Factor-augmented Error Correction Models[*]

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Abstract

This paper brings together several important strands of the econometrics literature: error-correction, cointegration and dynamic factor models. It introduces the Factor-augmented Error Correction Model (FECM), where the factors estimated from a large set of variables in levels are jointly modelled with a few key economic variables of interest. With respect to the standard ECM, the FECM protects, at least in part, from omitted variable bias and the dependence of cointegration analysis on the specific limited set of variables under analysis. It may also be in some cases a refinement of the standard Dynamic Factor Model (DFM), since it allows us to include the error correction terms into the equations, and by allowing for cointegration prevent the errors from being non-invertible moving average processes. In addition, the FECM is a natural generalization of factor augmented VARs (FAVAR) considered by Bernanke, Boivin and Eliasz (2005) inter alia, which are specified in first differences and are therefore misspecified in the presence of cointegration. The FECM has a vast range of applicability. A set of Monte Carlo experiments and two detailed empirical examples highlight its merits in finite samples relative to standard ECM and FAVAR models. The analysis is conducted primarily within an in-sample framework, although the out-of-sample implications are also explored.

Keywords: Dynamic Factor Models, Error Correction Models, Cointegration, Factor-augmented Error Correction Models, VAR, FAVAR

JEL-Codes: C32, E17

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1   Introduction

Our paper is an exploration of a few of the many themes studied by David Hendry, whom this conference volume honours. Starting at least with Davidson, Hendry, Srba and Yeo (1978), Hendry has argued in favour of the powerful role of error-correction mechanisms in modelling macroeconomic data. While originally undertaken in an environment with supposedly stationary data, the subsequent development of cointegration served to renew emphasis on the long-run co-movement of macroeconomic variables. Models lacking such information are likely to be misspecified both within-sample and out-of-sample (or forecasting context).

Although we do not develop this issue further in our paper, breaks in the structure of models pose additional challenges for forecasting since models well specified within sample may not provide any guide for the forecasting performance of such models. Key references for this observation include Clements and Hendry (1995) where an interesting finding is that including reduced-rank or cointegrating information may not have beneficial effects on the forecasting performance of models except in small sample sizes. However, unrestricted vector autoregressions will be dominated by models which incorporate cointegration restrictions for larger systems of equations where cointegration relations impose a large number of restrictions. This is important background for the analysis conducted here, since we focus precisely and very largely on the implications of modelling cointegration in very large systems of equations.

Yet more pertinently from the point of view of our analysis, the fact that in large datasets much of the cointegration information may be unknown or difficult to model, will lead to a dependence of the performance of the macroeconomic models on exactly how successfully the cointegration information is extracted from the data. This is by no means a trivial problem, especially if the dimension of the system N is large. Clements and Hendry (1995) explore this issue using alternative criteria for assessing forecasting accuracy including the trace mean squared forecast error criterion (TMSFE) and their preferred invariant generalised forecast error second moment (GFESM) criterion. More recent analysis by Hendry (2006) has argued in favour of using a differenced vector error model (DVECM) which introduces error-correction information into a double-differenced-VAR (DDVAR). Particularly in an environment with structural change, a DVECM retains information relating to the change in the equilibrium in the system.

The main contributions of our paper are (a) to bring together two important recent strands of econometric literature on modelling co-movement that have a common origin but, in their implementations, have remained apart, namely, cointegration and dynamic factor models [1] and (b) to evaluate the role of incorporating long-run information in modelling, within the framework of both simulation exercises (where the emphasis is on evaluating efficiency within-sample) and empirical examples (where we look at both within-sample and out-of sample performance). It is important, in our view, to consider factor models since a significant issue, as in Clements and Hendry (1995), is the modelling of large systems of equations in which the complete cointegrating space may either

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[1] Our focus here is on the widespread application of these methods in econometrics to model macroeconomic variables. Factor models have of course been used in a large number of other contexts for a much longer period.

be difficult to identify or it may not be necessary to do so since we may be interested in only a sub-system as our variables of interest. In such circumstances, as we shall see, proxying for the missing cointegrating information, may turn out to be extremely useful.

Our evaluations are based both on in-sample measures of model fit, including R^2 and adjusted-R^2 (which, in our simulation exercises, is equivalent to one-step ahead MSFE since here the models may be taken to be correctly specified and the fitted value of the modelled variable can be interpreted as its forecast), as well as on a number of other criteria such as AIC and BIC, in circumstances (such as in our empirical examples) where the cointegrating information needs to be estimated and correct specification can therefore no longer be assumed to hold.

The starting point of our analysis is the common-trend representation for a $N \times 1$ vector of $I(1)$ variables x_t, namely,

$$x_t = \Gamma f_t + u_t, \tag{1}$$

where f_t is a $r \times 1$ vector of $I(1)$ trends common to all the variables with $0 < r \leq N$, while u_t is an

N-dimensional vector of stationary errors, see e.g. Stock and Watson (1988). Γ is an $N \times r$ matrix with rank r.

From equation (1), it is possible to write the model for the first differences of x_t, Δx_t, as either

$$\Delta x_t = \Gamma \Delta f_t + \Delta u_t, \tag{2}$$

or

$$\Delta x_t = \alpha \beta' x_{t-1} + \epsilon_t, \tag{3}$$

where $\beta' = \Gamma'_\perp$, so that $\beta' x_{t-1}$ is $I(0)$, and the errors Δu_t and ϵ_t can be correlated over time and across variables. β' is the $N - r \times N$ matrix of cointegrating vectors with rank $N - r$.

The literature on dynamic factor models (DFM) has relied on a specification similar to (2) and has focused on the properties of the estimators of the common factors Δf_t, or of the common components $\Gamma \Delta f_t$, under certain assumptions on the idiosyncratic errors, when the number of variables N becomes large. See, for example, Stock and Watson (2002a, 2002b) and Forni, Hallin,Lippi and Reichlin (2000). A few papers have also analyzed the model in (1) for the divergent N case, most notably Bai and Ng (2004) and Bai (2004).[2] We shall make use of both specification (1) and (2) when discussing factor models in what follows.

By contrast, the literature on cointegration has focused on (3), the so-called error correction model (ECM), and studied the properties of tests for the cointegrating rank $(N - r)$ and estimators of the cointegrating vectors (β'), see e.g. Engle and Granger (1987) or Johansen (1995). A few papers have attempted to extend the analysis to the large N case, generating the so-called panel cointegration tests, where a factor structure is employed to explore issues relating to the dependence across the variables. See e.g. Banerjee, Marcellino and Osbat (2004) and Banerjee and Carrion-i-

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[2] Bai and Ng (2004) also allow for the possibility that some elements of the idiosyncratic error u_t are I(1). We will not consider this case and assume instead that all the variables under analysis are cointegrated, perhaps after pre-selection. We feel that this is a sensible assumption from an economic point of view.

Silvestre (2007), where the latter paper uses techniques used by Bai and Ng (2004) in developing their PANIC tests for unit roots in panels.[3] The extension of PANIC techniques to study cointegration is complicated by the curse of dimensionality which makes the modelling of cointegration - particularly when N is large and there are multiple cointegrating vectors, i.e. $N - r > 1$- extremely difficult and often subject to criticism.

Our attempt here is to develop a manageable approach to the problems posed by large datasets where there is cointegration and where such cointegration should be taken into account in modelling the data.[4] In particular, in this paper we study the relationship between dynamic factor models and error correction models. We introduce the Factor-augmented Error Correction Model (FECM), where the factors extracted from a dynamic factor model for a large set of variables in levels are jointly modelled with a limited set of economic variables of main interest.

The FECM represents an improvement with respect to the standard ECM for the subset of variables, since it protects, at least in part, from omitted variable bias and the dependence of cointegration analysis on the specific limited set of variables under analysis. The FECM is also a refinement of dynamic factor models, since it allows us to include the error correction terms into the equations for the key variables under analysis, preventing the errors from being non-invertible MA processes. The FECM can also be considered as a natural generalization of factor-augmented VARs (FAVAR) considered by Bernanke, Boivin and Eliasz (2005), Favero, Marcellino and Neglia (2005) and Stock and Watson (2005). The FAVARs in all of these papers are specified in first differences, so that they are misspecified in the presence of cointegration.

The FECM may be expected to have a vast range of applicability. Therefore, in order to evaluate its relative merits in small, medium and large samples, we conduct a set of Monte Carlo experiments, while to illustrate its use in practice we present two empirical applications with economic data. The first empirical example studies the relationships among four US interest rate series (at different maturities), and proceeds to analyze the relationships among these interest rate series and other macroeconomic variables. The second example reconsiders the famous article by King et al. (1991) on stochastic trends and economic fluctuations in the US economy. In both examples, the factors are estimated from a large set of 110 monthly US macroeconomic variables, extracted from the dataset in Stock and Watson (2005).

