Changes in nominal rigidities in Poland – a regime switching DSGE perspective

Paweł Baranowski
Zbigniew Kuchta

6/2015
Changes in nominal rigidities in Poland – a regime switching DSGE perspective

Abstract:

We estimate a dynamic stochastic general equilibrium model that allows for regimes Markov switching (MS-DSGE). Existing MS-DSGE papers for the United States focus on changes in monetary policy or shocks volatility, contributing the debate on the Great Moderation and/or Volcker disinflation. However, Poland which here serves as an example of a transition country, faced a wider range of structural changes, including long disinflation, EU accession or tax changes.

The model identifies high and low rigidity regimes, with the timing consistent with menu cost explanation of nominal rigidities. Estimated timing of the regimes captures the European Union accession and indirect tax changes. The Bayesian model comparison results suggest that model with switching in both analyzed rigidities is strongly favored by the data in comparison with switching only in prices or in wages. Moreover, we find significant evidence in support of independent Markov chains.

Keywords: nominal rigidities, Markov-switching DSGE models, Bayesian model comparison, regime switching.

JEL codes: C11, E31, E32, J30, P22.

1 We acknowledge support received from the Polish National Science Centre under Grant DEC-2014/15/B/HS4/01996. The views presented here do not necessarily represent the views of the affiliated institutions.
Introduction

Dynamic stochastic general equilibrium models (DSGE) are the cornerstone of modern macroeconomics. These models have traditionally been based on microeconomic assumptions on the intertemporal optimizing behaviors of households and firms. Parameters that govern technology and preferences, macroeconomic policy or structural shocks are treated as time-invariant. This feature may limit constant-parameters model capacities to explain certain episodes (e.g., Great Moderation or disinflation processes occurring during the Volcker chairmanship). As an alternative to the constant-parameters approach, several authors have proposed DSGE models that allow one to switch structural parameters based on the actual state of the economy (MS-DSGE henceforth). Numerous studies have investigated monetary policy rules and/or shock parameters [see, among others: Schorfheide, 2005; Davig, Doh, 2008; Bianchi, 2012; Baele et. al., 2015]. Less attention has been placed on explicit changes in nominal rigidities, which play a key role in mechanisms of shock propagation and which often ensure the real effects of monetary policy.

As a transition economy, Poland experienced major structural changes during the early 1990s that resulted in high inflation rates and high levels of unemployment. Throughout its transition, the country experienced a long disinflation period that was accompanied by several abrupt structural changes (i.e., the adoption of inflation targets and a fully floating exchange rate regime, VAT changes, sectoral deregulation and EU accession). These factors exogenously change institutional frameworks or market conditions faced by firms, rendering questions concerning possible nominal rigidity changes even more appealing.

In this paper, we estimate Erceg, Henderson and Levin’s [2000] sticky price and sticky wage model with regime changes in the degree of nominal rigidities. The analysis is based on Bayesian model comparisons that involve monthly data on the Polish economy for 1996:8 to 2015:6. Like Rabanal and Rubio-Ramirez [2005, 2008] and Liu, Waggoner and Zha [2011], we use a modified harmonic mean estimator to
find marginal data densities that reveal the model’s fit with the data and performance in terms of one-step-ahead forecasting [An, Schorfheide, 2007].

A number of recent papers have analyzed changes in the degree of nominal rigidities based on micro data [e.g., Berradi et al., 2015; Chakraborty et al., 2015; for Poland: Macias, Makarski, 2013]. To our knowledge, only few papers have addressed switching degrees of nominal rigidities based on aggregate data [Eo, 2009; Liu, Mumtaz, 2011; Lhuissier, Zabelina, 2015]. However, none of these studies take wage rigidities into account. Hence, the present study is novel in that it allows for (and tests) both price and wage rigidity regime switches. Second, the paper compares independent regime changes in price and wage rigidity parameters to changes following common Markov process for both parameters. As nominal rigidities determine the slope of the Phillips curve, our work also contributes to the debate on the variations of this slope [e.g., Chortareas, Magonis, Panagiotidis, 2012; Vavra, 2014] and to the monetary policy transmission mechanism.

Using our proposed model, we identify two regimes even though we apply identical prior distributions across the regimes. The data strongly favor regime switching degree specifications of both price and wage rigidity and support the case of independent regime switching relative to common regime for both nominal rigidities. The timing of these regimes appears to be intuitive, e.g., low levels of price rigidity occur during higher inflation, which is consistent with menu cost explanation. Moreover, we find that reactions to monetary policy and technological shocks vary considerably across the regimes.

The paper proceeds as follows: next section presents MS-DSGE model and details of Markov-switching specifications, third section describes the particular model used in investigation, fourth section presents methodology and data, fifth section shows our main results and the last section concludes.
DSGE model

This section presents the New Keynesian DSGE model. The model applied here is largely based on a work by Erceg, Henderson and Levin [2000] (EHL henceforth) that includes Calvo [1983] sticky prices and wages. The EHL model is theoretically appealing, as it implies that strict inflation targeting may not be an optimal strategy. On the other hand, it can be considered empirically plausible as it allows one to explain inflation persistence owing to the sluggish responses of real marginal costs [see Rabanal, Rubio-Ramirez, 2005; 2008; Kuchta, 2014].

The economy includes a perfectly competitive final goods producer, a continuum of monopolistically competitive intermediate goods producers that are indexed by \( j \in [0; 1] \), and continuum of households that are indexed by \( i \in [0; 1] \) and a perfectly competitive labor agency. We assume that final goods producing firms combine intermediate goods using a constant elasticity of substitution technology [see Dixit, Stiglitz, 1977]:

\[
Y_t = \left[ \int_0^1 \left( \frac{1}{Y_t^j} \frac{1}{P_t^j} \right)^{1+\tau_p} d_j \right]^{1+\tau_p}
\]

where \( Y_t \) represents the final product, \( Y_t^j \) is a quantity of intermediate goods and \( \tau_p > 0 \) represents the monopolistic mark-up on the goods market. Each final goods producer tends to maximize profits while taking prices of final and intermediate goods, \( P_t^j \), as a given. As a result, the optimal demand for intermediate goods is given by:

\[
Y_t^j = \left( \frac{P_t^j}{P_t} \right)^{-\frac{1+\tau_p}{\tau_p}} Y_t
\]

for all \( j \in [0; 1] \) and where:

\[
P_t = \left[ \int_0^1 \left( \frac{1}{P_t^j} \right)^{1+\tau_p} d_j \right]^{-\tau_p}
\]

is a final good price.
Each intermediate good $j$ is produced by a firm $j$ using the following constant return-to-scale technology:

$$Y_t^j = \varepsilon_t^a L_t^j$$

where $L_t^j$ is labor input, $\varepsilon_t^a$ is a technology shock which evolves according to a stationary first-order autoregressive process:

$$\ln \varepsilon_t^a = \rho_a \ln \varepsilon_{t-1}^a + \eta_t^a; \quad \eta_t^a \sim iid N(0; \sigma_a^2)$$

and $\rho_a \in (0; 1)$ is an autoregressive parameter. Each firm has access to a perfectly competitive labor market and pays the real wage $w_t$ for a labor unit. The introduction of linear production technology implies that real marginal cost does not depend on the amount of produced goods and it is identical among firms:

$$RMC_t^j = \frac{w_t}{\varepsilon_t^a}$$

We assume that prices are sticky according to Calvo [1983] and Yun [1996]; however the parameter of price stickiness follows a first-order discrete Markov process with two states and the transition matrix given by:

$$P = \begin{bmatrix} p_{11} & 1 - p_{11} \\ 1 - p_{22} & p_{22} \end{bmatrix}$$

where $p_{ii}^p = \Pr(s_t^p = i | s_{t-1}^p = i)$. The transition probabilities are constant over time, as there are many possible factors influencing degree of nominal rigidities and we do not want limit ourselves to a few of them.

