLPRIVINV _{t-4} F(.)	-0.565	-2.973	-	-	-	-	-	-	-	-
DDLREDIT _{t-1} F(.)	-	-	-0.653	-3.252	-0.165	-2.708	-	-	-	-
DDLREDIT _{t-2} F(.)	-	-	-0.468	-2.145	-0.184	-2.168	-	-	-	-
DDLREDIT _{t-3} F(.)	-	-	0.341	2.436	-	-	-	-	-	-
DDLREDIT _{t-4} F(.)	-	-	0.080	0.638	-0.243	-2.570	-	-	-	-
DRIQ _{t-1} F(.)	-	-	-3.674	-5.136	-	-	-	-	-3.662	-4.672
DRIQ _{t-2} F(.)	-	-	-	-	-	-	-	-	-2.437	-4.069
DRIQ _{t-3} F(.)	-	-	-	-	-0.251	-1.997	-	-	-	-
DRIQ _{t-4} F(.)	-	-	-	-	-	-	-	-	-4.586	-4.456
DLPRIVGDP _{t-1} F(.)	-	-	-	-	-	-	-	-	2.065	5.418
DLPRIVGDP _{t-2} F(.)	-1.569	-2.187	-	-	0.196	1.752	-	-	2.172	5.234
DLPRIVGDP _{t-3} F(.)	1.387	2.624	-	-	-	-	-	-	-	-
DLPRIVGDP _{t-4} F(.)	-	-	-	-	-	-	-	-	-2.004	-5.123
DLPUBINV _{t-1} F(.)	-	-	-	-	-0.075	-3.480	-	-	-0.377	-4.749
DLPUBINV _{t-2} F(.)	0.312	2.492	-	-	-	-	-	-	-0.997	-5.957
DLPUBINV _{t-3} F(.)	-	-	-	-	-	-	-	-	-0.346	-4.520
DLPUBINV _{t-4} F(.)	-	-	-	-	-	-	-	-	-	-
CIV F(.)	-	-	-	-	-	-	-	-	0.392	2.835
$\hat{\gamma}$	33.295	0.819	65.438	(fixed)	87.711	(fixed)	-	-	3.110	3.792
\hat{c}	0.008	2.223	0.035	22.195	-0.049	(fixed)	-	-	-0.047	-5.366
R ² adj	0.600		0.789		0.788		0.767		0.949	
JB	1.067		4.009		0.404		1.982		1.484	
FAR(1)	0.001		2.449		0.541		1.298		0.064	
FAR(4)	0.325		1.048		0.541		0.722		0.117	
FARCH(1)	0.002		0.015		1.132		0.611		0.510	
FARCH(4)	0.369		0.753		0.466		0.851		1.159	

Notes: To calculate FAR(i), i=1,4, missing observations at the beginning of the series of lagged residuals are replaced by zeros as recommended by Teräsvirta (1998), page 520. C1 and C2 denote the constant term in the linear and augmented part of each equation, respectively. R² adj. is the adjusted R². F(.) denotes the logistic smooth transition function. JB accounts for the Jarque-Bera statistic to test for normality. It is distributed as a χ_2^2 . CIV denotes the cointegrating vector.

IV.4 The estimated transition functions

Figures 4.1 and 4.2 depict the four estimated transition functions for Option 1. Transition is very fast from one regime to the other in all equations but public investment. In the credit and interest rate equations, with too few observations around the estimated transition parameters and a high speed of adjustment given by the estimated smooth parameters, the transition function takes mainly values of zero and one, indicating threshold specifications. The transition function for the private investment equation depicts a fast transition from the low to the high regime.

In the private investment equation, the estimated value of $c=0.008$ -which is close to zero- allows the association of these two regimes to credit contraction ($F(.)=0$) and credit expansion ($F(.)=1$). However, this cannot be generalized to other equations in the system because estimated transition parameters close to zero are not observed in those equations. For instance, the estimated value of c has similar negative values, -0.047 and -0.049 , in the public investment and interest rate equations respectively while it is positive and equal to 0.035 in the credit equation.

