Lecture 9:
Bayesian Estimation: Direct Sampling

Big Data and Machine Learning for Applied Economics
Econ 4676

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Agenda

Bayesian Estimation

- *Bayes Theorem*

$$\pi(\beta|X) = \frac{f(X|\beta)p(\beta)}{m(X)} \tag{1}$$

- with $m(X)$ is the marginal distribution of X, i.e.

$$m(X) = \int f(X|\beta)p(\beta)d\beta \tag{2}$$

- Bayes' theorem does not tell us what our beliefs should be, it tells us how they should change after seeing new information.

Frequentist Approach

- Suppose the model is

$$y_i = \beta x_i + u_i \tag{3}$$

$$u_i \sim N(0, \sigma^2) \tag{4}$$

$$\sigma^2 \text{ is known} \tag{5}$$

- Interest is on some form of $h(\beta)$ e.g. $|\beta|$
- Frequentists
  - $\hat{\beta}_{MLE} = (X'X)^{-1}X'y$
  - then use the Delta method (or bootsrap?)
- Bayesians
  - Using simulation based methods $\rightarrow$ direct sampling algorithm

Simulation methods

- Bayesians specify a prior distribution $\beta \sim N(\beta_0, \tau^2)$
- Use conjugate priors and get the posterior

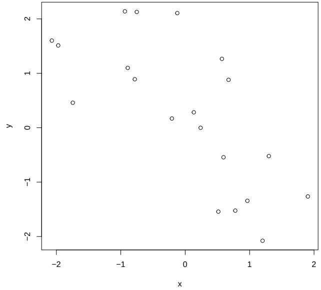
$$\beta |\, Y, X \;\sim\; N\left(\frac{\frac{1}{\sigma^2}\,\sum_{i=1}^{N} y_i x_i + \frac{1}{\tau^2}\beta_0}{\frac{1}{\sigma^2}\,\sum_{i=1}^{N} x_i^2 + \,\frac{1}{\tau^2}}, \frac{1}{\frac{1}{\sigma^2}\,\sum_{i=1}^{N} x_i^2 + \,\frac{1}{\tau^2}}\right) \tag{6}$$

- generate i.i.d. samples from the posterior distribution of β, $\pi(\beta|Y)$
- get $h(\beta)$ e.g. $|\beta|$

Direct Sampling

Example: Linear regression

- Goal: posterior mean for $|\beta|$ (quantile $t = 50$)
- I generate data y_i x_i with
  - $y_i = \beta x_i + u_i, \quad \mathrm{u_i} \sim N\left(0, \sigma^2\right)$
  - $N = 20$
  - $\beta_{\text{true}} = -1$ *and* $\sigma^2 = 1$
  - $\beta_0 = 0$ *and* $\tau = 100$

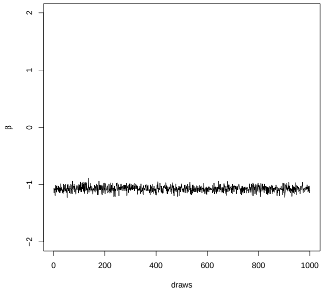


Direct Sampling

Example: Linear regression

- Step 1: we generate S draws from the $N(m, V)$, $\{\beta^s\}1, \ldots, S$

Figure 1: Example of draws $\left(\{\beta^s\}_{1,\ldots,S}\right)$, $S = 1,000$

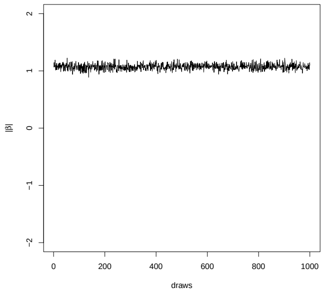


Direct Sampling

Example: Linear regression

- Step 2: we are interested in posterior moments of $|\beta|$.
- Turn draws into $\{|\beta|\}_{1,\ldots,S}$

Figure 2: Example of draws $\left(\{|\beta^s|\}_{1,\ldots,S}\right)$



Direct Sampling

Example: Linear regression

- Histogram approximation to $\pi\left(|\beta| \;|Y\right)$ using $\{|\beta^s|\}_{1,\dots,S}$

