

# Introduction to Machine Learning for Economists and Business Analysts

Anthony Strittmatter

# Zoom

Zoom Link:

<https://unibas.zoom.us/j/67539634534?pwd=S0F2cFBwWEp2UDI3cWg4YmVEM2VVQT09>

ID: 675 3963 4534

Password: ML\_eco\_bui

## Anthony Strittmatter

**Research Interests:** Business, Labour, and Health Economics, Program Evaluation, Computational Data Analytics

### Positions:

- Since 2020 Assistant Professor at the Institut Polytechnique in Paris, Center for Research in Economics and Statistics (CREST)
- 2014-2020 University of St.Gallen, with research visits at UC Berkeley, Stanford University, and Ludwig Maximilian University of Munich
- 2009-2016 Albert-Ludwig University of Freiburg

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# Course Outline

- ▶ **Lecture 1:** Introduction to Statistical Learning
- ▶ **Lecture 2-4:** Supervised Machine Learning
  - ▶ Penalized Regression
  - ▶ Trees and Random Forest
- ▶ **Lecture 5:** Unsupervised Machine Learning
  - ▶ Clustering
  - ▶ Principal Component Analysis
- ▶ **Lecture 6:** Reinforcement Learning
  - ▶ Bandit Algorithm

# Schedule

	<b>Monday July 19</b>	<b>Tuesday July 20</b>	<b>Wednesday July 21</b>	<b>Thursday July 22</b>	<b>Friday July 23</b>
<b>3:15-4:45pm CEST</b> <b>5:15-6:45pm CEST</b>	Lecture 1 Lecture 2	Lecture 3 PC Lab 1	Lecture 4 PC Lab 2	Lecture 5 PC Lab 3	Lecture 6 PC Lab 4

# PC Labs

- ▶ PC labs are integral part of the course.
- ▶ I will provide the entire course material on my GitHub repository:  
<https://github.com/AStrittmatter/Wuerzburg>
- ▶ I will use interactive Jupyter notebooks during the PC labs:  
<https://mybinder.org/v2/gh/AStrittmatter/Wuerzburg/HEAD>
- ▶ The advantage of the notebooks is that you do not need to install anything and the data is in the correct folder.
- ▶ However, in case the connection to the server is weak I also provide an R-file for download on my GitHub repository. To use it, you need to install R and RStudio on your PC. These are both open source softwares.

# Participation Certificate

- ▶ Home assignment after the course.
- ▶ Deadline for submission: Friday, July 25, 2021

# General

- ▶ Feel free to interrupt me at any time when you have questions.
- ▶ Tell me when I'm too slow or too fast. Ask me to repeat material in case something was not clear.
- ▶ You can also send me an email with questions:  
`anthony.strittmatter@ensae.fr`
- ▶ Proposals to improve the course are also welcome.
- ▶ Please try to interact as much as possible with your fellow students.  
Build learning groups.



# References

- ▶ Mullainathan and Spiess (2017): “Machine Learning: An Applied Econometric Approach”, Journal of Economic Perspectives, 31 (2), pp. 87-106, [download](#).
- ▶ Athey (2017): “Beyond Prediction: Using Big Data for Policy Problems”, Science, 355 (6324), pp. 483-485, [download](#).

# What is Machine Learning (ML)?

- ▶ ML (or statistical learning) methods exist already since decades.
- ▶ Currently "Machine Learning" is a buzz word
- ▶ Probably most people think of ML as some computational intensive methods that make data-driven modelling decisions and/or can deal with large data amounts.
- ▶ However, relevant textbooks consider even OLS/Logit as a statistical learning tool.

# Purpose of Machine Learning

- ▶ Consider the structural model

$$Y = f(X) + \epsilon = X\beta + \epsilon,$$

with  $E[\epsilon] = 0$ .

- ▶ Causal analysis has the purpose to estimate  $\hat{\beta}$ , with  $plim(\hat{\beta}) = \beta$ .
- ▶ **Machine learning** has the purpose to predict  $Y$ .
- ▶ There is a clear link between causal analysis and machine learning, because

$$\hat{Y} = \hat{f}(X) = X\hat{\beta}$$

is a potential predictor for  $Y$ .

- ▶ Parameter consistency has not the highest priority when it comes to predictions.

# Potential Advantages and Disadvantages of ML

- ▶ ML methods can be very powerful to predict  $Y$ , even when  $\hat{\beta}$  is biased.
- ▶ ML methods can incorporate many (or even high-dimensional) covariates  $X$  in a convenient way.
- ▶ ML methods can model  $\hat{f}(\cdot)$  in a very flexible and data-driven way.
- ▶ **Main disadvantage:** ML is a black-box approach and we lose the interpretability of  $\hat{f}(\cdot)$  or  $\hat{\beta}$ .

