Bayesian State Space Models

Introduction

- State space methods are used for a wide variety of time series problems
- They are important in and of themselves in economics (e.g. trend-cycle decompositions, structural time series models, dealing with missing observations, etc.)
- They can be used to deal with unit root issues and ARMA
- Also time-varying parameter (TVP) models can be used to deal with parameter change/structural breaks/regime change
- Dynamic factor models are state space models
- Stochastic volatility are state space models
- Advantage of state space models: well-developed set of MCMC algorithms for doing Bayesian inference

The Local Level Model

- Explain basic ideas in simplest state space model: the local level model
- For $t = 1, .., T$ have
$$y_t = \alpha_t + \varepsilon_t$$
- ε_t is i.i.d. $N\left(0, h^{-1}\right)$.
- α_t which is not observed (called a *state*) and follows random walk for $t = 1, .., T-1$:
$$\alpha_{t+1} = \alpha_t + u_t$$
- u_t is i.i.d. $N\left(0, Q\right)$
- ε_t and u_s are independent of one another for all s and t.
- First equation: measurement (observation) equation, second state equation
- α_1 is *initial condition*.

Relationship to Other Models

- Can write

$$\Delta y_t = \varepsilon_t - \varepsilon_{t-1} + u_{t-1}$$

- Δy_t is stationary ($I(0)$) whereas y_t has unit root ($I(1)$)
- Can write

$$\alpha_t = \alpha_1 + \sum_{j=1}^{t-1} u_j$$

- this is a trend (stochastic trend)
- local level model decomposes y_t, into a trend component, α_t, and an error or irregular component, ε_t.
- Test of whether $Q = 0$ is one way of testing for a unit root.
- These results illustrate how all usual univariate time series things: ARIMA modelling, unit root testing, etc. can be done in state space framework

Relationship to Other Models

- α_t is the mean (or level) of y_t.
- Mean is varying over time, hence terminology *local level model*
- Measurement equation can be interpreted as simple example of regression model involving only an intercept.
- But the intercept varies over time: time varying parameter model
- Extensions of local level model used to investigate parameter change in various contexts.

The Likelihood Function of the Local Level Model

- Define $y = (y_1, ..., y_T)'$ and $\varepsilon = (\varepsilon_1, ..., \varepsilon_T)'$ then local level model:

$$y = I_T \alpha + \varepsilon$$

- This is a regression model with explanatory variables I_T and coefficients $\alpha = (\alpha_1, .., \alpha_T)'$
- Likelihood function has standard form for the Normal linear regression model
- Note relation to Fat Data: T observations and T explanatory variables
- Here hierarchical prior is provided by state equation

Prior for Local Level Model

- State equation gives us:

$$\alpha_{t+1}|\alpha_t, Q \sim N(\alpha_t, q)$$

- Or

$$p(\alpha|Q) = \prod_{t=1}^{T} p(\alpha_{t+1}|\alpha_t, Q)$$

- This is a hierarchical prior: since it depends on Q which, in turn, requires its own prior.
- The fact that is it a Normal prior means can use standard results for Normal linear regression model

Posterior for Local Level Model

- I will not repeat exact formula here
- See Topic 1 slides or page 187 of my textbook for natural conjugate case
- But the formulae will depend on parameters Q and h
- Textbook discusses (pages 188-190) discusses one estimation method, see below for MCMC method
- An issue arises: α is $T \times 1$ which can be very large (dimension of states even larger in general state space models)
- Remember: if regression had k explanatory variables, posterior involved manipulations (inverting, etc.) $k \times k$ matrices
- If $k = T$ or more, this rapidly gets demanding (or impossible)
- For state space models, special methods based on Kalman filtering used to avoid such manipulations
- Will discuss below, but remember that state space models basically just regression models with a particular hierarchical prior

Filtering versus Smoothing in the Local Level Model

- Notation: superscripts for all observations up to a specific time
- E.g. $y^T = (y_1, .., y_T)'$ is all observations in the sample
- $\alpha^t = (\alpha_1, .., \alpha_t)'$ is all states up to the current period (t)
- Filtering = using y^t
- $E(\alpha_t | y^t)$ is the filtered estimate of the state
- $E(y_{t+1} | y^t)$ is estimate of y_{t+1} (unknown at time t)
- Used for real time forecasting
- Smoothing = using y^T
- $E(\alpha_t | y^T)$ is smoothed estimate of state
- E.g. estimate of trend inflation using the full sample of data

The Kalman Filter

- I will not derive or state exact formulae, just the main ideas
- Good reference: Durbin and Koopman, Time Series Analysis by State Space Methods
- Formulae below depend on Q and h, for now assume known
- Can prove

$$\begin{aligned} \alpha_t | y^{t-1} &\sim N\left(a_{t|t-1}, P_{t|t-1}\right) \\ \alpha_t | y^{t} &\sim N\left(a_{t|t}, P_{t|t}\right) \end{aligned}$$

- Kalman filter involves simple formulae linking $a_{t|t-1}, P_{t|t-1}, a_{t|t}, P_{t|t}$
- Also formula for predictive density $p\left(y_{t+1}|y^t\right)$ which can be used for real time forecasting
- Formula for likelihood function (used for maximum likelihood estimation)

Kalman Filter Recursions

- Start with initial condition, $a_{1|1}, P_{1|1}$ (Bayesians assume prior)
- Calculate $a_{2|1}$, $P_{2|1}$ using Kalman filtering formulae
- Calculate $a_{2|2}$, $P_{2|2}$
- ...
- Calculate $a_{t|t-1}$, $P_{t|t-1}$
- Calculate $a_{t|t}$, $P_{t|t}$
- etc.

