Kalman filter

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Spring 2018

Latent variables: Variables that are not directly observed but inferred from other variables

- Unobserved, but variable can still play important role in theoretical model

Example: Potential output

- Keynesian model inflationary pressure determined by deviation of output from potential output
- Consider GDP increase in last quarter but no sign of inflationary pressure: potential output increased

Q: Can we assume that there has been a change in potential output?

Signal vs. noise: Need to have a method that extracts useful signal from data that also contains lot of noise

- w.r.t. example; potential output probably stable from quarter to quarter while there is likelt random noise fluctuations in inflation

One way to extract a signal is the **Kalman filter**

Conditional expectations: We want an estimate of the value of variable X

- Problem: we don't observe X, only Z which is correlated with X.

Assume that X, Z are jointly normally distributed

$$\begin{pmatrix} X \\ Z \end{pmatrix} \sim N\left(\begin{pmatrix} \mu_X \\ \mu_Z \end{pmatrix}, \begin{pmatrix} \sigma_X^2 & \sigma_{XZ} \\ \sigma_{XZ} & \sigma_Z^2 \end{pmatrix}\right) \tag{1}$$

We get

$$\mathbb{E}(X|Z) = \mu_X + \frac{\sigma_{XZ}}{\sigma_Z^2}(Z - \mu_Z) \tag{2}$$

Alternatively, define ρ as correlation between X and Z

$$\rho = \frac{\sigma_{XZ}}{\sigma_X \sigma_Z} \tag{3}$$

Inserting in (2) we get

$$\mathbb{E}(X|Z) = \mu_X + \rho \frac{\sigma_X}{\sigma_Z}(Z - \mu_Z) \tag{4}$$

Weight put on information from Z depends on

1. Correlation between X and Z (ρ)
2. The relative standard deviation ($\frac{\sigma_X}{\sigma_Z}$)

If Z has high standard deviation, it is a poor signal.

Multivariate conditional expectations: Can generalise from 2 to n variables: Let X be 1 x n vector of variables and Z 1 x m

$$\begin{pmatrix} X \\ Z \end{pmatrix} \sim N\left(\begin{pmatrix} \mu_X \\ \mu_Z \end{pmatrix}, \begin{pmatrix} \sum_{XX} & \sum_{XZ} \\ \sum'_{XZ} & \sum_{ZZ} \end{pmatrix}\right) \tag{5}$$

Expected value of X conditional on Z is

$$\mathbb{E}(X|Z) = \mu_X + \sum_{xz} \sum_{zz}^{-1} (Z - \mu_Z) \tag{6}$$

This is an important formula in the Kalman filter

State-space models: Linear time-series models that mix observable and unobservable variables.

$$S_t = FS_{t-1} + u_t \tag{7}$$

State equation - or transition equation - describes how unobservables S_t evolve over time

$$Z_t = HS_t + v_t \tag{8}$$

Measurement equation, relates set of observable variables Z_t to unobservable variables S_t

Errors: Both u_t and v_t can include either

1. Normally distributed errors
2. Zeros, if the described equation is an identity

$$u_t \sim N(0, \textstyle\sum^u) \tag{9}$$
$$v_t \sim N(0, \textstyle\sum^v) \tag{10}$$

$\sum$ might not have full matrix rank

- Or rank deficient
- i.e. not enough information in data to estimate equation

Estimation: Observed data described by

$$Z_t = HS_t + v_t \tag{11}$$

Cannot observe S_t but can replace it with unbiased guess based on information available at time t

$$S_{t|t-1} \tag{12}$$

Assume that errors are normally distributed with known covariance matrix

$$S_t - S_{t|t-1} \sim N(0, \textstyle\sum_{t|t-1}^{S}) \tag{13}$$

Can express observed variables as

$$Z_t = HS_{t|t-1} + v_t + H(S_t - S_{t|t-1}) \tag{14}$$

Can estimate model using ML; variance of error term, after conditioning on $t-1$ state-variable estimate, is given by

$$v_t + H(S_t - S_{t|t-1}) \sim N(0, \Omega_t) \tag{15}$$

$$\Omega_t = \sum^v + H \sum^S_{t|t-1} H' \tag{16}$$

Parameters of model are given by

$$\theta = (F, H, \sum^u, \sum^v) \tag{17}$$

Log-likelihood function for Z_t given observables at $t-1$ is

$$\begin{aligned} log\ f(Z_t|Z_{t-1}, \theta) = -log\ 2\pi - log\ |\Omega_t| - \\ \frac{1}{2}(Z_t - HS_{t|t-1})'\Omega_t^{-1}(Z_t - HS_{t|t-1}) \end{aligned} \tag{18}$$