More specifically, we assume that during each period $t$, a portion of randomly chosen prices $1 - \theta_p(s_t^p) \in (0; 1)$, $s_t^p = \{1, 2\}$ can be set optimally in order to maximize the expected value of future discounted firm real profits, which are expressed by:

$$E_t \left( \sum_{\tau=0}^{\infty} \theta_p(s_t^p)^\tau \beta^\tau \frac{\lambda_{t+\tau}}{\lambda_t} \left( \frac{P_{t+\tau}}{P_{t+\tau}^*} Y_t^j - RT + Y_t^j \right) \right)$$

under the constraint given by final producer demand, where: $P_{t+\tau}^*$ is an optimal price level, $\beta^\tau \frac{\lambda_{t+\tau}}{\lambda_t}$ is a stochastic discount factor, $\theta_p(s_t^p)^\tau$ measures the probability that price set in period $t$ will not be reoptimized up until period $t + \tau$, $E_t$ is a rational expecta-
tions operator and $RTC_t(Y^i)$ represents the real total cost depending on the quantity of goods produced. The first order condition for a firm that can set price optimally is given by:

$$E_t \left\{ \sum_{\tau=0}^{\infty} [\beta \theta_p(s^p_t)]^{\frac{\lambda_{t+\tau}}{\lambda_t}} Y^*_t \left[ (1 + \tau_p) RM C_{t+\tau} - \frac{P^*_t}{P_{t+\tau}} \right] \right\} = 0$$

This implies that each firm sets price in order to equate expected average future marginal revenues to average future expected mark-ups over real marginal costs with weights dependent on the probability of non-reoptimizing price and stochastic discount factor. The other prices, namely $\theta_p(s^p_t)$, remain unchanged. The real marginal cost is constant with respect to produced goods and is identical among firms, and all firms face the same demand constraints. Hence, all firms that can optimally choose price during period $t$ set it at the same level ($P^*_t$). As a result, we can rewrite the final goods price as:

$$P_t = \left[ \left(1 - \theta_p(s^p_t)\right) P^*_t \right]^{-\frac{1}{\tau_p}} + \theta_p(s^p_t) P_{t-1}$$

We assume that all households maximize utility obtained through consumption, $C^i_t$, and labor effort. Each household supplies differentiated and imperfect substitutive labor services, $L^i_t$, to labor agency which combine them into homogeneous labor inputs and sells them to firms. Labor agency aggregates household labor services using following formula:

$$L_t = \left[ \int_0^1 (L^i_t)^{1+\tau_w} \, di \right]^{1+\tau_w}$$

where $\tau_w > 0$ represents a monopolistic household’s mark-up. Labor agency maximizes profits based on the nominal wage of each household, $W^i_t$, and market nominal wage are taken as a given. As a result, the optimal demand for labor is given by:

$$L^i_t = \left( \frac{W^i_t}{W_t} \right)^{1+\tau_w} L_t$$

for all $i \in [0; 1]$ and where:
\[ W_t = \left[ \int_0^1 (W_t^i) \frac{1}{\tau_w} d\tau_i \right]^{-\tau_w} \]

is a nominal wage in the economy. Finally, a household’s lifetime utility function is given by:

\[ E_t \left\{ \sum_{\tau=0}^{\infty} \beta^\tau \varepsilon^b_{t+\tau} \left[ \frac{(C^i_{t+\tau})^{1-\delta_c}}{1-\delta_c} - \varepsilon^l_{t+\tau} \frac{(L^i_{t+\tau})^{1+\delta_l}}{1+\delta_l} \right] \right\} \]

where \( \beta \in (0;1) \) is a discount factor, \( \delta_c > 0 \) is a relative risk averse parameter and \( \delta_l > 0 \) denotes inverse Frisch elasticity. The utility function is affected by two disturbances, a preference shock, \( \varepsilon^b_t \), and a labor supply shock, \( \varepsilon^l_t \). We assume that these shocks follow a first-order autoregressive process:

\[
\begin{align*}
\ln \varepsilon^b_t & = \rho_b \ln \varepsilon^b_{t-1} + \eta^b_t; \quad \eta^b_t \sim iid N(0; \sigma^2_b) \\
\ln \varepsilon^l_t & = \rho_l \ln \varepsilon^l_{t-1} + \eta^l_t; \quad \eta^l_t \sim iid N(0; \sigma^2_l)
\end{align*}
\]

where \( \rho_b \in (0;1) \) and \( \rho_l \in (0;1) \) are autoregressive parameters.

Households receive income from labor; from financial investments, \( B^i_{t-1} \), represented by one-period riskless nominal bonds; and from shares from firms that produce intermediate goods, \( d_t \), assuming equal shares among particular households. Moreover, each household participates in state-contingent securities, \( D^i_t \), which protect them from risk related to staggered wage settings. Hence, budget constraint in real terms can be expressed as:

\[
\frac{B^i_t}{R_t P_t} + C^i_t = \frac{B^i_{t-1}}{P_t} + \frac{W^i_t}{P_t} L^i_t + D^i_t + d_t
\]

where \( R_t \) is the short-term gross nominal interest rate.

Each household chooses consumption and the quantity of bonds. The household’s first order condition is given by a standard Euler equation with respect to consumption:

\[
\varepsilon^b_t (C^i_t)^{-\delta_c} = \beta E_t \left\{ \varepsilon^b_{t+1} (C^i_{t+1})^{-\delta_c} \frac{R_t}{\pi_{t+1}} \right\}
\]

Moreover, the standard transversality condition should hold in each period:

\[
\lim_{t \to \infty} \beta^t \varepsilon^b_t (C^i_t)^{-\delta_c} B^i_t = 0
\]
We assume that each household can choose nominal wage conditionally according to the Calvo scheme. Similarly to firm optimization problem, we assume that during every period, a randomly chosen set of households of measure $1 - \theta_w(s_t^w)$, $s_t^w = \{1, 2\}$ can reoptimize wage while tending to maximize the lifetime utility function:

$$\max_{W_t^*} \mathbb{E}_t \left\{ \sum_{s=0}^{\infty} \left( \beta \theta_w(s_t^w) \right)^s \varepsilon_{t+s}^b \left[ \left( \frac{C_{t+s}^i}{1 - \delta} \right)^{1 - \delta_c} - \varepsilon_{t+s}^l \frac{\left( L_{t+s}^i \right)^{1 + \delta_l}}{1 + \delta_l} \right] \right\}$$

under budget constraint:

$$\frac{B_{t+s}^i}{R_{t+s}^i P_{t+s}^i} + C_{t+s}^i = \frac{B_{t+s-1}^i}{P_{t+s}^i} + \frac{W_t^*_i}{P_{t+s}^i} L_{t+s}^i + D_{t+s}^i + d_{t+s}$$

and labor agency demand function:

$$L_{t+s}^* = \left( \frac{W_t^*}{W_{t+s}^*} \right)^{1 + \tau_w} \frac{L_{t+s}^i}{MUL_t^i}$$

where $W_t^*$ represents the optimal nominal wage. The rest of the wages, of measure $\theta_w(s_t^w)$, remain unchanged. Like price stickiness, for wages, we allow for parameter switching by assuming that parameter $\theta_w(s_t^w)$ is governed by a first-order discrete Markov process with two states and the transition matrix given by:

$$P_w^i = \begin{bmatrix} p_{11}^{w} & 1 - p_{11}^{w} \\ \frac{1 - p_{22}^{w}}{p_{22}^{w}} & p_{22}^{w} \end{bmatrix}$$

where $p_{ii}^{w} = \Pr(s_t^w = i|s_{t-1}^w = i)$. The first order condition for wage choice is given by:

$$\sum_{s=0}^{\infty} \left( \beta \theta_w(s_t^w) \right)^s \mathbb{E}_t \left\{ L_{t+s}^* \left[ (1 + \tau_w) MUL_t^* - \lambda_{t+s}^i \frac{W_t^*}{P_{t+s}^i} \right] \right\} = 0$$