Kalman Filter Recursions

- Each calculation on previous slide only depended on the last one
- New observation added, only need to update using this
- Simplifies computation: no need for manipulations involving $T \times T$ matrices
- At every point in time get filtered estimate of state, predictive density, etc.
- Run the Kalman filter from $t = 1, .., T$

State Smoothing

- Smoothing uses full sample, y^T
- Suitable for estimation (e.g. estimating trend inflation)
- Standard recursive formulae exist with same "update one observation at a time"
- Can prove

$$\alpha_t | y^T \sim N\left(a_{t|T}, P_{t|T}\right)$$

- First run Kalman filter from $t = 1, .., T$
- Then state smoother from $t = T, .., 1$
- Set of simple recursive formulae for $a_{t|T}$ and $P_{t|T}$

Summary of Estimation in Local Level Model

- Local level model has parameters α^T, Q and h
- Kalman filter and state smoother provides formula for $p\left(\alpha^T|y^T, Q, h\right)$ and $p\left(\alpha^T|y^t, Q, h\right)$
- And $p\left(y^{t+1}|y^t, Q, h\right)$ for forecasting
- Bayesian can complete the Gibbs sampler with $p\left(Q|y^T, h, \alpha^T\right)$ and $p\left(h|y^T, Q, \alpha^T\right)$
- Exact forms depend on prior, but simple based on Normal linear regression model

The Normal Linear State Space Model

- General version of Normal linear state space model:
- Measurement equation:

$$y_t = W_t \delta + Z_t \beta_t + \varepsilon_t$$

- State equation:

$$\beta_{t+1} = T_t \beta_t + u_t$$

- y_t and ε_t defined as for regression model
- Illustrate as though for a regression or AR model, but much more general
- General theory has y_t being $M \times 1$ vector
- Usual for macroeconomics: VARs have M variables, DSGE models involve M variables
- But my applications will be for single equation: $M = 1$

The Normal Linear State Space Model

- W_t is known $M \times p_0$ matrix (e.g. lagged dependent variables or explanatory variables with constant coefficients)
- Z_t is known $M \times K$ matrix (e.g. lagged dependent variables or explanatory variables with time varying coefficients)
- β_t is $k \times 1$ vector of states (e.g. regression or AR coefficients)
- ε_t ind $N(0, \Sigma_t)$
- u_t ind $N(0, Q_t)$.
- ε_t and u_s are independent for all s and t.
- T_t is a $k \times k$ matrix (usually fixed, but sometimes not).

- Key idea: for given values for δ, T_t, Σ_t and Q_t (called "system matrices") posterior simulators for β_t for $t = 1, .., T$ exist.
- E.g. Carter and Kohn (1994, Btka), Fruhwirth-Schnatter (1994, JTSA), DeJong and Shephard (1995, Btka) and Durbin and Koopman (2002, Btka).
- I will not present details of these (standard) algorithms
- I have outlined general form for the local level model above
- Recently other algorithms have been proposed in several papers by Joshua Chan (University of Technology Sydney) and Bill McCausland (University of Montreal)
- These do not use Kalman filter, but exploit special band structure of large $T \times T$ matrices to invert key matrices directly

- Notation: $\beta^t = \left(\beta_1', .., \beta_t'\right)'$ stacks all the states up to time t (and similar superscript t convention for other things)
- Gibbs sampler: $p\left(\beta^T | y^T, \delta, T^T, \Sigma^T, Q^T\right)$ drawn use such an algorithm
- $p\left(\delta | y^T, \beta^T, T^T, \Sigma^T, Q^T\right)$, $p\left(T^T | y^T, \beta^T, \delta, \Sigma^T, Q^T\right)$, $p\left(\Sigma^T | y^T, \beta^T, \delta, T^T, Q^T\right)$ and $p\left(Q^T | y^T, \beta^T, \delta, T^T, \Sigma^T\right)$ depend on precise form of model (typically simple since, conditional on β^T have a Normal linear model)
- Typically restricted versions of this general model used
- TVP-VAR of Primiceri (2005, ReStud) has $\delta = 0$, $T_t = I$ and $Q_t = Q$
- Computer tutorial 4 considers a time-varying parameter AR model
- Z_t contains lags of dependent variable, $\delta = 0$, $T_t = I$ and Q_t is a diagonal matrix

Example of an MCMC Algorithm

- Special case $\delta = 0$, $T_t = I, \Sigma_t = h$ and $Q_t = Q$
- Homoskedastic TVP-VAR of Cogley and Sargent (2001, NBER)
- Need prior for all parameters
- But state equation implies hierarchical prior for β^T:

$$\beta_{t+1} | \beta_t, Q \sim N\left(\beta_t, Q\right)$$

- Formally:

$$p\left(\beta^T | Q\right) = \prod_{t=1}^{T} p\left(\beta_t | \beta_{t-1}, Q\right)$$

- Hierarchical: since it depends on Q which, in turn, requires its own prior.

- Note β_0 enters prior for β_1.
- Need prior for β_0
- Standard treatments exist.
- E.g. assume $\beta_0 = 0$, then:

$$\beta_1 | Q \sim N(0, Q)$$

- Or Carter and Kohn (1994) simply assume β_0 has some prior that researcher chooses
- h is error precision in measurement equation, just use Gamma prior for it as in Normal linear regression model

- Common to use Wishart prior for Q^{-1}
- $$Q^{-1} \sim W\left(\underline{Q}^{-1}, \underline{\nu}_Q\right)$$

Digression

- Remember regression models had parameters β and σ^2
- There proved convenient to work with $h = \frac{1}{\sigma^2}$
- With Q proves convenient to work with Q^{-1}
- In regression h typically had Gamma distribution
- With state equations (more than one equation) Q^{-1} will typically have Wishart distribution
- Wishart is matrix generalization of Gamma
- Details see appendix to textbook.
- If Σ^{-1} is $W(C, c)$ then "Mean" is cC and c is degrees of freedom.
- Note: easy to take random draws from Wishart.

- Want MCMC algorithm which sequentially draws from $p\left(h^{-1}|y^T, \beta^T, Q\right)$, $p\left(Q^{-1}|y^T, h, \beta^T\right)$ and $p\left(\beta^T|y^T, h, Q\right)$.
- For $p\left(\beta^T|y^T, h, Q\right)$ use standard algorithm for state space models (e.g. Carter and Kohn, 1994)
- Can derive $p\left(h|y^T, \beta^T, Q\right)$ using Normal linear regression model results
- That is, conditional on β^T, measurement equation is just a regression with known coefficients.

