



# Time Series Analysis and Forecasting

## Chapter 3: ARIMA Models



Daniel Traian PELE

Bucharest University of Economic Studies

IDA Institute Digital Assets

Blockchain Research Center

AI4EFin Artificial Intelligence for Energy Finance

Romanian Academy, Institute for Economic Forecasting

MSCA Digital Finance

## Learning Objectives

By the end of this chapter, you will be able to:

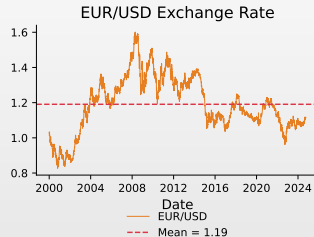
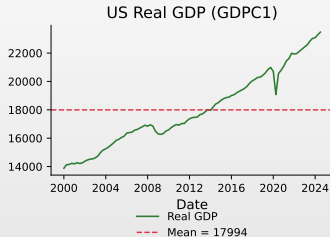
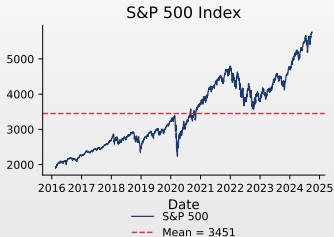
- ▣ Understand the concept and implications of non-stationarity
- ▣ Apply differencing to achieve stationarity in time series
- ▣ Use the Augmented Dickey-Fuller (ADF) test for unit root detection
- ▣ Build, estimate, and forecast with ARIMA models

## Chapter Outline

- ▣ Motivation
- ▣ Non-Stationarity in Time Series
- ▣ Differencing and the Difference Operator
- ▣ ARIMA(p,d,q) Models
- ▣ Unit Root Tests
- ▣ ARIMA Model Identification
- ▣ ARIMA Estimation
- ▣ Diagnostic Checking
- ▣ Forecasting with ARIMA
- ▣ Case Study
- ▣ Summary
- ▣ AI Use Case
- ▣ Quiz

## Motivating Example: Non-Stationary Data Is Everywhere

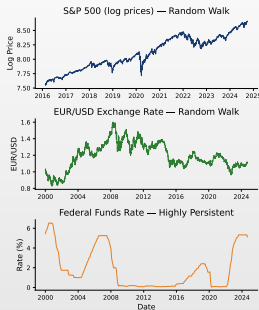
Non-stationary data: sample mean is meaningless



### Key Observations

- Stock prices, GDP, exchange rates all exhibit **trends** or **wandering behavior**
- The sample mean (red line) is meaningless for a random walk
- Standard ARMA models **cannot** handle these series directly

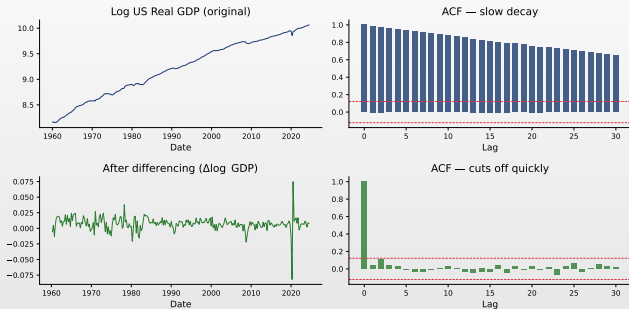
## Real-World Applications



### The Challenge

Financial/economic data are typically  $I(1)$ : stock prices, exchange rates, interest rates.

## The Solution: Differencing



### Key Insight

**Differencing** transforms a non-stationary series into a stationary one:  $\Delta Y_t = Y_t - Y_{t-1}$ . The ACF changes from slow decay to quick decay!

## What We'll Learn Today

### Core Concepts

1. **Non-Stationarity:** Why it matters and how to detect it
2. **Unit Root Tests:** ADF, PP, KPSS tests
3. **Differencing:** The key transformation
4. **ARIMA Models:** Combining differencing with ARMA
5. **Box-Jenkins Methodology:** Identify  $\rightarrow$  Estimate  $\rightarrow$  Diagnose

### By the End of This Lecture

You will be able to model and forecast non-stationary time series like stock prices, GDP, and exchange rates using ARIMA models.

## Why Non-Stationarity Matters

### The Problem

Many economic and financial time series are **non-stationary**:

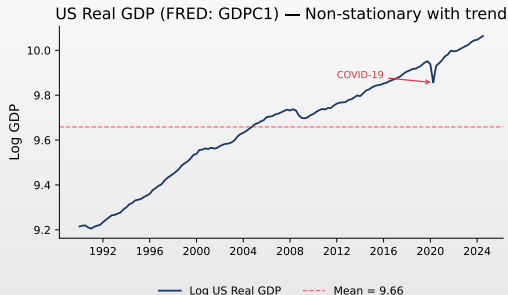
- ▣ GDP, stock prices, exchange rates, inflation indices
- ▣ They exhibit trends, changing means, or growing variance

### Consequences of Non-Stationarity

- ▣ Standard ARMA models assume stationarity
- ▣ OLS regression with non-stationary data leads to **spurious regression**
- ▣ Sample moments (mean, variance, ACF) are not consistent estimators
- ▣ Statistical inference becomes invalid



## Example: US Real GDP



### Key Observations

- Clear upward **trend** – mean is not constant
- This is a classic example of a **non-stationary** time series
- We cannot apply ARMA models directly to this data

## Types of Non-Stationarity

### Deterministic Trend

$$Y_t = \alpha + \beta t + \varepsilon_t$$

- Trend is a deterministic function of time
- Can be removed by **detrending**
- Shocks have temporary effects

### Stochastic Trend (Unit Root)

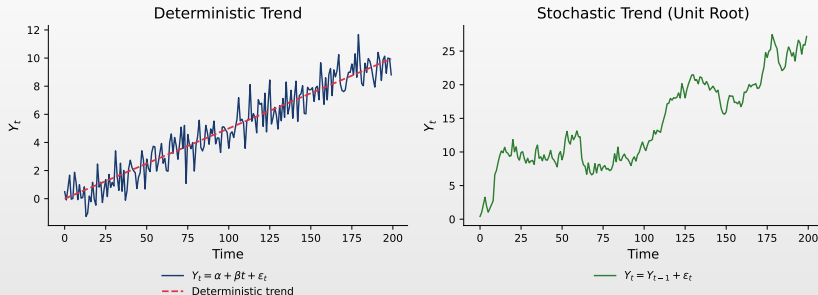
$$Y_t = Y_{t-1} + \varepsilon_t$$

- Random walk process
- Must be removed by **differencing**
- Shocks have permanent effects

### Key Distinction

Correct identification is crucial: detrending a unit root  $\rightarrow$  misspecification; differencing trend-stationary  $\rightarrow$  misspecification.

## Visualizing the Difference



### Key Distinction

- **Left:** Deterministic trend – deviations from trend are temporary
- **Right:** Stochastic trend – shocks accumulate permanently
- Both look similar, but require **different** treatments!

## The Random Walk Process

### Definition 1 (Random Walk)

A **random walk** is defined as:

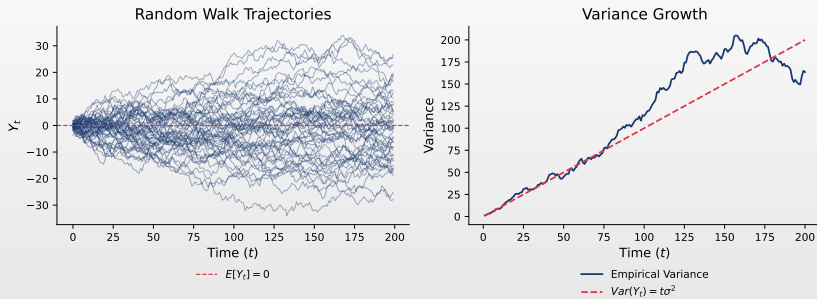
$$Y_t = Y_{t-1} + \varepsilon_t, \quad \varepsilon_t \sim WN(0, \sigma^2)$$

With initial condition  $Y_0 = 0$ , we have:  $Y_t = \sum_{i=1}^t \varepsilon_i$

### Properties of Random Walk

- ▣  $\mathbb{E}[Y_t] = 0$  (constant mean)
- ▣  $\text{Var}(Y_t) = t\sigma^2$  (variance grows with time!)
- ▣  $\text{Cov}(Y_t, Y_{t-k}) = (t-k)\sigma^2$  for  $k \leq t$
- ▣ ACF:  $\rho_k = \sqrt{\frac{t-k}{t}} \rightarrow 1$  as  $t \rightarrow \infty$

## Random Walk: Visual Illustration



### Key Properties

**Left:** Paths wander unpredictably, no mean reversion. **Right:**  $Var(Y_t) = t\sigma^2$  grows linearly  $\Rightarrow$  non-stationary.