According to this condition, wages are chosen in order to ensure that the expected stream of future marginal revenues is equal to the expected stream of future mark-ups over marginal costs, which are represented in this case by the marginal disutility of labor ($MUL_t$), where both are weighed by the future expected labor demand.

The introduction of state-contingent securities causes each household to be homogenous with respect to income regardless of the results of the Calvo lottery. Moreover, the utility function is separable with respect to consumption and labor efforts,
and labor demand depends only on wages that are chosen by a household. Hence, we can limit ourselves to an investigation of symmetric equilibrium whereby all households that are able to set the wage optimally will select it at the same level. This property allows us to rewrite the aggregate nominal wage in the economy as:

\[ W_t = \left[ \theta_w(s^w_t)W_{t-1}^{1-\frac{1}{\tau_w}} + (1 - \theta_w(s^w_t))(W^*_t)^{1-\frac{1}{\tau_w}} \right]^{-\tau_w} \]

In the remainder of this paper, we consider the equilibrium on labor and goods markets. In particular, we assume that the following conditions hold in every period:

\[ \frac{1}{\Delta_p} \int_0^1 Y^j_t \, dj = Y_t \]
\[ \frac{1}{\Delta_w} \int_0^1 L^i_t \, di = L_t \]

where \( \Delta_p \equiv \int_0^1 \left( \frac{p_j}{p^*_t} \right)^{1+\rho_p} \, dj \geq 1 \) and \( \Delta_w \equiv \int_0^1 \left( \frac{w^i_t}{w^*_t} \right)^{1+\rho_w} \, di \geq 1 \) measure the price and wage dispersion, respectively, which in both cases are directly related to staggered wage and price mechanisms [see e.g., Yun, 1996, p. 355]. As we are interested in a closed economy model without capital accumulation, the aggregate demand equation is given by:

\[ Y_t = C_t \]

The model is closed by a monetary policy rule according to Taylor [1993] with interest rate smoothing of the following form:

\[ \frac{R_t}{R} = \left( \frac{R_{t-1}}{R} \right)^\rho \left( \frac{\pi_t}{\pi} \right)^{\phi_\pi} \left( \frac{Y_t}{Y} \right)^{\phi_Y} \exp(\eta_t^R) ; \quad \eta_t^R \sim iid \ N(0; \sigma_R^2) \]

where \( \rho \in (0; 1) \) is a smoothing parameter and where \( \phi_\pi > 0 \) and \( \phi_Y > 0 \) measure interest rate reactions with respect to inflation and the output gap, respectively. While the Taylor principle holds in our model with time-invariant parameters, we do not assume that central bank reactions to inflation must be always greater than one, as we

---

2 State-contingent securities also ensure symmetric equilibrium.
are also interested in parameter vectors that allow for indeterminacy in one regime even when the linear rational expectations model solution exists and is unique.

**Estimated models**

The presented model allows us to consider five different specifications. In the first specification (CONSTANT), we assume that all parameters are time-invariant. This model is treated throughout our analysis as a benchmark specification. In the second specification (PRICES), we allow for Markov switching in the Calvo probability for prices $\theta_p(s_t^p)$, assuming that parameter $\theta_w(s_t^w)$ is time-invariant while estimating $1 - p_{11}^p$ and $1 - p_{22}^p$ probabilities. The third specification (WAGES) introduces the Markov switching mechanism for the Calvo wages parameter, $\theta_w(s_t^w)$, while imposing the price stickiness as time-invariant. As a consequence, we estimate $1 - p_{11}^w$ and $1 - p_{22}^w$ probabilities. In the fourth specification (SYNCHRONISED), we assume that both Calvo probabilities, namely $\theta_p(s_t^p), \theta_w(s_t^w)$, are time-dependent according to the discrete first order Markov process while also assuming that both are governed by the same Markov chain. In this specification, we also estimate the transition probabilities for a common chain. In our last specification (INDEPENDENT), we relax the assumption on synchronized changes in price and wage rigidity and consider a model wherein both Calvo probabilities are governed by two independent Markov chains. In this specification, we also estimate the $1 - p_{11}^p, 1 - p_{22}^p, 1 - p_{11}^w, 1 - p_{22}^w$ transition probabilities.\(^3\)

**Data and methods**

Bayesian techniques are widely used to estimate DSGE models. These methods allow one to incorporate prior knowledge into statistical inferences while performing reliable model comparisons. The popular approach is based on state-space represen-

\(^3\) We also account for switching of: policy parameters, shocks’ variances, and parameters governing persistence (corresponding results are shown in Appendix C).
tation of linear rational expectation model (LRE) solutions; the Kalman filter, which is used to evaluate the likelihood function; and the MCMC algorithm, which is used to find posterior distribution draws [see, among others, An, Schorfheide, 2007; Fernandez-Villaverde, 2010; Guerron-Quintana, Nason, 2012].

Introducing Markov switching causes the estimation procedure to become much more complicated than it is in the constant parameter case. This issue is twofold. First, Markov-switching linear rational expectation system solutions are much more complicated, as agents must consider that existing regime can change in the future. Moreover, a rational equilibrium can be indeterminate in certain regimes, even if the solution of an entire system is unique [see Farmer, Waggoner, Zha, 2005]. As a consequence, popular methods of solving LRE that have been introduced, among others, by Blanchard and Kahn [1980], Klein [2000] and Sims [2001] cannot be used. Second, likelihood must account for the fact that regimes can change in a sample. Hence, likelihood is dependent on possible state histories, causing the number of possible paths to grow exponentially. As a result, the Kalman filter is difficult to apply [see Blagov, 2013; Alstadheim, Bjørnland, Maih, 2013].