The simulation and empirical results show systematic gains in terms of explanatory power from the use of the FECM with respect to both an ECM and a FAVAR model.

The rest of the paper is organized as follows. In Section 2 we introduce the FECM. In Section 3 we discuss a simple analytical example. In Section 4 we present the design and results of the Monte Carlo experiments to evaluate the finite sample performance of the FECM. In Section 5 we discuss the empirical examples. Finally, in Section 6 we summarize and conclude.

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[3] Other papers in this area include Breitung and Das (2005, 2007), Pesaran (2006), Bai, Kao and Ng (2007).

[4] Note that as $N \to \infty$, and the number of factors r remains fixed, the number of cointegrating relations $N - r \to \infty$.

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2 The Factor-augmented Error Correction Model

Let us assume that the N $I(1)$ variables x_t evolve according to the $VAR(p)$ model

$$x_t = \Pi_1 x_{t-1} + \ldots + \Pi_p x_{t-p} + \epsilon_t, \tag{4}$$

where ϵ_t is $i.i.d.(0, \Omega)$ and, for simplicity, the starting values are fixed and equal to zero. The $VAR(p)$ can be reparametrized into the Error Correction Model (ECM)

$$\Delta x_t = \alpha \beta' x_{t-1} + v_t, \tag{5}$$

or in the so-called common trend specification

$$x_t = \Psi f_t + u_t, \tag{6}$$

see, e.g., Johansen (1995, p.49). In particular,

$$\Pi = \sum_{s=1}^{p} \Pi_s - I_n = \underset{N \times N-r}{\alpha} \underset{N-r \times N}{\beta'},$$

$$v_t = \Gamma_1 \Delta x_{t-1} + \ldots + \Gamma_{p-1} \Delta x_{t-p+1} + \epsilon_t, \quad \Gamma_i = -\sum_{s=i+1}^{p} \Pi_s, \quad \Gamma = I - \sum_{s=1+1}^{p-1} \Gamma_i,$$

$$\underset{N \times r}{\Psi} = \beta_\perp (\alpha_\perp' \Gamma \beta_\perp)^{-1}, \quad \underset{r \times 1}{f_t} = \alpha_\perp' \sum_{s=1}^{t} \epsilon_s, \quad u_t = C(L)\epsilon_t,$$

where $N - r$ is the number of cointegrating vectors, r is the number of common stochastic trends (or factors), and the matrix $\alpha_\perp' \Gamma \beta_\perp$ is invertible since each variable is $I(1)$. We also assume that there are no common cycles in the sense of Engle and Kozicki (1993), i.e., no linear combinations of the first differences of the variables that are correlated of lower order than each of the variables (in first differences), although adding such cycles (as in the analytical example below) poses no significant complications and is assumed here only for convenience.[5]

Moreover, without any loss of generality, we impose the identifying condition

$$\underset{N-r \times N}{\beta'} = \left(\underset{N-r \times r}{\beta^{*'}} : \underset{N-r \times N-r}{I} \right).$$

This is standard practice in this literature, as also implemented by Clements and Hendry (1995, page 129, lines 1 - 5) and ensures that the transformation from the levels x_t which are $I(1)$ to $I(0)$-space (involving taking the cointegrated combinations and the differences of the $I(1)$ variables) is scale preserving.

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[5] Common cycles are associated with reduced rank of (some of) the coefficient matrices in $C(L)$, where we remember that the errors in the stochastic trend representation (6) are $u_t = C(L)\epsilon_t$. Therefore, the presence of common cycles is associated with stationary common factors driving x_t, in addition to the I(1) factors.

From (6), partitioning u_t into

$$u_t = \begin{pmatrix} u_{1t} \\ {\scriptstyle r \times 1} \\ u_{2t} \\ {\scriptstyle N-r \times 1} \end{pmatrix},$$

the model for the error correction terms can be written as

$$\beta' x_t = \beta' u_t = \beta^{*'} u_{1t} + u_{2t}. \tag{7}$$

In this model each of the $N - r$ error correction terms depends on a common component that is a function of only r shocks, u_{1t}, and on an idiosyncratic component, u_{2t}. Different normalizations of the cointegrating vectors change the exact shocks that influence each error correction term, but its decomposition into a common component driven by r shocks and an idiosyncratic component remains valid. This is also in line with the stochastic trend representation in (6), where the levels of the variables are driven by r common trends.

Let us now partition the N variables in x_t into the N_A of major interest, x_{At}, and the $N_B = N - N_A$ remaining ones, x_{Bt}. We can partition the common trends model in (6) accordingly as

$$\begin{pmatrix} x_{At} \\ x_{Bt} \end{pmatrix} = \begin{pmatrix} \Psi_A \\ \Psi_B \end{pmatrix} f_t + \begin{pmatrix} u_{At} \\ u_{Bt} \end{pmatrix}, \tag{8}$$

where Ψ_A is of dimension $N_A \times r$ and Ψ_B is $N_B \times r$. Notice that when the number of variables N increases, the dimension of Ψ_A is fixed, while the number of rows of Ψ_B increases correspondingly. Therefore, for (8) to preserve a factor structure asymptotically, driven by r common factors, it is necessary that the rank of Ψ_B remains equal to r. Instead, the rank of Ψ_A can be smaller than r, i.e., x_{At} can be driven by a smaller number of trends, say $r_A \leq r$.

From the specification in (8), it is evident that x_{At} and f_t are cointegrated, while the f_t are uncorrelated random walks. Therefore, from the Granger representation theorem, there must exist an error correction specification of the type

$$\begin{pmatrix} \Delta x_{At} \\ \Delta f_t \end{pmatrix} = \begin{pmatrix} \gamma_A \\ \gamma_B \end{pmatrix} \delta' \begin{pmatrix} x_{At-1} \\ f_{t-1} \end{pmatrix} + \begin{pmatrix} e_{At} \\ e_t \end{pmatrix}. \tag{9}$$

In practice, correlation in the errors of (9) is handled by adding additional lags of the dependent variables, so that the model becomes

$$\begin{pmatrix} \Delta x_{At} \\ \Delta f_t \end{pmatrix} = \begin{pmatrix} \gamma_A \\ \gamma_B \end{pmatrix} \delta' \begin{pmatrix} x_{At-1} \\ f_{t-1} \end{pmatrix} + A_1 \begin{pmatrix} \Delta x_{At-1} \\ \Delta f_{t-1} \end{pmatrix} + ... + A_q \begin{pmatrix} \Delta x_{At-q} \\ \Delta f_{t-q} \end{pmatrix} + \begin{pmatrix} \epsilon_{At} \\ \epsilon_t \end{pmatrix}. \tag{10}$$

We label (10) as a Factor-augmented Error Correction Model (FECM).

Since there are $N_A + r$ dependent variables in the FECM model (10), x_{At} is driven by f_t or a subset of them, and the f_t are uncorrelated random walks, there must be N_A cointegrating relationships in (10). Moreover, since Ψ_A is of dimension $N_A \times r$ but can have reduced rank r_A, there are $N_A - r_A$

cointegrating relationships that involve the x_A variables only, say $\delta'_A x_{At-1}$, and the remaining r_A cointegrating relationships involve x_A and the factors f.

The cointegrating relationships $\delta'_A x_{At-1}$ would also emerge in a standard ECM for Δx_{At} only, say

$$\Delta x_{At} = \alpha_A \delta'_A x_{At-1} + v_{At}. \tag{11}$$

However, in addition to these $N_A - r_A$ relationships, in the FECM there are r_A cointegrating relationships that involve x_{At} and f_t, and that proxy for the potentially omitted $N - N_A$ cointegrating relationships in (11) with respect to the equations for Δx_{At} in the full ECM in (5).[6] Moreover, in the FECM there appear lags of Δf_t as regressors in the equations for Δx_{At}, that proxy for the potentially omitted lags of Δx_{Bt} in the standard ECM for Δx_{At} in (11). Therefore, the FECM provides an improved representation for the variables of interest x_{At}, in terms of modelling both the long-run and short-run evolution of these variables.

