I

HW1

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1. (a) First, we assume $\{x_i, y_i\}$ is i.i.d.
Second, we assume $E[V_{it}|\eta_i, X_i] = 0$. For η_i, $E[\eta_i|X_i] = 0$ by construction:

$$E[\eta_i|\bar{X}_i, X_{it}] \;=\; E[\eta_i|X_{i1}, X_{i2}, \cdots, X_{iT}] = E[\eta_i|X_i] = 0.$$

Now we show the consistency. Define $\theta \equiv (\delta_0, \gamma_0', \beta_0')'$ and $\tilde{X}_{it} \equiv (1, \bar{X}_i', X_{it}')'$. Denote $(1, \cdots, 1)' \in \mathbb{R}^k$ as ι_k. Then,

$$\begin{aligned}
\hat{\theta}_{n,POLS} &= (\sum_i \sum_t \tilde{X}_{it}\tilde{X}_{it}')^{-1}(\sum_i \sum_t \tilde{X}_{it} Y_{it}) \\
&= (\sum_i \sum_t \tilde{X}_{it}\tilde{X}_{it}')^{-1}(\sum_i \sum_t \tilde{X}_{it}(\delta_0 + \bar{X}_i'\gamma_0 + X_{it}'\beta_0 + \eta_i + V_{it})) \\
&= \theta_0 + (\sum_i \sum_t \tilde{X}_{it}\tilde{X}_{it}')^{-1}(\sum_i \sum_t \tilde{X}_{it}(\eta_i + V_{it})) \\
&= \theta_0 + (\sum_i \tilde{X}_i'\tilde{X}_i)^{-1}\left(\sum_i \tilde{X}_i'(\eta_i \iota_T + V_i)\right)
\end{aligned}$$

To apply WLLN, we further assume $E[\tilde{X}_i'\tilde{X}_i]$ is finite and invertible and $E[\tilde{X}_i'\eta_i\eta_i'\tilde{X}_i] < \infty$, $E[\tilde{X}i' V_i V_i' \tilde{X}_i] < \infty$. Note

$$\begin{aligned}
E(\tilde{X}_i'\eta_i\iota_T) &= E[E(\tilde{X}_i'\eta_i\iota_T|X_i)] = 0, \\
E(\tilde{X}_i'V_i) &= E[E(\tilde{X}_i'V_i|X_i)] = 0.
\end{aligned}$$

Applying WLLN, CMT, and Slutsky's lemma shows the second term converges in probability to 0. □

(b) Apply the FWL theorem to (1.46). First, observe that $\bar{X} = (\bar{X}_1', \cdots, \bar{X}_n')'$ can be constructed by projecting X onto D where $D = (D_1', \cdots, D_n')'$,

$D_i = (D_{it})_{t=1}^T = (D_{i1}, \cdots, D_{iT})'$, $D'_{it} = (\delta_{j,it})_{j=1}^T$, $\delta_{j,it} = 1_{[j=i],it}$, $1_{[\cdot]}$ is an indicator function. Then

$$\bar{X} = D(D'D)^{-1}DX := P_D X$$

Let $M_X = I - X(X'X)^{-1}X'$. Then

$$\begin{aligned}
\hat{\beta}_{FWL} &= (X'M_{(1,\bar{X})}X)^{-1}(X'M_{(1,\bar{X})}Y) \\
&= (X'M_{(1,P_D X)}X)^{-1}(X'M_{(1,P_D X)}Y) \\
&= (X'M_{(1,D)}X)^{-1}(X'M_{(1,D)}Y) \\
&= (X'M_D X)^{-1}(X'M_D)Y) \\
&= (\dot{X}'\dot{X})^{-1}(\dot{X}'\dot{Y}) \\
&= \hat{\beta}_{n,FE}
\end{aligned}$$

where $\dot{X}$ is a within-transform of X.

(c) Check if CRE satisfies the assumptions of FE. Since CRE contains a time-invariant regressors 1 and $\bar{X}_i$, $E(\dot{\tilde{X}}_i'\dot{\tilde{X}}_i)$ is not invertible. Thus, CRE does not belong to a family of FE (X_{it} does not contain time-invariant regressors in CRE for invertibility, too). On the other hand, FE does not assume any specific functional form of the correlation between α_i and x_i so FE does not belong to a family of CRE. Therefore, we cannot say the statement is true.

(d)

$$\frac{\partial E[\alpha_i|X_i]}{\partial X_i'} = \begin{pmatrix} \gamma_1/T & \cdots & \gamma_k/T \\ \vdots & \vdots & \vdots \\ \gamma_1/T & \cdots & \gamma_k/T \end{pmatrix} = 0 \Leftrightarrow \gamma = 0$$

Therefore, we can simply test $H_0 : \gamma = 0$ from the OLS of (1.46).