Combined likelihood is given by

- Based on initial estimate of first period unobservable state $S_{1|0}$

$$f(Z_1, ..., Z_T | S_{1|0}, \theta) = f(Z_1 | S_{1|0}, \theta) \prod_{i=2}^{i=T} f(Z_i | Z_{i-1}, \theta) \tag{19}$$

All we need is a method to get an unbiased guess based on information available at $t-1$: This is where the Kalman filter comes in

- Iterative method
- Given estimates of state variables for t, it uses observable data for $t+1$ to update estimates

Estimating state variables: Formulate estimate of state variable at time t given information at $t-1$

$$S_t = FS_{t-1} + u_t \Rightarrow S_{t|t-1} = FS_{t-1|t-1} \tag{20}$$

At $t-1$, expected value for the observables at t are

$$Z_{t|t-1} = HS_{t|t-1} = HFS_{t-1|t-1} \tag{21}$$

At t we observe Z_t; need to update estimate of state variable given information

$$Z_t - HFS_{t-1|t-1} \tag{22}$$

Model assumptions imply

$$\begin{pmatrix} S_t \\ Z_t \end{pmatrix} \sim N\left(\begin{pmatrix} FS_{t-1|t-1} \\ HFS_{t-1|t-1} \end{pmatrix}, \begin{pmatrix} \sum_{t|t-1}^{S} & \left(H\sum_{t|t-1}^{S}\right)' \\ H\sum_{t|t-1}^{S} & \sum^{V} + H\sum_{t|t-1}^{S} H' \end{pmatrix}\right) \tag{23}$$

Use conditional expectations to state that minimum variance unbiased estimate of $S_t|Z_t$ is

$$\mathbb{E}(S_t|Z_t) = S_{t|t} = FS_{t-1|t-1} + K_t(Z_t - HFS_{t-1|t-1}) \tag{24}$$

K_t is the **Kalman gain** matrix

$$K_t = \left(H \sum_{t|t-1}^{S}\right)' \left(\sum^{V} + H \sum_{t|t-1}^{S} H'\right)^{-1} \tag{25}$$

Covariance matrices required to compute K_t are updated by

$$\sum_{t|t-1}^{S} = F \sum_{t-1|t-1}^{S} F' + \sum^{U} \tag{26}$$

$$\sum_{t|t}^{S} = (I - K_t H) \sum_{t|t-1}^{S} \tag{27}$$

Initialising the Kalman filter we still need

1. Initial estimate $S_{1|0}$
2. Covariance matrix

In many macroeconomic models S can be assumed to have zero mean. For the covariance matrix we use

$$\sum_{t|t-1}^{S} = F \sum_{t-1|t-1}^{S} F' + \sum^{u} \tag{28}$$

Values of this covariance matrix will converge; for unconditional covariance matrix can use value for $\sum$ that solves

$$\sum = F \sum F' + \sum^{u} \tag{29}$$

Hodrick-Prescott filter

$$\sum_{t=1}^{N}[(y_t - y_t^*)^2 + \lambda(\Delta y_t^* - \Delta y_{t-1}^*)] \tag{30}$$

Consider state-space model

$$y_t = y_t^* + C_t \tag{31}$$

$$\Delta y_t^* = \Delta Y_{t-1}^* + \epsilon_t^g \tag{32}$$

$$C_t = \epsilon_t^c \tag{33}$$

Here

$$Var(\epsilon_t^g) = \sigma_g^2; Var(\epsilon_t^c) = \sigma_c^2 \tag{34}$$

HP filer = Kalman filter when

$$\lambda = \frac{\sigma_c^2}{\sigma_g^2} \tag{35}$$

It is assumed that σ_c^2 is 5 percentage points and σ_g^2 one-eight percentage point: $\lambda = 1600$