Contents

1 Introduction 1
1.1 Motivation 1
1.2 Outline 4

2 Systems Cointegration Tests 7
2.1 Introduction 7
2.2 Cointegration Rank Tests: The Framework 9
2.2.1 Data Generating Process 9
2.2.2 Hypotheses and Testing Procedure 11
2.3 Likelihood Ratio Tests 12
2.3.1 DGPs and Test Statistics 13
2.3.1.1 Arbitrary Mean and Trend Term 13
2.3.1.2 Trending Variables and No Trend in the Cointegration Relations 17
2.3.1.3 Arbitrary Mean and No Trend Term . . 19
2.3.2 Summary of Models and Test Statistics 22
2.3.3 Previous Simulation Studies 22
2.4 Other Tests 27
2.4.1 Tests Based on Canonical Correlations of Levels . 27
2.4.1.1 DGPs and Test Statistics 27
2.4.1.2 Previous Simulation Results 30
2.4.2 Stock–Watson Tests 30
2.4.2.1 DGPs and Test Statistics 30
2.4.2.2 Previous Simulation Results 32
2.4.3 Bierens' Nonparametric Tests 33
2.4.3.1 DGPs and Test Statistics 33
2.4.3.2 Previous Simulation Results 34
2.5 New Small Sample Simulations 35
2.5.1 Previous Simulation Studies 35
2.5.2 Simulation Details 40
2.5.3 The Toda DGP 41

2.5.4 Two-dimensional VAR(1): Simulation Results . . 45
2.5.4.1 Sizes of the Tests 45
2.5.4.2 Power Performance: DGP without Linear Trend 49
2.5.5 Three-dimensional VAR(1): Simulation Results . 52
2.5.5.1 Size of the Tests 53
2.5.5.2 Power Performance: DGP with Linear Trend 58
2.5.6 Three-dimensional VAR(2): DGP and Simulation Results 70
2.5.7 Conclusions from Simulations 73
2.6 Further Deterministic Terms: Dummy Variables 76
2.7 Recommendations for Applied Research 81

3 A Cointegrated Monetary System for Germany 83
3.1 Introduction 83
3.2 Monetary Policy Strategies and the ECB 84
3.2.1 Inflation Targeting versus Monetary Targeting . . 84
3.2.2 'Discretion versus Rule' or 'Flexibility versus Transparency' 87
3.2.3 German Monetary Policy: Monetary Targeting and the Stability of the Demand for Money . . . 89
3.3 Long-Run Monetary Relations 92
3.3.1 The Demand for Money 93
3.3.1.1 Theories on Money Demand 93
3.3.1.2 Recent Empirical Literature of the Demand for the Monetary Aggregate M3 in Germany 98
3.3.1.3 Estimation of Money Demand Systems for other Countries 101
3.3.2 The Term Structure of Interest Rates 101
3.3.2.1 The Expectations Theory of the Term Structure 102
3.3.2.2 Cointegration Analysis of the Term Structure of Interest Rates 103
3.3.3 The Fisher Effect 105
3.3.3.1 Is the Real Interest Rate Stationary? . . 105
3.3.3.2 Recent Empirical Evidence for the Fisher Effect 106
3.4 Empirical Analysis 108
3.4.1 The initial VAR 109

3.4.1.1 Data 109
3.4.1.2 Univariate Tests for Unit Roots 112
3.4.1.3 Model Specification 115
3.4.2 Tests for the Cointegration Rank 120
3.4.2.1 The Johansen Rank Test 122
3.4.2.2 Trend-adjusted LR Tests 123
3.4.2.3 Rank Test for a Model without a linear Trend 124
3.4.3 Testing Restrictions on the Cointegration Space . 127
3.4.3.1 Weak Exogeneity and Stationarity . . . 127
3.4.3.2 Long-run Restrictions 129
3.4.3.3 The Cointegration Vectors: Economic Interpretation 139
3.4.4 Conclusion 140

4 Concluding Remarks and Outlook **143**
4.1 Systems Cointegration Tests 143
4.2 Empirical Analysis of a German Monetary System 144
4.3 Further Research 145
4.4 Outlook: Lessons for the ECB 147

A Trend-adjusted LR Tests: Dummy Variables **149**

B Data **153**

List of Figures **155**

List of Tables **157**

Bibliography **159**