2. (a) (Symmetric)

$$Q' = (I_n \otimes (I_T - J_T/T))' = I_T' \otimes (I_T' - J_T'/T) = Q$$

(Idempotent)

$$\begin{aligned}
Q^2 &= (I_n \otimes (I_T - J_T/T))(I_n \otimes (I_T - J_T/T)) \\
&= I_n I_n \otimes (I_T - J_T/T)(I_T - J_T/T) \\
&= I_n \otimes [I_T - 2J_T/T + J_T^2/T^2] \\
&= I_n \otimes [I_T - 2J_T/T + TJ_T/T^2] \\
&= I_n \otimes [I_T - J_T/T] = Q
\end{aligned}$$

(Q is not invertible) Since Q is idempotent,

$$\text{rank}(Q) = \text{tr}(Q^2) = \text{tr}(Q) = n(T-1) < nT.$$

(b) Consider QY.

$$\begin{aligned}
QY &= [I_n \otimes (I_T - J_T/T)]Y \\
&= \begin{pmatrix} I_T - J_T/T & O & \cdots & O \\ O & I_T - J_T/T & \cdots & O \\ \vdots & \vdots & \vdots & \vdots \\ O & \cdots & O & I_T - J_T/T \end{pmatrix} \begin{pmatrix} Y_1 \\ Y_2 \\ \vdots \\ Y_n \end{pmatrix} \\
&= \dot{Y}
\end{aligned}$$

Therefore,

$$\begin{aligned}
\hat{\beta}_{n,FE} &= \left(\dot{X}'\dot{X}\right)^{-1}\left(\dot{X}'\dot{Y}\right) \\
&= (XQ'QX)^{-1}(XQ'QY) \\
&= (X'QX)^{-1}(X'QY)
\end{aligned}$$

(c) Denote $x_i = X_i'$, $y_i = Y_i$, $Q_i = I_T - J_T/T$. Consider the variance of $\dot{v}$.

$$\begin{aligned}
\Omega_i &= E(\dot{v}_i\dot{v}_i') \\
&= E(Q_i v_i v_i' Q_i) \\
&= \sigma_V^2 Q_i
\end{aligned}$$

so that $\Omega \equiv E(\dot{v}\dot{v}') = I_n \otimes \sigma_V^2 Q_i = \sigma_V^2 Q$.
Hence, the GLS of (1.24) with the weighting matrix $1/\sigma_V^2 Q^-$ is

$$\begin{aligned}
\hat{\beta}_{GLS} &= (\dot{X}'\cancel{\frac{1}{\sigma_V^2}}Q^-\dot{X})^{-1}(\dot{X}'\cancel{\frac{1}{\sigma_V^2}}Q^-\dot{Y}) \\
&= (X'QQ^-QX)^{-1}(X'QQ^-QY) \\
&= (X'QX)^{-1}(X'QY) \\
&= \hat{\beta}_{FE}
\end{aligned}$$

Finally, we show the above GLS (in fact WLS) is efficient.

(d) Observe

$$
\begin{aligned}
\sum_{i=1}^{n}\sum_{t=1}^{2}(x_{it}-\bar{x}_i)(x_{it}-\bar{x}_i)' &= \sum_{i=1}^{n}\sum_{t=1}^{2}(x_{it}-\bar{x}_i)(x_{it}-\bar{x}_i)' \\
&= \sum_{i=1}^{n}[(x_{i2}-\frac{x_{i1}+x_{i2}}{2})(x_{i2}-\frac{x_{i1}+x_{i2}}{2})' \\
&\qquad + (x_{i1}-\frac{x_{i1}+x_{i2}}{2})(x_{i1}-\frac{x_{i1}+x_{i2}}{2})'] \\
&= \sum_{i=1}^{n}(\frac{x_{i2}}{2}-\frac{x_{i1}}{2})(\frac{x_{i2}}{2}-\frac{x_{i1}}{2})' + (\frac{x_{i1}}{2}-\frac{x_{i2}}{2})(\frac{x_{i1}}{2}-\frac{x_{i2}}{2})' \\
&= \frac{1}{2}\sum_{i}\Delta x_{i2}\Delta x_{i2}'.
\end{aligned}
$$

Thus,

$$
\begin{aligned}
\hat{\beta}_{n,FE} &= \left(\sum_{i}\sum_{t=1}^{2}(x_{it}-\bar{x}_i)(x_{it}-\bar{x}_i)'\right)^{-1}\left(\sum_{i}\sum_{t=1}^{2}(x_{it}-\bar{x}_i)(y_{it}-\bar{y}_i)\right) \\
&= \left(\cancel{\frac{1}{2}}\sum_{i}\Delta x_{i2}\Delta x_{i2}'\right)^{-1}\left(\cancel{\frac{1}{2}}\sum_{i}\Delta x_{i2}\Delta y_{i2}\right) = \hat{\beta}_{n,FD}.
\end{aligned}
$$