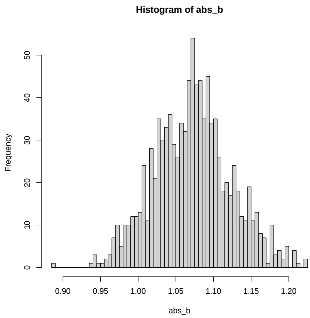


Figure 3: Example of draws $\left(\{|\beta^s|\}_{1,\dots,S}\right)$

Direct Sampling
Example: Linear regression

- The posterior mean of $|\beta|$ is approximated by

$$E_Y^{\beta}\left[|\beta|\right] \approx \frac{1}{S}\sum_{s=1}^{S}|\beta^s| = 1.0719 \tag{7}$$

- Numerical accuracy use CLT

Gibbs Sampling

- Consider now the linear regression model

$$y_i = \beta x_i + u_i, \quad u_i \sim N(0,\, \sigma^2)$$

- but assume σ^2 is unknown
- The prior on β is the same as before

$$\beta \;\sim\; N\left(\beta_0,\, \tau^2\right)$$

- We add now a prior on σ^2 is the Inverse-Gamma

$$\sigma^2 \;\sim\; IG\left(a, b\right)$$

- We want to know the joint posterior distribution

$$\pi(\beta,\, \sigma^2 \,|Y, X)$$

- Or we want to know the marginal distribution of β and σ^2

Gibbs Sampling

- We know the conditional distribution of β

$$\beta|Y,X,\,\sigma^2 \;\sim\; N\left(m,V\right)$$

- We can show that that

$$\sigma^2|Y,\beta \;\sim\; \text{IG}\left(a+\frac{N}{2},\;\; b+\frac{1}{2}\sum_{i=1}^{N}\left(y_i-x_i\beta\right)^2\right)$$

- That is, IG is conjugate prior for σ^2

Gibbs Sampling

- Derivation of the conditional posterior distribution

$$
\begin{aligned}
p(\sigma^2 \,|Y,\, X,\, \beta) &\propto p\ \left(Y \middle| X,\ \sigma^2,\, \beta\right)\ p\left(\sigma^2\right) && (8)\\
&\propto \left(\frac{1}{\sqrt{2\ \pi\sigma^2}}\right)^N \exp\left(-\frac{1}{2}\sum_{i=1}^N \frac{(y_i - x_i\beta)^2}{\sigma^2}\right) \times \frac{b^a}{\Gamma(a)}\ \left(\sigma^2\right)^{-a-1} \exp\left(-\frac{b}{\sigma^2}\right)\\
&\propto \left(\sigma^2\right)^{\left(\ -a\ -1\ -\frac{N}{2}\right)} \exp\left(-\frac{b}{\sigma^2} - \frac{1}{2}\sum_{i=1}^N \frac{(y_i - x_i\beta)^2}{\sigma^2}\right)
\end{aligned}
$$

(keep terms that are related to σ^2)

Gibbs Sampling

- Derivation of the conditional posterior distribution
- We can see that the conditional posterior has the IG density form and we can easily deduce that

$$\sigma^2|Y,\, \beta \;\sim\; IG\,(\bar{a}\;\bar{b})$$

- Where

$$\begin{aligned}\bar{a} &= a + \frac{N}{2} \\ \bar{b} &= b + \frac{1}{2}\sum_{i=1}^{N}(y_i - x_i\beta)^2\end{aligned} \tag{9}$$

Gibbs sampling

- We know conditional posteriors. Can we use these to recover joint distribution?

Gibbs sampling

- We know conditional posteriors. Can we use these to recover joint distribution?
- The answer turns out to be yes
- This is very cool. Joint distribution may be nasty and high-dimensional.
- But, Gibbs sampling allows us to break the nasty joint distribution piece by piece

Gibbs Sampling

Example: Linear regression

- In the context of linear regression example, the Gibbs algorithm works as below
- Enter the following iteration with β^0 *and* $s = 1$

1. $\left(\sigma^2\right)^s \sim p\left(\sigma^2|Y,\ \beta^{(s-1)}\right)$
2. $\beta^s \sim p\left(\beta|Y, \sigma^{(s-1)}\right)$
3. Go to step 1 with $i = i + 1$ if $i < S$. Otherwise, exit loop

- At the end of the algorithm, you get draws $\left\{\beta^{(s)},\ \left(\sigma^2\right)^s\right\}_{s=1,\ldots,S}$.