- $p\left(Q^{-1}|y^T, h, \beta^T\right)$ use multiple equation extension of Normal linear regression model
- Conditional on β^T, state equation is also like a series of regression equations
- This leads to:

$$Q^{-1}|y^T, \beta^T \sim W\left(\overline{Q}^{-1}, \overline{\nu}_Q\right)$$

- where

$$\overline{\nu}_Q = T + \underline{\nu}_Q$$

-

$$\overline{Q} = \underline{Q} + \sum_{t=1}^{T}\left(\beta_{t+1} - \beta_t\right)\left(\beta_{t+1} - \beta_t\right)'.$$

DSGE Models as State Space Models

- If time permits, I will discuss DSGE (if not, skip to stochastic volatility)
- DSGE = Dynamic, stochastic general equilibrium models popular in modern macroeconomics and commonly used in policy circles (e.g. central banks).
- I will not explain the macro theory, other than to note they are:
- Derived from microeconomic principles (based on agents and firms decision problems), dynamic (studying how economy evolves over time) and general equilibrium.
- Solution (using linear approximation methods) is a linear state space model
- Note: recent work with second order approximations yields nonlinear state space model
- Survey: An and Schorfheide (2007, Econometric Reviews)
- Computer code: http://www.dynare.org/ or some authors post code (e.g. code for Del Negro and Schorfheide 2008, JME on web)

Estimation Strategy for DSGE

- Most linearized DSGE models written as:

$$\Gamma_0(\theta) z_t = \Gamma_1(\theta) E_t(z_{t+1}) + \Gamma_2(\theta) z_{t-1} + \Gamma_3(\theta) u_t$$

- z_t is vector containing both observed variables (e.g. output growth, inflation, interest rates) and unobserved variables (e.g. technology shocks, monetary policy shocks).
- Note, theory usually written in terms of z_t as deviation of variable from steady state (an issue I will ignore here to keep exposition simple)
- θ are structural parameters (e.g. parameters for steady states, tastes, technology, policy, etc.).
- u_t are structural shocks ($N(0, I)$).
- $\Gamma_j(\theta)$ are often highly nonlinear functions of θ

Solving the DSGE Model

- Methods exist to solve linear rational expectations models such as the DSGE
- If unique equilibrium exists can be written as:

$$z_t = A(\theta) z_{t-1} + B(\theta) u_t$$

- Looks like a VAR, but....
- Some elements of z_t typically unobserved
- and highly nonlinear restrictions involved in $A(\theta)$ and $B(\theta)$

Write DSGE Model as State Space Model

- Let y_t be elements of z_t which are observed.
- Measurement equation:
$$y_t = Cz_t$$
where C is matrix which picks out observed elements of z_t
- Equation on previous slide is state equation in states z_t
- Thus we have state space model
- Special case since measurement equation has no errors (although measurement errors often added) and state equation has some states which are observed.
- But state space algorithms described earlier in this lecture still work
- Remember, before I said: "for given values for system matrices, posterior simulators for the states exist"
- If θ were known, DSGE model provides system matrices in Normal linear state space model

Estimating the Structural Parameters

- If $A(\theta)$ and $B(\theta)$ involved simple linear restrictions, then linear methods similar to regressions could be used to carry out inference on θ.
- Unfortunately, restrictions in $A(\theta)$ and $B(\theta)$ are typically nonlinear and complicated
- Parameters in θ are structural so we are likely to have prior information about them
- Example from Del Negro and Schorfheide (2008, JME):
- "Household-level data on wages and hours worked could be used to form a prior for a labor supply elasticity"
- "Product level data on price changes could be the basis for a price-stickiness prior"

Estimating the Structural Parameters (cont.)

- Prior for structural parameters, $p(\theta)$, can be formed from other sources of information (e.g. micro studies, economic theory, etc.)
- Here: prior times likelihood is a mess
- Thus, no analytical posterior for θ, no Gibbs sampler, etc...
- Solution: Metropolis-Hastings algorithm (see my textbook chapter 5, section 5)

- Popular (e.g. DYNARE) to use random walk Metropolis-Hastings with DSGE models.
- Note acceptance probability depends only on posterior = prior times likelihood
- DSGE Prior chosen as discussed above
- Algorithms for Normal linear state space models evaluate likelihood function

Nonlinear State Space Models

- Normal linear state space model useful for empirical macroeconomists
- E.g. trend-cycle decompositions, TVP-VARs, linearized DSGE models, dynamic factor models, etc.
- Some models have y_t being a nonlinear function of the states (e.g. DSGE models which have not been linearized)
- Increasing number of Bayesian tools for nonlinear state space models (e.g. the particle filter)
- Here we will focus on stochastic volatility

Stochastic Volatility

- Popular in finance, but increasingly macroeconomists realize importance of allowing for time-varying volatility
- Note: multivariate stochastic volatility in VARs is very popular (also nonlinear state space model, simple extension of univariate case)
- Stochastic volatility model:

$$y_t = \exp\left(\frac{h_t}{2}\right)\varepsilon_t$$

- $$h_{t+1} = \mu + \phi\left(h_t - \mu\right) + \eta_t$$

- ε_t is i.i.d. $N(0,1)$ and η_t is i.i.d. $N\left(0,\sigma_\eta^2\right)$. ε_t and η_s are independent.
- This is state space model with states being h_t, but measurement equation is not a linear function of h_t

- h_t is log of the variance of y_t (log volatility)
- Since variances must be positive, common to work with log-variances
- Note μ is the unconditional mean of h_t.
- Initial conditions: if $|\phi| < 1$ (stationary) then:

$$h_0 \sim N\left(\mu, \frac{\sigma_\eta^2}{1-\phi^2}\right)$$

- if $\phi = 1$, μ drops out of the model and However, when $\phi = 1$, need a prior such as $h_0 \sim N\left(\underline{h}, \underline{V}_h\right)$
- e.g. Primiceri (2005) chooses $\underline{V}_h$ using training sample

MCMC Algorithm for Stochastic Volatility Model

- MCMC algorithm involves sequentially drawing from $p\left(h^T|y^T,\mu,\phi,\sigma_\eta^2\right)$, $p\left(\phi|y^T,\mu,\sigma_\eta^2,h^T\right)$, $p\left(\mu|y^T,\phi,\sigma_\eta^2,h^T\right)$ and $p\left(\sigma_\eta^2|y^T,\mu,\phi,h^T\right)$
- Last three standard forms based on results from Normal linear regression model and will not present here.
- Several algorithms exist for $p\left(h^T|y^T,\mu,\phi,\sigma_\eta^2\right)$
- Here we describe a popular one from Kim, Shephard and Chib (1998, ReStud)
- For complete details, see their paper. Here we outline ideas.