3. (a) Plugging $y_{it} = \frac{1}{1-\beta_0}\alpha_i + \sum_{s=0}^{\infty}\beta_0^s v_{i,t-s}$ into (1.47),

$$
\begin{aligned}
RHS &= \beta_0\left(\frac{1}{1-\beta_0}\alpha_i + \sum_{s=0}^{\infty}\beta_0^s v_{i,t-1-s}\right) + \alpha_i + v_{it} \\
&= \frac{1}{1-\beta_0}\alpha_i + \sum_{s=0}^{\infty}\beta_0^{s+1} v_{i,t-1-s} + v_{it} \\
&= \frac{1}{1-\beta_0}\alpha_i + \sum_{s=1}^{\infty}\beta_0^{s} v_{i,t-s} + v_{it} \\
&= LHS
\end{aligned}
$$

(b) Note

$$\begin{aligned}
\Delta y_{it} &= y_{it} - y_{i,t-1} = \sum_{s=0}^{\infty} \beta_0^s (v_{i,t-s} - v_{i,t-1-s}) \\
&= (v_{it} - v_{i,t-1}) + \beta_0 (v_{it-1} - v_{it-2}) + \cdots \\
&= v_{it} - (1-\beta_0) v_{it-1} - \beta_0 (1-\beta_0) v_{it-2} + \cdots \\
&= v_{it} - (1-\beta_0) \sum_{s=0}^{\infty} \beta_0^s v_{i,t-1-s}
\end{aligned}$$

Then, denoting $\mathrm{var}(v_{it}) = \sigma^2$,

$$\begin{aligned}
\Delta y_{it} \Delta y_{it} &= (v_{it}^2 + (1-\beta_0)^2 v_{i,t-1}^2 + (1-\beta_0)^2 \beta_0^2 v_{i,t-2}^2 + \cdots) \\
&\quad +(\text{cross products}) \\
E(\Delta y_{it} \Delta y_{it}) &= \sigma^2 + \frac{(1-\beta_0)^2 \sigma^2}{1-\beta_0^2} = \frac{2\sigma^2}{1+\beta_0}
\end{aligned}$$

Similarly,

$$\begin{aligned}
\Delta y_{it} \Delta y_{it-1} &= -(1-\beta_0) v_{i,t-1}^2 + (1-\beta_0)^2 \beta_0 v_{i,t-2}^2 \\
&\quad +(1-\beta_0)^2 \beta_0^3 v_{it-3}^2 + \cdots \\
\Rightarrow E(\Delta y_{it} \Delta y_{it-1}) &= \frac{-1+\beta_0}{1+\beta_0} \sigma^2
\end{aligned}$$

Then, applying LLN over i (considering $Z_i = (\alpha_i, v_i)$ where $v_i = (v_{it})_{t=-\infty}^{\infty}$ and $Z_i \sim_{iid} F$ for some F),

$$\begin{aligned}
\hat{\beta}_{n,FD} &= (\frac{1}{n} \sum_i \sum_t \Delta y_{it-1} \Delta y_{it-1})^{-1} (\frac{1}{n} \sum_i \sum_t \Delta y_{it-1} \Delta y_{it}) \\
&\xrightarrow{p} \left(\frac{2\sigma^2}{1+\beta_0} \right)^{-1} \frac{-1+\beta_0}{1+\beta_0} \sigma_V^2 = \frac{\beta_0 - 1}{2}
\end{aligned}$$

Thus,

$$\hat{\beta}_{n,FD} - \beta_0 \xrightarrow{p} \frac{-1-\beta_0}{2}$$

so it does not depend on T.

(c) Similarly to (b),

$$E(y_{i0})^2 = \frac{\sigma_\alpha^2}{(1-\beta_0)^2} + \frac{\sigma^2}{1-\beta_0^2}.$$

Meanwhile,

$$\begin{aligned} E[\Delta y_{i1} y_{i0}] &= E[-(1-\beta_0)v_{i0}^2 - (1-\beta_0)\beta_0^2 v_{i,-1}^2 - \cdots + (\text{C.P.})] \\ &= -\frac{1-\beta_0}{1-\beta_0^2}\sigma^2 = \frac{-\sigma^2}{1+\beta_0} \end{aligned}$$

Then,

$$\hat{\beta}_{OLS} = (\frac{1}{n}\sum_i \Delta y_{i1}\Delta y_{i1})^{-1}(\frac{1}{n}\sum_i \Delta y_{i1} y_{i0}) \xrightarrow{p} \frac{(1-\beta_0)^2\sigma^2}{(1+\beta_0)\sigma_\alpha^2 + (1-\beta_0)\sigma^2}$$

Thus, if $\sigma_\alpha^2 >> \sigma^2$ or $\beta_0 \approx 1$, the coefficient is close to zero, which implies that Y_{i0} is a weak instrument.