Through our Bayesian estimations of MS-DSGE, we are interested in the vector of structural parameters, \( \omega \), in the vector of transition probabilities, \( \varphi \), and in states of the system, \( S^T \). These vectors are jointly estimated using the following Bayes theorem [see Schorfheide, 2005, p. 401]:

\[
p(\omega, \varphi, S^T | Y^T, M_i) = \frac{p(Y^T | \omega, \varphi, S^T, M_i) p(S^T | \varphi, M_i) p(\varphi, \omega, M_i)}{p(Y^T, M_i)}
\]

where \( p(Y^T | \omega, \varphi, S^T, M_i) \) is the likelihood function of model \( M_i \), \( p(S^T | \varphi, M_i) \) denotes the prior distribution of the state, \( p(\varphi, \omega, M_i) \) is the prior for vectors of the structural parameters \( \omega \), and state probabilities \( \varphi \) and \( p(Y^T, M_i) \) denotes the marginal data density, which is given by:

\[ 4 \text{ For example, if we consider a model with two possible states and evaluate likelihood function using 10 observations, the number of possible paths is equal to } 2^{10}. \]
\[ p(Y^T, M_i) = \int p(Y^T | \omega, \varphi, S^T, M_i) p(S^T | \varphi, M_i) p(\varphi, \omega, M_i) \, d(\omega, \varphi, S^T) \]

Marginal data density measures the model fit to the data and one-step-ahead forecasting performance [An, Schorfheide, 2007, p. 144-147] and is used in our Bayesian model comparisons. It is defined as an integral over whole parameters and state spaces, and it averages particular likelihoods treating priors for state probabilities and structural parameters as weights. It is thus sensitive to the dimensionality of the parameter and state spaces, and it punishes the model with more parameters when parameters are empirically irrelevant. As a consequence, a more complex model should not necessary be evaluated as better than a simpler model [see Rabanal, 2007, p. 924-925].

We estimate the models examined over several steps. In the first step, we log-linearize equilibrium conditions around the deterministic steady state with a zero inflation rate.\(^5\) We consider the non-inflationary long-run equilibrium, as it ensures that steady state in our model is time- and state-independent even when Calvo probabilities switch between particular regimes.\(^6\) As a consequence, the steady state does not depend on particular system states.\(^7\) In the second step, we apply perturbation method with first-order approximation in order to find the solution to the Markov-switching linear rational expectation system. This solution allows us to find the transition equation for state space representation of the DSGE model. Next, we apply Kim and Nelson [1999] filter in order to evaluate the likelihood function. Finally, the MCMC algorithm with adaptation and delayed rejection is used to find draws from posterior distribution. Obtained draws are then used in order to obtain moments of marginal posterior distributions and to evaluate marginal data densities using the Modified Harmonic Mean Estimator (MHM) proposed by Geweke [1998].

\(^5\)The log-linear form of the EHL model is presented in Appendix A.

\(^6\)It is worth noting that this approach excludes the possibility to analyze changes in inflation targeting and determines data filtering methods.

\(^7\)It is theoretically interesting to consider a model with steady state depending on a particular system state. We omit this possibility, as the considered model is time-consuming to compute, even when we only consider a Markov chain with two states.
Bayesian estimation allows us to compare different model specifications. It is worth noting that the comparison results are consistent, even when the models compared are misspecified or nonnested. Performed comparisons are based on the Posterior Odds Ratio given by:

\[ \text{POR}_{i,j} = \frac{p(M_i) p(Y^T, M_i)}{p(M_j) p(Y^T, M_j)} \]

where \( \frac{p(M_i)}{p(M_j)} \) is a prior odds ratio and where \( \frac{p(Y^T, M_i)}{p(Y^T, M_j)} \) is a Bayes factor. In evaluating a particular model, we apply Jeffreys’ rules [see Kass, Raftery, 1995]. Accordingly, we treat model \( M_i \) as favored by the data when the posterior odds ratio is greater than 100. Moreover, a posterior odds ratio of less than 3 is interpreted as an insignificant difference between compared models.

The models presented in the previous section are estimated using monthly data for the Polish economy for 1996:8 to 2015:6. Although most of the DSGE models are estimated using quarterly data, we prefer to use more frequently recorded data for two reasons. First, such data allow us to capture not only long- and medium-term regime changes but also short-term regime changes that cannot be found using quarterly data. Second, monthly data allow us to increase the number of observations, as DSGE model estimations for the Polish economy seem to suffer from a limited number of observations relative to similar studies on the U.S. economy or euro area. Our data set includes\(^8\) (i) monthly HICP inflation rate, (ii) industrial production volumes, (iii) money market interest rates (WIBOR 1M) and (iv) real wages. Before estimation, all of the series were filtered.

All variables in the theoretical model are expressed as a percentage deviation from the steady state. Moreover, the theoretical model does not exhibit a balanced growth path or inflation in the long run equilibrium. As a consequence, all series

\(^8\) All data were collected from the Reuters DataStream database,
should be transformed prior to estimation. Our approach was conducted as follows. First, all series (with the exception of interest rates) were seasonally adjusted using TRAMO/SEATS. Second, we removed trends from the logs of real variables using a Hodrick-Prescott (HP) filter. Rather than excluding deterministic trends, the HP filter does not require explicit assumptions on the growth path of potential output. We also exclude the first order difference filter, as it causes observables to be much more volatile, thus potentially generating very frequent and biased estimates of regime changes (especially when using monthly data). Moreover, we decided to remove deterministic trends of nominal variables for 1996:8 to 2003:12. During this period, Poland underwent a disinflation process, and the inflation target gradually declined. These processes appear difficult to explain using a model with constant long-run inflation rate, causing regime changes rare and biased. Finally, we demeaned all of the series.

**Priors**

Before carrying out estimations, it is necessary to specify prior distributions for estimated parameters. Smets and Wouters [2003] proposed to divide a vector of parameters into two groups. The first group includes these parameters, which are calibrated and treated as a constant in the estimation. The second group includes parameters that are estimated. We follow this approach and calibrate the discount factor, $\beta$; the inverse of the labor supply elasticity, $\delta_i$; and household and firm monopolistic mark-ups denoted by $\tau_w$ and $\tau_p$, respectively. We use a value of 0.997 for the parameter $\beta$, implying that the annual steady-state real interest rate is equal to 4%. This value appears to be consistent with previous quarterly DSGE model estimations for the

---

9 Means of transforming data are always a source of controversy. Interesting discussions on this issue are provided in Canova [2009] and Chiàea [2009], among others.

10 When we apply the HP filter, we use $\lambda = 129600$ as proposed by Ravn and Uhlig [2002].

11 As noted above, we decided to analyze the model without considering steady state inflation rate as this allowed us to assume that long-run equilibrium is independent of regime switching mechanisms.

12 Chosen parameters are the least important in the transmission mechanism on one hand and difficult to identify empirically in the DSGE model on the other.
Polish economy. For the $\delta_l$ parameter, we select a value of 1.25, which lies between micro- and macro-evidence [see Peterman, 2016]. The steady-state firm mark-up $\tau_p$ is set as 0.1, which is slightly above Hagemejer and Popowski’s [2014] estimated value. The same value was selected for the $\tau_w$ parameter. Both imply that the elasticities of labor and good demand are equal to 11.

The rest of the parameters were estimated. Our prior distribution selections are presented in Table 1. It is worth noting that chosen priors are the same for both regimes. Hence, we do not impose any ex ante restrictions, allowing us to identify two different regimes. Moreover, chosen priors seem to be rather diffuse in comparison to priors used in previous studies.

Table 1. Prior distributions.