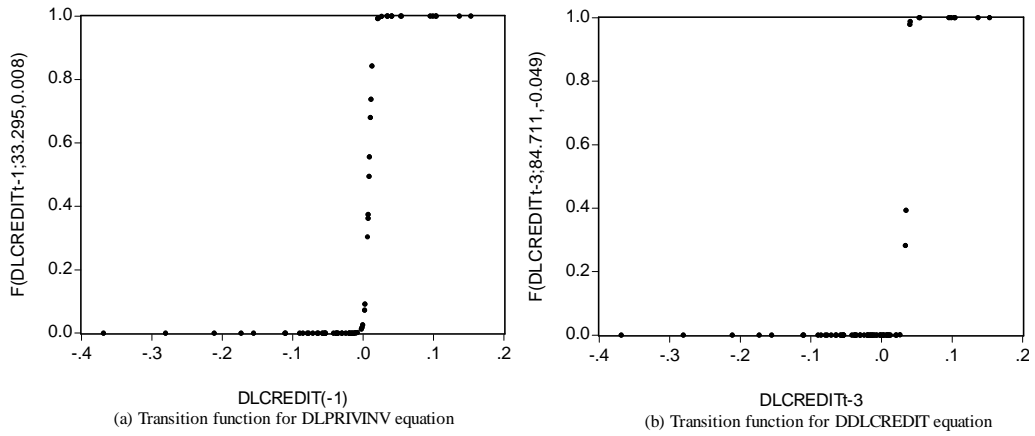


Figure 4.1. Private investment and credit equations: Estimated logistic transition functions versus transition variables.

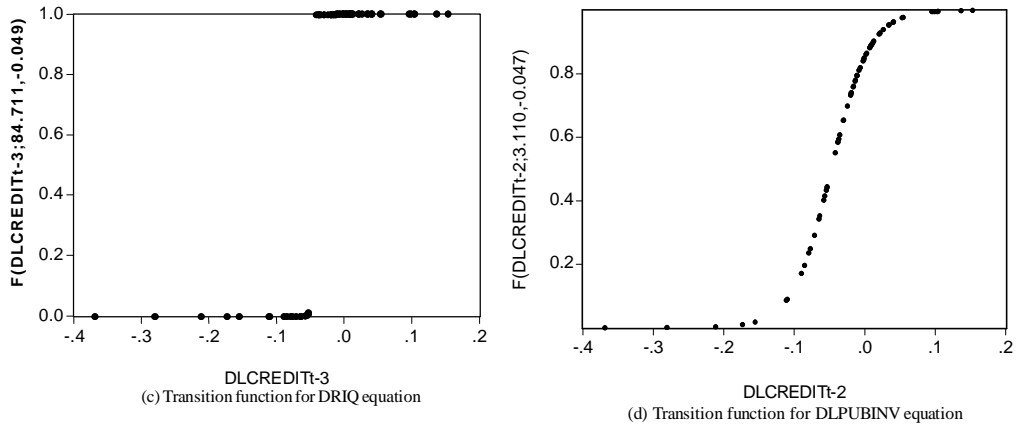


Figure 4.2. Real interest rate and public investment equations: Estimated transition functions versus transition variables.

V. Testing for differential effects of real interest rates and credit availability on private investment

To investigate the differential effects of interest rates and credit availability on private investment, we compute generalized impulse response functions³⁴ using the Monte Carlo technique described in Koop, *et al.*, (1996) and applied by Weise (1999) to study the asymmetric effects of monetary policy using data for the US. We explore how private investment responds to shocks of different sizes and signs and how different this response is when there is a credit contraction or expansion. In addition to shocks to financial variables, we also investigate how the growth rate of private investment responds to shocks to the growth rate of public investment, private GDP and to its own growth rate³⁵.