It is also important to point out that in the dynamic factor models à la Stock and Watson (2002a, 2002b) and in FAVAR specifications the error correction terms never appear, i.e., $\gamma_A = 0$ is imposed in (10). Therefore, the FECM also represents an improvement for the specification of dynamic factor models and FAVAR models. Moreover, in our context where the Data Generating Process is the common trends specification in (6), standard factor and FAVAR models have two additional substantial problems. In fact, differencing both sides of (6) yields

$$\Delta x_t = \Psi \Delta f_t + \Delta u_t. \tag{12}$$

Therefore, the error term has a non-invertible moving average component that prevents, from a theoretical point of view, the approximation of each equation of the model in (12) with an AR model augmented with lags of the factors. Second, and perhaps even more problematic, in (12) Δf_t and Δu_t are in general not orthogonal to each other, and in fact they can be highly correlated. This feature disrupts the factor structure and, from an empirical point of view, can require a large number of factors to summarize the information contained in Δx_t.

Notice that if the starting model is

$$x_t = \Psi f_t + u_t, \tag{13}$$

but the shocks driving the integrated factors are orthogonal to u_t, so that Δf_t and Δu_t are also orthogonal, then the model in (12) is a proper factor model, but with a non-invertible moving average component. This feature does not pose any additional complications for the estimation of the common component $\Psi \Delta f_t$ either with the static principal component approach of Stock and Watson (2002a,b) or with the dynamic principal component method of Forni et al. (2000, 2005). However, the presence of a unit root in the moving average component still prevents the approximation of each equation of

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[6]In the full ECM model (5), there would be up to $N - r_A$ cointegrating relationships in the equations for Δx_{At}, while in (11) there are only $N_A - r_A$ cointegrating relationships, so that there are $N - N_A$ potentially omitted long run relationships in the ECM for Δx_{At} only.

the model in (12) with an AR model augmented with lags of the factors, while factor augmented AR models have become a standard tool for forecasting.

The FECM also has its problems. In particular, it cannot handle situations where there is a large number of error correction terms affecting each equation, or when the cointegrating relationships include all the variables in x_t and not just the subset x_{At}.

An additional complication for the FECM is that in practice the common stochastic (integrated) factors, f_t, are not known. However, the principal components of x_t are a consistent estimator for (the space spanned by) f_t when N diverges, see e.g. Stock and Watson (1988) and Bai (2004). Moreover, Bai (2004) and Bai and Ng (2006)have shown that, when $\sqrt{T}/N$ is $o_p(1)$, the estimated factors can be used in subsequent analyses without creating any generated regressors problems. Therefore, the estimated factors can be used in the FECM instead of the true factors, assuming that the available dataset is large enough to satisfy the condition $\sqrt{T}/N$ is $o_p(1)$. The role of the use of estimated versus true factors in finite sample is one of the issues explored in the simulation exercise.

3   An analytical example

Before proceeding to the simulations, we first consider a simple analytical example to illustrate the relationships between the ECM representation, the FECM, and the FAVAR. Let us assume that the N variables are generated by the ECM model

$$\Delta x_t = \alpha \beta' x_{t-1} + \epsilon_t, \tag{14}$$

with $\epsilon_t \sim i.i.d.(0, I_N)$, one common stochastic trend ($r = 1$), and

$$\beta' = \begin{pmatrix} -1 & 1 & 0 & 0 & ... & 0 & 0 \\ -1 & 0 & 1 & 0 & ... & 0 & 0 \\ -1 & 0 & 0 & 1 & & & \\ ... & & & & & & \\ -1 & 0 & 0 & 0 & ... & 0 & 1 \end{pmatrix}, \quad \alpha = \begin{pmatrix} 0 & 0 & 0 & ... & 0 \\ -1 & 0 & 0 & ... & 0 \\ -1 & -1 & 0 & ... & 0 \\ -1 & 0 & -1 & & \\ ... & & & & \\ -1 & 0 & 0 & ... & -1 \end{pmatrix}.$$

Therefore, the equations of the ECM are

$$\Delta x_{1t} = \epsilon_{1t} \tag{15}$$
$$\Delta x_{2t} = -(-x_{1t-1} + x_{2t-1}) + \epsilon_{2t}$$
$$\Delta x_{3t} = -(-x_{1t-1} + x_{2t-1}) - (-x_{1t-1} + x_{3t-1}) + \epsilon_{3t}$$
$$\Delta x_{4t} = -(-x_{1t-1} + x_{2t-1}) - (-x_{1t-1} + x_{4t-1}) + \epsilon_{4t}$$
$$...$$
$$\Delta x_{Nt} = -(-x_{1t-1} + x_{2t-1}) - (-x_{1t-1} + x_{Nt-1}) + \epsilon_{Nt}.$$

The stochastic trend representation becomes

$$x_{1t} = \sum_{s=1}^{t} \epsilon_{1s} \tag{16}$$

$$x_{2t} = x_{1t-1} + \epsilon_{2t}$$

$$x_{3t} = x_{1t-1} - \epsilon_{2t-1} + \epsilon_{1t-1} + \epsilon_{3t}$$

$$x_{4t} = x_{1t-1} - \epsilon_{2t-1} + \epsilon_{1t-1} + \epsilon_{4t}$$

$$...$$

$$x_{Nt} = x_{1t-1} - \epsilon_{2t-1} + \epsilon_{1t-1} + \epsilon_{Nt}.$$

From this representation it clearly emerges that the variables are driven by an I(1) common factor, $\sum_{s=1}^{t} \epsilon_{1s}$, and by an I(0) common factor, $\epsilon_{1t} - \epsilon_{2t}$. If we write the model in (16) in a compact notation as

$$x_t = \nu \sum_{s=1}^{t-1} \epsilon_{1s} + \epsilon_t + C_1 \epsilon_{t-1},$$

where $\nu = (1, 1, ..., 1)'$, it clearly emerges that C_1 has reduced rank (equal to one), i.e., there are common cycles in the sense of Engle and Kozicki (1993).

From the stochastic trend representation in (16), we can easily derive that the specification for the error correction terms (cointegrating relationships) $\beta' x_{t-1}$ is given by

$$x_{2t} - x_{1t} = -(\epsilon_{1t} - \epsilon_{2t}) \tag{17}$$

$$x_{3t} - x_{1t} = \epsilon_{1t-1} - \epsilon_{2t-1} - \epsilon_{1t} + \epsilon_{3t}$$

$$x_{4t} - x_{1t} = \epsilon_{1t-1} - \epsilon_{2t-1} - \epsilon_{1t} + \epsilon_{4t}$$

$$...$$

$$x_{Nt} - x_{1t} = \epsilon_{1t-1} - \epsilon_{2t-1} - \epsilon_{1t} + \epsilon_{Nt}.$$

Therefore, the error correction terms are driven by two common I(0) factors, one is the same as for the levels of the variables, $\epsilon_{1t} - \epsilon_{2t}$, the other is the first difference of the common I(1) factor, $\Delta \sum_{s=1}^{t} \epsilon_{1s} = \epsilon_{1t}$.

Substituting the expression in (17) for $\beta' x_{t-1}$ into the ECM in (14), the representation for Δx_t corresponding to (12) is

$$\Delta x_{1t} = \epsilon_{1t} \tag{18}$$

$$\Delta x_{2t} = \epsilon_{1t-1} - \epsilon_{2t-1} + \epsilon_{2t}$$

$$\Delta x_{3t} = \epsilon_{1t-1} - \epsilon_{2t-1} - (\epsilon_{1t-2} - \epsilon_{2t-2}) + \epsilon_{1t-1} + \epsilon_{3t} - \epsilon_{3t-1}$$

$$\Delta x_{4t} = \epsilon_{1t-1} - \epsilon_{2t-1} - (\epsilon_{1t-2} - \epsilon_{2t-2}) + \epsilon_{1t-1} + \epsilon_{4t} - \epsilon_{4t-1}$$

$$...$$

$$\Delta x_{Nt} = \epsilon_{1t-1} - \epsilon_{2t-1} - (\epsilon_{1t-2} - \epsilon_{2t-2}) + \epsilon_{1t-1} + \epsilon_{Nt} - \epsilon_{Nt-1}.$$

A few features of the model in (18) are worth noting. First, the common factors are the same as those in the model for $\beta' x_{t-1}$, namely, $\epsilon_{1t} - \epsilon_{2t}$ and ϵ_{1t}. Second, the common factors have a dynamic impact on the variables. Therefore, the number of static factors à la Stock and Watson (2002a, 2002b) in (18) would be larger than that of dynamic factors à la Forni et al. (2000, 2005). The difference can be substantial in models with more dynamics. Third, the idiosyncratic errors are non-invertible MA(1) in almost all the equations, given by $\epsilon_{it} - \epsilon_{it-1}$. This feature remains valid in models with a more complex dynamics and suggests, as mentioned, that AR approximations to the equations of (18), namely FAVAR models, are inappropriate, at least from a theoretical point of view, when the factor model structure is (at least in part) due to cointegration. Finally, in this example the common factors driving the error correction terms, namely $\epsilon_{1t} - \epsilon_{2t}$ and ϵ_{1t}, are orthogonal to most of the errors $\epsilon_{1t}, \epsilon_{2t}, ..., \epsilon_{Nt}$, which makes (18) a proper factor model. However, as mentioned in the previous Section, typically the model for Δx_t no longer has a factor structure due to correlation between the driving forces of the error correction terms and the errors in the equations for the components of Δx_t.

