

A VAR MODEL FOR THE MONETARY SECTOR OF THE CYPRUS ECONOMY

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Abstract

Very little empirical research has been done on the Cyprus economy and, therefore, its structure and workings remain essentially unexplored. This monograph: (i) reviews the literature on VAR models from the perspective of the Probabilistic Reduction Approach; and (ii) illustrates the VAR methodology using the empirical relationship between macroeconomic variables in Cyprus. The discussion of the VAR methodology focuses on issues relating to model specification, estimation, misspecification testing, cointegration, Granger causality, impulse response analysis, variance decompositions and forecasting. The methodology is illustrated using time series data to develop a model of money, output, prices and interest rates in Cyprus. The model is intended for forecasting purposes and to analyse the dynamic interrelationships between the main economic variables. It also aims to help provide answers to questions such as whether money is inflationary, whether money affects output (and vice-versa) and what, if any, is the appropriate monetary aggregate to target.