Gibbs Sampling

Example: Linear regression

- Under regular conditions,

$$\frac{1}{S - S_0} \sum_{s=S_{0+1}}^{S} h\left(\beta^{(s)}, \left(\sigma^2\right)^{(s)}\right) \rightarrow_{\text{a.s.}} \int h\left(\beta, \sigma^2 \middle| Y\right) d\beta d\sigma^2$$

- Where the first S_0 draws are discarded
- CLT also holds so that we can evaluate the quality of the numerical approximation

Gibbs Sampling

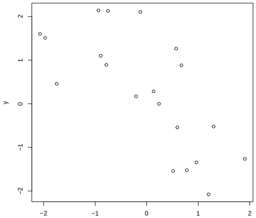
Example: Linear regression

- Like before, I generate data y_i and x_i with

$$y_i = \beta x_i + u_i, \quad u_i \sim N(0, \sigma^2)$$

with

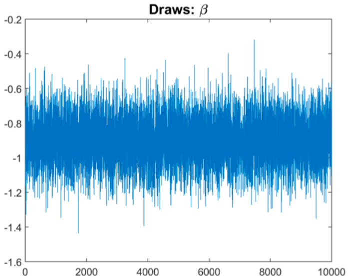
- N = 100
- $\beta_{\text{true}} = -1$ and $\sigma^2 = 1$
- Prior for β : $\beta_0 = 0$ and $\tau = 1$
- Prior for σ^2 : $a = 10,\ b = 20$
- Start the algorithm with $\beta^{(0)} = 5$

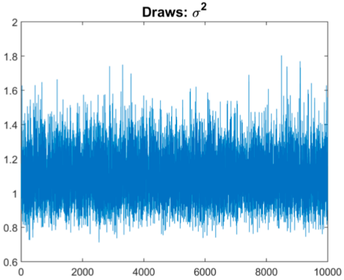


Gibbs Sampling

Example: Linear regression

- Gibbs sampling: Posterior draws

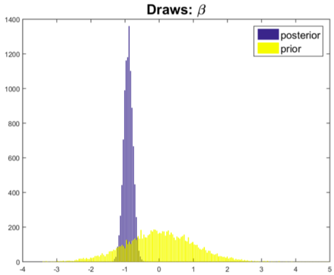


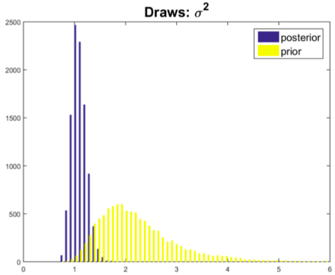


Gibbs Sampling

Example: Linear regression

- Gibbs sampling: Posterior draws





- Once we observe data, we update our belief accordingly.
- Distribution shrinks. Center of the distribution moved toward where the data generated from:

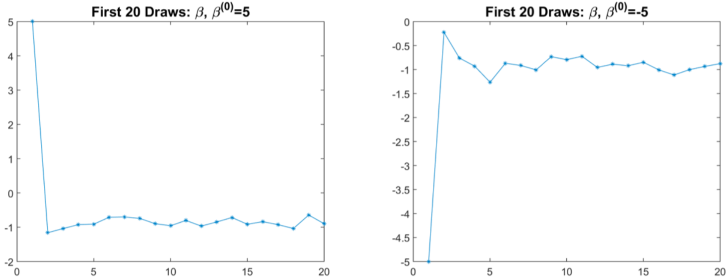
$$\beta_{\text{true}} = -1 \tag{10}$$

$$\sigma^2 = 1 \tag{11}$$

Gibbs Sampling

Initial value effect

- Initial value effect
- We start the algorithm with some arbitrary number β^0. Theory tells us that this initial value should not matter in the long run.



- To get rid of the initial value effect, we usually take out first x draws (say, 1,000 draws)

Gibbs Sampling

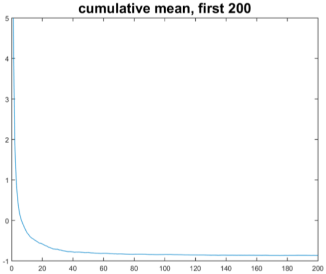
Checking convergence

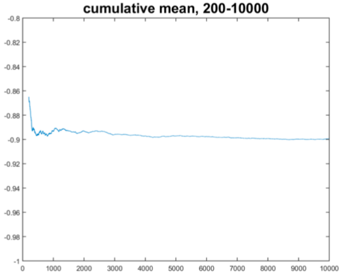
- Checking convergence
- We start from arbitrary $\beta^{(0)}$
- We can view $\beta^{(0)}$as a draw from the arbitrary distribution (does not have to be the distribution we are interested in).
- Theory tells us that the sequence from Gibbs algorithm converges to the joint posterior distribution.
  - After some iteration, $\beta^{(i)}$, $\left(\sigma^2\right)^i$ is a draw from $\pi\left(\beta, \sigma^2|Y\right)$
- How can we check the convergence? There are many ways.