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Symbol</th>
<th>Support</th>
<th>Distribution</th>
<th>Mean</th>
<th>S.D.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calvo probability for prices</td>
<td>$\theta_p(s^p)$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Calvo probability for wages</td>
<td>$\theta_w(s^w)$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Relative risk aversion</td>
<td>$\delta_c$</td>
<td>$\mathbb{R}^+$</td>
<td>Normal</td>
<td>4</td>
<td>1.5</td>
</tr>
<tr>
<td>Monetary policy reaction to inflation</td>
<td>$\phi_\pi$</td>
<td>$\mathbb{R}^+$</td>
<td>Normal</td>
<td>1.5</td>
<td>0.25</td>
</tr>
<tr>
<td>Monetary policy reaction to output</td>
<td>$\phi_Y$</td>
<td>$\mathbb{R}^+$</td>
<td>Normal</td>
<td>0.042</td>
<td>0.02</td>
</tr>
<tr>
<td>Interest rate smoothing</td>
<td>$\rho$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.254</td>
</tr>
<tr>
<td>Technological shock persistence</td>
<td>$\rho_a$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.254</td>
</tr>
<tr>
<td>Preference shock persistence</td>
<td>$\rho_b$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.254</td>
</tr>
<tr>
<td>Labor supply shock persistence</td>
<td>$\rho_l$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.5</td>
<td>0.254</td>
</tr>
<tr>
<td>Technological shock variance</td>
<td>$\sigma^2_a$</td>
<td>$\mathbb{R}^+$</td>
<td>Inverse Gamma</td>
<td>0.0174*</td>
<td>–</td>
</tr>
<tr>
<td>Preference shock variance</td>
<td>$\sigma^2_b$</td>
<td>$\mathbb{R}^+$</td>
<td>Inverse Gamma</td>
<td>0.0174*</td>
<td>–</td>
</tr>
<tr>
<td>Labor supply shock variance</td>
<td>$\sigma^2_l$</td>
<td>$\mathbb{R}^+$</td>
<td>Inverse Gamma</td>
<td>0.0174*</td>
<td>–</td>
</tr>
<tr>
<td>Monetary policy shock variance</td>
<td>$\sigma^2_R$</td>
<td>$\mathbb{R}^+$</td>
<td>Inverse Gamma</td>
<td>0.0174*</td>
<td>–</td>
</tr>
<tr>
<td>Transition probability for prices</td>
<td>$1 - p_{11}^P$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.0452</td>
<td>0.0285</td>
</tr>
<tr>
<td>Transition probability for prices</td>
<td>$1 - p_{22}^P$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.0452</td>
<td>0.0285</td>
</tr>
<tr>
<td>Transition probability for wages</td>
<td>$1 - p_{11}^W$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.0452</td>
<td>0.0285</td>
</tr>
<tr>
<td>Transition probability for wages</td>
<td>$1 - p_{22}^W$</td>
<td>[0; 1]</td>
<td>Beta</td>
<td>0.0452</td>
<td>0.0285</td>
</tr>
</tbody>
</table>

* - distribution modes.
To reflect the theoretical restrictions, we impose a beta distribution for all parameters contained in the interval \([0; 1]\). For price and wage stickiness parameters, we set the mean value to 0.5 and the standard deviation to 0.2. For the other structural parameters \((\rho, \rho_a, \rho_b, \text{ and } \rho_t)\), we use a slightly looser prior, as we are using more frequently recorded data than are typically used. The priors of the transition probabilities imply an average duration (90% HPD) of between 10 and 100 months. For the monetary policy reaction parameters, we choose a normal distribution with means comparable to Taylor’s [1993] initial calibration. Chosen priors do not restrict the parameter space to those values that ensure equilibrium determinacy. We do this to reflect the fact that for the MS-DSGE model, indeterminacy can be achieved in some regimes, even when a system is unique overall. For all of the shock variances, we use an inverse gamma distribution in line with the existing literature.

Results

This section presents the results of the Bayesian estimation models considered. We begin with a short description of the posterior estimates with an emphasis on differences between the particular regimes. We then identify regimes using smoothed probabilities and perform Bayesian model comparisons to determine the empirical importance of Markov-switching for the Polish economy. Finally, we analyze the differences between impulse response functions that can occur when we assume that parameters governing nominal rigidities are time-dependent.

All of the results presented in this section are based on an MCMC algorithm with 2 chains with 400,000 draws each and where the last 200,000 draws are used to find posterior distributions for each model. We use the RISE package for this task.

Marginal posteriors for the estimated parameters are presented in Table 2.\(^\text{13}\) We focus on the posterior mean and on a 90% HPD. Overall, the posteriors are far more

\(^{13}\text{A graphical comparison between the priors and posteriors is presented in Appendix B.}\)
concentrated than the priors, confirming that most of the parameters were strongly affected by the data during the estimation. The exceptions were parameters $\delta_c$, $\phi_\pi$ and $\phi_\gamma$. However, the posteriors obtained for these parameters seem to be comparable to those of previous results for the Polish economy [see, among others: Kolasa, 2008; Kuchta, 2014], especially considering the fact that we used more frequently recorded data than are typically used. Moreover, most of “non-switching” parameters do not vary considerably across particular models, even if we assume that the parameters governing nominal rigidities were time-dependent. This implies a substantial degree of interest rate smoothing, moderate monetary policy reaction to output gap and limited reaction to inflation.
Table 2. Posterior statistics across the models (means and 90% HPD in parentheses)

