Structural Estimation 3: Simulated Method of Moments and Indirect Inference

Christine Braun

Last Time

- Last time we talked about GMM
  - we had closed for solutions to moments
  - this is rarely the case
- **Today:**
  - Simulated Method of Moments (SMM)
  - Indirect Inference

Simulated Method of Moments

- Same notation as GMM
- Y_t: n-dimensional vector of observations
  - t does not have to mean time, could be people
  - unemployment, wages, duration, observables characteristics, ect..
- θ_0: vector of true parameters
- $g(Y_t, \theta)$: a vector valued function of data and parameters
  - such that $E[g(Y_t, \theta_0)] = 0$

Simulated Method of Moments

- Basic idea is the same:

$$E[g(Y_t,\theta)] \to \frac{1}{T}\sum_{t=1}^{T} g(Y_t,\theta)$$

- Last time we had

$$g(Y_i,\theta) = \begin{bmatrix} u_i - \frac{\delta}{\delta+\lambda[1-F(w_R;\mu,\sigma)]} \\ tu_i - \frac{1}{\lambda[1-F(w_R;\mu,\sigma)]} \\ te_i - \frac{1}{\delta} \\ w_i - E[w;\mu,\sigma] \\ w_i^2 - E[w^2;\mu,\sigma] \end{bmatrix}$$

- What do we do if we don't have a closed for $E[w^2;\mu,\sigma]$ or any other moment?

Simulated Method of Moments

- We will replace g with an estimate $\hat{g}$

$$E[g(Y_t,\theta)] \rightarrow \frac{1}{T}\sum_{t=1}^{T} g(Y_t,\theta) \rightarrow \frac{1}{T}\sum_{t=1}^{T} \hat{g}(Y_t,\theta)$$

- For a given θ we simulate $\{\hat{Y}_s\} = \{\hat{u}_s, \hat{tu}_s, \hat{te}_s, \hat{w}_s\}$, then

$$\hat{g}(Y_i,\theta) = \begin{bmatrix} u_i - N_s^{-1}\sum_s \hat{u}_s \\ tu_i - N_s^{-1}\sum_s \hat{tu}_s \\ te_i - N_s^{-1}\sum_s \hat{te}_s \\ w_i - N_s^{-1}\sum_s \hat{w}_s \\ w_i^2 - N_s^{-1}\sum_s \hat{w}_s^2 \end{bmatrix}$$

where N_s is the number of obs. in the simulated data.

Simulated Method of Moments

- The SMM estimate of θ_0 is

$$\hat{\theta} = \underset{\theta \in \Theta}{\operatorname{argmin}} \left(\frac{1}{T} \sum_{t=1}^{T} \hat{g}(Y_t, \theta) \right)' W \left(\frac{1}{T} \sum_{t=1}^{T} \hat{g}(Y_t, \theta) \right)$$

  where W is the weighting matrix.

- The asymptotic distribution of SMM Estimator is

$$\sqrt{n}(\hat{\theta} - \theta_0) \to N\big(0, (J'WJ)^{-1} J'W\Omega WJ(J'WJ)^{-1}\big)$$

- $J = E[\nabla_\theta g(Y_t, \theta)]$: jacobian of g
- $\Omega = E[g(Y_t, \theta_0) g(Y_t, \theta_0)']$
- If we have $W = \Omega^{-1}$

$$\sqrt{n}(\hat{\theta} - \theta_0) \to N\big(0, (J'\Omega J)^{-1}\big)$$

Simulated Method of Moments

- The general procedure is the same
  1. choose a weighting matrix
  2. estimate
  3. calculated $\hat{W} = \hat{\Omega}^{-1}$
  4. estimate
  5. repeat if necessary
- **What's New:** we need to simulate data

Model

- We will still use the simple search model
- We still have the same identification problem
  - $\hat{w}_R = \min_i w_i$
  - and set $r = 0.05$
- **Parameters to estimate:** λ, δ, μ, σ
- **Moments to match:**
  1. unemployment rate
  2. unemployment duration
  3. employment duration
  4. first moment of wages
  5. second moment of wages

Simulating Data

- What data do we need to simulate?
  - unemployment dummy
  - unemployment duration
  - wages
  - employment duration
- We will simulate the model in steady state
- How many observations should we simulate?
  - no perfect answer
  - I usually do the same as in the observed data
- **Very Important Note:** you must set a seed so that each simulation is creased with the same random numbers. $rng(\cdot)$