This section presents the impulse response functions for one-standard-error positive, negative and average shocks³⁶. Negative shocks are multiplied by minus one to make them comparable to the responses to one-standard-error shocks. We also compute impulse response functions to two-standard-error shocks and normalize them by dividing by two to make them comparable to the responses to one-standard-error shocks.

34 Generalized impulse response functions can be used for linear and nonlinear models. However, they are particularly recommended for computing the effect of shocks in one variable on the forecast of another variable when using a nonlinear model. Generalized impulse response functions take into account that in a nonlinear model impulse response functions depend on the initial conditions and on the sign and magnitude of the shocks.

35 Structural shocks are identified using a Choleski decomposition following the order DLPUBINV, DLPRIVGDP, DLPRIVINV, DRIQ, DDLCREDIT. With this ordering, it is assumed that the government takes investment decisions based on the past information of private sector variables. Also, it is probably that DLPRIVGDP affects DLPRIVINV rather than in the other way around in the short run. Since the correlation between DLPRIVINV and DRIQ is contemporaneously positive, then DLPRIVINV should affect DRIQ. The converse does not make theoretical sense even though we investigate whether the effects of the real interest rate on private investment can be positive given some economic conditions. A similar ordering is used for the ordering of DRIQ and DDLCREDIT. For more specific details on how the generalized impulse response functions are constructed in this study, see Mendoza Lugo (2001, chapter IV).

36 One-standard-error shock to these five variables, in the same order as them is listed, are of the following size: 1.044, 1.074, 0.996, 1.178 and 1.018.

However, these results are not shown because, in general, we found similar impulse response functions to one-standard-error shocks.

V.1 Response of DLPRIVINV to shocks of different sign to DRIQ

Shocks to DRIQ have opposite sign on DLPRIVINV. Figure 5.1 reports the effect of shocks of different signs to DRIQ on DLPRIVINV. This figure shows that DLPRIVINV is more responsive to negative shocks than to positive shocks to DRIQ and this effect is stronger for both, positive and negative shocks, when the shock is caused in the low credit regime. At longer periods, a negative shock has a cumulative positive effect on DLPRIVINV and this effect seems to be stronger when the shock occurs in the low credit regime. Positive shocks are also found to be stronger in the lower credit regime, but this effect, in absolute terms, is smaller than the effect of negative shocks to DRIQ.

V.2 Response of DLPRIVINV to shocks of different sign to DDLCREDIT

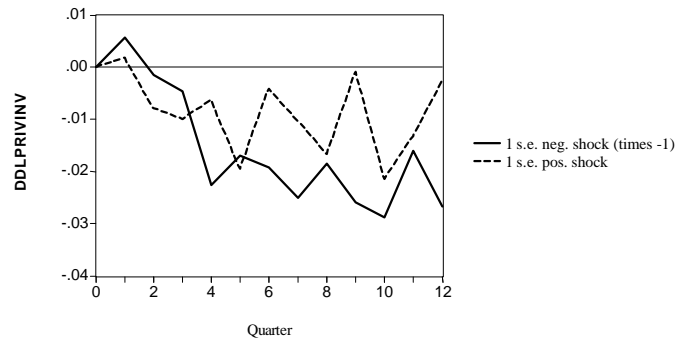
Figure 5.2 reports that positive shocks to DDLCREDIT have positive impacts on DLPRIVINV and that these impacts are stronger and less volatile when the economy is initially in the high credit regime. While negative shocks cause a contraction in DLPRIVINV in earlier periods, the cumulative response of DLPRIVINV to DDLCREDIT oscillates between positive and negative values in later periods. We interpret this last result as having no effect on the rate of growth of private investment.

When the economy is initially facing a credit contraction, in earlier periods, a negative shock to DDLCREDIT has a stronger effect on DLPRIVINV than a positive shock (see Figure 5.2.c). This result provides mild evidence for a more responsive private investment to credit when credit restrictions are more severe as the theory of financial liberalization predicts.