## Proof: Random Walk Variance

**Claim:** For  $Y_t = Y_{t-1} + \varepsilon_t$  with  $Y_0 = 0$ :  $\text{Var}(Y_t) = t\sigma^2$

**Proof:** By recursive substitution:  $Y_t = \sum_{i=1}^t \varepsilon_i$

Taking variance:

$$\text{Var}(Y_t) = \text{Var}\left(\sum_{i=1}^t \varepsilon_i\right) = \sum_{i=1}^t \text{Var}(\varepsilon_i) + 2 \sum_{i < j} \text{Cov}(\varepsilon_i, \varepsilon_j)$$

Since  $\varepsilon_t$  independent (white noise):  $\text{Var}(Y_t) = \sum_{i=1}^t \sigma^2 = \boxed{t\sigma^2}$

Variance depends on  $t \Rightarrow$  non-stationary

## Proof: Random Walk Autocovariance

**Claim:**  $\text{Cov}(Y_t, Y_{t-k}) = (t-k)\sigma^2$  for  $k \leq t$

**Proof:** Using  $Y_t = \sum_{i=1}^t \varepsilon_i$  and  $Y_{t-k} = \sum_{i=1}^{t-k} \varepsilon_i$ :

$$\begin{aligned}\text{Cov}(Y_t, Y_{t-k}) &= \text{Cov}\left(\sum_{i=1}^t \varepsilon_i, \sum_{j=1}^{t-k} \varepsilon_j\right) \\ &= \sum_{i=1}^t \sum_{j=1}^{t-k} \text{Cov}(\varepsilon_i, \varepsilon_j) = \sum_{i=1}^{t-k} \text{Var}(\varepsilon_i) = \boxed{(t-k)\sigma^2}\end{aligned}$$

Only terms with  $i = j$  survive (when  $i \leq t-k$ ).

**ACF:**

$$\rho(k) = \frac{\text{Cov}(Y_t, Y_{t-k})}{\sqrt{\text{Var}(Y_t)\text{Var}(Y_{t-k})}} = \frac{(t-k)\sigma^2}{\sqrt{t\sigma^2 \cdot (t-k)\sigma^2}} = \sqrt{\frac{t-k}{t}}$$

## Random Walk with Drift

### Definition 2 (Random Walk with Drift)

A random walk with drift includes a constant term:

$$Y_t = \mu + Y_{t-1} + \varepsilon_t$$

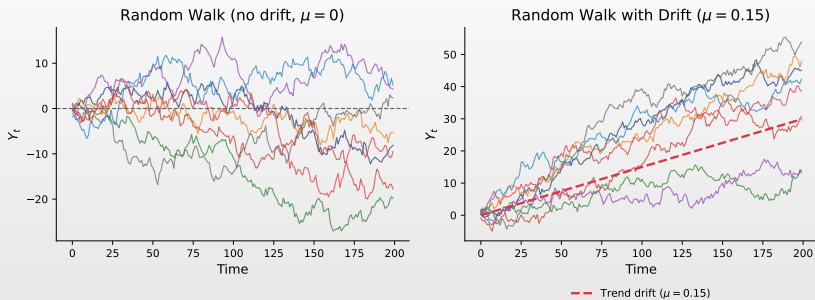
Equivalently:  $Y_t = Y_0 + \mu t + \sum_{i=1}^t \varepsilon_i$

### Properties

- ▣  $\mathbb{E}[Y_t] = Y_0 + \mu t$  (mean grows linearly)
- ▣  $\text{Var}(Y_t) = t\sigma^2$  (variance still grows)
- ▣ The drift  $\mu$  creates an upward or downward trend
- ▣ Still non-stationary despite having a “trend”



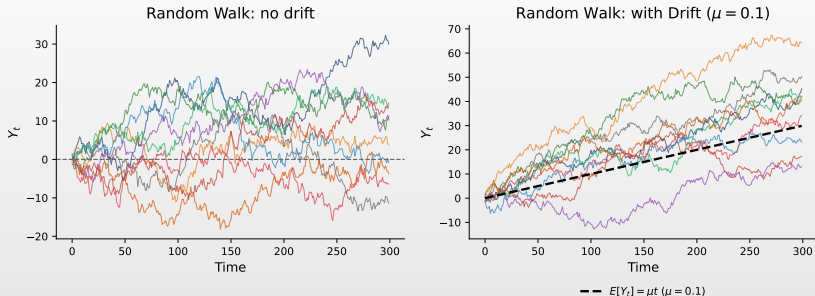
## Random Walk with Drift: Visual Illustration



### Comparison

Without drift (blue): wanders around zero with no direction. With drift  $\mu > 0$  (red): systematic upward trend. Both are non-stationary — drift adds deterministic trend to stochastic wandering.

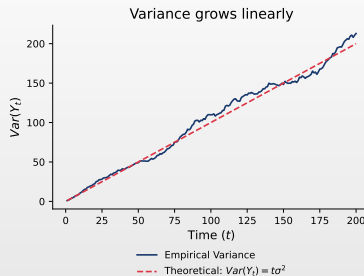
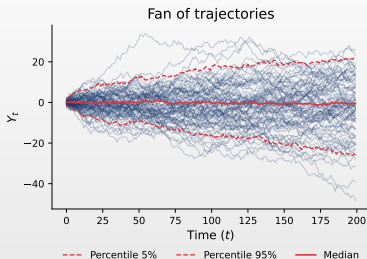
## Simulating Random Walks



### Random Walk Types

- Left: Pure random walks – no drift, wander unpredictably
- Right: Random walks with drift – upward trend on average
- Each path is unique; uncertainty grows over time

## Variance Growth: Why Random Walks Are Non-Stationary



### Key Observations

- Left: Fan of paths shows uncertainty growing over time
- Right: Variance grows linearly:  $\text{Var}(Y_t) = t\sigma^2$
- This violates stationarity (variance should be constant)

## Integrated Processes

### Definition 3 (Integrated Process of Order $d$ )

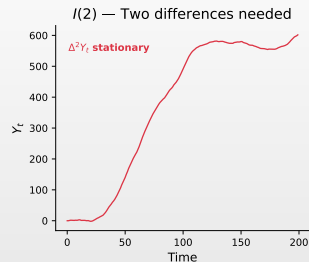
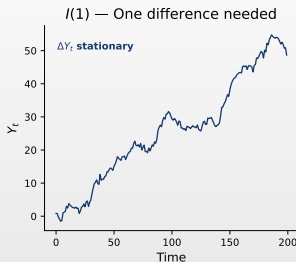
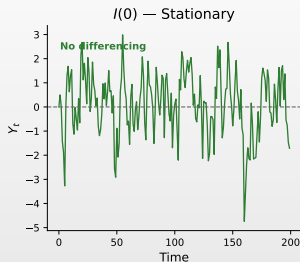
A time series  $\{Y_t\}$  is **integrated of order  $d$** , written  $Y_t \sim I(d)$ , if:

- ▣  $Y_t$  is non-stationary
- ▣  $(1 - L)^d Y_t = \Delta^d Y_t$  is stationary
- ▣  $(1 - L)^{d-1} Y_t$  is still non-stationary

### Common Cases

- ▣  $I(0)$ : Stationary process (e.g., ARMA)
- ▣  $I(1)$ : First difference is stationary (most common for economic data)
- ▣  $I(2)$ :
  - ▶ Second difference is stationary (less common)

## Integrated Process: Visual Illustration



### Order of Integration

- $I(0)$ : Stationary  $\Rightarrow$  no differencing needed
- $I(1)$ : One difference needed (random walk)
- $I(2)$ : Two differences needed
- Most economic series are  $I(0)$  or  $I(1)$

## The Difference Operator

### Definition 4 (First Difference)

The **first difference operator**  $\Delta$  is defined as:  $\Delta Y_t = Y_t - Y_{t-1} = (1 - L)Y_t$ , where  $L$  is the lag operator ( $LY_t = Y_{t-1}$ ).