# Prediction vs. Causality



# Causal vs. Predictive Questions

## Predictive Questions:

- ▶ How will the oil price change tomorrow (forecasting)?
- ▶ How high is the current unemployment rate (nowcasting)?
- ▶ Which adolescents have a high probability of becoming addicted to drugs (policy prediction)?

## Causal Questions:

- ▶ What is the effect of a tweet by president Donald Trump on oil prices?
- ▶ How does inflation affect the unemployment rate?
- ▶ Can prevention programs reduce the probability of drug addiction among high risk youths?

# Assessing the Model Accuracy

## Causal Analysis:

- ▶ True  $\beta$  is unobservable.
- ▶ Assess the model with asymptotic properties

$$\sqrt{N}(\hat{\beta} - \beta) \xrightarrow{d} N(0, \sigma^2).$$

- ▶ Finite sample biases are mostly neglected.

# Assessing the Model Accuracy

## Prediction:

- ▶ We observe  $Y$  for each unit (e.g. individual).
- ▶ We can assess the model accuracy directly in the sample of our analysis, for example, using the mean-squared-error (MSE)

$$\frac{1}{N} \sum_{i=1}^N (Y_i - \hat{Y}_i)^2.$$

- ▶ MSE accounts for finite sample biases.



## Example: Prediction of Used Car Prices

- ▶ We have access to web-scraped data from the online advertisement platform *myLemons*.
- ▶ We want to predict asking prices of used cars based on observable characteristics.
- ▶ We observe around 40 covariates about car brand, mileage, age, emissions, maintenance certificate, seller type, guarantee, etc. (including several non-linear and interaction terms)

# In-Sample MSE

- ▶ Partition data into training and test sample
- ▶ In the training sample, we estimate the empirical model

$$Y_{tr} = \hat{f}_{tr}(X_{tr}) + \hat{\epsilon}_{tr} = X_{tr}\hat{\beta}_{tr} + \hat{\epsilon}_{tr}$$

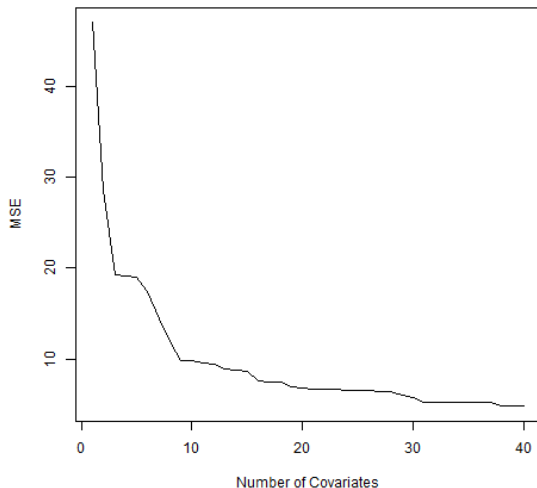
- ▶ In the training sample, we predict the fitted values

$$\hat{Y}_{tr} = \hat{f}_{tr}(X_{tr}) = X_{tr}\hat{\beta}_{tr}$$

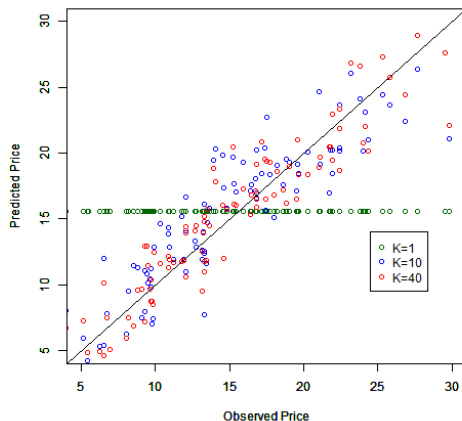
and calculate the MSE

$$\widehat{MSE}_{tr} = \frac{1}{N_{tr}} \sum_{i=1}^{N_{tr}} (Y_{i,tr} - \hat{Y}_{i,tr})^2.$$

# MSE in Training Sample



# Predicted Car Prices in Training Sample



Number of Covariates	1	10	40
MSE	46.948	9.819	4.866

# Out-of-Sample MSE

- In the training sample, we estimate the empirical model

$$Y_{tr} = \hat{f}_{tr}(X_{tr}) + \hat{\epsilon}_{tr} = X_{tr}\hat{\beta}_{tr} + \hat{\epsilon}_{tr}$$