Let us now assume that we are particularly interested in $x_{At} = (x_{2t}, x_{3t}, x_{4t})'$ and derive the subset ECM model for Δx_{At}. Since the three variables are driven by one stochastic trend, there will be two cointegrating relationships, whose parameters can be set equal to

$$\beta'_A = \begin{pmatrix} -1 & 1 & 0 \\ -1 & 0 & 1 \end{pmatrix}.$$

It can be shown that the pseudo-true values of the loadings of the cointegrating relationships are

$$\alpha_A = \begin{pmatrix} -1/7 & -1/7 \\ 6/7 & -1/7 \\ -1/7 & 6/7 \end{pmatrix}.$$

Hence, the ECM for Δx_{At} is

$$\Delta x_{At} = \alpha_A \beta'_A x_{t-1} + u_t, \tag{19}$$

where the errors follow a complex MA(2) process. Therefore, with respect to the equations for Δx_{At} in the ECM (15) for the whole vector Δx_t, there is a bias both in the long-run and short-run dynamics.

The FECM in this context requires modelling the variables $x_{ft} = (f_{1t}, x_{2t}, x_{3t}, x_{4t})'$, where the stochastic trend model in (16) implies that $f_{1t} = x_{1t-1}$. Therefore, the relevant equations of the FECM are

$$\Delta x_{2t} = -(-f_{1t-1} + x_{2t-1}) + \epsilon_{2t} + \epsilon_{1t-1} \tag{20}$$
$$\Delta x_{3t} = -(-f_{1t-1} + x_{2t-1}) - (-f_{1t-1} + x_{3t-1}) + \epsilon_{3t} + 2\epsilon_{1t-1}$$
$$\Delta x_{4t} = -(-f_{1t-1} + x_{2t-1}) - (-f_{1t-1} + x_{4t-1}) + \epsilon_{4t} + 2\epsilon_{1t-1}.$$

Comparing (20) with the subset of equations for Δx_{At} in the ECM (15), we see that α and β are unaffected, and the errors remain uncorrelated over time. It is worth recalling that both these properties no longer necessarily hold in more complex specifications, e.g., if the variables in x_{At} depend on more than three cointegrating relationships or on the lags of other variables in x_t. Moreover, the standard deviation of the errors in (20) increases with respect to (15), and the errors become correlated across equations. With respect to the corresponding equations in (18), the standard deviation of the errors is larger for Δx_{3t} and Δx_{4t}. It can instead be shown that the standard deviation of the errors of the FECM is smaller than that of the subset ECM in (19).

Finally, it is worth considering the equation for Δf_{1t}. From, (14), it can be written as either

$$\Delta f_{1t} = \epsilon_{1t-1}, \tag{21}$$

or

$$\Delta f_{1t} = -(-f_{1t-1} + x_{2t-1}) - \epsilon_{2t-1}. \tag{22}$$

The two representations are observationally equivalent. The former is in line with the theoretical model (9), and indicates that the changes in the factors should be weakly exogenous for the parameters of the cointegration relationships. However, standard econometric packages for VAR and cointegration analysis will use the latter representation, where Δf_{1t} is instead affected by the error correction term.

4   Monte Carlo experiments

In this section we conduct a set of simulation experiments to evaluate in finite samples the performance of the FECM, relative to that of an ECM and a FAVAR for the same small subset of variables of interest. An important feature to consider in the Monte Carlo design, is the way in which error-correcting or cointegrating information enters into the system for the variables of interest, i.e. whether the cointegrating vectors are common to each variable, or are idiosyncratic, or are a combination of the two. Another important aspect to bear in mind is how much cointegrating information needs to be incorporated, when looking at a sub-system of interest, from outside this sub-system. In the terminology established above, FECM should not in theory be able to handle well situations where there is a large number of error correction terms affecting each equation, or when the cointegrating relationships include all the variables in x_t and not just the subset x_{At}. However, in these cases, which are likely encountered in practical empirical situations, ECM and FAVAR would also experience serious problems. It is therefore worthwhile studying the performance of the alternative estimation methods using both simulations and empirical examples.

4.1 Design of the Monte Carlo

The basic data generating process (DGP) is the error correction mechanism

$$\Delta x_t = \alpha \beta' x_{t-1} + \epsilon_t, \tag{23}$$

where x_t is N-dimensional, α and β are of dimension $N \times N - r$, r is the number of common stochastic trends, and $\epsilon_t \sim N(0, I)$. We fix $r = 1$, set the cointegrating vectors equal to

$$\beta' = \begin{pmatrix} -1 & 1 & 0 & 0 & \dots & 0 & 0 \\ -1 & 0 & 1 & 0 & \dots & 0 & 0 \\ -1 & 0 & 0 & 1 & & & \\ \dots & & & & & & \\ -1 & 0 & 0 & 0 & \dots & 0 & 1 \end{pmatrix},$$

and assume that we are particularly interested in the variables $x_{At} = (x_{2t}, x_{3t}, x_{4t})'$.

We then consider three versions of this DGP, which differ according to the shape of the matrix of loadings, α. In DGP1, α is given by

$$\alpha = \begin{pmatrix} 0 & 0 & 0 & \dots & 0 \\ -1 & 0 & 0 & \dots & 0 \\ 0 & -1 & 0 & \dots & 0 \\ \dots & & & & \\ 0 & 0 & 0 & \dots & -1 \end{pmatrix},$$

so that each cointegrating relationship affects a single variable. This is a simplified version of the analytical example in the previous section. Using techniques similar to those used in the analytical example, it can be shown that the subset ECM for x_{At} leads to biases in α and β, and to correlated errors with a larger variance than those from the FECM. The ranking of the FAVAR and of the FECM should also favour the latter, since the model for Δx_t has a proper factor structure but the errors are non invertible.

The loading matrix for DGP2 is

$$\alpha = \begin{pmatrix} 0 & 0 & 0 & \dots & 0 \\ -1 & 0 & 0 & \dots & 0 \\ -1 & -1 & 0 & \dots & 0 \\ -1 & 0 & -1 & & \\ \dots & & & & \\ -1 & 0 & 0 & \dots & -1 \end{pmatrix},$$

as in the analytical example in the previous section, so that one cointegrating relationship is common while the remaining $N - 2$ relationships are idiosyncratic.

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Finally, in DGP3 we set

$$
\alpha = \begin{pmatrix}
0 & 0 & 0 & ... & ... & ... & ... & ... & 0 & 0 \\
-1 & -1 & -1 & -1 & 0 & 0 & 0 & ... & 0 & 0 \\
0 & -1 & -1 & -1 & -1 & -1 & 0 & ... & ... & 0 \\
0 & 0 & -1 & -1 & -1 & -1 & 0 & 0 & ... & 0 \\
0 & 0 & 0 & 0 & -1 & 0 & 0 & 0 & ... & 0 \\
0 & 0 & 0 & 0 & 0 & -1 & 0 & 0 & ... & 0 \\
. & . & . & . & . & . & . & . & . \\
. & . & . & . & . & . & . & . & . \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & ... & -1
\end{pmatrix}.
$$

This is a case where the ranking of the ECM and FECM is less clear-cut for two reasons. First, the FECM equations should depend on as many error correction terms as modelled variables, four, while at most three error correction terms can be included in the FECM. Second, some of the error correction terms depend on variables not modelled in the FECM, such as x_5 and x_6.

For all three DGPs, we consider the following configurations for T and N: $T \in (50, 100, 200, 500)$ and $N \in (50, 100, 200)$. The number of replications is set to $m = 10000$.

The comparisons between ECM, FECM and FAVAR are based on the residual variances for each estimated equation/variable in x_{At} normalized on the variance obtained from estimating the ECM. Rankings based on the adjusted-R^2 of each equation are qualitatively similar and not reported to save space.