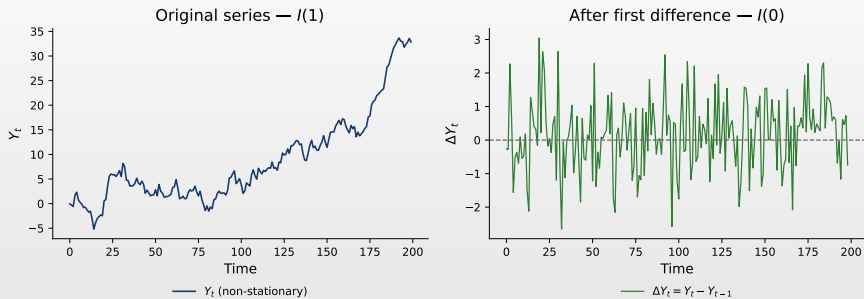
### Higher-Order Differences

- ▣ Second difference:  $\Delta^2 Y_t = \Delta(\Delta Y_t) = (1 - L)^2 Y_t$
- ▣  $\Delta^2 Y_t = Y_t - 2Y_{t-1} + Y_{t-2}$
- ▣  $d$ -th difference:  $\Delta^d Y_t = (1 - L)^d Y_t$

### Key Result

If  $Y_t \sim I(d)$ , then  $\Delta^d Y_t \sim I(0)$  (stationary).

## First Difference: Visual Illustration



### Observation

- Left: non-stationary series
- Right: after first difference, the series becomes stationary

## Example: Differencing a Random Walk

### Random Walk to White Noise

Let  $Y_t = Y_{t-1} + \varepsilon_t$  (random walk). Taking the first difference:

$$\Delta Y_t = Y_t - Y_{t-1} = \varepsilon_t$$

The first difference is white noise – a stationary process!

### Interpretation

- ▣ A random walk is  $I(1)$
- ▣ One difference transforms it to  $I(0)$
- ▣ The “changes” in a random walk are stationary



## Proof: Differencing Induces Stationarity

**Claim:** If  $Y_t \sim I(1)$ , then  $\Delta Y_t = Y_t - Y_{t-1}$  is stationary.

**Proof for Random Walk with Drift:**  $Y_t = \mu + Y_{t-1} + \varepsilon_t$

The first difference is:

$$\Delta Y_t = Y_t - Y_{t-1} = \mu + \varepsilon_t$$

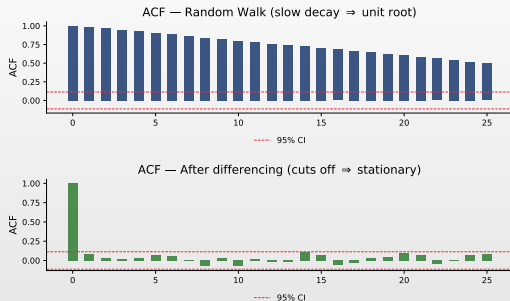
Check stationarity conditions:

1. **Mean:**  $\mathbb{E}[\Delta Y_t] = \mu$  (constant, does not depend on  $t$ ) ✓
2. **Variance:**  $\text{Var}(\Delta Y_t) = \text{Var}(\varepsilon_t) = \sigma^2$  (constant) ✓
3. **Autocovariance:**  $\text{Cov}(\Delta Y_t, \Delta Y_{t-k}) = \text{Cov}(\varepsilon_t, \varepsilon_{t-k}) = 0$  for  $k \neq 0$  ✓

### General Principle

Differencing removes the “memory” that causes variance to accumulate. For  $I(d)$  processes,  $d$  differences are needed.

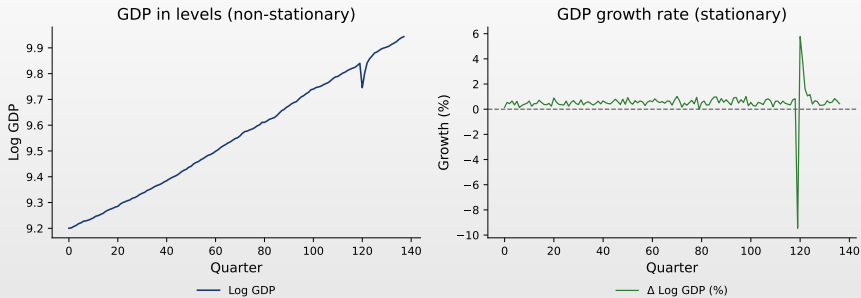
## ACF Diagnostic: Detecting Non-Stationarity



### ACF Patterns

- Top: Random walk ACF decays very slowly  $\Rightarrow$  unit root
- Bottom: After differencing, ACF cuts off  $\Rightarrow$  stationary

## Differencing in Practice: GDP Example



### Transformation

**Left:** GDP in levels with clear upward trend (non-stationary). **Right:** GDP growth rate  $\Delta \log(\text{GDP}_t)$  fluctuates around constant mean (stationary). One difference removes the stochastic trend.

## Overdifferencing

### Warning: Overdifferencing

Differencing more than necessary introduces problems:

- Creates artificial negative autocorrelation
  - ▶ ACF shows spurious patterns
- Inflates variance
  - ▶ Reduces forecast accuracy
- Loses information
  - ▶ Cannot recover original level

### Example

If  $Y_t \sim I(1)$ , then  $\Delta Y_t \sim I(0)$ . But if we difference again:

$$\Delta^2 Y_t = \Delta Y_t - \Delta Y_{t-1} = \varepsilon_t - \varepsilon_{t-1}$$

This is an MA(1) with  $\theta = 1$  (non-invertible boundary)!

## Definition of ARIMA

### Definition 5 (ARIMA(p,d,q))

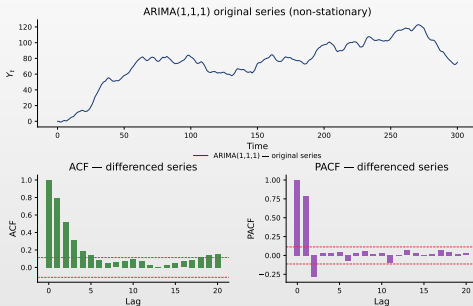
A time series  $\{Y_t\}$  follows an **ARIMA(p,d,q)** process if:

$$\phi(L)(1-L)^d Y_t = c + \theta(L)\varepsilon_t$$

where:

- $\phi(L) = 1 - \phi_1 L - \phi_2 L^2 - \dots - \phi_p L^p$  (AR polynomial)
- $\theta(L) = 1 + \theta_1 L + \theta_2 L^2 + \dots + \theta_q L^q$  (MA polynomial)
- $d$  is the order of integration (number of differences)
- $\varepsilon_t \sim WN(0, \sigma^2)$

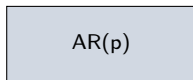
## ARIMA: Visual Illustration



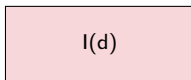
### Interpretation

Top: original ARIMA series (non-stationary). Bottom: after differencing  $d$  times, ACF/PACF reveal the AR and MA orders for the stationary component.

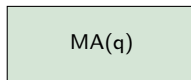
## ARIMA Components



Autoregressive  
Memory



Integration  
Differencing



Moving Average  
Shocks

### Special Cases

- ▣  $ARIMA(p,0,q) = ARMA(p,q)$  – stationary
- ▣  $ARIMA(0,1,0) =$  Random walk
- ▣  $ARIMA(0,1,1) = IMA(1,1)$  – exponential smoothing
- ▣  $ARIMA(1,1,0) = ARI(1,1)$  – differenced  $AR(1)$

## ARIMA(1,1,0) Example

### AR(1,1) Model

$$\Delta Y_t = c + \phi_1 \Delta Y_{t-1} + \varepsilon_t$$

Equivalently:  $(1 - \phi_1 L)(1 - L)Y_t = c + \varepsilon_t$

### Interpretation

- ▣ The **changes** in  $Y_t$  follow an AR(1) process
- ▣ If  $|\phi_1| < 1$ , the changes are stationary
- ▣  $Y_t$  itself has a stochastic trend
- ▣ Common model for many economic time series



## ARIMA(0,1,1) Example

### IMA(1,1) Model

$$\Delta Y_t = c + \varepsilon_t + \theta_1 \varepsilon_{t-1}$$

Equivalently:  $(1 - L)Y_t = c + (1 + \theta_1 L)\varepsilon_t$

### Connection to Exponential Smoothing

The IMA(1,1) model is equivalent to **simple exponential smoothing**:

$$\hat{Y}_{t+1} = \alpha Y_t + (1 - \alpha) \hat{Y}_t$$

where  $\alpha = 1 + \theta_1$  (for  $-1 < \theta_1 < 0$ ).