Simulating Data: Unemployment $\hat{u}_s$

- The steady state unemployment rate is

$$urate = \frac{\delta}{\delta + \lambda[1 - F(w_R)]} \in [0, 1]$$

- The probability of an individual being unemployed
- Simulation
  - N_s draws from $udraw_s \sim Unif[0, 1]$
  - Then create unemployment dummy

$$\hat{u}_s = \begin{cases} 1 & udraw_s < urate \\ 0 & udraw_s \geq urate \end{cases}$$

- check $N_s^{-1} \sum \hat{u}_s \approx urate$

Simulating Data: Unemployment duration $\hat{tu}_s$

- Unemployment duration follows an exponential dist.

$$G(tu) = 1 - \exp(-\lambda[1 - F(w_R)]tu)$$

- **Note:** in matlab all functions of the exponential dist. use as an input the mean rather than the rate

$$mean = \frac{1}{\lambda[1 - F(w_R)]}$$

- Simulation 1
  - N_s draws from $tudraw_s \sim Unif[0, 1]$
  - $\hat{tu}_s = expinv\big(tudraw_s, 1/(\lambda[1 - F(w_R)])\big)$
- or Simulation 2
  - N_s draws from $\hat{tu}_s = exprnd\big(1/(\lambda[1 - F(w_R)])\big)$
- check $N_s^{-1} \sum \hat{tu}_s \approx 1/(\lambda[1 - F(w_R)])$

Simulating Data: Employment duration $\hat{te}_s$

- Employment duration follows an exponential dist.

$$G(te) = 1 - \exp(-\delta te)$$

- Simulation 1
  - N_s draws from $tedraw_s \sim Unif[0,1]$
  - $\hat{te}_s = expinv\big(tedraw_s, 1/\delta\big)$
- or Simulation 2
  - N_s draws from $\hat{te}_s = exprnd\big(1/\delta\big)$
- check $N_s^{-1} \sum \hat{te}_s \approx 1/\delta$

Simulating Data: Wage $\hat{w}_s$

- Wage offer distribution: $F(w) \sim \ln N(\mu, \sigma)$
- Accepted wage distribution

$$F^A(w) = \frac{f(w)}{1 - F(w_R)}$$

- We need to simulate from the accepted wage distribution
- Simulation
  - N_s draws from $wdraw_s \sim Unif[F(w_R), 1]$
  - $\hat{w}_s = logniv\left(wdraw_s, \mu, \sigma\right)$
- check

$$N_s^{-1} \sum \hat{w}_s \approx \exp\left(\mu + \frac{\sigma^2}{2}\right) \frac{\Phi\left(\frac{\mu + \sigma^2 - \ln(w_R)}{\sigma}\right)}{1 - \Phi\left(\frac{\ln(w_R) - \mu}{\sigma}\right)}$$

Matlab Estimation

- using data4.csv
- File 1: SE4_main
  - first we will work on simulating data, part 1
  - then estimate
- File 2: simulate_data.m
  - inputs ?
  - outputs ?
- File 3: g_function_sim.m
  - inputs ?
  - outputs ?
- File 4: SMM.m
  - inputs ?
  - outputs ?

Matlab Estimation: Part 1 Answer

- guess $= [1, 1, 0.5, 0.5]$
- $rng(7890)$
- $n_s = 10000$

Moment	Theoretical	Simulated Data
unemp. rate	0.9686	0.9680
unemp. dur.	154.3150	154.1840
emp. dur.	5.0000	4.7410
$E[w]$	10.5764	10.6417

Matlab Estimation: Part 2 & 3 Answer

	SMM $W = \hat{\Omega}^{-1}$		SMM $W = I/mean(data)$	
Parameter	Estimate	Std. Err.	Estimate	Std. Err.
λ	0.2883	0.0112	0.2879	0.0112
δ	0.0216	0.0002	0.0216	0.0002
μ	2.2058	0.0196	2.2066	0.0195
σ	0.4021	0.0088	0.4018	0.0088

$$\hat{b} = 0.5670$$

SMM and Indirect Inference

- **Indirect Inference:** a simulation-based method for estimating parameters
  - useful when the likelihood function or moments are not analytically tractable or difficult to evaluate
  - example: models with latent variables
- **Auxiliary Model:** aspects of the data that can be calculated in the observed and simulated data
- **Main Idea:** Minimize the distance between the auxiliary model of the observed data and the simulated data
- SMM is a special case of Indirect Inference
  - auxiliary model: moments of the data

Indirect Inference

- Other examples of an auxiliary model
  - the likelihood function
  - coefficients from regressions
  - impulse response functions
  - coefficient of interest from an RCT
  - quantile regressions