As discussed above, under correct specification as in most of our simulation experiments, the residual variance criterion yields a ranking equivalent to that resulting from a comparison of one-step ahead MSFEs. Instead, the equivalence does not necessarily hold in empirical applications, and therefore we also report the one-step-ahead MSFEs in our empirical examples in Section 5.

In the FECM, the number of cointegrating relationships is taken as given, although the cointegrating vectors and the loading matrix are estimated using maximum likelihood, see Johansen (1995). The factors are estimated from the levels of the data using the methods proposed by Bai (2004). His information criterion IPC_2 is used to select the number of factors.

In the ECM, the number of cointegrating relationships is taken as known. The cointegrating vectors and the loading matrix are again estimated.

Finally, in the FAVAR, the factors are estimated from the first differences of the data using the methods proposed by Stock and Watson (2002a, 2002b). Wherever the number of factors needs to be estimated, i.e. they are not imposed, the choice is based on the PC_2 criterion of Bai and Ng (2002).

4.2 Results

The results of the comparisons are reported in Tables 1 to 3 below. Each table contains, in its sub-panels, the results for each of the three equations (x_{2t}, x_{3t}, x_{4t}), the different methods, and the different combinations of N and T. Table 1 reports the results for DGP 1, where in panel A the

number of factors is assumed known and is imposed while in panel B it is chosen according to Bai's (2004) IPC_2 information criterion when analyzing data in levels and Bai and Ng's (2002) PC_2 criterion for data in differences. We will refer to the two panels of Table 1 as Tables 1A and 1B. Tables 2A and 2B and Tables 3A and 3B report the corresponding results for DGP 2 and DGP 3 respectively. The average number of estimated factors is also reported in each table.

The following main comments on the results can be made. For DGP 1, which is the simplest DGP, Table 1A indicates that FECM clearly dominates ECM and FAVAR, with gains in the order of 16%. FAVAR is better than ECM in all cases but by smaller margins: up to approximately 12%, but mostly in the region of 5%, and close to zero for large values of T This holds when the number of factors is assumed to be known. The relevant panels of Table 1B show however that when the number of factors is estimated, while the dominance of FECM remains, FAVAR is now the worst performing method. Losing the long-run, by estimating the model in differences, is a major loss for the fit of the equations. This matches our predictions from the theory above.

For DGP 2, where the system for the first four variables is still self-contained (in the sense of there not being any extra cointegrating information coming from the rest of the system) but there is idiosyncratic cointegration, FECM continues to dominate FAVAR (except for $T = 50$, when perhaps over-fitting happens because the number of factors is over-estimated by FAVAR). However, the gains are systematically smaller than for DGP1. FAVAR is occasionally worse than ECM, for Δx_{2t}, but on the whole does better than the ECM.

For DGP 3, where each model under comparison is misspecified, there is a interesting dominance of FECM over the other models, with ECM ranked second and FAVAR third. However, the size of the gains from FECM depends on the equation estimated, with gains of only about 4% in the case of equation 3 with large T, but up to about 20% for equation 1.

Overall, the simulation results suggest that the FECM can provide a good modelling choice, even though the best test of its performance is with real economic data which we consider in the next section of the paper.

5   Empirical examples

In this section we present two empirical examples as illustrations of the theoretical and simulation results presented above. The first example analyzes the relationships among US interest rates at different maturities, and among them and macroeconomic variables, an issue that is receiving increasing attention in the literature, see e.g. Diebold, Rudebusch and Arouba (2006) and the references therein. The second example reconsiders the famous article by King et al. (1991) on stochastic trends and economic fluctuations in the US economy.

In both examples, the factors are estimated from a large set of 110 monthly US macroeconomic variables, extracted from the dataset given in Stock and Watson (2005). The time span of the data series is 1959:1 to 2003:12, although for our examples we look only at a smaller interval, starting in the 1985. We focus on the post-1985 period, both to consider a homogenous monetary policy regime

and to avoid the potentially problematic effects of the great moderation on factor estimation. The data series as well as the transformations implemented are listed in Table 4.

The number of factors is estimated using the criteria in Bai (2004) for the I(1) case, and in Bai and Ng (2002) for the stationary case. Specifically, as in the simulations, we use their $IPC2$ and $PC2$ criteria respectively, which seem to have better finite sample properties.

Note that it is not the purpose of the estimation methodology proposed to identify the factors (which are incorporated in the FECM), since the estimated factors are not invariant to rotations of the space of factors. Instead, the factors proxy for and provide independent information on common trends, missing from both the standard ECM and the FAVAR. In particular, since the factors are orthogonal to each other they cannot be cointegrated - i.e. the additional cointegrating relations cannot simply be I(0) combinations of the factors being added, since such combinations are by construction impossible.

For each model, we report the standard R^2, the adjusted R^2 (denoted $\overline{R}^2$) and also the AIC and BIC criteria, in order to provide sufficient information for a comparison of the within-sample performance of each model. In addition, in order to assess the performance of these models in a forecasting context, we also report the MSFE and mean absolute error (MAE) for 1-step-ahead forecasts over the evaluation sample 1999:1 - 2003:12.

We provide a summary of the results in the two panels of Table 5, which will be called Tables 5A and 5B, with further details available from us upon request.

5.1   Interest rates at different maturities

We focus on four interest rates: the fed-fund, the 3-month t-bill rate, and the 1- and 10-year bond rates. Thus, in the notation of Section 2, $N_A = 4$. Over the sample under analysis, the variables tend to move closely together, with some more persistent deviations for the 10-year bond rate.

Empirically, the hypothesis of a unit root cannot be rejected for any series, using a standard ADF test with AIC or BIC lag-length selection. The interesting issue is whether and how many cointegrating relationships there are among the four rates. From a theoretical point of view, the expectational theory of the term structure implies the existence of 3 cointegrating vectors. However, when cointegration is tested with the Johansen (1988) trace statistic in a VAR with AIC or BIC lag-length selection, only two cointegrating vectors are detected (more formally, the hypothesis of at most one cointegrating vector is rejected), at the conventional 10% level. This result, $r_A = 2$ in the notation of Section 2, does not change either with the addition of a lag in the VAR to capture possible serial correlation in the residuals, or when using the maximum eigenvalue version of the test.

The fit of the resulting ECM model, which corresponds to equation (11), is summarized in the first row of the first panel of Table 5A.

A possible rationale for the finding of two cointegrating vectors among the four rates is that the interest rate spreads are likely driven by the evolution of the economic fundamentals, and omitting these variables from the analysis can spuriously decrease the number of cointegrating vectors. To evaluate whether this is the case, we have enlarged the information set with the estimated factors

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from the non-stationary large dataset (that includes the 110 variables less the 4 rates, i.e. $N = 110$ and $N_B = 106$), and jointly modelled the rates and the factors with a FECM, which corresponds to equation (10).

The Bai (2004) criterion suggests a single factor is sufficient to summarize the information in the whole dataset, but since it instead indicates the need for four factors for the subset of real variables (one for the nominal variables), and omitting relevant variables in the FECM is problematic, we prefer to proceed with four factors. In this case, the AIC and BIC criteria for lag-length determination indicate either 3 or 1 lags in the VAR for the rates and the estimated factors, and again we prefer the less parsimonious specification to protect from omitted variable bias and serial correlation in the residuals.

For the FECM, the Johansen trace test indicates 4 cointegrating vectors. This is in line with the theoretical prediction of Section 2 that we should find in the FECM a cointegrating rank equal to N_A. The fit of the resulting FECM is summarized in the second row of Table 5A. There is a systematic increase both in R^2 and in $\overline{R}^2$ with respect to the ECM and, interestingly, the gains increase with the maturity.

Finally, we evaluate a FAVAR model, where the changes in the variables are regressed on their own lags and on lags of estimated factors, using two lags of each regressor as suggested by the information criteria. More precisely, the $N_B = 106$ macroeconomic variables plus the $N_A = 4$ interest rates are assumed to depend on a set of common factors and on an idiosyncratic error. Each variable is properly transformed to achieve stationarity; in particular, the interest rates are first differenced. The factors are estimated as the principal components of the (stationary) variables, while we recall that the factors in the FECM are extracted from the variables in levels. The Bai and Ng (2002) criterion indicates six factors.

From the third row of Table 5A it may be seen that both the R^2 and the $\overline{R}^2$ of the FAVAR are lower than those of the FECM for each of the four interest rates (even though the FECM uses only four factors). The strongest gains from the FECM arise from looking at the 10-year bond rate, which is in some sense an intuitive result given that long-run movements of the stock market are likely to be very relevant for this variable.