## The Role of the Constant in ARIMA

### Constant Term in ARIMA(p,d,q)

When  $d > 0$ , the constant  $c$  has a different interpretation:  $\phi(L)(1-L)^d Y_t = c + \theta(L)\varepsilon_t$

### Important Implications

- For  $d = 1$ :  $c$  represents the **drift**
  - ▶ Average change:  $\mathbb{E}[\Delta Y_t] = \frac{c}{1 - \phi_1 - \dots - \phi_p}$
  - ▶ Linear trend in levels
- For  $d = 2$ :  $c$  affects the **curvature**
  - ▶ Quadratic trend in levels
- Often  $c = 0$  is assumed when  $d \geq 1$ 
  - ▶ No deterministic trend component

## Testing for Unit Roots

### Why Test?

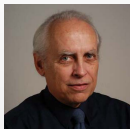
Before fitting an ARIMA model, we need to determine:

1. Is the series stationary? (Is  $d = 0$ ?)
2. If not, how many differences are needed? (What is  $d$ ?)

### Common Unit Root Tests

- **Dickey-Fuller (DF)** and **Augmented Dickey-Fuller (ADF)**
- **Phillips-Perron (PP)**
- **KPSS** (stationarity test – reversed null hypothesis)

## Researcher Spotlight: Dickey & Fuller



David Dickey (\*1945)



Wayne Fuller (1931–2022)



### Biography

- **David Dickey:** American statistician at NC State University. PhD student of Wayne Fuller at Iowa State
- **Wayne Fuller:** American statistician, professor at Iowa State University
- Together they developed the foundational test for unit roots in time series

### Key Contributions

- **Dickey-Fuller test** (1979) — the fundamental unit root test
- **Augmented Dickey-Fuller (ADF)** — extension with lagged differences
- **Critical value tables** — non-standard distributions under the null
- Enabled rigorous testing of integration order for ARIMA modeling

## The Dickey-Fuller Test

### Setup

Consider the AR(1) model:  $Y_t = \phi Y_{t-1} + \varepsilon_t$ . Subtract  $Y_{t-1}$ :  $\Delta Y_t = (\phi - 1)Y_{t-1} + \varepsilon_t = \gamma Y_{t-1} + \varepsilon_t$ , where  $\gamma = \phi - 1$ .

### Hypotheses

- $H_0$ :  $\gamma = 0$  (unit root,  $\phi = 1$ , non-stationary)
- $H_1$ :  $\gamma < 0$  (stationary,  $|\phi| < 1$ )

### Key Issue

Under  $H_0$ , the  $t$ -statistic does **not** follow a standard  $t$ -distribution! Must use Dickey-Fuller critical values.

## Dickey-Fuller Test Variants

### Three Specifications

1. **No constant, no trend:**  $\Delta Y_t = \gamma Y_{t-1} + \varepsilon_t$
2. **With constant (drift):**  $\Delta Y_t = \alpha + \gamma Y_{t-1} + \varepsilon_t$
3. **With constant and trend:**  $\Delta Y_t = \alpha + \beta t + \gamma Y_{t-1} + \varepsilon_t$

### Choosing the Right Specification

- Examine the data: does it have a visible trend?
- Including unnecessary terms reduces power
- Excluding necessary terms leads to incorrect inference

## Augmented Dickey-Fuller (ADF) Test

### The Problem with Simple DF

If AR dynamics beyond AR(1) exist, DF residuals will be autocorrelated.

### Definition 6 (ADF Test)

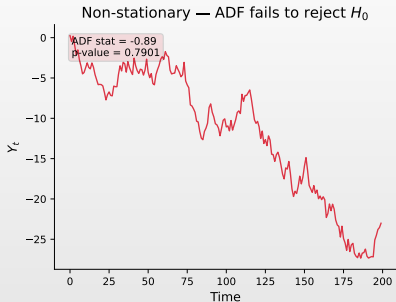
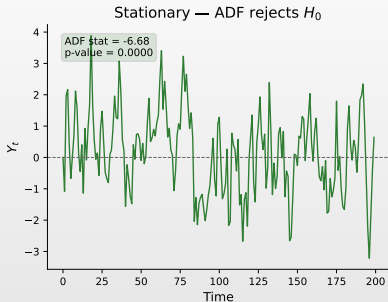
Add lagged differences:  $\Delta Y_t = \alpha + \beta t + \gamma Y_{t-1} + \sum_{j=1}^k \delta_j \Delta Y_{t-j} + \varepsilon_t$

Test  $H_0 : \gamma = 0$  using ADF critical values.

### Choosing Lag Length $k$

- Use information criteria (AIC, BIC)
- Start with  $k_{max}$ , reduce until last lag significant

## ADF Test: Visual Illustration



### Observation

- Left: stationary series  $\Rightarrow$  ADF rejects unit root
- Right: non-stationary  $\Rightarrow$  ADF fails to reject



## ADF Test Critical Values

Model	1%	5%	10%
No constant, no trend	-2.58	-1.95	-1.62
With constant	-3.43	-2.86	-2.57
With constant and trend	-3.96	-3.41	-3.13

### Decision Rule

- Test statistic  $<$  critical value  $\Rightarrow$  Reject  $H_0$  (stationary)
- Test statistic  $\geq$  critical value  $\Rightarrow$  Fail to reject (unit root)

## The Phillips-Perron (PP) Test

### Motivation

Like ADF, tests  $H_0$ : Unit root vs  $H_1$ : Stationary, but uses a **non-parametric correction** for serial correlation instead of adding lagged differences.

### Test Statistic

The PP test modifies the DF  $t$ -statistic:

$$Z_t = t_{\hat{\gamma}} \cdot \sqrt{\frac{\hat{\sigma}^2}{\hat{\lambda}^2}} - \frac{T(\hat{\lambda}^2 - \hat{\sigma}^2)(se(\hat{\gamma}))}{2\hat{\lambda}^2 \cdot s}$$

where  $\hat{\lambda}^2$  is a consistent estimate of the long-run variance using Newey-West.

### Advantages over ADF

- ▣ Robust to heteroskedasticity and serial correlation
- ▣ No need to select lag length (uses bandwidth instead)

## The KPSS Test

### Reversed Hypotheses

Unlike ADF:  $H_0$ : Stationary vs  $H_1$ : Unit root

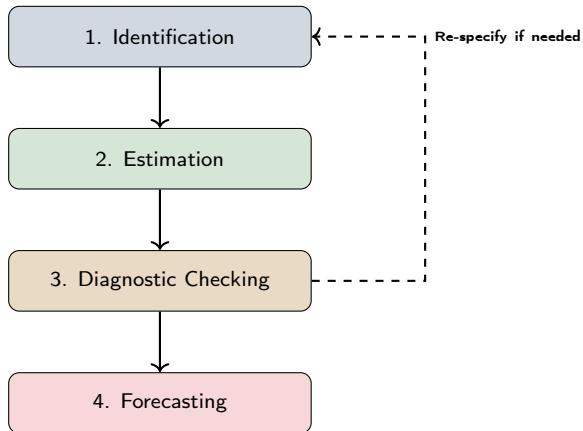
### KPSS Procedure

Decompose:  $Y_t = \xi t + r_t + \varepsilon_t$  where  $r_t = r_{t-1} + u_t$ . Test whether  $\text{Var}(u_t) = 0$ .