<table>
<thead>
<tr>
<th></th>
<th>INDEPENDENT</th>
<th>SYNCHRONISED</th>
<th>PRICES</th>
<th>WAGES</th>
<th>CONSTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\theta_p(s^p_t = 1)$</td>
<td>0.904</td>
<td>0.903</td>
<td>0.912</td>
<td></td>
<td>0.936</td>
</tr>
<tr>
<td></td>
<td>[0.884 0.923]</td>
<td>[0.881 0.923]</td>
<td>[0.894 0.929]</td>
<td></td>
<td>[0.924 0.947]</td>
</tr>
<tr>
<td>$\theta_p(s^p_t = 2)$</td>
<td>0.942</td>
<td>0.940</td>
<td>0.946</td>
<td></td>
<td>0.903</td>
</tr>
<tr>
<td></td>
<td>[0.933 0.952]</td>
<td>[0.929 0.950]</td>
<td>[0.937 0.955]</td>
<td></td>
<td>[0.881 0.923]</td>
</tr>
<tr>
<td>$\theta_w(s^w_t = 1)$</td>
<td>0.752</td>
<td>0.773</td>
<td>0.860</td>
<td>0.773</td>
<td>0.903</td>
</tr>
<tr>
<td></td>
<td>[0.692 0.806]</td>
<td>[0.730 0.814]</td>
<td>[0.841 0.877]</td>
<td>[0.724 0.816]</td>
<td>[0.850 0.895]</td>
</tr>
<tr>
<td>$\theta_w(s^w_t = 2)$</td>
<td>0.872</td>
<td>0.873</td>
<td>0.912</td>
<td>0.912</td>
<td>0.936</td>
</tr>
<tr>
<td></td>
<td>[0.849 0.894]</td>
<td>[0.850 0.895]</td>
<td>[0.894 0.929]</td>
<td>[0.894 0.929]</td>
<td></td>
</tr>
<tr>
<td>$\delta_c$</td>
<td>6.267</td>
<td>6.184</td>
<td>5.975</td>
<td>6.286</td>
<td>6.085</td>
</tr>
<tr>
<td></td>
<td>[4.862 7.736]</td>
<td>[4.769 7.648]</td>
<td>[4.596 7.394]</td>
<td>[4.860 7.762]</td>
<td></td>
</tr>
<tr>
<td>$\phi_\pi$</td>
<td>1.421</td>
<td>1.418</td>
<td>1.394</td>
<td>1.382</td>
<td>1.375</td>
</tr>
<tr>
<td></td>
<td>[1.141 1.709]</td>
<td>[1.128 1.718]</td>
<td>[1.119 1.678]</td>
<td>[1.112 1.664]</td>
<td></td>
</tr>
<tr>
<td>$\phi_Y$</td>
<td>0.069</td>
<td>0.068</td>
<td>0.071</td>
<td>0.067</td>
<td>0.069</td>
</tr>
<tr>
<td></td>
<td>[0.045 0.093]</td>
<td>[0.045 0.092]</td>
<td>[0.047 0.095]</td>
<td>[0.044 0.091]</td>
<td></td>
</tr>
<tr>
<td>$\rho$</td>
<td>0.971</td>
<td>0.971</td>
<td>0.970</td>
<td>0.970</td>
<td>0.969</td>
</tr>
<tr>
<td></td>
<td>[0.964 0.977]</td>
<td>[0.964 0.977]</td>
<td>[0.963 0.977]</td>
<td>[0.963 0.976]</td>
<td></td>
</tr>
<tr>
<td>$\rho_a$</td>
<td>0.569</td>
<td>0.516</td>
<td>0.555</td>
<td>0.437</td>
<td>0.434</td>
</tr>
<tr>
<td></td>
<td>[0.485 0.650]</td>
<td>[0.431 0.601]</td>
<td>[0.472 0.637]</td>
<td>[0.354 0.522]</td>
<td></td>
</tr>
<tr>
<td>$\rho_b$</td>
<td>0.841</td>
<td>0.836</td>
<td>0.830</td>
<td>0.862</td>
<td>0.846</td>
</tr>
<tr>
<td></td>
<td>[0.800 0.880]</td>
<td>[0.795 0.875]</td>
<td>[0.789 0.870]</td>
<td>[0.819 0.903]</td>
<td></td>
</tr>
<tr>
<td>$\rho_l$</td>
<td>0.015</td>
<td>0.016</td>
<td>0.016</td>
<td>0.017</td>
<td>0.016</td>
</tr>
<tr>
<td></td>
<td>[0.003 0.032]</td>
<td>[0.003 0.032]</td>
<td>[0.003 0.033]</td>
<td>[0.003 0.036]</td>
<td></td>
</tr>
<tr>
<td>$\sigma_a^2$</td>
<td>0.215</td>
<td>0.240</td>
<td>0.250</td>
<td>0.350</td>
<td>0.373</td>
</tr>
<tr>
<td></td>
<td>[0.141 0.300]</td>
<td>[0.153 0.348]</td>
<td>[0.166 0.346]</td>
<td>[0.224 0.505]</td>
<td></td>
</tr>
<tr>
<td>$\sigma_b^2$</td>
<td>0.138</td>
<td>0.136</td>
<td>0.131</td>
<td>0.139</td>
<td>0.134</td>
</tr>
<tr>
<td></td>
<td>[0.109 0.169]</td>
<td>[0.106 0.167]</td>
<td>[0.103 0.161]</td>
<td>[0.110 0.170]</td>
<td></td>
</tr>
<tr>
<td>$\sigma_l^2$</td>
<td>5.652</td>
<td>5.389</td>
<td>7.541</td>
<td>6.317</td>
<td>7.991</td>
</tr>
<tr>
<td>100$\sigma_R^2$</td>
<td>0.0885</td>
<td>0.0885</td>
<td>0.0885</td>
<td>0.0885</td>
<td>0.0885</td>
</tr>
<tr>
<td></td>
<td>[0.088 0.089]</td>
<td>[0.088 0.089]</td>
<td>[0.088 0.089]</td>
<td>[0.088 0.089]</td>
<td></td>
</tr>
<tr>
<td>$1 - p_{11}^p$</td>
<td>0.073</td>
<td>0.068</td>
<td>0.040</td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td></td>
<td>[0.034 0.119]</td>
<td>[0.043 0.095]</td>
<td>[0.019 0.063]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$1 - p_{11}^w$</td>
<td>0.126</td>
<td>0.158</td>
<td>0.068</td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td></td>
<td>[0.077 0.179]</td>
<td>[0.104 0.215]</td>
<td>[0.031 0.112]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$1 - p_{22}^p$</td>
<td>0.039</td>
<td>0.043</td>
<td></td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td></td>
<td>[0.020 0.060]</td>
<td>[0.023 0.066]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$1 - p_{22}^w$</td>
<td>0.039</td>
<td>0.043</td>
<td></td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td></td>
<td>[0.020 0.060]</td>
<td>[0.023 0.066]</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
We identify two different regimes: (i) one with high price and wage rigidities and (ii) one with low price and wage rigidities.\textsuperscript{14} For the high rigidity regime, the average price duration was evaluated for a period of between 15 and 21 months when two independent Markov chains were considered (INDEPENDENT) and for a period of between 14 and 20 months\textsuperscript{15} when only one Markov chain was introduced for both rigidities (SYNCHRONISED). For the low rigidity regime, these intervals were estimated for values recorded within periods of 9 and 13 months and 8 and 13 months, respectively. Similar results were obtained when wage rigidity was assumed to be time-invariant.

We found wage rigidities to be lower than price rigidities in all of the estimated models, even when we assumed price and/or wage stickiness to be time-dependent. However, this may be somewhat counterintuitive, similar result holds for a variety of DSGE models when constant returns to scale are considered [see Smets, Wouters, 2003]. In the model with two independent Markov chains, wage rigidity was evaluated for a period of between 3 and 5 months for the low rigidity regime and for a period of between 7 and 9 months for the high rigidity regime. These results do not change substantially when we introduce only one Markov process that governs both rigidities and when we assume that price rigidity is time-invariant.

In contrast to these results, the model with fixed parameters identifies only high levels of rigidity for both wage and price stickiness. Our estimates suggest that the average durations were evaluated for a period of between 14 and 19 months in the case of prices and for a period of between 7 and 8 months in the case of wages.

By introducing switching between the regimes, we were able to identify low rigidity regimes that cannot be observed in a constant-parameters model. Figure 1 pre-

\textsuperscript{14} It is worth noting that we identify both regimes using the same priors which means that we do not impose any ex ante restrictions.

\textsuperscript{15} It should be stressed that four different regimes were included in the INDEPENDENT model, as we used two independent Markov chains.
sents the smoothed probability of the Polish economy remaining in a higher price or wage rigidity regime from 1996:8 to 2015:8. The presented values were evaluated using two independent Markov chains, with one assigned to each form of rigidity.

Figure 1. Estimated probability of higher nominal rigidity regimes (i.e., $s_t^w = 2$ and $s_t^p = 2$):

The probabilities shown in Figure 1 allow us to highlight several results that seem to be fairly intuitive, especially for prices. First, lower price rigidity degree were found to be more probable at the beginning of the sample, when Poland experienced a high inflation period (before 2002). Second, throughout the historically low inflation period in Poland occurring after 2004 (and through deflation since the mid-2014), the high price rigidity regime has dominated. This result seems reasonable, as during high inflation periods, non-adjusting price is more costly, for example due to changes in relative prices. More frequent price adjustments (i.e. lower price rigidity) is also consistent with a wide variety of models based on the menu cost approach. Third, short-lived switching from higher to lower price rigidity degree occurred at almost
the same time as two significant institutional changes: May 2004, when Poland joined European Union, and January 2011, when VAT rates increased.\textsuperscript{16}