- Square and log the measurement equation:

$$y_t^* = h_t + \varepsilon_t^*$$

- where $y_t^* = \ln\left(y_t^2\right)$ and $\varepsilon_t^* = \ln\left(\varepsilon_t^2\right)$.
- Now the measurement equation is linear so maybe we can use algorithm for Normal linear state space model?
- No, since error is no longer Normal (i.e. $\varepsilon_t^* = \ln\left(\varepsilon_t^2\right)$)
- Idea: use mixture of different Normal distributions to approximate distribution of ε_t^*.

- Mixtures of Normal distributions are very flexible and have been used widely in many fields to approximate unknown or inconvenient distributions.
- $$p\left(\varepsilon_t^*\right) \approx \sum_{i=1}^{7} q_i f_N\left(\varepsilon_t^* | m_i, v_i^2\right)$$
- where $f_N\left(\varepsilon_t^* | m_i, v_i^2\right)$ is the p.d.f. of a $N\left(m_i, v_i^2\right)$
- since ε_t is $N\left(0, 1\right)$, ε_t^* involves no unknown parameters
- Thus, q_i, m_i, v_i^2 for $i = 1, .., 7$ are not parameters, but numbers (see Table 4 of Kim, Shephard and Chib, 1998).

- Mixture of Normals can also be written in terms of component indicator variables, $s_t \in \{1, 2, .., 7\}$
- $$\begin{aligned} \varepsilon_t^* | s_t &= i \sim N\left(m_i, v_i^2\right) \\ \Pr\left(s_t = i\right) &= q_i \end{aligned}$$
- MCMC algorithm does not draw from $p\left(h^T | y^T, \mu, \phi, \sigma_\eta^2\right)$, but from $p\left(h^T | y^T, \mu, \phi, \sigma_\eta^2, s^T\right)$.
- But, conditional on s^T, knows which of the Normals ε_t^* comes from.
- Result is a Normal linear state space model and familiar algorithm can be used.
- Finally, need $p\left(s^T | y^T, \mu, \phi, \sigma_\eta^2, h^T\right)$ but this has simple form (see Kim, Shephard and Chib , 1998)

Summary and Other Directions

- This completes discussion of general ideas underlying state space models and few key models
- Computer tutorial 4 considers time-varying parameter AR model
- Suitable for modelling parameter change (structural breaks/regime change, etc.)
- Computer tutorial 5 considers the popular unobserved components stochastic volatility model
- State space methods growing in popularity in many other contexts
- SSVS and Lasso methods used with state space models
- Frühwirth-Schnatter and Wagner (2010). "Stochastic model specification search for Gaussian and partial non-Gaussian state space models," Journal of Econometrics.
- Dynamic mixture models used to model structural breaks, outliers, nonlinearities, etc.
- Giordani, Kohn and van Dijk (2007, JoE).

A Macroeconomic Application: Inflation Forecasting using Dynamic Model Averaging

- I will end this course with application which involves time series regression, state space models, model averaging and forecasting as way of summarizing major themes of this course
- Based on the paper: Koop and Korobilis (2012, International Economic Review)
- Macroeconomists typically have many time series variables
- But even with all this information forecasting of macroeconomic variables like inflation, GDP growth, etc. can be very hard
- Sometimes hard to beat very simple forecasting procedures (e.g. random walk)
- Imagine a regression of inflation on many predictors
- Such a regression might fit well in practice, but forecast poorly

- Why? There are many reasons, but three stand out:
- Regressions with many predictors can over-fit (over-parameterization problems)
- Marginal effects of predictors change over time (parameter change/structural breaks)
- The relevant forecasting model may change (model change)
- We use an approach called Dynamic Model Averaging (DMA) in an attempt to address these problems

The Generalized Phillips Curve

- Phillips curve: inflation depends on unemployment rate
- Generalized Phillips curve: Inflation dependent on lagged inflation, unemployment and other predictors
- Many papers use generalized Phillips curve models for inflation forecasting
- Regression-based methods based on:

$$y_t = \phi + x'_{t-1}\beta + \sum_{j=1}^{p} \gamma_j y_{t-j} + \varepsilon_t$$

- y_t is inflation and x_{t-1} are lags of other predictors
- To make things concrete, following is our list of predictors (other papers use similar)

- UNEMP: unemployment rate.
- CONS: the percentage change in real personal consumption expenditures.
- INV: the percentage change in private residential fixed investment.
- GDP: the percentage change in real GDP.
- HSTARTS: the log of housing starts (total new privately owned housing units).
- EMPLOY: the percentage change in employment (All Employees: Total Private Industries, seasonally adjusted).
- PMI: the change in the Institute of Supply Management (Manufacturing): Purchasing Manager's Composite Index.

- TBILL: three month Treasury bill (secondary market) rate.
- SPREAD: the spread between the 10 year and 3 month Treasury bill rates.
- DJIA: the percentage change in the Dow Jones Industrial Average.
- MONEY: the percentage change in the money supply (M1).
- INFEXP: University of Michigan measure of inflation expectations.
- COMPRICE: the change in the commodities price index (NAPM commodities price index).
- VENDOR: the change in the NAPM vendor deliveries index.