### Complementary Use with ADF

- ▣ ADF rejects, KPSS doesn't  $\Rightarrow$  Stationary
- ▣ ADF doesn't reject, KPSS rejects  $\Rightarrow$  Unit root
- ▣ Both reject or neither  $\Rightarrow$  Inconclusive

## The Box-Jenkins Methodology



## Step 1: Determining $d$

### Procedure

1. Plot the time series – look for trends, changing variance
2. Examine ACF – slow decay suggests non-stationarity
3. Apply unit root tests (ADF, KPSS)
4. If non-stationary, difference and repeat

### Practical Guidelines

- ▣ Most economic series:  $d = 1$  is sufficient
- ▣ Rarely need  $d > 2$
- ▣ If ACF of  $\Delta Y_t$  still decays slowly, try  $d = 2$
- ▣ Watch for overdifferencing (ACF with  $\rho_1 \approx -0.5$ )

## Step 2: Determining $p$ and $q$

### After Differencing

Once  $W_t = \Delta^d Y_t$  is stationary, use ACF/PACF to identify ARMA( $p, q$ ):

Model	ACF	PACF
AR( $p$ )	Decays exponentially	Cuts off after lag $p$
MA( $q$ )	Cuts off after lag $q$	Decays exponentially
ARMA( $p, q$ )	Decays	Decays

### Information Criteria

When patterns are unclear, compare models using:

□  $AIC = -2 \ln(L) + 2k$ ;     $BIC = -2 \ln(L) + k \ln(n)$

Lower is better. BIC penalizes complexity more.

## Auto-ARIMA Algorithms

### Automated Model Selection

Modern software can automatically select  $(p, d, q)$ :

- Python: `pmdarima.auto_arima()`
- R: `forecast::auto.arima()`

### How Auto-ARIMA Works

1. Use unit root tests to determine  $d$
2. Fit models for various  $(p, q)$  combinations
3. Select model with lowest AIC/BIC
4. Optionally use stepwise search for efficiency

### Caution

Automated selection is helpful but not infallible. Always check diagnostics!

## Estimation Methods

### Maximum Likelihood Estimation (MLE)

The standard approach for ARIMA:

- ▣ Assumes  $\varepsilon_t \sim N(0, \sigma^2)$
- ▣ Maximizes the likelihood function
- ▣ Provides consistent, efficient estimators
- ▣ Yields standard errors for inference

### Conditional vs Exact MLE

- ▣ **Conditional MLE:** Conditions on initial values
- ▣ **Exact MLE:** Treats initial values as unknown
- ▣ Difference diminishes as sample size grows



## Conditional Log-Likelihood

### Gaussian Log-Likelihood Function

- ▣  $\ell(\boldsymbol{\theta}, \sigma^2) = -\frac{T}{2} \ln(2\pi) - \frac{T}{2} \ln(\sigma^2) - \frac{1}{2\sigma^2} \sum_{t=1}^T e_t^2(\boldsymbol{\theta})$
- ▣  $e_t(\boldsymbol{\theta}) = X_t - \hat{X}_{t|t-1}$  are the **one-step prediction errors**
- ▣  $\boldsymbol{\theta} = (\phi_1, \dots, \phi_p, \theta_1, \dots, \theta_q, c)$

### Example: ARIMA(1,1,1)

- ▣ Prediction errors:  $e_t = \Delta X_t - \phi_1 \Delta X_{t-1} - \theta_1 e_{t-1} - c$
- ▣ Conditional MLE: set  $e_0 = 0$ , compute  $e_1, \dots, e_T$ , maximize  $\ell$

### Estimating $\sigma^2$

- ▣ At optimal parameters  $\hat{\boldsymbol{\theta}}$ :  $\hat{\sigma}^2 = \frac{1}{T} \sum_{t=1}^T e_t^2(\hat{\boldsymbol{\theta}})$

## Parameter Constraints

### Stationarity and Invertibility

The estimated ARIMA model should satisfy:

- ▣ **AR stationarity:** Roots of  $\phi(z) = 0$  outside unit circle
- ▣ **MA invertibility:** Roots of  $\theta(z) = 0$  outside unit circle

### Checking in Practice

Most software reports:

- ▣ Estimated coefficients with standard errors
- ▣ Roots of AR and MA polynomials
- ▣ Warning if near-unit-root detected

## Residual Analysis

### What to Check

If the model is correct, residuals  $\hat{\varepsilon}_t$  should be white noise:

1. Zero mean
2. Constant variance
3. No autocorrelation
4. (Optional) Normality

### Diagnostic Tools

- ▣ **Residual ACF/PACF:** Should show no significant spikes
- ▣ **Ljung-Box test:** Tests for autocorrelation at multiple lags
- ▣ **Q-Q plot:** Checks normality assumption
- ▣ **Residual vs fitted:**
  - ▶ Checks for heteroskedasticity

## The Ljung-Box Test

### Definition 7 (Ljung-Box Q Statistic)

$Q(m) = n(n+2) \sum_{k=1}^m \frac{\hat{\rho}_k^2}{n-k}$ . Under  $H_0$  (no autocorrelation):  $Q(m) \sim \chi^2(m - p - q)$

### Usage

- Choose  $m \approx \ln(n)$  or  $m = 10$  for quarterly,  $m = 20$  for monthly
- Degrees of freedom adjusted for estimated parameters
- Reject if  $Q(m)$  exceeds critical value

### If Test Fails

Consider adding AR or MA terms, or check for structural breaks.

## Point Forecasts

### Minimum MSE Forecast

The optimal  $h$ -step ahead forecast is the conditional expectation:  $\hat{Y}_{T+h|T} = \mathbb{E}[Y_{T+h}|Y_T, Y_{T-1}, \dots]$

### ARIMA(1,1,1) Forecasting

Model:  $(1 - \phi_1 L)(1 - L)Y_t = c + (1 + \theta_1 L)\varepsilon_t$

One-step forecast:  $\hat{Y}_{T+1|T} = c + Y_T + \phi_1(Y_T - Y_{T-1}) + \theta_1 \hat{\varepsilon}_T$

For  $h > 1$ : replace unknown  $\varepsilon_{T+j}$  with 0, unknown  $Y_{T+j}$  with  $\hat{Y}_{T+j|T}$

## Forecast Intervals

### Forecast Uncertainty

The  $h$ -step forecast error variance:  $\text{Var}(e_{T+h}) = \sigma^2 \sum_{j=0}^{h-1} \psi_j^2$ , where  $\psi_j$  are  $\text{MA}(\infty)$  coefficients.

### Confidence Intervals

Under normality,  $(1 - \alpha)\%$  interval:  $\hat{Y}_{T+h|T} \pm z_{\alpha/2} \sqrt{\text{Var}(e_{T+h})}$

### Key Property for $I(1)$ Series

For integrated processes, forecast variance grows without bound as  $h \rightarrow \infty$ . Intervals widen over time!

## Long-Run Forecasts for ARIMA

### Behavior as $h \rightarrow \infty$

For ARIMA(p,1,q) with drift  $c$ :

- Point forecasts: Linear trend with slope = drift
- Forecast intervals: Width grows with  $\sqrt{h}$

For ARIMA(p,1,q) without drift:

- Point forecasts: Converge to last level
- Forecast intervals: Still grow unboundedly

### Practical Implication

ARIMA forecasts are most reliable for short horizons. Long-term forecasts have very wide uncertainty bands.

## Rolling Forecasting: Concept

### What is Rolling Forecasting?

A technique to evaluate forecast accuracy out-of-sample:

1. Fix a **training window** of size  $w$
2. Estimate model on observations  $t = 1, \dots, w$
3. Forecast  $h$  steps ahead:  $\hat{Y}_{w+h|w}$
4. **Roll** the window forward by one period
5. Repeat until end of sample

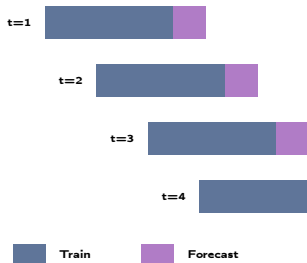
### Why Rolling Forecasts?