In contrast to the price stickiness results, the high wage rigidity regime seems to dominate the sample. Exceptions include the period of 1999 – 2000, when lower wage rigidities were more probable that higher wage rigidities. For the rest of the sample, only short-lived switches are observable. Smoothed probabilities seem to be less predictable than those of high price rigidity regime. One may expect that during high inflation periods, nominal wages change more often than they do during low inflation periods, as real wages decrease faster. However, our results can be justified as follows. First, our estimates suggest that real wages in the regime of low wage rigidity are rather flexible, as the average duration is no longer than half a year. Second, during high inflation periods, unemployment rates were higher than 10\%, potentially alleviating pressures to increase wages even when inflation rates were high.\textsuperscript{17}

<table>
<thead>
<tr>
<th></th>
<th>log MDD</th>
<th>Posterior Odds Ratio\textsuperscript{*}</th>
<th>Posterior Odds Ratio\textsuperscript{**}</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDEPENDENT</td>
<td>−558.30</td>
<td>1.025 \times 10^{23}</td>
<td>102</td>
</tr>
<tr>
<td>SYNCHRONISED</td>
<td>−562.92</td>
<td>1.005 \times 10^{21}</td>
<td>1</td>
</tr>
<tr>
<td>PRICES</td>
<td>−599.25</td>
<td>1.680 \times 10^5</td>
<td>1.672 \times 10^{-16}</td>
</tr>
<tr>
<td>WAGES</td>
<td>−570.44</td>
<td>5.465 \times 10^{17}</td>
<td>5.440 \times 10^{-24}</td>
</tr>
<tr>
<td>CONSTANT</td>
<td>−611.28</td>
<td>1</td>
<td>9.953 \times 10^{-22}</td>
</tr>
</tbody>
</table>

\textsuperscript{*,**} Posterior Odds Ratios were evaluated by treating model M\textsubscript{j} as CONSTANT and SYNCHRONISED.

Next, we evaluate the empirical importance of introducing Markov-switching for prices and wages by conducting Bayesian model comparisons.\textsuperscript{19} The results are presented in table 3. The posterior odds ratios strongly support models with Markov-switching when they are compared to a model with time-invariant parameters.

\textsuperscript{16} Note that during Poland’s accession to the European Union, Polish VAT rates also changed substantially.

\textsuperscript{17} Similar explanations can be given for the entire period. For example, we do not find strong evidence of low wage rigidity regime from mid-2002 to the end of 2004. During this period, unemployment rates were higher than 18\%.

\textsuperscript{18} Applying Laplace approximations did not change the model’s rank.

\textsuperscript{19} In Appendix C, we present the results of our Bayesian model comparisons, when taking into account regime changes in monetary policy rule, structural shock persistence and shock volatility.
Moreover, the models with Markov-switching for both rigidities are strongly favored by the data over model PRICES or WAGES. However, the empirical difference between the model with one chain (SYNCHRONISED) and that with two independent chains (INDEPENDENT) is small but sufficient, whereas the difference between PRICES and WAGES is extremely significant\(^{20}\), and the model with wage switching is favored.

Finally, we determine how the economy reacts to disturbances when we allow for price and wage rigidity switching. In particular, we compare impulse response functions obtained from the model with time-invariant parameters (denoted in Figures 2 and 3 as a solid black line with asterisks) with those that can be obtained from the INDEPENDENT model. Figure 2 presents the impulse response functions for observables in the case of technological shock. The dynamics of this model is determined by four different regimes: i) low price and wage rigidity regime denoted as solid gray lines, ii) low price and high wage rigidity regime denoted by dashed gray lines, iii) high price and low wage rigidity regime denoted by dashed black lines, and iv) high price and wage rigidity regime denoted by solid black lines. All of these impulse response functions were computed from posterior distribution means, which are shown in Table 1.

\(^{20}\) The posterior odds ratio is equal to \(3.25 \times 10^{12}\) and favors model WAGES with respect to PRICES.
Figure 2. Impulse response functions for observables – technological shock

Solid gray lines denote low price and wage rigidity regime, dashed gray lines denote low price rigidity and high wage rigidity regime, black dashed lines denote high price rigidity and low wage rigidity regime, black solid lines denote high price and wage rigidity regime, and black lines with asterisks denote model with constant parameters.

The appearance of positive technological shock increases output and marginal product of labor. Moreover, changes in technology and real wage affect real marginal cost and encourage a decline in prices. In turn, inflation rate declines. As interest rate is set according to the Taylor rule, it also falls. Marginal product of labor increase allows for changes in real wages. However, reaction sign is regime-dependent and implies that real wage may fall when prices are sticky and wages are relatively flexible.21

Introducing time-dependent price and wage stickiness substantially increases response magnitudes. While high price rigidity regimes (denoted by black lines) appear to be comparable to constant-parameter models (denoted by a line with asterisks), accounting for low price rigidity regimes causes economy to react more strongly to aggregate supply disturbances. Moreover, reaction magnitudes do not depend heavily on wage stickiness, though real wage reactions are an exception.

21 This result can be justified as follows. When prices are sticky, very few firms can reoptimize their prices while the rest remain unchanged, but all labor units become more productive. Hence, the demand for goods produced by firms that cannot optimize declines and as a consequence, labor demand also falls, decreasing real wage, even when positive technological shock is observable in the economy.
Figure 3. Impulse response functions for observables – monetary policy shock

Solid gray lines denote low price and wage rigidity regime, dashed gray lines denote low price rigidity and high wage rigidity regime, black dashed lines denote high price rigidity and low wage rigidity regime, black solid lines denote high price and wage rigidity regime, and black lines with asterisks denote model with constant parameters.

Figure 3 presents impulse response functions for the observables in the case of monetary policy shock. The appearance of monetary policy shock increases interest rate and causes output and real wage to fall as a result of decreased aggregate demand. In turn, inflation also falls. Interest rate and output responses are comparable between particular models, and notable differences are observed in the case of inflation and real wages. Our results seem to be fairly intuitive and suggest that the most severe inflation reactions occur during regimes characterized by more flexible wages and prices. Both whereas regimes with high degree of nominal rigidity are similar to model with constant parameters. Similarly, the strongest reactions of wages are observed in the regimes with the low wage rigidity. These results suggest that the economy reacts more strongly on monetary policy shocks during regimes characterized by low wage rigidities. Moreover, in contrast to technological shock, response magnitudes seem to be governed by wage stickiness switches, whereas changes in price stickiness appear to be rather unimportant.
Conclusions

In this paper, we examined changes in the degree of nominal rigidity in Poland. Using monthly data for 1996-2015, we estimated a set of sticky price and wage models while allowing for Markov switching in Calvo price and/or wage stickiness parameters. We compared four variants (varying in terms of switching parameters) to the model without regime changes (which was treated as a benchmark). Our findings are as follows.

First, the data reveal two regimes and strongly prefer models with switching degrees of both price and wage rigidity. The model with two independent Markov chains that govern price and wage rigidity is preferred than the model with synchronized price and wage rigidity changes.

Second, the timing of the estimated rigidity changes is fairly intuitive. The model identifies a low price stickiness regime during the transition period when inflation rates were rather high, which is consistent with the menu cost interpretation. The model also switches in May 2004 when Poland joined the European Union and in January 2011 when VAT rates increased. However, we do not find similar results in the case of wages, potentially due to high unemployment rates occurring during the transition period. Surprisingly, we do not find significant changes in either regime during the last financial crisis.