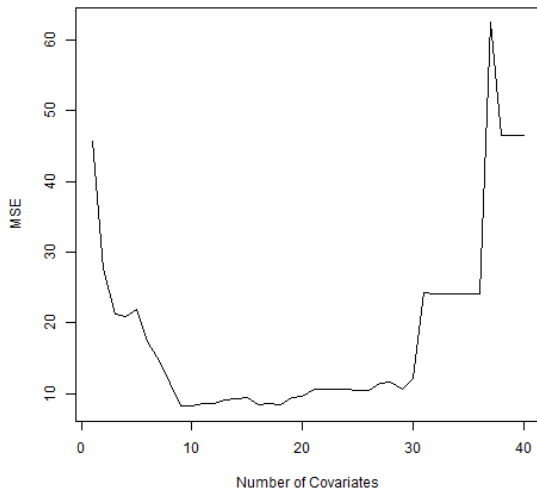
- In the test sample, we predict the fitted values

$$\hat{Y}_{te} = \hat{f}_{tr}(X_{te}) = X_{te}\hat{\beta}_{tr}$$

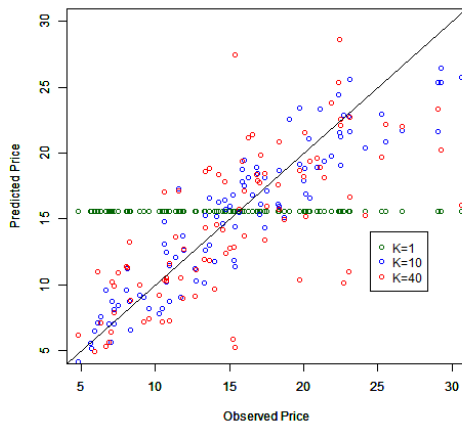
and calculate the MSE

$$\widehat{MSE}_{te} = \frac{1}{N_{te}} \sum_{i=1}^{N_{te}} (Y_{i,te} - \hat{Y}_{i,te})^2.$$

# MSE in Test Sample



# Predicted Car Prices in Test Sample



Number of Covariates	1	10	40
MSE	45.742	8.222	46.499

# Bias-Variance Trade-Off

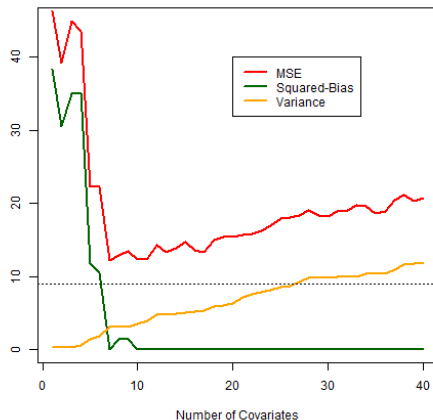
- When we assess the model for one randomly drawn individual from the test sample with fixed characteristics  $x_{te}$ , then we can decompose the MSE to

$$\begin{aligned}MSE_{te} &= E[(Y_{te} - \hat{Y}_{te})^2] \\&= E[(f(x_{te}) + \epsilon_{te} - \hat{f}_{tr}(x_{te}))^2] \\&= \underbrace{E[(f(x_{te}) - \hat{f}_{tr}(x_{te}))^2]}_{\text{Reducible}} + \underbrace{Var(\epsilon_{te})}_{\text{Irreducible}} \\&= \underbrace{E[f(x_{te}) - \hat{f}_{tr}(x_{te})]^2}_{\text{Squared-Bias}} + \underbrace{Var(\hat{f}_{tr}(x_{te}))}_{\text{Variance}} + Var(\epsilon_{te})\end{aligned}$$

- For i.i.d. data,  $\hat{f}_{tr}(\cdot)$  and  $\epsilon_{te}$  are independent of each other.



# Simulation of Bias-Variance Trade-Off



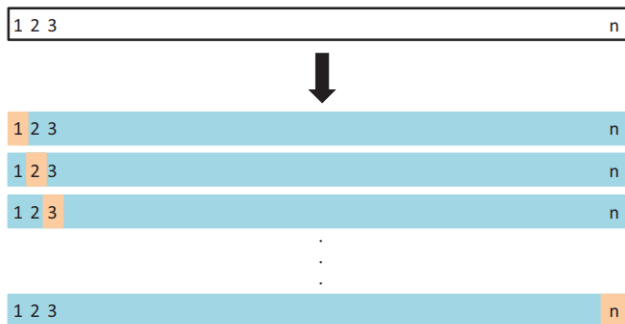
- Only the first ten covariate have an impact on car prices in the simulation.
- Horizontal dashed line is the simulated noise  $Var(\epsilon_{te})$ .