- Mimics real-time forecasting scenario
- Provides multiple forecast errors for evaluation
- Avoids overfitting to full sample

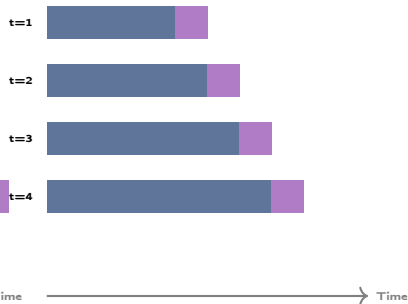


## Fixed vs Expanding Window

### Fixed Window (Rolling)



### Expanding Window



### Comparison

- ▣ **Fixed:** Window slides forward, constant size — adapts to regime changes
- ▣ **Expanding:** Window grows over time — uses all historical data

## 1-Step vs Multi-Step Forecasting

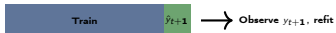
### 1-Step Ahead (Recursive)

- Forecast only next period
  - Refit model after each step
  - Use actual value once revealed
- Most accurate for short horizons

### Multi-Step (Direct)

- Forecast multiple periods ahead
  - No refit between steps
  - Uses forecasted values as inputs
- Uncertainty compounds over horizon

#### 1-Step Ahead



#### Multi-Step (h=3)



## Rolling Forecast: Step-by-Step Example

Setup: ARIMA(1,1,0) with  $\phi_1 = 0.6$

Model:  $\Delta Y_t = \phi_1 \Delta Y_{t-1} + \varepsilon_t$  where  $\Delta Y_t = Y_t - Y_{t-1}$

Given Data at Time  $T$

$$Y_{T-2} = 100, \quad Y_{T-1} = 103, \quad Y_T = 108 \quad \Rightarrow \quad \Delta Y_{T-1} = 3, \quad \Delta Y_T = 5$$

1-Step Ahead Point Forecast

$$\begin{aligned}\Delta \hat{Y}_{T+1|T} &= \phi_1 \cdot \Delta Y_T = 0.6 \times 5 = 3 \\ \hat{Y}_{T+1|T} &= Y_T + \Delta \hat{Y}_{T+1|T} = 108 + 3 = \boxed{111}\end{aligned}$$

## Multi-Step Point Forecasts

### 2-Step Ahead Forecast

$$\begin{aligned}\Delta \hat{Y}_{T+2|T} &= \phi_1 \cdot \Delta \hat{Y}_{T+1|T} = 0.6 \times 3 = 1.8 \\ \hat{Y}_{T+2|T} &= \hat{Y}_{T+1|T} + \Delta \hat{Y}_{T+2|T} = 111 + 1.8 = \boxed{112.8}\end{aligned}$$

### General Formula for $h$ -Step Forecast (ARIMA(1,1,0))

$$\begin{aligned}\Delta \hat{Y}_{T+h|T} &= \phi_1^h \cdot \Delta Y_T \\ \hat{Y}_{T+h|T} &= Y_T + \Delta Y_T \cdot \frac{\phi_1(1 - \phi_1^h)}{1 - \phi_1}\end{aligned}$$

### Numerical: 3-Step Forecast

$$\hat{Y}_{T+3|T} = 108 + 5 \times \frac{0.6(1-0.6^3)}{1-0.6} = 108 + 5 \times 1.092 = \boxed{113.46}$$

## Confidence Intervals: Formulas

### Forecast Error Variance

For ARIMA(1,1,0), the  $h$ -step forecast error variance:

$$\text{Var}(e_{T+h|T}) = \sigma^2 \left( 1 + \sum_{j=1}^{h-1} \psi_j^2 \right)$$

where  $\psi_j = \phi_1^{j-1}(1 + \phi_1 + \dots + \phi_1^{j-1}) = \phi_1^{j-1} \cdot \frac{1 - \phi_1^j}{1 - \phi_1}$

### $(1 - \alpha)\%$ Confidence Interval

$$\hat{Y}_{T+h|T} \pm z_{\alpha/2} \cdot \sqrt{\text{Var}(e_{T+h|T})}$$

For 95% CI:  $z_{0.025} = 1.96$

## Confidence Interval: Numerical Example

Given:  $\sigma^2 = 4$ ,  $\phi_1 = 0.6$ ,  $\hat{Y}_{T+1|T} = 111$

### 1-Step Ahead CI

$$\text{Var}(e_{T+1|T}) = \sigma^2 = 4$$

$$95\% \text{ CI} = 111 \pm 1.96 \times \sqrt{4} = 111 \pm 3.92 = [107.08, 114.92]$$

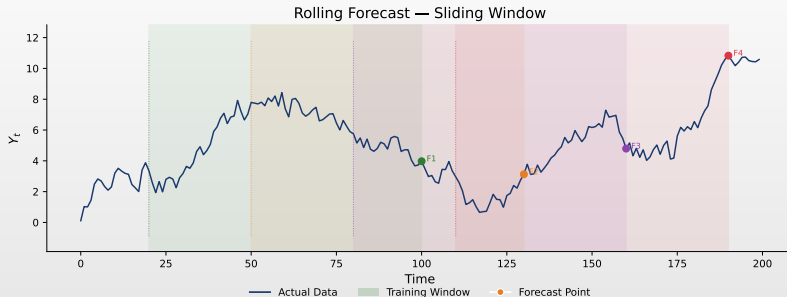
### 2-Step Ahead CI (for $\hat{Y}_{T+2|T} = 112.8$ )

$$\psi_1 = 1 + \phi_1 = 1.6, \quad \text{Var}(e_{T+2|T}) = 4(1 + 1.6^2) = 14.24$$

$$95\% \text{ CI} = 112.8 \pm 1.96 \times \sqrt{14.24} = 112.8 \pm 7.40 = [105.40, 120.20]$$

**Note:** CI widens as horizon increases!

## Rolling Window Illustration



### Rolling Procedure

- Each window produces a 1-step ahead forecast
- Compare forecasts to actuals to compute RMSE, MAE
- Rolling window keeps model estimation up-to-date

## Case Study: Complete ARIMA Analysis

### Objective

- Forecast US Real GDP using the Box-Jenkins methodology

### Steps

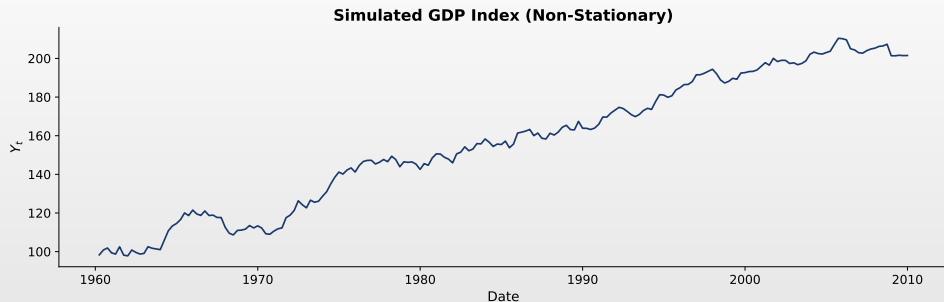
1. **Step 1:** Visualize data and check stationarity
2. **Step 2:** Apply unit root tests (ADF, KPSS)
3. **Step 3:** Difference if needed, identify  $p$  and  $q$
4. **Step 4:** Estimate the ARIMA model
5. **Step 5:** Model diagnostics
6. **Step 6:** Generate forecasts with confidence intervals
7. **Step 7:** Evaluate forecast accuracy

### Data

- US Real GDP (FRED: GDPC1), Quarterly, 1990Q1–2024Q2,  $n = 138$



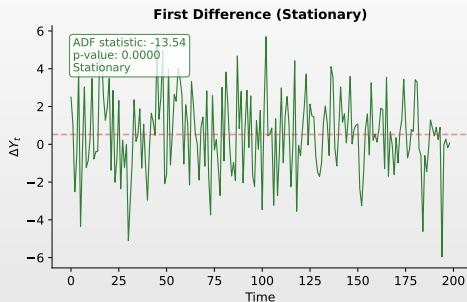
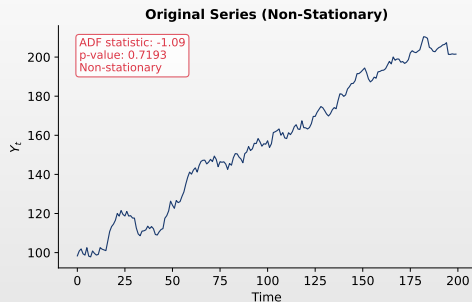
## Case Study: US Real GDP (FRED)



Data: FRED GDPC1 (1960Q1–2024Q3)

Quarterly Real GDP, seasonally adjusted, billions of chained 2017 dollars. Non-stationary series with upward trend  $\Rightarrow$  requires differencing.