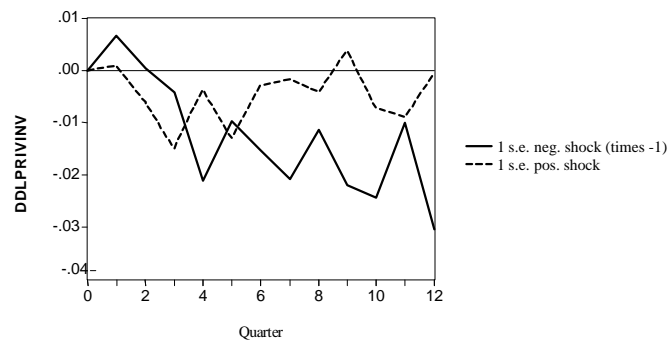
V.3 Response of DLPRIVINV to shocks of different sign to DLPUBINV

Shocks to DLPUBINV have opposite effects on DLPRIVINV. A negative shock to DLPUBINV has an important cumulative positive effect on DLPRIVINV up to period 12. Some asymmetries are observed after the third

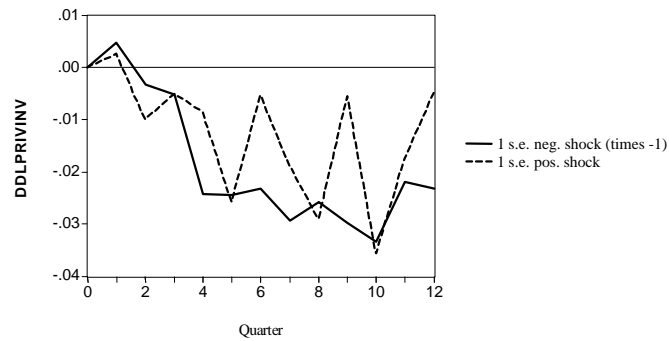
period between positive and negative shocks. That is, DLPRIVINV is more volatile with positive shocks and more responsive to negative shocks to DLPUBINV (Figure 5.3).