The second panel of Table 5A provides information on the computed AIC and BIC for the three models. The AIC ranking is very coherent with that reported in the first panel, while the BIC, which puts a stronger penalty on over-parameterization, prefers the more parsimonious ECM for 3-month and 10-year maturities.

The findings so far confirm empirically that it is important to take cointegration into account. Moreover, we recall that in the presence of cointegration the errors of the model forΔx_t are not invertible, so that they cannot be approximated by an AR process, as in the FAVAR, at least from a theoretical point of view.

The results reported in the third panel of Table 5A are, as expected, more ambiguous with respect to the efficacy of FECM models in a forecasting context. Comparisons of the (one-step ahead) MSFE and MAE criteria show that both the standard ECM and FECM provide better forecasts than FAVAR

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for each maturity. The comparison between the ECM and FECM is more mixed, attributable perhaps to the fact that the factor space is estimated and may thus be susceptible to the presence of structural breaks (which are of course important for forecasting and are not taken account of here). In future research it would be interesting to consider modifications of the FECM model to take account of structural breaks - along the lines of a differenced FECM model (DFECM) to correspond to the Hendry (2006) formulation of a DVECM model described briefly in the introduction, in order to allow for change in the cointegrating or equilibrium information that may have occurred.

5.2 Stochastic trends and economic fluctuations

As a second example, we consider an updated and slightly simplified version of the model in King Plosser Stock Watson (1991, KPSW). KPSW analyzed a system with 6 variables at the quarterly level, over the period 1949-1988: per capita real consumption, per capita gross private fixed investment, per capita "private" gross national product, money supply, inflation and a short term interest rate. They detected three cointegrating vectors, which they identified as a money demand function (where real money depends on GNP and the interest rate), a consumption equation (where the ratio of consumption to GNP depends on the real interest rate), and an investment equation (where the ratio of investment to GNP depends on the real interest rate).

Since we have monthly time series, we focus on four variables ($N_A = 4$): real consumption (C), real personal income (PI), real money (M), and real interest rate (Ri), where the first three variables are expressed in logs. We consider again the sample 1985-2003, and focus on three models: ECM, FECM, and FAVAR.[7]

The AIC and BIC criteria select 2 lags in the VAR, and in this case the Johansen trace test detects two cointegrating vectors, i.e. $r_A = 2$ (more formally, the hypothesis of at most one cointegrating vector is rejected), at the conventional 10% level. The cointegrating vectors are similar to the money demand and consumption equations of KPSW, except that personal income appears not to matter in the former. The fit of the resulting ECM model (the counterpart of the theoretical equation (11)) is summarized in the first row of the first panel of Table 5B.

We then enlarge the information set with the estimated factors from the non-stationary large dataset (that includes the $N = 110$ variables less the $N_A = 4$ variables included in the ECM), and jointly model the four variables and the factors with a FECM (equation (10)). As in the previous example, and not surprisingly since the data are mostly the same, the Bai (2004) criterion suggests a single factor but it indicates four factors for the subset of real variables. Therefore, we proceed with four factors. In this case, the AIC and BIC criteria for lag-length determination indicate either 3 or 2 lags in the extended VAR and, as in the previous example, we prefer the less parsimonious specification to protect from omitted variable bias and serial correlation in the residuals. In this case, the Johansen trace test suggests 4 cointegrating vectors, two more than the standard ECM. This result is again in line with the theoretical prediction of rank equal to N_A. The fit of the resulting

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[7]Comparable results are obtained in a five variable system where the real interest rate is split into the nominal rate and the inflation rate.

FECM is summarized in the second row of Table 5B.

As in the previous example, the performance of the FAVAR is slightly but systematically worse than that of the FECM, which also dominates the ECM in terms of fit.[8] This further reinforces the message that it is important to take cointegration between the variables and the factors explicitly into consideration.

The results reported in the second panel of Table 5B show that the ranking of the models is virtually unaltered according to the AIC, while, as in the case of the previous empirical example, the BIC prefers the more parsimonious ECM in most cases. For each variable, the FAVAR performs worst according to both AIC and BIC.

The final panel of Table 5B reports more mixed results when the models are used for one-step ahead forecasting. In particular, the FAVAR is best for the real interest rate, the ECM for real consumption, and the FECM for personal income and real money. Also in this case the mixed results could be related to the presence of structural breaks, and as above, research into robustifying the FECM to the presence of such breaks is an important element of our future research.

6   Conclusions

In this paper we study the case where a large set of variables are linked by cointegration relationships, which is a very important topic both from a theoretical point of view and for empirical applications. Early studies, such as Stock and Watson (1988), show that (the levels of) each cointegrated variable is driven by a limited number of common integrated trends plus an idiosyncratic stationary error term. Therefore, the variables in levels can be represented as a factor model, where orthogonality between the common and the idiosyncratic components is guaranteed by the fact that the former is integrated while the latter is stationary by construction.

A first result of this paper is to notice that, in general, the factor structure is lost when the differences of the variables are modelled. In fact, even though the first differences of the factors are driving all the variables, they are no longer necessarily orthogonal to the "idiosyncratic" errors. Moreover, even when the factors are orthogonal to the idiosyncratic errors, the latter are non invertible. While this is not a problem for factor estimation, the presence of non-invertible errors does not allow autoregressive approximations of the factor model, FAVAR, which are instead commonly used in the literature.

The presence of the non-invertible errors in the model for the variables in differences is related to the omission of the error correction terms. Hence, we introduce the FECM which requires us to summarize the information in the (levels of the) large set of variables with a limited number of factors, and then to model jointly the factors and the variables of interest with a cointegrated VAR.

The FECM improves upon the standard small scale ECM by protecting from omitted variable bias both in the long run and in the short run. It also improves upon the FAVAR model by taking long run restrictions into explicit account. However, the FECM remains an approximation, which is

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[8] The Bai and Ng (2002) criteria indicate again six factors (extracted from the 106 macroeconomic variables plus the four variables under analysis in this example, after a proper transformation of each variable to achieve stationarity).

expected to work well only under certain conditions, in particular when the few variables of interest are influenced by a limited number of error correction terms.

Both Monte Carlo experiments and empirical analyses show that the FECM performs often better than ECM and FAVAR models.

To conclude, we believe that the FECM represents an interesting modelling approach, and a natural generalization of the FAVAR (to include long run information) and ECM (to include information from a large set of *cointegrated* variables). Because of this, the FECM is of potential usefulness in a wide range of empirical analyses.

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Table 1: Results for DGP1
Ratios of Residual Variances

	A: Number of factors imposed									**B: Number of factors estimated**								
	Equation 1			**Equation 2**			**Equation 3**			**Equation 1**			**Equation 2**			**Equation 3**		
N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW
50	0,823	0,887	50	0,825	0,886	50	0,826	0,894	50	0,833	1,044	50	0,825	1,032	50	0,829	1,041
100	0,838	0,953	100	0,837	0,953	100	0,840	0,952	100	0,838	1,065	100	0,839	1,071	100	0,838	1,069
200	0,842	0,978	200	0,842	0,980	200	0,843	0,980	200	0,842	1,070	200	0,841	1,066	200	0,842	1,073
500	0,845	0,998	500	0,846	0,995	500	0,847	0,996	500	0,847	1,075	500	0,845	1,074	500	0,845	1,073
N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW
50	0,835	0,887	50	0,838	0,886	50	0,836	0,894	50	0,832	1,044	50	0,835	1,032	50	0,836	1,041
100	0,846	0,953	100	0,845	0,953	100	0,845	0,952	100	0,842	1,065	100	0,842	1,071	100	0,842	1,069
200	0,846	0,978	200	0,846	0,980	200	0,849	0,980	200	0,846	1,070	200	0,848	1,066	200	0,849	1,073
500	0,851	0,998	500	0,851	0,995	500	0,851	0,996	500	0,851	1,075	500	0,850	1,074	500	0,852	1,073
N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW
50	0,841	0,895	50	0,837	0,891	50	0,834	0,891	50	0,837	1,059	50	0,833	1,055	50	0,833	1,058
100	0,844	0,947	100	0,844	0,948	100	0,843	0,947	100	0,847	1,069	100	0,849	1,072	100	0,847	1,068
200	0,848	0,975	200	0,848	0,974	200	0,848	0,973	200	0,851	1,073	200	0,851	1,070	200	0,851	1,067
500	0,852	0,991	500	0,853	0,992	500	0,853	0,991	500	0,853	1,071	500	0,852	1,072	500	0,853	1,071

k_estim

N=50 T	FECM SW	FAVAR SW		N=100 T	FECM SW	FAVAR SW		N=200 T	FECM SW	FAVAR SW
50	1	1,6		50	1	1,172		50	1	1,006
100	1	1,001		100	1	1		100	1	1
200	1	1		200	1	1		200	1	1
500	1	1		500	1	1		500	1	1