# Lasso Example

$$\arg \min_{\beta} \left\{ \sum_{i=1}^N \left( Y_i - \beta_0 - \sum_{j=1}^p X_{ij} \beta_j \right)^2 + \lambda \sum_{j=1}^p |\beta_j| \right\}$$

	OLS	Lasso
Intercept	21.246	22.776
diesel	2.075	.
other_car_owner	0.730	.
pm_green	1.635	.
private_seller	6.100	0.076
guarantee	-2.440	-0.437
inspection	-0.813	.
maintenance_cert	1.481	.
mileage	-0.049	-0.031
age_car_years	-1.291	-1.012
$R^2$ training	0.655	0.543
$R^2$ test	0.606	0.611

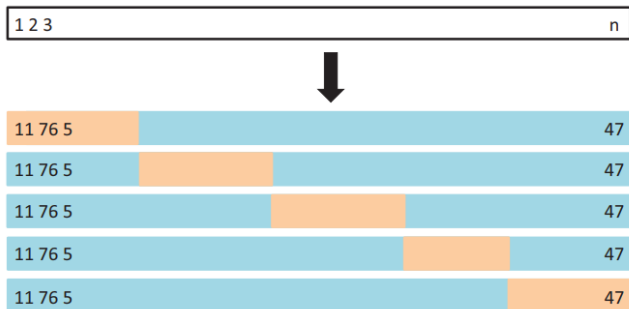
# Leave-One-Out Cross-Validation



Source: James et al. (2013), p. 179

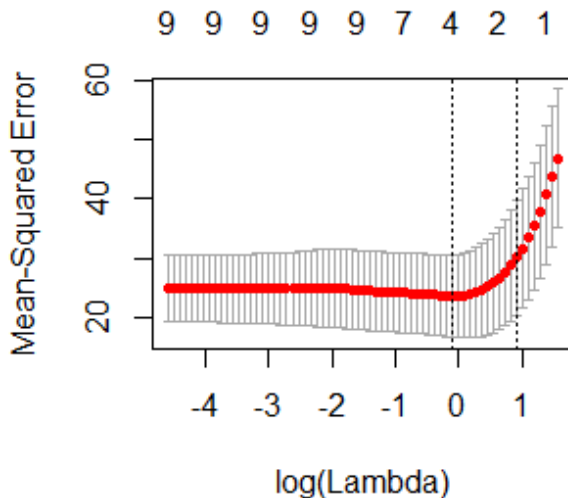
# Selection of Optimal Penalty Parameter

## k-fold Cross-Validation (CV) Algorithm



Source: James et al. (2013), p. 181

# Cross-Validated MSE



# Stability of the Lasso Model

	Lasso 1	Lasso 2	Lasso 3	Lasso 4	Lasso 5
Intercept	22.776	25.947	24.937	27.309	25.116
diesel	.	.	2.387	.	0.886
other_car_owner	.	-1.257	0.393	.	.
pm_green	.	2.871	.	.	.
private_seller	0.076	5.094	.	-1.037	.
guarantee	-0.437	1.677	15.939	.	.
inspection	.	-0.666	-0.374	.	.
maintenance_cert	.	-2.579	-0.868	.	.
mileage	-0.031	-0.037	-0.041	-0.069	-0.062
age_car_years	-1.012	-1.347	-1.416	-0.874	-1.115

- We do not learn the “true” structural model from ML
- ML is a black-box approach

# Stability of the Lasso Predictions

**Correlation of Predicted Car Prices in Test Sample:**

	Lasso 1	Lasso 2	Lasso 3	Lasso 4
Lasso 2	0.94			
Lasso 3	0.85	0.81		
Lasso 4	0.97	0.91	0.85	
Lasso 5	0.99	0.94	0.87	0.99

# When could Predictions be Useful?

Tasks with a prediction purpose:

- ▶ Predict stock or commodity prices using Twitter data.
- ▶ Nowcasting unemployment rate or GDP using Google search queries.
- ▶ Pre-screening of job applications.
- ▶ Consumer demand (shipping before the order occurs).
- ▶ Movie recommendations on Netflix.
- ▶ Handwriting, image, face, or voice recognition.
- ▶ Generating data



# Examples of Business and Economic Studies

## Prediction Tasks:

- ▶ [Chandler, Levitt, and List \(2011\)](#) predict shootings among high-risk youth to target mentoring interventions.
- ▶ [Kleinberg, et al. \(2018\)](#) predict the crime probability of defendants released from investigative custody to improve judge decisions.

## Pre-Processing Unstructured Data:

- ▶ [Glaeser et al. \(2016\)](#) use images from Google Street View to measure block-level income in New York City and Boston.
- ▶ [Kang et al. \(2013\)](#) use restaurant reviews on Yelp.com to predict the outcome of hygiene inspections.
- ▶ [Kogan et al. \(2009\)](#) predict volatility of firms from market-risk disclosure texts (annual 10-K forms).