(a) Cumulative response of DLPRIVINV to DRIQ: Total average

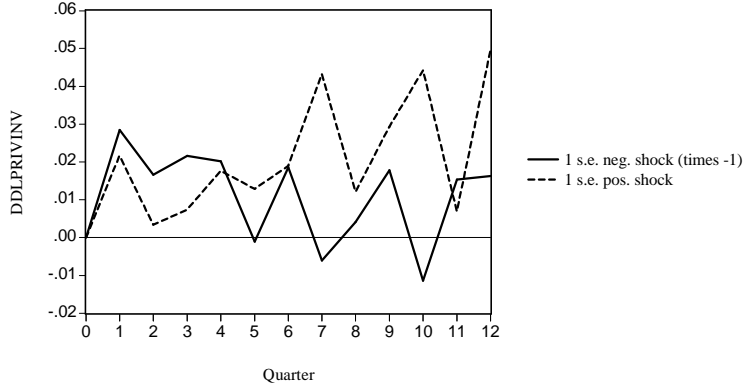


(b) Cumulative response of DLPRIVINV to DRIQ: High credit regime

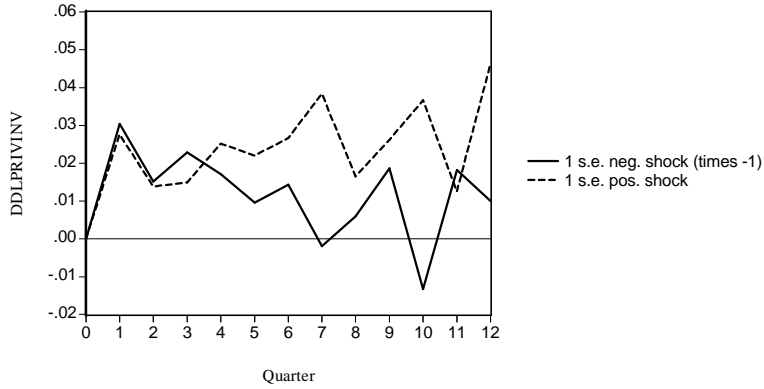


(c) Cumulative response of DLPRIVINV to DRIQ: Low credit regime

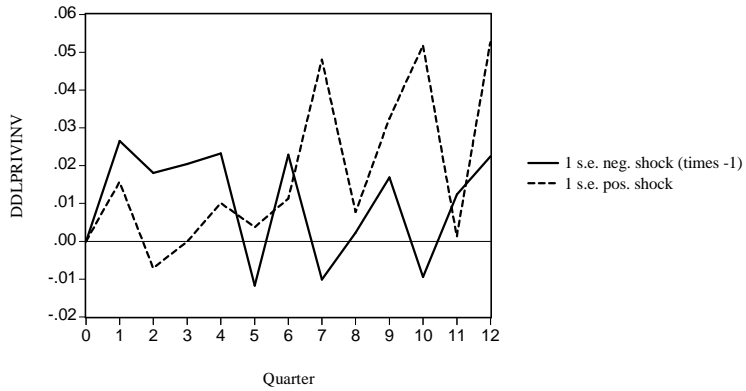
Figure 5.1. Venezuela: Effects of one-standard-error positive and negative shocks to DRIQ on DLPRIVINV (total average and given the initial state of the economy).