Notes: Each cell of the table (i.e. for each equation, estimation method and (N, T) configuration) in the panel labelled 'Ratios of residual variances' records the residual variance of the equation relative to the residual variance obtained from estimating the sub-set ECM consisting of (x(2t), x(3t), x(4t)) only for the same configuration.
Equation 1 refers to the equation for x(2t), Equation 2 to x(3t) and Equation 3 to x(4t).
FECM-SW estimates the factor error-correction model with the factors extracted from the levels of the data according to Bai (2004).
FAVAR-SW estimates factor augmented VAR model with factors extracted from differences of the data according to Stock and Watson (2002)
The panel labelled k_estim records the number of estimated factors

Table 2: Results for DGP2
Ratios of Residual Variances

	A: Number of factors imposed										**B: Number of factors estimated**								

	Equation 1			**Equation 2**			**Equation 3**			**Equation 1**			**Equation 2**			**Equation 3**	
N=50	FECM	FAVAR	N=50	FECM	FAVAR	N=50	FECM	FAVAR	N=50	FECM	FAVAR	N=50	FECM	FAVAR	N=50	FECM	FAVAR
T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW
50	0,912	0,998	50	0,898	0,888	50	0,895	0,886	50	0,918	0,692	50	0,898	0,630	50	0,900	0,626
100	0,943	1,053	100	0,924	0,947	100	0,925	0,947	100	0,943	0,960	100	0,927	0,857	100	0,926	0,856
200	0,955	1,074	200	0,938	0,971	200	0,938	0,972	200	0,954	1,063	200	0,939	0,964	200	0,938	0,964
500	0,961	1,090	500	0,943	0,988	500	0,943	0,988	500	0,961	1,092	500	0,943	0,993	500	0,944	0,993
N=100	FECM	FAVAR	N=100	FECM	FAVAR	N=100	FECM	FAVAR	N=100	FECM	FAVAR	N=100	FECM	FAVAR	N=100	FECM	FAVAR
T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW
50	0,916	0,998	50	0,898	0,888	50	0,899	0,886	50	0,911	0,692	50	0,894	0,630	50	0,894	0,626
100	0,945	1,053	100	0,929	0,947	100	0,929	0,947	100	0,946	0,960	100	0,927	0,857	100	0,928	0,856
200	0,958	1,074	200	0,942	0,971	200	0,941	0,972	200	0,957	1,063	200	0,940	0,964	200	0,940	0,964
500	0,965	1,090	500	0,948	0,988	500	0,948	0,988	500	0,965	1,092	500	0,948	0,993	500	0,949	0,993
N=200	FECM	FAVAR	N=200	FECM	FAVAR	N=200	FECM	FAVAR	N=200	FECM	FAVAR	N=200	FECM	FAVAR	N=200	FECM	FAVAR
T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW	T	SW	SW
50	0,915	0,997	50	0,899	0,879	50	0,898	0,886	50	0,917	0,671	50	0,900	0,609	50	0,898	0,606
100	0,947	1,058	100	0,931	0,947	100	0,932	0,948	100	0,945	0,945	100	0,931	0,840	100	0,932	0,842
200	0,960	1,080	200	0,945	0,974	200	0,944	0,974	200	0,961	1,059	200	0,945	0,951	200	0,945	0,954
500	0,966	1,088	500	0,951	0,989	500	0,951	0,988	500	0,966	1,094	500	0,949	0,992	500	0,949	0,992

k_estim

N=50	FECM	FAVAR		N=100	FECM	FAVAR		N=200	FECM	FAVAR
T	SW	SW		T	SW	SW		T	SW	SW
50	1	5,941		50	1	6		50	1	6
100	1	5,212		100	1	5,686		100	1	6
200	1	2,777		200	1	2,997		200	1	3,747
500	1	1		500	1	1		500	1	1

Notes: See notes to Table 1

Table 3: Results for DGP3
Ratios of Residual Variances

A: Number of factors imposed

Equation 1			Equation 2			Equation 3		
N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW
50	0,820	1,198	50	0,891	1,159	50	0,918	1,108
100	0,807	1,012	100	0,890	1,086	100	0,942	1,064
200	0,806	0,973	200	0,890	1,072	200	0,955	1,061
500	0,806	0,963	500	0,889	1,064	500	0,961	1,060
N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW
50	0,813	1,179	50	0,889	1,141	50	0,915	1,090
100	0,808	1,012	100	0,891	1,092	100	0,940	1,069
200	0,808	0,975	200	0,890	1,074	200	0,955	1,065
500	0,809	0,966	500	0,890	1,072	500	0,962	1,067
N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW
50	0,815	1,195	50	0,892	1,142	50	0,918	1,091
100	0,808	1,004	100	0,890	1,085	100	0,940	1,064
200	0,809	0,973	200	0,890	1,074	200	0,953	1,065
500	0,810	0,966	500	0,890	1,074	500	0,961	1,070

B: Number of factors estimated

Equation 1			Equation 2			Equation 3		
N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW	N=50 T	FECM SW	FAVAR SW
50	0,680	1,006	50	0,733	0,888	50	0,755	0,846
100	0,734	0,908	100	0,809	0,945	100	0,862	0,936
200	0,735	0,929	200	0,811	0,988	200	0,873	0,985
500	0,687	0,934	500	0,755	0,989	500	0,814	0,993
N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW
50	0,720	0,996	50	0,775	0,879	50	0,805	0,850
100	0,749	0,913	100	0,823	0,945	100	0,877	0,944
200	0,752	0,932	200	0,827	0,997	200	0,888	0,993
500	0,733	0,940	500	0,806	1,004	500	0,869	1,004
N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW
50	0,722	0,997	50	0,777	0,876	50	0,799	0,838
100	0,742	0,917	100	0,811	0,949	100	0,860	0,945
200	0,757	0,929	200	0,830	0,989	200	0,889	0,987
500	0,756	0,942	500	0,832	1,011	500	0,895	1,008

k_estim

N=50 T	FECM SW	FAVAR SW	N=100 T	FECM SW	FAVAR SW	N=200 T	FECM SW	FAVAR SW
50	2,442	5,982	50	2,128	6	50	2,005	6
100	2,034	5,685	100	2	5,911	100	2	6
200	2	3,955	200	2	4,03	200	2	4,598
500	2	3,002	500	2	3	500	2	3