Gibbs Sampling

Checking convergence: Running Mean Plots

- Cumulative mean over draws



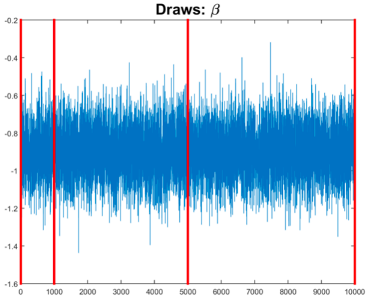


- This sequence behaves well in the sense that the Monte Carlo average converges to some number (posterior moment of interest) as the number of draws increases.

Gibbs Sampling

Checking convergence: Geweke's diagnostic check

- Take out the first x draws
- Split draws into two non-overlapping parts (e.g. first 10% vs last 50%)
- Compare Z-score



- Standardized mean (Z-score) of the left sample: -6.9363
- Standardized mean (Z-score) of the right sample: -6.9401
- (you can formally test via hypothesis testing).

- A sequence from the Gibbs sampling is serially correlated
  - Previous draw affects the current draw.
  - Gibbs sampler creates a Markov chain. For this reason, it belongs to the class of *Markov chain Monte Carlo (MCMC)* procedures.
- Recall Direct sampling procedure generates i.i.d. draws.

Gibbs Sampling

Gibbs sampling versus Direct sampling

- Both "Direct sampling" and "Gibbs sampling" generate draws that satisfy CLT.
- For draws from direct sampling:

$$\sqrt{S}\left(\frac{1}{S}\sum_{i=1}^{N} h\left(\beta^{i}\right)-\int h(\beta)\,\pi(\beta|Y)\,d\beta\right)\rightarrow_{d} N\left(0,V_{\pi}\right)$$

- For draws from Gibbs sampling (after discarding first few draws):

$$\sqrt{S}\left(\frac{1}{S}\sum_{i=1}^{N} h\left(\beta^{i}\right)-\int h(\beta)\,\pi(\beta|Y)\,d\beta\right)\rightarrow_{d} N\left(0,V_{G}\right)$$

- $V_{\pi} < V_{G}$
- To achieve the same level of approximation error, we need more draws X for Gibbs sampler.

Review

General Gibbs sampler

- Gibbs sampler works for more than two parameters case. Let be θ unknown parameter with $\dim \theta > 1$
- Requirements:
  - Parameter vector θ can be partitioned into $\theta = (\theta_1, \theta_2, \ldots, \theta_m)$
  - For each s it is possible to generate draws of θ_s from the conditional distribution, $p(\theta_s | \theta_{s-1}, Y)$ where θ_{-s} denotes the vector θ without the partition θ_s
- Gibbs sampler: For $s = 1, \ldots, S$:
  - Draw $\theta_1^{(s+1)}$ from the density $p\left(\theta_1 | \theta_2^{(s)}, \theta_3^{(s)}, \ldots, \theta_m^{(s)}, Y\right)$
  - Draw $\theta_2^{(s+1)}$ from the density $p\left(\theta_2 | \theta_1^{(s+1)}, \theta_3^{(s)}, \ldots, \theta_m^{(s)}, Y\right)$
  - $\vdots$
  - Draw $\theta_m^{(s+1)}$ from the density $p\left(\theta_m | \theta_1^{(s)}, \theta_2^{(s+1)}, \theta_3^{(s+1)}, \ldots, \theta_{m-1}^{(s+1)}, Y\right)$

Review & Next Steps

- **Next Class:** Empirical Bayes
- **Next Week:** PS 2

Further Readings

- Casella, G., & Berger, R. L. (2002). Statistical inference (Vol. 2, pp. 337-472). Pacific Grove, CA: Duxbury. Chapter 7
- Hoff, P. D. (2009). A first course in Bayesian statistical methods (Vol. 580). New York: Springer.
- Roberts, G.O. and J.S. Rosenthal (2004): General State Space Markov Chains and MCMC algorithms, Probability Surveys, 1, 20–71.
- Geweke, J. (2005): Contemporary Bayesian Econometrics and Statistics, John Wiley & Sons.