(a) Cumulative response of DLPRIVINV to DDLPCREDIT: Total average

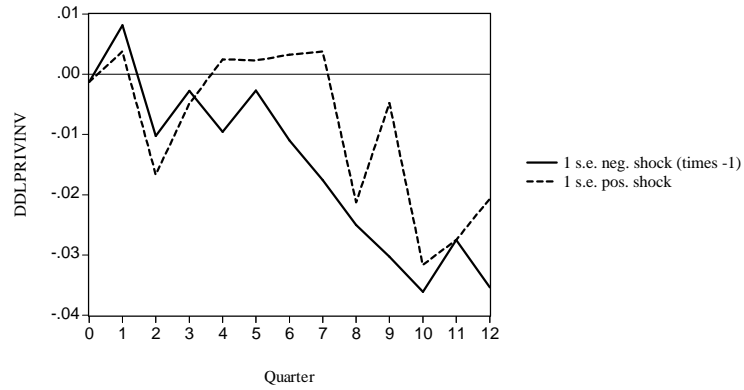


(b) Cumulative response of DLPRIVINV to DDLPCREDIT: High credit regime

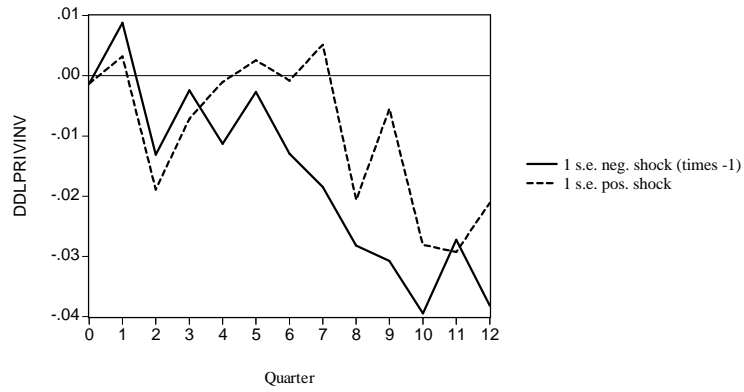


(c) Cumulative response of DLPRIVINV to DDLPCREDIT: Low credit regime

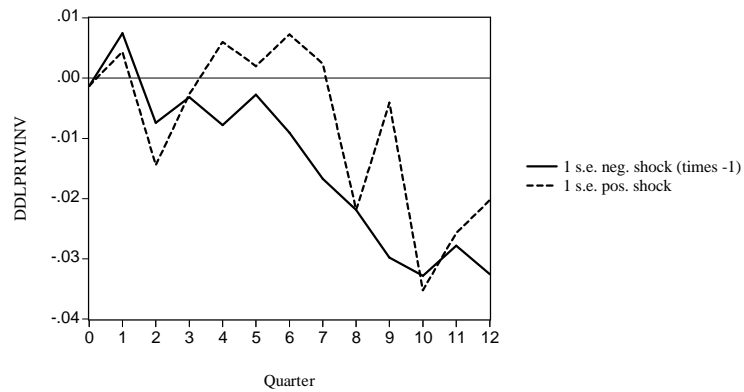
Figure 5.2. Venezuela: Effects of one-standard-error negative and positive shocks to DDLPCREDIT on DLPRIVINV (total average and given the initial state of the economy).



(a) Cumulative response of DDLPRIVINV to DLPUBINV: Total average



(b) Cumulative response of DDLPRIVINV to DLPUBINV: High credit regime

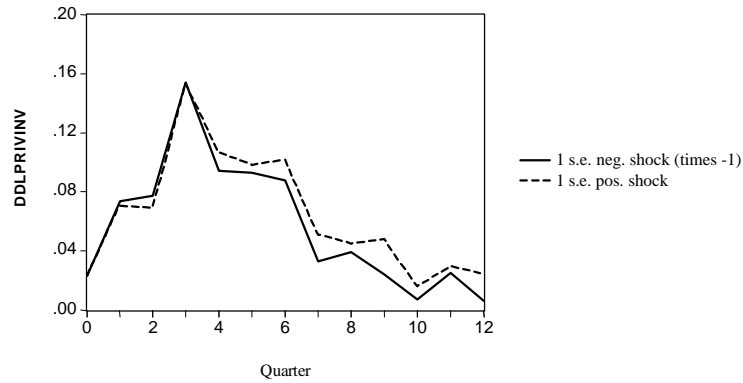


(c) Cumulative response of DDLPRIVINV to DLPUBINV: Low credit regime

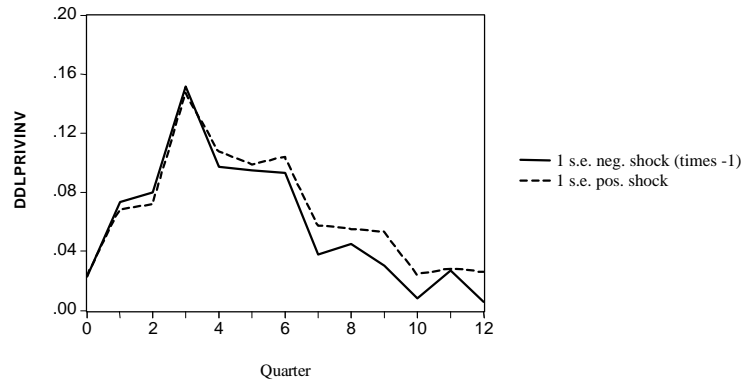
Figure 5.3. Venezuela: Effects of one-standard-error positive and negative shocks to DLPUBINV on DLPRIVINV (total average and given the initial state of the economy).