Third, our comparison of impulse response functions shows that during periods of low rigidity, the economy reacts more strongly to structural shocks. The magnitudes of responses to technological shock are largely driven by changes in price stickiness, whereas wage stickiness switches are rather unimportant. In contrast to the effects of technological shock, we find that the economy reacts more strongly to monetary policy shock during low wage rigidity regimes, and the magnitudes of responses are largely driven by changes in wage stickiness.
Literature


Appendix A:

This appendix presents a log-linear representation of the theoretical model. It is given by the following equations:

\[
\dot{y}_t = E_t\{\dot{y}_{t+1}\} - \frac{1}{\delta_c} E_t\{\dot{r}_t - \dot{\pi}_{t+1} + \dot{\varepsilon}^b_t - \dot{\varepsilon}^\ell_t\}
\]

\[
\dot{\pi}_t = \frac{\left(1 - \theta_p(s^p_t)\right) \left(1 - \beta \theta_p(s^p_t)\right)}{\theta_p(s^p_t)} r \tilde{m}c_t + \beta E_t\{\dot{\pi}_{t+1}\}
\]

\[
\tilde{w}_t = \frac{\left(1 - \theta_w(s^{w}_t)\right) \left(1 - \beta \theta_w(s^{w}_t)\right)}{\theta_w(s^{w}_t)} \frac{b_w \tau_w}{\delta_t (1 + \tau_w)} m \tilde{m}c_t + b_w \beta E_t\{\dot{\pi}_{t+1} + \tilde{w}_{t+1}\} - b_w \dot{\pi}_t
\]

where \( b_w = \frac{\theta_w(s^{w}_t) |\delta_t (1 + \tau_w) + \tau_w|}{\theta_w(s^{w}_t) |\delta_t (1 + \tau_w) + \tau_w| + \beta \theta_w(s^{w}_t)|\delta_t (1 + \tau_w) + \tau_w|} > 0 \) is a parameter, \( \dot{y}_t \) is the output, \( \dot{r}_t \) is the nominal interest rate, \( \dot{\pi}_t \) denotes inflation, \( r \tilde{m}c_t \) is the real marginal cost, \( m \tilde{m}c_t \) is the marginal rate of substitution between consumption and labor, \( \tilde{w}_t \) is the real wage, \( \dot{\varepsilon}^a_t \) denotes technological shock, \( \dot{\varepsilon}^b_t \) denotes preference shock, \( \dot{\varepsilon}^\ell_t \) denotes labor supply shock, \( \theta_p(s^p_t) \in [0; 1] \) is the price stickiness parameter, \( s^p_t = \{1, 2\} \) represents the discrete Markov chain for the price stickiness parameter, \( \theta_w(s^{w}_t) \in [0; 1] \) is the wage stickiness parameter, \( s^{w}_t = \{1, 2\} \) represents the discrete Markov chain for the wage stickiness parameter, \( \delta_t > 0 \) is the relative risk aversion parameter, \( \delta_t > 0 \) is the inverse of labour supply elasticity, \( \beta \in [0; 1] \) is the discount factor, \( \tau_w > 0 \) is the wage mark-up, \( E_t \) is the rational expectation operator and all variables denoted by “^\wedge” represent the percentage deviation from a steady state defined for variable “x_t” as:

\[
\hat{x}_t = \ln \left(\frac{x_t}{\bar{x}}\right)
\]
Appendix B:

Figure B1. Prior and posterior marginal distributions (INDEPENDENT)
(part 1: structural parameters)

(part 2: shocks persistence and variance parameters)
(part 3: transition probabilities)
Appendix C:

This appendix presents the result of Bayesian model comparison for a model with time-varying parameters of monetary policy rule (POLICY), shock’s persistence and interest rate smoothing (PERSISTENCE) and shock’s variances (VOLATILITY). The results provide additional support for the models with switching nominal rigidities (INDEPENDENT and SYNCHRONISED).

Table C1.

<table>
<thead>
<tr>
<th></th>
<th>log(MDD)</th>
<th>Posterior Odds Ratio*</th>
<th>Posterior Odds Ratio**</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDEPENDENT</td>
<td>−558.30</td>
<td>1.025 * 10^{−5}</td>
<td>102</td>
</tr>
<tr>
<td>SYNCHRONISED</td>
<td>−562.92</td>
<td>1.005 * 10^{−21}</td>
<td>1</td>
</tr>
<tr>
<td>POLICY</td>
<td>−611.08</td>
<td>1.223</td>
<td>1.217 * 10^{−21}</td>
</tr>
<tr>
<td>PERSISTENCE</td>
<td>−598.68</td>
<td>2.974 * 10^{4}</td>
<td>2.960 * 10^{−16}</td>
</tr>
<tr>
<td>VOLATILITY</td>
<td>−617.55</td>
<td>0.0019</td>
<td>1.882 * 10^{−24}</td>
</tr>
<tr>
<td>CONSTANT</td>
<td>−611.28</td>
<td>1</td>
<td>9.953 * 10^{−22}</td>
</tr>
</tbody>
</table>

*,** Posterior Odds Ratios were evaluated by treating model M_j as CONSTANT and SYNCHRONISED.
Appendix D:

This appendix presents the summary of estimations with more diffuse priors on Calvo parameters. More specifically we assumed prior distribution with 90% HPD ranging from 0.0975 to 0.9025 (identical for price and wage rigidity, and for both regimes). The remaining prior distributions was set as in the baseline (see Table 1 and Priors section). In the Table D1 posterior distribution for the parameters of interest are presented, while in the Table D2 – the Bayesian model comparison results. Overall, this sensitivity analysis show that posterior distribution was only little affected by change of the priors.

Table D1. Posterior statistics across the models (Calvo parameters only; means and 90% HPD in parentheses)

<table>
<thead>
<tr>
<th></th>
<th>INDEPENDENT</th>
<th>SYNCHRONISED</th>
<th>CONSTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\theta_p(s^p_t = 1)$</td>
<td>0.909 [0.888 0.929]</td>
<td>0.907 [0.887 0.926]</td>
<td>0.940 [0.930 0.949]</td>
</tr>
<tr>
<td>$\theta_p(s^p_t = 2)$</td>
<td>0.945 [0.935 0.955]</td>
<td>0.942 [0.931 0.952]</td>
<td></td>
</tr>
<tr>
<td>$\theta_w(s^w_t = 1)$</td>
<td>0.767 [0.629 0.806]</td>
<td>0.785 [0.744 0.823]</td>
<td>0.870 [0.857 0.880]</td>
</tr>
<tr>
<td>$\theta_w(s^w_t = 2)$</td>
<td>0.879 [0.856 0.899]</td>
<td>0.879 [0.857 0.899]</td>
<td></td>
</tr>
</tbody>
</table>

Table D2. Bayesian model comparisons (MHM logarithm of marginal data density)

<table>
<thead>
<tr>
<th></th>
<th>log (MDD)</th>
<th>Posterior Odds Ratio*</th>
<th>Posterior Odds Ratio**</th>
</tr>
</thead>
<tbody>
<tr>
<td>SYNCHRONISE</td>
<td>−559.80</td>
<td>7.862 * 10^{21}</td>
<td>1</td>
</tr>
<tr>
<td>INDEPENDENT</td>
<td>−554.98</td>
<td>6.349 * 10^{23}</td>
<td>123.8</td>
</tr>
<tr>
<td>CONSTANT</td>
<td>−610.00</td>
<td>1</td>
<td>1.575 * 10^{-22}</td>
</tr>
</tbody>
</table>

*,** Posterior Odds Ratios were evaluated by treating model $M_i$ as CONSTANT and SYNCHRONISED.