Forecasting With Generalized Phillips Curve

- Write more compactly as:

$$y_t = z_t\theta + \varepsilon_t$$

- z_t contains all predictors, lagged inflation, an intercept
- Note $z_t =$ information available for forecasting y_t
- When forecasting h periods ahead will contain variables dated $t - h$ or earlier

- Consider forecasting $y_{\tau+1}$.
- Recursive forecasting methods: $\widehat{\theta} =$ estimate using data through τ.
- So $\widehat{\theta}$ will change (a bit) with τ, but can change too slowly
- Rolling forecasts use: $\widehat{\theta}$ an estimate using data from $\tau - \tau_0$ through τ.
- Better at capturing parameter change, but need to choose τ_0
- Recursive and rolling forecasts might be imperfect solutions
- Why not use a model which formally models the parameter change as well?

Time Varying Parameter (TVP) Models

- TVP models gaining popularity in empirical macroeconomics

$$
\begin{aligned}
y_t &= z_t \theta_t + \varepsilon_t \\
\theta_t &= \theta_{t-1} + \eta_t
\end{aligned}
$$

- $\varepsilon_t \overset{ind}{\sim} N(0, H_t)$
- $\eta_t \overset{ind}{\sim} N(0, Q_t)$
- State space methods described above can be used to estimate them

- Why not use TVP model to forecast inflation?
- Advantage: models parameter change in a formal manner
- Disadvantage: same predictors used at all points in time.
- If number of predictors large, over-fit, over-parameterization problems
- In our empirical work, we show very poor forecast performance

Dynamic Model Averaging (DMA)

- Define K models which have $z_t^{(k)}$ for $k = 1, .., K$, as predictors
- $z_t^{(k)}$ is subset of z_t.
- Set of models:

$$
\begin{aligned}
y_t &= z_t^{(k)} \theta_t^{(k)} + \varepsilon_t^{(k)} \\
\theta_{t+1}^{(k)} &= \theta_t^{(k)} + \eta_t^{(k)}
\end{aligned}
$$

- $\varepsilon_t^{(k)}$ is $N\left(0, H_t^{(k)}\right)$
- $\eta_t^{(k)}$ is $N\left(0, Q_t^{(k)}\right)$
- Let $L_t \in \{1, 2, .., K\}$ denote which model applies at t

- Why not just forecast using BMA over these TVP models at every point in time?
- Different weights in averaging at every point in time.
- Or why not just select a single TVP forecasting model at every point in time?
- Different forecasting models selected at each point in time.
- If K is large (e.g. $K = 2^m$), this is computationally infeasible.
- With cross-sectional BMA have to work with model space $K = 2^m$ which is computationally burdensome
- In present time series context, forecasting through time τ involves $2^{m\tau}$ models.
- Also, Bayesian inference in TVP model requires MCMC (unlike cross-sectional regression). Computationally burdensome.
- Even clever algorithms like MC-cubed are not good enough to handle this.

- Another strategy has been used to deal with similar problems in different contexts (e.g. multiple structural breaks): Markov switching
- Markov transition matrix, P,
- Elements $p_{ij} = \Pr\left(L_t = i | L_{t-1} = j\right)$ for $i, j = 1, .., K$.
- "If j is the forecasting model at $t-1$, we switch to forecasting model i at time t with probability p_{ij}"
- Bayesian inference is theoretically straightforward, but computationally infeasible
- P is $K \times K$: an enormous matrix.
- Even if computation were possible, imprecise estimation of so many parameters

Solution: DMA

- Adopt approach used by Raftery et al (2010 Technometrics) in an engineering application
- Involves two approximations
- First approximation means we do not need MCMC in each TVP model (only need run a standard Kalman filtering and smoothing)
- See paper for details. Idea: replace $Q_t^{(k)}$ and $H_t^{(k)}$ by estimates

- Sketch of some Kalman filtering ideas (where y^{t-1} are observations through $t-1$)

$$\theta_{t-1}|y^{t-1} \sim N\left(\widehat{\theta}_{t-1}, \Sigma_{t-1|t-1}\right)$$

- Textbook formula for $\widehat{\theta}_{t-1}$ and $\Sigma_{t-1|t-1}$
- Then update

$$\theta_t|y^{t-1} \sim N\left(\widehat{\theta}_{t-1}, \Sigma_{t|t-1}\right)$$

-

$$\Sigma_{t|t-1} = \Sigma_{t-1|t-1} + Q_t$$

- Get rid of Q_t by approximating:

$$\Sigma_{t|t-1} = \frac{1}{\lambda}\Sigma_{t-1|t-1}$$

- $0 < \lambda \leq 1$ is forgetting factor

- Forgetting factors like this have long been used in state space literature
- Implies that observations j periods in the past have weight λ^j.
- Or effective window size of $\frac{1}{1-\lambda}$.
- Choose value of λ near one
- $\lambda = 0.99$: observations five years ago $\approx 80\%$ as much weight as last period's observation.
- $\lambda = 0.95$: observations five years ago $\approx 35\%$ as much weight as last period's observations.
- We focus on $\lambda \in [0.95, 1.00]$.
- If $\lambda = 1$ no time variation in parameters (standard recursive forecasting)

Back to Model Averaging/Selection

- Goal for forecasting at time t given data available at time $t-1$ is $\pi_{t|t-1,k} \equiv \Pr\left(L_t = k|y^{t-1}\right)$
- Can average across $k = 1, .., K$ forecasts using $\pi_{t|t-1,k}$ as weights (DMA)
- E.g. point forecasts ($\widehat{\theta}_{t-1}^{(k)}$ from Kalman filter in model k):

$$E\left(y_t|y^{t-1}\right) = \sum_{k=1}^{K} \pi_{t|t-1,k} z_t^{(k)} \widehat{\theta}_{t-1}^{(k)}$$

- Can forecast with model j at time t if $\pi_{t|t-1,j}$ is highest (Dynamic model selection: DMS)
- Raftery et al (2010) propose another forgetting factor to approximate $\pi_{t|t-1,k}$