5.4 Responses of DLPRIVINV to shocks to DLPRIVGDP and DLPRIVINV

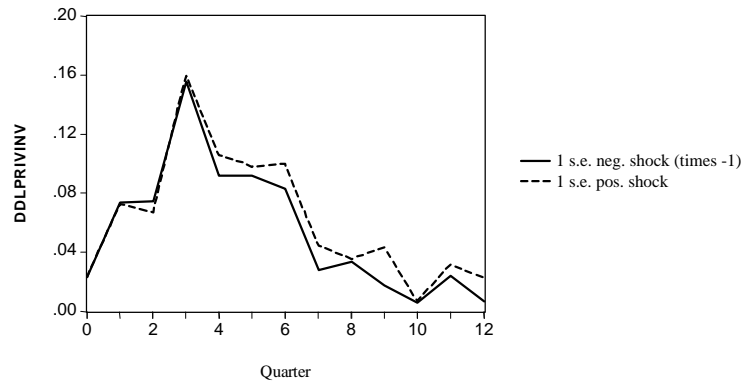
Even when private investment causes private GDP in the long run without causality observed in the opposite direction, impulse response functions of DLPRIVINV to shocks to DLPRIVGDP reveal this variable to be the most important determinant of private investment in the short run. A standard error shock to DLPRIVGDP causes a cumulative response in DLPRIVINV of 16% by the third period. After that period, this effect starts to decrease achieving values near zero by the twelfth period (Figure 5.4). Furthermore, DLPRIVINV has an important immediate response of the same sign to its own shocks. This, however, vanishes as time passes and reaches near zero by the twelfth period (Figure 5.5). In both cases, responses are symmetric and independent of the initial state of the economy.



(a) Cumulative response of DLPRIVINV to DLPRIVGDP: Total average

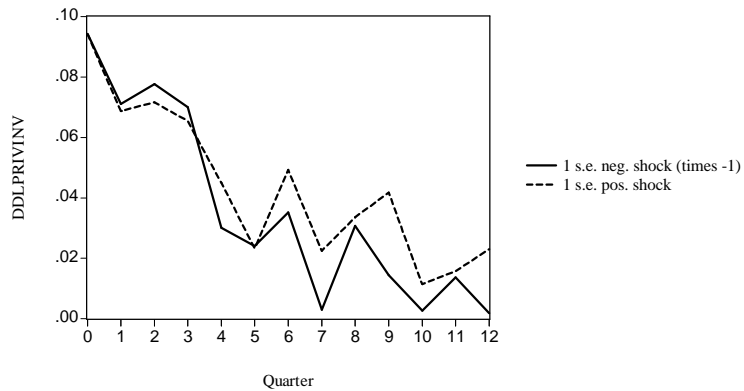


(b) Cumulative response of DLPRIVINV to DLPRIVGDP: High credit

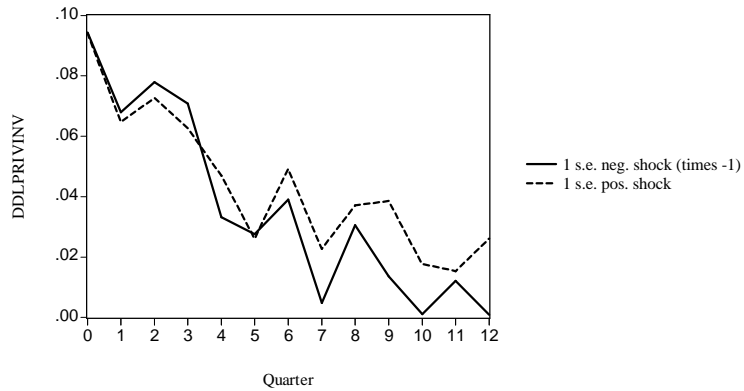


(c) Cumulative response of DLPRIVINV to DLPRIVGDP: Low credit

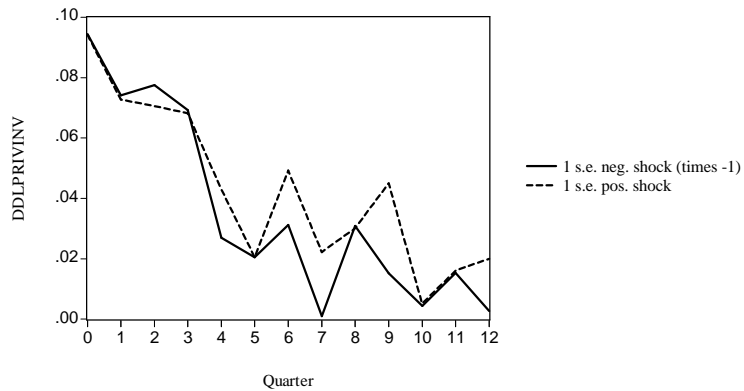
Figure 5.4 Venezuela: Effects of one-standard-error positive and negative shocks to DLPRIVGDP on DLPRIVINV (total average and given the initial state of the economy)