4. (a) In our simulation settings ($\sigma_\alpha^2 = \sigma^2 = 1$), we can speculate the followings

   i. $\hat{\beta}_{n,POLS} - \beta_0 \xrightarrow{p} \frac{(1-\beta_0)(1+\beta_0)\sigma_\alpha^2}{(1+\beta_0)\sigma_\alpha^2+(1-\beta_0)\sigma^2} = \frac{1-\beta_0^2}{2}$ (omitted variable bias)

   ii. $\hat{\beta}_{n,FE} - \beta_0 \xrightarrow{p} \dfrac{1+\beta_0}{\frac{2\beta_0}{1-\beta_0} - \frac{T-1}{1-\beta_0^{T-1}}}$ (Nickell, 1981)

   iii. $\hat{\beta}_{n,FD} - \beta_0 \xrightarrow{p} -\dfrac{1+\beta_0}{2}$ (Q3)

   iv. $\hat{\beta}_{n,AH} - \beta_0 \xrightarrow{p} 0$ (Anderson and Hsiao, 1982), but this will suffer from weak instruments (Blundell and Bond, 1998). The first stage estimation coefficient (if we do 2SLS) is $\frac{(1-\beta_0)^2}{2}$.

   The simulation results are presented in Figure 1. First, the bias of $\hat{\beta}_{n,POLS}$ decreased as β_0 approaches 1 as expected. The bias of $\hat{\beta}_{n,FD}$ decreased until $\beta_0 = 0.75$. $\hat{\beta}_{n,FDIV}$, which is an $\hat{\beta}_{n,AH}$, gave an unbiased result, but showed a large standard error as $\beta_0 \to 1$.

   (b) The simulation results are presented in Figure 2 and 3. When T was short ($T = 3$), $\hat{\beta}_{n,FDIV}$ gave unstable results. It also gave a large variance regardlessly of T when β_0 is close to 1.

5.

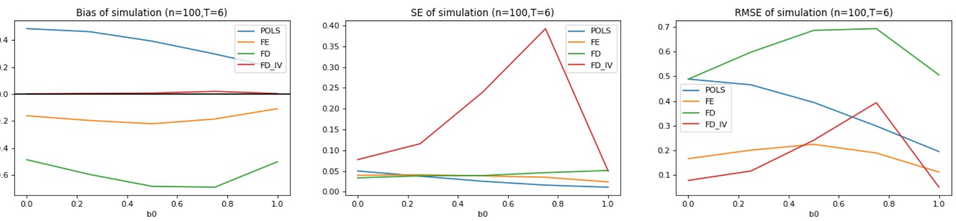

Figure 1: The simulation results of n=100, T=6

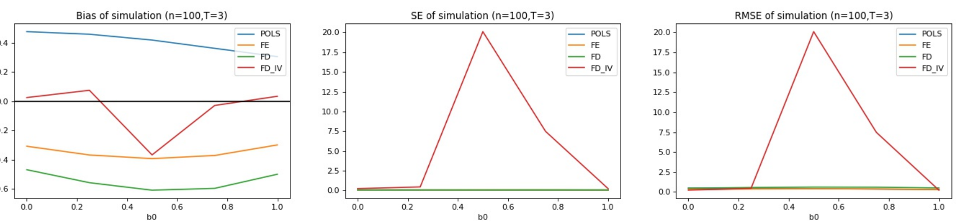

Figure 2: The simulation results of n=100, T=3

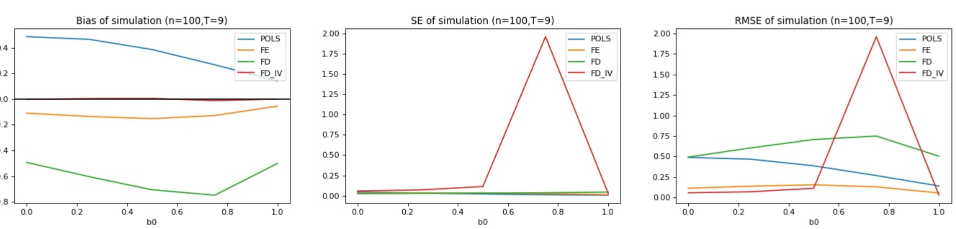

Figure 3: The simulation results of n=100, T=9