- Complete details in Raftery et al's paper.
- Basic idea is that can use similar state space updating formulae for models as is done with states
- Then use similar forgetting factor to get approximation

$$\pi_{t|t-1,k} = \frac{\pi^{\alpha}_{t-1|t-1,k}}{\sum_{l=1}^{K} \pi^{\alpha}_{t-1|t-1,l}}$$

- $0 < \alpha \leq 1$ is forgetting factor with similar interpretation to λ
- Focus on $\alpha \in [0.95, 1.00]$

- Interpretation of forgetting factor α
- Easy to show:

$$\pi_{t|t-1,k} = \prod_{i=1}^{t-1} \left[p_k \left(y_{t-i} | y^{t-i-1} \right) \right]^{\alpha^i}$$

- $p_k \left(y_t | y^{t-1} \right)$ is predictive density for model k evaluated at y_t (measure of forecast performance of model k)
- Model k will receive more weight at time t if it has forecast well in the recent past
- Interpretation of "recent past" is controlled by the forgetting factor, α
- $\alpha = 0.99$: forecast performance five years ago receives 80% as much weight as forecast performance last period
- $\alpha = 0.95$: forecast performance five years ago receives only about 35% as much weight.
- $\alpha = 1$: can show $\pi_{t|t-1,k}$ is proportional to the marginal likelihood using data through time $t-1$ (standard BMA)

Summary So Far

- We want to do DMA or DMS
- These use TVP models which allow marginal effects to change over time
- These allow for forecasting model to switch over time
- So can switch from one parsimonious forecasting model to another (avoid over-parametization)
- But a full formal Bayesian analysis is computationally infeasible
- Sensible approximations make it computationally feasible.
- State space updating formula must be run K times, instead of (roughly speaking) K^T MCMC algorithms

Forecasting US Inflation

- Data from 1960Q1 through 2008Q4
- Real time data (forecasting at time τ using data as known at time τ)
- Two measure of inflation based on PCE deflator (core inflation) and GDP deflator
- 14 predictors listed previously (all variables transformed to be approximately stationary)
- All models include an intercept and two lags of the dependent variable
- 3 forecast horizons: $h = 1,4,8$

Is DMA Parsimonious?

- Even though 14 potential predictors, most probability is attached to very parsimonious models with only a few predictors.
- $Size_k$ = number of predictors in model k
- ($Size_k$ does not include the intercept plus two lags of the dependent variable)
- Figure 1 plots

$$E\left(Size_t\right) = \sum_{k=1}^{K} \pi_{t|t-1,k} Size_k$$

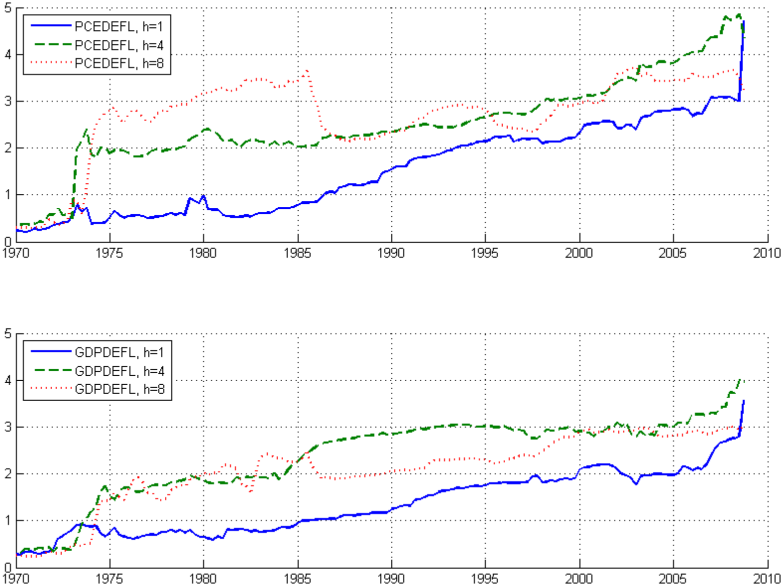

Figure 1: Expected Number of Predictors

Which Variables are Good Predictors for Inflation?

- Posterior inclusion probabilities for j^{th} predictor $=$

$$\sum_{k \in J} \pi_{t|t-1,k}$$

- where $k \in J$ indicates models which include j^{th} predictor
- See Figure 2, 3 and 4 for 2 measures of inflation and 3 forecast horizons
- Any predictor where the inclusion probability is never above 0.5 is excluded from the appropriate figure.
- Lots of evidence of predictor change in all cases.
- DMA/DMS will pick this up automatically

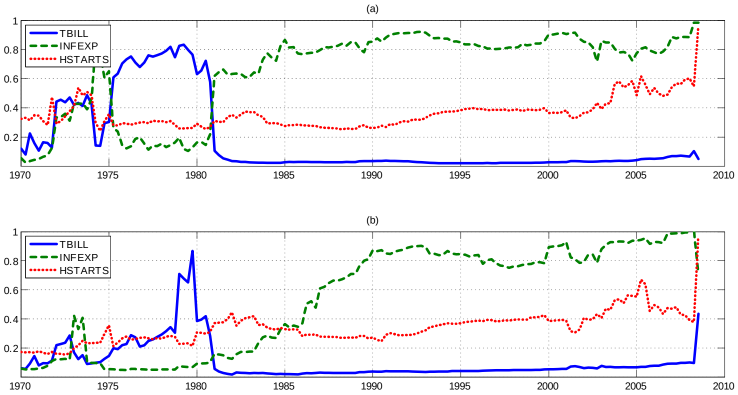

Figure 2: Posterior Probability of Inclusion of Predictors, $h = 1$. GDP deflator inflation top, PCE deflator inflation bottom