Notes: See notes to Table 1

Table 4: Dataset for the empirical examples

Code	Short Descrip.	Nom	Real	Fin	Tcode I(0) dataset	Tcode I(1) dataset	Code	Short Descrip.	Nom	Real	Fin	Tcode I(0) dataset	Tcode I(1) dataset
a0m052	PI	0	1	0	5	4	HSBR	BP: total	0	1	0	4	4
A0M051	PI less transfers	0	1	0	5	4	HSBNE	BP: NE	0	1	0	4	4
A0M224_R	Consumption	0	1	0	5	4	HSBMW	BP: MW	0	1	0	4	4
A0M057	M&T sales	0	1	0	5	4	HSBSOU	BP: South	0	1	0	4	4
A0M059	Retail sales	0	1	0	5	4	HSBWST	BP: West	0	1	0	4	4
IPS10	IP: total	0	1	0	5	4	PMI	PMI	0	1	0	1	1
IPS11	IP: products	0	1	0	5	4	PMNO	NAPM new ordrs	0	1	0	1	1
IPS299	IP: final prod	0	1	0	5	4	PMDEL	NAPM vendor del	0	1	0	1	1
IPS12	IP: cons gds	0	1	0	5	4	PMNV	NAPM Invent	0	1	0	1	1
IPS13	IP: cons dble	0	1	0	5	4	A0M008	Orders: cons gds	0	1	0	5	4
IPS18	iIP:cons nondble	0	1	0	5	4	A0M007	Orders: dble gds	0	1	0	5	4
IPS25	IP:bus eqpt	0	1	0	5	4	A0M027	Orders: cap gds	0	1	0	5	4
IPS32	IP: matls	0	1	0	5	4	A1M092	Unf orders: dble	0	1	0	5	4
IPS34	IP: dble mats	0	1	0	5	4	A0M070	M&T invent	0	1	0	5	4
IPS38	IP:nondble mats	0	1	0	5	4	A0M077	M&T invent/sales	0	1	0	2	1
IPS43	IP: mfg	0	1	0	5	4	FM1	M1	1	0	0	6	5
IPS307	IP: res util	0	1	0	5	4	FM2	M2	1	0	0	6	5
IPS306	IP: fuels	0	1	0	5	4	FM3	M3	1	0	0	6	5
PMP	NAPM prodn	0	1	0	1	1	FM2DQ	M2 (real)	1	0	0	5	4
A0m082	Cap util	0	1	0	2	1	FMFBA	MB	1	0	0	6	5
LHEL	Help wanted indx	0	1	0	2	1	FMRRA	Reserves tot	1	0	0	6	5
LHELX	Help wanted/emp	0	1	0	2	1	FMRNBA	Reserves nonbor	1	0	0	6	5
LHEM	Emp CPS total	0	1	0	5	4	FCLNQ	C&I loans	1	0	0	6	5
LHNAG	Emp CPS nonag	0	1	0	5	4	FCLBMC	C&I loans	1	0	0	1	1
LHUR	U: all	0	1	0	2	1	CCINRV	Cons credit	1	0	0	6	5
LHU680	U: mean duration	0	1	0	2	1	A0M095	Inst cred/PI	1	0	0	2	1
LHU5	U < 5 wks	0	1	0	5	4	FYFF	FedFunds	0	0	1	2	1
LHU14	U 5-14 wks	0	1	0	5	4	FYGM3	3 mo T-bill	0	0	1	2	1
LHU15	U 15+ wks	0	1	0	5	4	FYGT1	1 yr T-bond	0	0	1	2	1
LHU26	U 15-26 wks	0	1	0	5	4	FYGT10	10 yr T-bond	0	0	1	2	1
LHU27	U 27+ wks	0	1	0	5	4	PWFSA	PPI: fin gds	1	0	0	6	5
A0M005	UI claims	0	1	0	5	4	PWFCSA	PPI: cons gds	1	0	0	6	5
CES002	Emp: total	0	1	0	5	4	PWIMSA	PPI: int mat'ls	1	0	0	6	5
CES003	Emp: gds prod	0	1	0	5	4	PWCMSA	PPI: crude mat'ls	1	0	0	6	5
CES006	Emp: mining	0	1	0	5	4	PSCCOM	Commod: spot price	1	0	0	6	5
CES011	Emp: const	0	1	0	5	4	PSM99Q	Sens mat'ls price	1	0	0	6	5
CES015	Emp: mfg	0	1	0	5	4	PMCP	NAPM com price	1	0	0	1	1
CES017	Emp: dble gds	0	1	0	5	4	PUNEW	CPI-U: all	1	0	0	6	5
CES033	Emp: nondbles	0	1	0	5	4	PU83	CPI-U: apparel	1	0	0	6	5
CES046	Emp: services	0	1	0	5	4	PU84	CPI-U: transp	1	0	0	6	5
CES048	Emp: TTU	0	1	0	5	4	PU85	CPI-U: medical	1	0	0	6	5
CES049	Emp: wholesale	0	1	0	5	4	PUC	CPI-U: comm.	1	0	0	6	5
CES053	Emp: retail	0	1	0	5	4	PUCD	CPI-U: dbles	1	0	0	6	5
CES088	Emp: FIRE	0	1	0	5	4	PUS	CPI-U: services	1	0	0	6	5
CES140	Emp: Govt	0	1	0	5	4	PUXF	CPI-U: ex food	1	0	0	6	5
A0M048	Emp-hrs nonag	0	1	0	5	4	PUXHS	CPI-U: ex shelter	1	0	0	6	5
CES151	Avg hrs	0	1	0	1	1	PUXM	CPI-U: ex med	1	0	0	6	5
CES155	Overtime: mfg	0	1	0	2	1	GMDC	PCE defl	1	0	0	6	5
aom001	Avg hrs: mfg	0	1	0	1	1	GMDCD	PCE defl: dlbes	1	0	0	6	5
PMEMP	NAPM empl	0	1	0	1	1	GMDCN	PCE defl: nondble	1	0	0	6	5
HSFR	HStarts: Total	0	1	0	4	4	GMDCS	PCE defl: services	1	0	0	6	5
HSNE	HStarts: NE	0	1	0	4	4	CES275	AHE: goods	1	0	0	6	5
HSMW	HStarts: MW	0	1	0	4	4	CES277	AHE: const	1	0	0	6	5
HSSOU	HStarts: South	0	1	0	4	4	CES278	AHE: mfg	1	0	0	6	5
HSWST	HStarts: West	0	1	0	4	4	HHSNTN	Consumer expect	0	1	0	2	1

Notes

Transformation codes: 1 no transformation; 2 first difference; 3 second difference;
4 logarithm; 5 first difference of log; 6 second difference of log.
Dataset extracted from Stock and Watson (2005). Sample is 1985:1-2003:12

Table 5. Empirical analyses

A - Alternative models for interest rates

	R-squared				Adjusted R-squared			
	FF	3m	1y	10y	FF	3m	1y	10y
ECM (1 lag, 2 coint.)	0.41	0.31	0.23	0.11	0.40	0.29	0.21	0.09
FECM (2 lags, 4 facs-lev, 4 coint.)	0.49	0.42	0.40	0.31	0.44	0.36	0.34	0.24
FAVAR (2 lags, 6 facs)	0.46	0.41	0.37	0.25	0.41	0.35	0.31	0.17

	AIC				BIC			
	FF	3m	1y	10y	FF	3m	1y	10y
ECM (1 lag, 2 coint.)	-0,42	-0,52	0,09	0,14	-0,29	-0,39	0,22	0,27
FECM (2 lags, 4 facs-lev, 4 coint.)	-0,65	-0,65	-0,18	0,002	-0,33	-0,33	0,14	0,32
FAVAR (2 lags, 6 facs)	-0,59	-0,63	-0,14	0,09	-0,27	-0,32	0,18	0,41

	MSE				MAE			
	FF	3m	1y	10y	FF	3m	1y	10y
ECM (1 lag, 2 coint.)	0,016	0,031	0,043	0,069	0,098	0,135	0,162	0,211
FECM (2 lags, 4 facs-lev, 4 coint.)	0,033	0,023	0,037	0,101	0,146	0,119	0,155	0,249
FAVAR (2 lags, 6 facs)	0,024	0,032	0,046	0,087	0,133	0,143	0,171	0,239

Note:
FF is the federal fund rate while 3m, 1y and 10y are, respectively, three month, 1 year and 10 year treasury bill rates
Information criteria are defined as minus log likelihood plus penalty function, hence should be minimized
MSE and MAE are for 1-step ahead forecasts (for interest rates in levels) over the sample 1999:1-2003:12.

B - alternative models for KPSW example

	R-squared				Adjusted R-squared			
	C	PI	M	Ri	C	PI	M	Ri
ECM (1 lag, 2 coint.)	0.16	0.13	0.32	0.38	0.13	0.10	0.30	0.36
FECM (2 lags, 4 facs-lev, 4 coint.)	0.28	0.18	0.50	0.47	0.21	0.10	0.45	0.41
FAVAR (2 lags, 6 facs)	0.26	0.18	0.40	0.37	0.19	0.10	0.34	0.31

	AIC				BIC			
	C	PI	M	Ri	C	PI	M	Ri
ECM (1 lag, 2 coint.)	-7,78	-7,54	-8,65	4.33	-7,68	-7,43	-8,55	4,44
FECM (2 lags, 4 facs-lev, 4 coint.)	-7,81	-7,49	-8,85	4,31	-7,49	-7,17	-8,53	4,62
FAVAR (2 lags, 6 facs)	-7,79	-7,47	-8,66	4,47	-7,47	-7,15	-8,33	4,79

	MSE				MAE			
	C	PI	M	Ri	C	PI	M	Ri
ECM (1 lag, 2 coint.)	0,180	0,338	0,246	27,010	0,332	0,506	0,324	3,985
FECM (2 lags, 4 facs-lev, 4 coint.)	0,309	0,124	0,216	34,906	0,427	0,279	0,322	4,464
FAVAR (2 lags, 6 facs)	0,243	0,141	0,224	9,363	0,376	0,295	0,316	2,369

Note:
C is per capita real consumption, PI per capita real personal income, M real money, and Ri real interest rate
Information criteria are defined as minus log likelihood plus penalty function, hence should be minimized
MSE and MAE are for 1-step ahead forecasts of growth in C, PI, M and change in Ri over the sample 1999:1-2003:12.
MSEs for C, PI and M are multiplied by 10000, MAE by 100