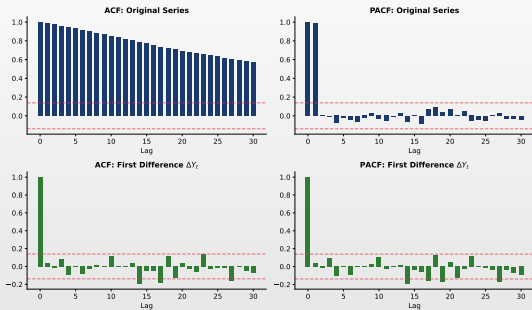
## Step 1: ADF Test for Stationarity



### ADF Test Results

**Original series:** Large p-value  $\Rightarrow$  fail to reject  $H_0$  (unit root present). **First difference:** p-value  $< 0.01 \Rightarrow$  reject  $H_0 \Rightarrow d = 1$  is sufficient.

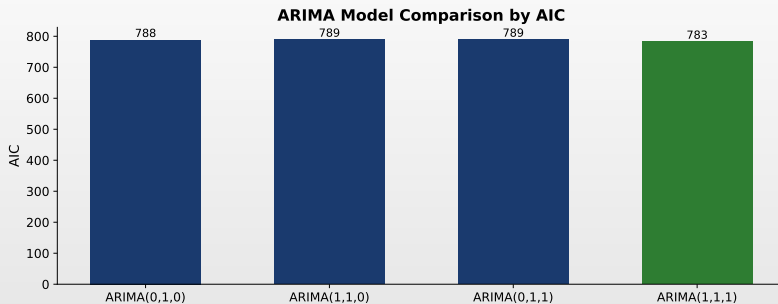
## Step 2: ACF/PACF Before and After Differencing



### ACF/PACF Analysis

Top: Slow ACF decay (non-stationary) | Bottom: After differencing, low-order ARMA

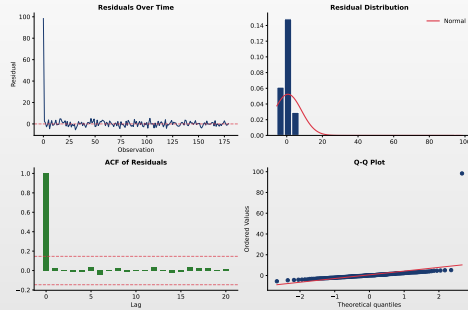
## Step 3: ARIMA Model Comparison



### Model Selection

Compare ARIMA(0,1,0), ARIMA(1,1,0), ARIMA(0,1,1), ARIMA(1,1,1). The model with lowest AIC is selected.

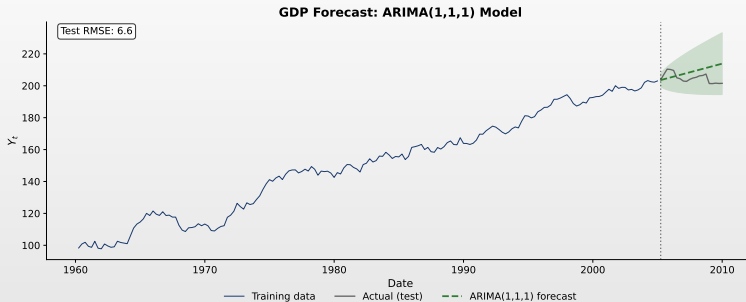
## Step 4: Diagnostic Checking



### ARIMA(1,1,1) Diagnostics

ACF: no autocorrelation ✓    Q-Q: **non-normal** (COVID-19 outlier)    JB test:  $p < 0.001$

## Step 5: Out-of-Sample Forecasting



**Train/Val/Test Split (70%/15%/15%)**

**Train 70% (blue):** Estimation | **Val 15% (green):** Tuning | **Test 15% (purple):** Evaluation with 95% CI

## Step 6: Rolling Forecast with Train/Val/Test



### Rolling 1-Step Ahead Forecast (Expanding Window, 95% CI)

Train 70% → Val 15% → Test 15% | Expanding window refits model at each step

## Summary

### What we learned in this chapter

- Non-stationarity in time series
  - ▶ Deterministic vs stochastic trend; consequences for statistical inference
- Differencing and integrated processes
  - ▶  $\Delta Y_t = Y_t - Y_{t-1}$ ; if  $Y_t \sim I(d)$ , then  $\Delta^d Y_t \sim I(0)$
- ARIMA( $p, d, q$ ) models and unit root tests
  - ▶ ADF, PP, KPSS; Box-Jenkins: identify  $\rightarrow$  estimate  $\rightarrow$  validate
- Forecasts with confidence intervals
  - ▶ For  $I(1)$ : CIs widen without bound ( $\propto \sqrt{h}$ )

### Key Insight

- **Difference carefully:** One difference is usually sufficient ( $d = 1$ ). Over-differencing creates artificial autocorrelation.



## AI Exercise: Critical Thinking

Prompt to test in ChatGPT / Claude / Copilot

"I have a quarterly GDP time series (80 observations). Test stationarity, difference if needed, estimate an ARIMA model, and forecast 8 quarters ahead. Give me complete Python code with plots."

### Exercise:

1. Run the prompt in an LLM of your choice and critically analyze the response.
2. Does it test stationarity with ADF *before* estimating ARIMA? Does it also use KPSS?
3. How does it determine the differencing order  $d$ ? Does it check for over-differencing?
4. How does it choose  $p$  and  $q$ ? ACF/PACF or just `auto_arima`?
5. Do forecast confidence intervals widen with horizon? (key  $I(1)$  property)

**Warning:** AI-generated code may run without errors and look professional. *That does not mean it is correct.*

## Quick Quiz

### Test your knowledge

1. What types of non-stationarity do you know and how is each treated?
2. Why does random walk variance grow with time?
3. What is the difference between ADF and KPSS tests?
4. What happens if we over-difference a series?
5. Why do ARIMA confidence intervals widen without bound for  $I(1)$  series?

## Quiz Answers

### Answers

1. **Types:** Deterministic trend (regression); stochastic trend/unit root (differencing)
2. **Variance:**  $Y_t = \sum_{i=1}^t \varepsilon_i \Rightarrow \text{Var}(Y_t) = t\sigma^2$  (shocks accumulate)
3. **ADF vs KPSS:** ADF:  $H_0 = \text{unit root}$ ; KPSS:  $H_0 = \text{stationary}$ . Used as complements.
4. **Over-differencing:** Creates artificial negative autocorrelation ( $\rho_1 \approx -0.5$ ); non-invertible MA(1)
5. **Unbounded CIs:**  $\text{Var}(e_{T+h}) = \sigma^2 \sum_{j=0}^{h-1} \psi_j^2 \rightarrow \infty$  because  $\psi_j$  do not decay

## What's Next?

### Chapter 4: SARIMA Models for Seasonal Data

- ▣ **Seasonality:** repetitive patterns at regular intervals
- ▣ **Seasonal differencing:** the  $(1 - L^s)$  operator
- ▣ **SARIMA( $p, d, q$ )( $P, D, Q$ )<sub>s</sub>:** seasonal extension of ARIMA
- ▣ **Model identification:** seasonal ACF/PACF
- ▣ **Case study:** Airline passengers forecast

Questions?

## Question 1

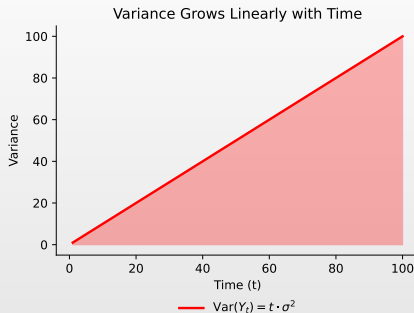
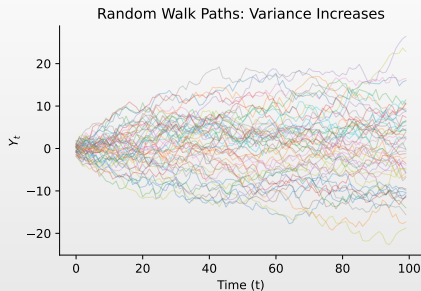
### Question

□ A time series  $Y_t$  follows a random walk:  $Y_t = Y_{t-1} + \varepsilon_t$ . What is  $\text{Var}(Y_t)$ ?