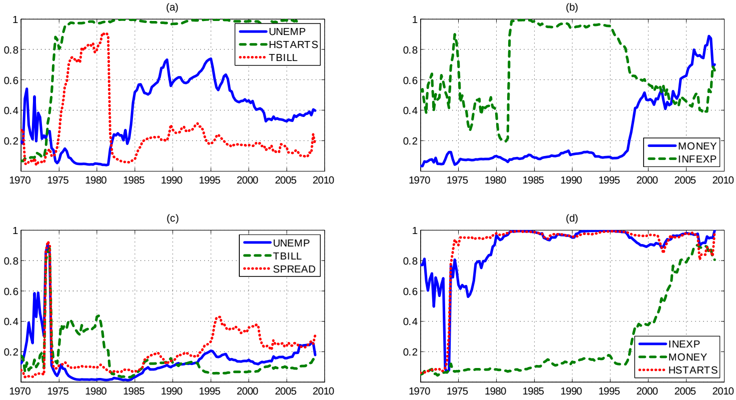

Figure 3: Posterior Probability of Inclusion of Predictors, $h = 4$. GDP deflator inflation top, PCE deflator inflation bottom

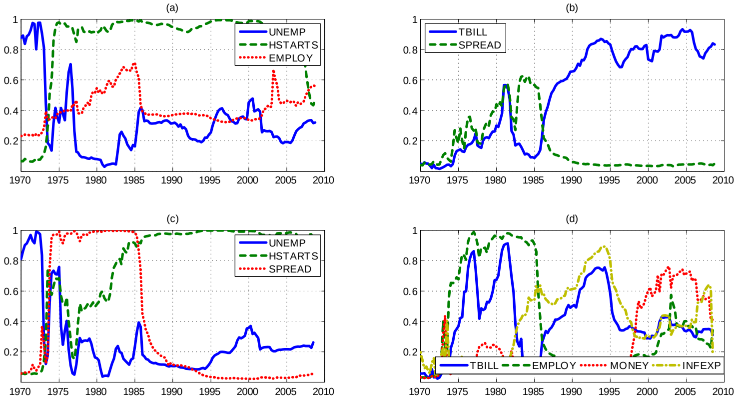

Figure 4: Posterior Probability of Inclusion of Predictors, $h = 8$. GDP deflator inflation top, PCE deflator inflation bottom

Forecast Performance

- recursive forecasting exercise
- forecast evaluation begins in 1970Q1
- Measures of forecast performance using point forecasts
- Mean squared forecast error (MSFE) and mean absolute forecast error (MAFE).
- Forecast metric involving entire predictive distribution: the sum of log predictive likelihoods.
- Predictive likelihood = Predictive density for y_t (given data through time $t-1$) evaluated at the actual outcome.

Forecasting Methods

- DMA with $\alpha = \lambda = 0.99$.
- DMS with $\alpha = \lambda = 0.99$.
- DMA with $\alpha = \lambda = 0.95$.
- DMS with $\alpha = \lambda = 0.95$.
- DMA, with constant coefficients ($\lambda = 1$, $\alpha = 0.99$)
- BMA as a special case of DMA (i.e. we set $\lambda = \alpha = 1$).
- TVP-AR(2)-X: Traditional TVP model .
- TVP-AR(2) model (as preceding but excluding predictors)

- Traditional g-prior BMA
- UC-SV: Unobserved components with stochastic volatility model of Stock and Watson (2007).
- Recursive OLS using AR(p)
- As preceding, but adding the predictors.
- Rolling OLS using AR(p) (window of 40 quarters)
- As preceding, but adding the predictors
- Random walk
- Note: in recursive and rolling OLS forecasts p selected at each point in time using BIC

Discussion of Log Predictive Likelihoods

- Preferred method of Bayesian forecast comparison
- Some variant of DMA or DMS always forecast best.
- DMS with $\alpha = \lambda = 0.95$ good for both measures of inflation at all horizons.
- Conventional BMA forecasts poorly.
- TVP-AR(2) and UC-SV have substantially lower predictive likelihoods than the DMA or DMS approaches.
- Of the non-DMA approaches, UC-SV approach of Stock and Watson (2007) consistently is the best performer.
- TVP model with all predictors tends to forecast poorly
- Shrinkage provided by DMA or DMS is of great value in forecasting.
- DMS tends to forecast a bit better than DMA

Discussion of MSFE and MAFE

- Patterns noted with predictive likelihoods mainly still hold (although DMA does better relative to DMS)
- Simple forecasting methods (AR(2) or random walk model) are inferior to DMA and DMS
- Rolling OLS using all predictors forecast bests among OLS-based methods.
- DMS and DMA with $\alpha = \lambda = 0.95$ always lead to lower MSFEs and MAFEs than rolling OLS with all the predictors.
- In some cases rolling OLS with all predictors leads to lower MSFEs and MAFEs than other implementations of DMA or DMS.
- In general: DMA and DMS look to be safe options. Usually they do best, but where not they do not go too far wrong
- Unlike other methods which might perform well in some cases, but very poorly in others

Forecast results: GDP deflator inflation, $h = 1$

	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.248	0.306	-0.292
DMS ($\alpha = \lambda = 0.99$)	0.256	0.318	-0.277
DMA ($\alpha = \lambda = 0.95$)	0.248	0.310	-0.378
DMS ($\alpha = \lambda = 0.95$)	0.235	0.297	-0.237
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.249	0.306	-0.300
BMA (DMA with $\alpha = \lambda = 1$)	0.256	0.316	-0.320
TVP-AR(2) ($\lambda = 0.99$)	0.260	0.327	-0.344
TVP-AR(2)-X ($\lambda = 0.99$)	0.309	0.424	-0.423
BMA-MCMC ($g = \frac{1}{T}$)	0.234	0.303	-0.369
UC-SV ($\gamma = 0.2$)	0.256	0.332	-0.320
Recursive OLS - AR(BIC)	0.251	0.326	-
Recursive OLS - All Preds	0.265	0.334	-
Rolling OLS - AR(2)	0.251	0.325	-
Rolling OLS - All Preds	0.252	0.327	-
Random Walk	0.262	0.349	-

