

ECON 409 Project Proposal

Idalee Vargas, Lora Yovcheva, Mauricio Vargas, Santiago Naranjo

Model

As suggested by Molodtsova and Papell, the model is outlined as follows:

$$\Delta s_{t+1} = \beta_0 + \beta_1(\tilde{\pi}_t - \pi_t) + \beta_2(\tilde{y}_t - y_t) + \epsilon_t, \quad \epsilon_t \sim_{i.i.d.} N(0, \sigma^2)$$

$$\Delta s_{t+1} = s_{t+1} - s_t$$

$$s_t = \ln S_t$$

This model is delineated as symmetric, non-smoothed, and homogeneous, with:

- S_t representing the price of 1 pound sterling in US dollars.
- $\tilde{\pi}_t$ being the UK inflation rate.
- π_t being the US inflation rate.
- \tilde{y}_t indicating the UK output gap.
- y_t indicating the US output gap.

The output gaps are determined through:

$$\ln Y_t = y_t + \bar{y}_t$$

$$\bar{y}_t = \alpha_0 + \bar{y}_{t-1} + \nu_t, \quad \nu_t \sim_{i.i.d.} N(0, \sigma_\nu^2)$$

$$y_t = \alpha_1 y_{t-1} + \eta_t, \quad \eta_t \sim_{i.i.d.} N(0, \sigma_\eta^2)$$

Introducing a stochastic trend for potential output and an autoregressive model for the output gap. It assumes that $\ln Y_t$ and \bar{y}_t are I(1) variables, and y_t is I(0).

For the UK output gap, we have:

$$\ln \tilde{Y}_t = \tilde{y}_t + \bar{\tilde{y}}_t$$

$$\bar{\tilde{y}}_t = \gamma_0 + \bar{\tilde{y}}_{t-1} + \tilde{\nu}_t, \quad \tilde{\nu}_t \sim_{i.i.d.} N(0, \sigma_{\tilde{\nu}}^2)$$

$$\tilde{y}_t = \gamma_1 \tilde{y}_{t-1} + \tilde{\eta}_t, \quad \tilde{\eta}_t \sim_{i.i.d.} N(0, \sigma_{\tilde{\eta}}^2)$$

This approach assumes $\ln \tilde{Y}_t$ and $\bar{\tilde{y}}_t$ are I(1) variables and \tilde{y}_t is I(0).

Data

The model utilizes monthly data, with updates occurring on the last business day of each month:

- π_t : US CPI index, released with a one-month delay.
- $\tilde{\pi}_t$: UK CPI index, released with a one-month delay.
- Y_t : US Industrial Production Index, released with a one-month delay.
- \tilde{Y}_t : UK Industrial Production Index, released with a two-month delay.

The publication lag for these variables does not hinder the strategy's application, as the prediction for Δs_{t+1} relies on data available up to month t .

Given the two-month delay in publishing \tilde{Y}_t , we propose an adjustment to the model:

$$\Delta s_{t+1} = \beta_0 + \beta_1(\tilde{\pi}_t - \pi_t) + \beta_2(\mathbb{E}_{t-1}[\tilde{y}_t] - y_t) + \epsilon_t$$

$$\Delta s_{t+1} = s_{t+1} - s_t$$

$$s_t = \ln S_t$$

Predicting the UK output gap with:

$$\mathbb{E}_{t-1}[\tilde{y}_t] = \gamma_1 \tilde{y}_{t-1}$$

Ridge Regression

We define the loss function as:

$$L(\widehat{\Delta s}_{t+1} | \beta_0, \beta_1, \beta_2) = MSE(\widehat{\Delta s}_{t+1}) + \lambda \sum_{i=0}^2 \beta_i^2$$

where:

$$\beta^* = (\beta_0^*, \beta_1^*, \beta_2^*)' = \arg \min_{\beta \in \mathbb{R}^3} L(\widehat{\Delta s}_{t+1} | \beta)$$

Tunning Parameters

1. λ : Regularization term in **Ridge** regression.
2. h : Rolling window size for model estimation and the output gaps, to avoid including structural breaks that could affect forecasts.

Estimating y_t and \tilde{y}_t

To estimate $\Delta \ln Y_t$:

$$\Delta \ln Y_t = \Delta y_t + \Delta \bar{y}_t$$

Knowing y_t is $I(0)$:

$$\Delta y_t = y_t - y_{t-1}$$

$$\mathbb{E}[\Delta y_t] = \mathbb{E}[y_t - y_{t-1}]$$

$$\mathbb{E}[\Delta y_t] = 0$$

Since:

$$\mathbb{E}(y_{t+s}) = 0, \forall s \in \mathbb{Z}$$

For $\Delta \bar{y}_t$:

$$\Delta \bar{y}_t = \bar{y}_t - \bar{y}_{t-1}$$

$$\Delta \bar{y}_t = \alpha_0 + \bar{y}_{t-1} + \nu_{t-1} - \bar{y}_{t-1}$$

$$\mathbb{E}[\Delta \bar{y}_t] = \alpha_0 + \mathbb{E}[\bar{y}_{t-1}] + \mathbb{E}[\nu_{t-1}] - \mathbb{E}[\bar{y}_{t-1}]$$

$$\mathbb{E}[\Delta \bar{y}_t] = \alpha_0$$

Thus:

$$\mathbb{E}[\Delta \ln Y_t] = \mathbb{E}[\Delta y_t] + \mathbb{E}[\Delta \bar{y}_t]$$

$$\mathbb{E}[\Delta \ln Y_t] = \alpha_0$$

We estimate the drift α_0 of \bar{y}_t as:

$$\hat{\alpha}_0 = \frac{1}{h} \sum_{i=t-h}^t \Delta \ln Y_i$$

h is the previously mentioned second tuning parameter.

Similarly, for \tilde{y}_t :

$$\hat{\gamma}_0 = \frac{1}{h} \sum_{i=t-h}^t \Delta \ln \tilde{Y}_i$$