(a) Cumulative response of DLPRIVINV to DLPRIVINV: Total average



(b) Cumulative response of DLPRIVINV to DLPRIVINV: High credit regime



(c) Cumulative response of DLPRIVINV to DLPRIVINV: Low credit regime

Figure 5.5. Venezuela: Effects of one-standard-error positive and negative shocks to DLPRIVINV on DLPRIVINV (total average and given the initial state of the economy).

VI. Conclusions

Venezuela is a developing country that had very low-average real interest rates in the past. Part of the period of study, 1983:1-1988:4 was characterized by administrative controls on nominal interest rates. Since 1989, more flexible interest rate policies have been adopted. According to the financial liberalization theory, we should expect that in those economies with very low or negative real interest rates, a positive shock to interest rates would cause a positive effect on private investment while the same effect is negative, according to the traditional theory, at higher rates. This theory suggests a nonlinear relationship between private investment and real interest rates with real interest rates describing the states of the economy. However, from the Venezuelan data we did not find evidence for using real interest rate as a transition variable in a smooth transition logistic vector error correction (LSTVEC) model. Evidence was in favor of using lagged values of DLCREDIT as a transition variable. Under such a specification with two regimes-low credit and high credit-we have estimated the effects of shocks to changes in real interest rates, DRIQ, on the growth rate of private investment, DLPRIVINV. We should expect that in periods of credit contraction, a positive shock to real interest rates will have a positive effect on private investment. However, we did not find evidence for such an effect using Venezuelan data. In both regimes positive shocks to DRIQ have negative effects on DLPRIVINV and this accumulated effect is more negative in the lower regime. Furthermore, the effect of positive shocks to DRIQ on DLPRIVINV is lower in absolute values than the response to negative shocks. Negative shocks to DRIQ on DLPRIVINV have a stronger cumulative effect when it starts in the low regime.

Despite the fact that we have found evidence for asymmetric effects between positive and negative shocks to DRIQ on DLPRIVINV, those results do not support McKinnon's argument of positive shocks on DRIQ causing a rise in DLPRIVINV, even in periods of credit contraction.

In addition, the Venezuelan data provides evidence for an asymmetric response of DLPRIVINV to shocks in DDLKCREDIT for immediate periods after a negative shock to credit when the economy is already facing credit contractions as was expected. On the other hand, the cumulative response of DLPRIVINV to positive shocks to DDLKCREDIT becomes bigger in later periods when the high credit regime prevails. Why investment is more responsive to negative shocks to the interest rates when facing credit contraction and more responsive to positive shocks to DDLKCREDIT when facing credit expansion is difficult to explain.

While the responses of the rate of growth of private investment to shocks to the rate of growth of private GDP and to its own shocks are symmetric, they emerges as the most important forces driving investment spending in the short run.

Furthermore, the fact that the cointegrating vector does not enter into the private investment equation tells us that the opposite effect on DLPRIVINV of shocks to DLPUBINV is temporal. This is evidence that public investment acts as a substitute for private investment in the Venezuelan economy. Public investment has a negative effect on private investment when the government competes with the private sector to obtain the resources to finance the investment projects or when it provides goods that can be produced by the private sector. Shocks to DLPUBINV of opposite effect on DLPRIVINV invites us to study the effects of public investment policy in more detail using disaggregate data on public investment spending.

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