### Answer Choices

- (A)  $\sigma^2$  (constant)
- (B)  $t \cdot \sigma^2$  (grows linearly with time)
- (C)  $\sigma^2/t$  (decreases with time)
- (D)  $\sigma^{2t}$  (grows exponentially)

## Question 1: Answer



Answer: (B)

- ☐ Random walk variance grows linearly with time — this is why random walks are non-stationary.

## Question 2

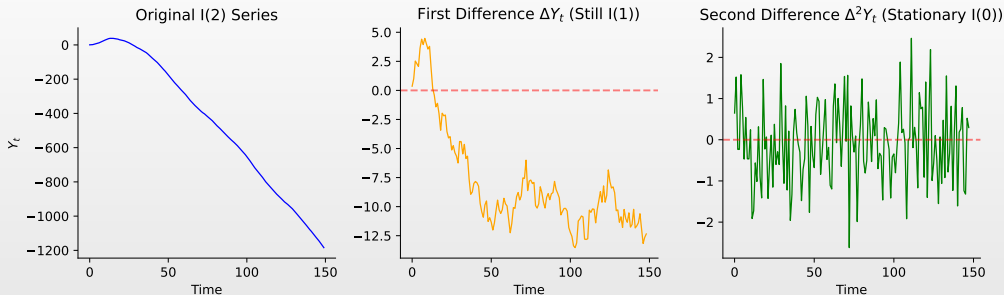
### Question

□ If a series  $Y_t$  is  $I(2)$ , how many times must you difference it to achieve stationarity?

### Answer Choices

- (A) 0 times (already stationary)
- (B) 1 time
- (C) 2 times
- (D) Cannot be made stationary by differencing

## Question 2: Answer



Answer: (C)

- $I(d)$  means “integrated of order  $d$ ” — requires  $d$  differences for stationarity.



### Question 3

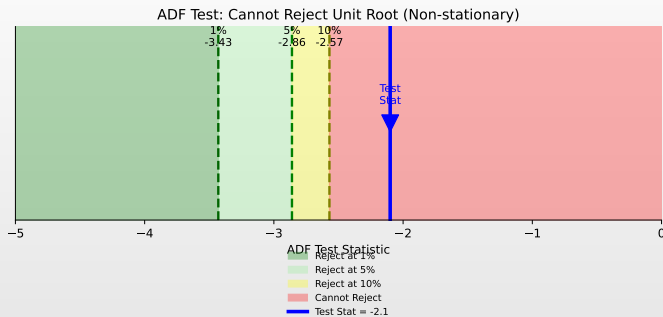
#### Question

- ☐ You run an ADF test and get a test statistic of  $-2.1$  with critical values:  $-3.43$  (1%),  $-2.86$  (5%),  $-2.57$  (10%). What do you conclude?

#### Answer Choices

- (A) Reject  $H_0$ : series is stationary at all levels
- (B) Reject  $H_0$ : series is stationary at 10% level only
- (C) Fail to reject  $H_0$ : series likely has a unit root
- (D) The test is inconclusive

## Question 3: Answer



Answer: (C)

□ Test stat  $-2.1 > -2.57$  (10% CV)  $\Rightarrow$  Cannot reject at any level. Consider differencing.

## Question 4

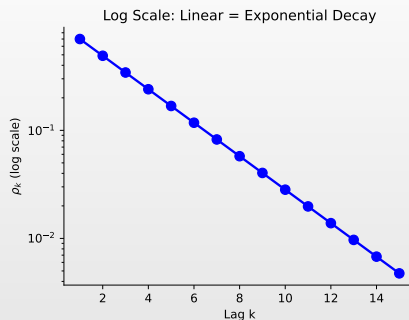
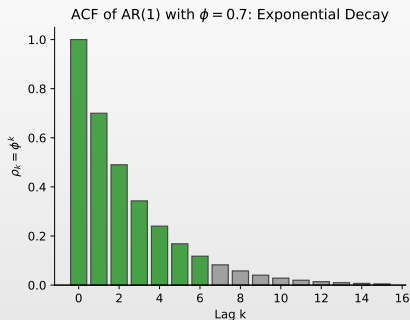
### Question

□ For an ARIMA(1,1,0) model, what is the ACF pattern of the **differenced** series  $\Delta Y_t$ ?

### Answer Choices

- (A) Cuts off after lag 1
- (B) Decays exponentially
- (C) Alternates in sign
- (D) Is zero at all lags

## Question 4: Answer



Answer: (B)

□ ARIMA(1,1,0)  $\Rightarrow \Delta Y_t$  follows AR(1) with ACF  $\rho_k = \phi_1^k$  (geometric decay).

## Question 5

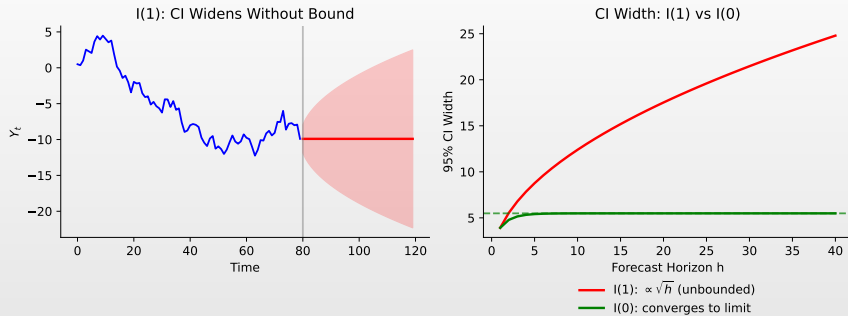
### Question

□ What happens to ARIMA forecast confidence intervals as the horizon  $h$  increases for an  $I(1)$  series?

### Answer Choices

- (A) They stay constant
- (B) They narrow (more precision)
- (C) They widen without bound
- (D) They widen but converge to a limit

## Question 5: Answer



Answer: (C)

□ For  $I(1)$ : CI width  $\propto \sqrt{h}$  (unbounded). For  $I(0)$ : CIs converge to a limit.

## Bibliography I

### Unit Root Tests

- Dickey, D.A., & Fuller, W.A. (1979). Distribution of the Estimators for Autoregressive Time Series with a Unit Root, *JASA*, 74(366), 427–431.
- Phillips, P.C.B., & Perron, P. (1988). Testing for a Unit Root in Time Series Regression, *Biometrika*, 75(2), 335–346.
- Kwiatkowski, D., Phillips, P.C.B., Schmidt, P., & Shin, Y. (1992). Testing the Null Hypothesis of Stationarity, *Journal of Econometrics*, 54(1-3), 159–178.

### ARIMA Models and Automatic Selection

- Box, G.E.P., & Jenkins, G.M. (1970). *Time Series Analysis: Forecasting and Control*, Holden-Day.
- Hyndman, R.J., & Khandakar, Y. (2008). Automatic Time Series Forecasting: The forecast Package for R, *Journal of Statistical Software*, 27(3), 1–22.

## Bibliography II

### Textbooks and Additional References

- ▣ Hamilton, J.D. (1994). *Time Series Analysis*, Princeton University Press.
- ▣ Shumway, R.H., & Stoffer, D.S. (2017). *Time Series Analysis and Its Applications*, 4th ed., Springer.
- ▣ Hyndman, R.J., & Athanasopoulos, G. (2021). *Forecasting: Principles and Practice*, 3rd ed., OTexts.

### Online Resources and Code



- ▣ **Quantlet**: <https://quantlet.com> > Code repository for statistics
- ▣ **Quantinar**: <https://quantinar.com> > Learning platform for quantitative methods
- ▣ **GitHub TSA**: [https://github.com/QuantLet/TSA/tree/main/TSA\\_ch3](https://github.com/QuantLet/TSA/tree/main/TSA_ch3) > Python code for this chapter



# Thank You!

## Questions?

Course materials available at: <https://danpele.github.io/Time-Series-Analysis/>

 Quantlet     Quantinar