Forecast results: GDP deflator inflation, $h = 4$

	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.269	0.349	-0.421
DMS ($\alpha = \lambda = 0.99$)	0.277	0.361	-0.406
DMA ($\alpha = \lambda = 0.95$)	0.255	0.334	-0.455
DMS ($\alpha = \lambda = 0.95$)	0.249	0.316	-0.307
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.277	0.355	-0.445
BMA (DMA with $\alpha = \lambda = 1$)	0.282	0.363	-0.463
TVP-AR(2) ($\lambda = 0.99$)	0.320	0.401	-0.480
TVP-AR(2)-X ($\lambda = 0.99$)	0.336	0.453	-0.508
BMA-MCMC ($g = \frac{1}{T}$)	0.285	0.364	-0.503
UC-SV ($\gamma = 0.2$)	0.311	0.396	-0.473
Recursive OLS - AR(BIC)	0.344	0.433	-
Recursive OLS - All Preds	0.302	0.376	-
Rolling OLS - AR(2)	0.328	0.425	-
Rolling OLS - All Preds	0.273	0.349	-
Random Walk	0.333	0.435	-

Forecast results: GDP deflator inflation, $h = 8$

	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.333	0.413	-0.583
DMS ($\alpha = \lambda = 0.99$)	0.338	0.423	-0.578
DMA ($\alpha = \lambda = 0.95$)	0.293	0.379	-0.570
DMS ($\alpha = \lambda = 0.95$)	0.295	0.385	-0.424
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.346	0.423	-0.626
BMA (DMA with $\alpha = \lambda = 1$)	0.364	0.449	-0.690
TVP-AR(2) ($\lambda = 0.99$)	0.398	0.502	-0.662
TVP-AR(2)-X ($\lambda = 0.99$)	0.410	0.532	-0.701
BMA-MCMC ($g = \frac{1}{T}$)	0.319	0.401	-0.667
UC-SV ($\gamma = 0.2$)	0.350	0.465	-0.613
Recursive OLS - AR(BIC)	0.436	0.516	-
Recursive OLS - All Preds	0.369	0.441	-
Rolling OLS - AR(2)	0.380	0.464	-
Rolling OLS - All Preds	0.325	0.398	-
Random Walk	0.428	0.598	-

Forecast results: core inflation, $h = 1$

	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.253	0.322	-0.451
DMS ($\alpha = \lambda = 0.99$)	0.259	0.326	-0.430
DMA ($\alpha = \lambda = 0.95$)	0.267	0.334	-0.519
DMS ($\alpha = \lambda = 0.95$)	0.236	0.295	-0.348
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.250	0.317	-0.444
BMA (DMA with $\alpha = \lambda = 1$)	0.259	0.331	-0.464
TVP-AR(2) ($\lambda = 0.99$)	0.280	0.361	-0.488
TVP-AR(2)-X ($\lambda = 0.99$)	0.347	0.492	-0.645
BMA-MCMC ($g = \frac{1}{T}$)	0.269	0.352	-0.489
UC-SV ($\gamma = 0.2$)	0.269	0.341	-0.474
Recursive OLS - AR(BIC)	0.310	0.439	-
Recursive OLS - All Preds	0.303	0.421	-
Rolling OLS - AR(2)	0.316	0.430	-
Rolling OLS - All Preds	0.289	0.414	-
Random Walk	0.294	0.414	-

Forecast results: core inflation, $h = 4$

	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.311	0.406	-0.622
DMS ($\alpha = \lambda = 0.99$)	0.330	0.431	-0.631
DMA ($\alpha = \lambda = 0.95$)	0.290	0.382	-0.652
DMS ($\alpha = \lambda = 0.95$)	0.288	0.353	-0.499
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.315	0.412	-0.636
BMA (DMA with $\alpha = \lambda = 1$)	0.325	0.429	-0.668
TVP-AR(2) ($\lambda = 0.99$)	0.355	0.459	-0.668
TVP-AR(2)-X ($\lambda = 0.99$)	0.378	0.556	-0.764
BMA-MCMC ($g = \frac{1}{T}$)	0.307	0.414	-0.633
UC-SV ($\gamma = 0.2$)	0.340	0.443	-0.651
Recursive OLS - AR(BIC)	0.390	0.513	-
Recursive OLS - All Preds	0.325	0.442	-
Rolling OLS - AR(2)	0.378	0.510	-
Rolling OLS - All Preds	0.313	0.422	-
Random Walk	0.407	0.551	-

Forecast results: core inflation, $h = 8$

	h=8		
	MAFE	MSFE	log(PL)
DMA ($\alpha = \lambda = 0.99$)	0.357	0.448	-0.699
DMS ($\alpha = \lambda = 0.99$)	0.369	0.469	-0.699
DMA ($\alpha = \lambda = 0.95$)	0.317	0.403	-0.673
DMS ($\alpha = \lambda = 0.95$)	0.293	0.371	-0.518
DMA ($\lambda = 1$, $\alpha = 0.99$)	0.366	0.458	-0.733
BMA (DMA with $\alpha = \lambda = 1$)	0.397	0.490	-0.779
TVP-AR(2) ($\lambda = 0.99$)	0.450	0.573	-0.837
TVP-AR(2)-X ($\lambda = 0.99$)	0.432	0.574	-0.841
BMA-MCMC ($g = \frac{1}{T}$)	0.357	0.454	-0.788
UC-SV ($\gamma = 0.2$)	0.406	0.528	-0.774
Recursive OLS - AR(BIC)	0.463	0.574	-
Recursive OLS - All Preds	0.378	0.481	-
Rolling OLS - AR(2)	0.428	0.540	-
Rolling OLS - All Preds	0.338	0.436	-
Random Walk	0.531	0.698	-

Conclusions for DMA Application

- When forecasting in the presence of change/breaks/turbulence want an approach which:
- Allows for forecasting model to change over time
- Allows for marginal effects of predictors to change over time
- Automatically does the shrinkage necessary to reduce risk of overparameterization/over-fitting
- In theory, DMA and DMS should satisfy these criteria
- In practice, we find DMA and DMS to forecast well in an exercise involving US inflation.