

# ECON 340

## Economic Research Methods

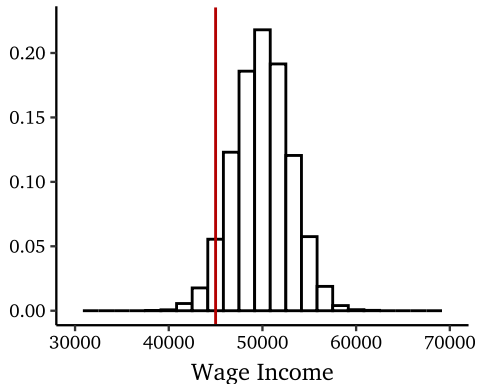
Div Bhagia

Lecture 4

Covariance and Correlation

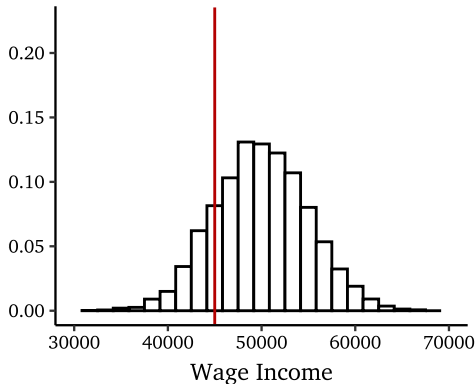
# Where would you want to live?

## Mushroom Kingdom



Mean = Median= \$50,000  
SD= \$3,000

## Bowser's Kingdom



Mean = Median= \$50,000  
SD= \$5,000

# Z-Score

We can calculate the Z-Score to capture how many standard deviations ( $\sigma$ ) away from the mean ( $\mu$ ) a specific observation is.

$$Z = \frac{X - \mu}{\sigma} \quad \rightarrow \quad X = \mu + Z \cdot \sigma$$

Example:  $\sigma_{MK} = 3000$ ,  $\sigma_{BK} = 5000$

$$Z_{MK} = \frac{45000 - 50000}{3000} = -1.66 \qquad Z_{BK} = \frac{45000 - 50000}{5000} = -1$$

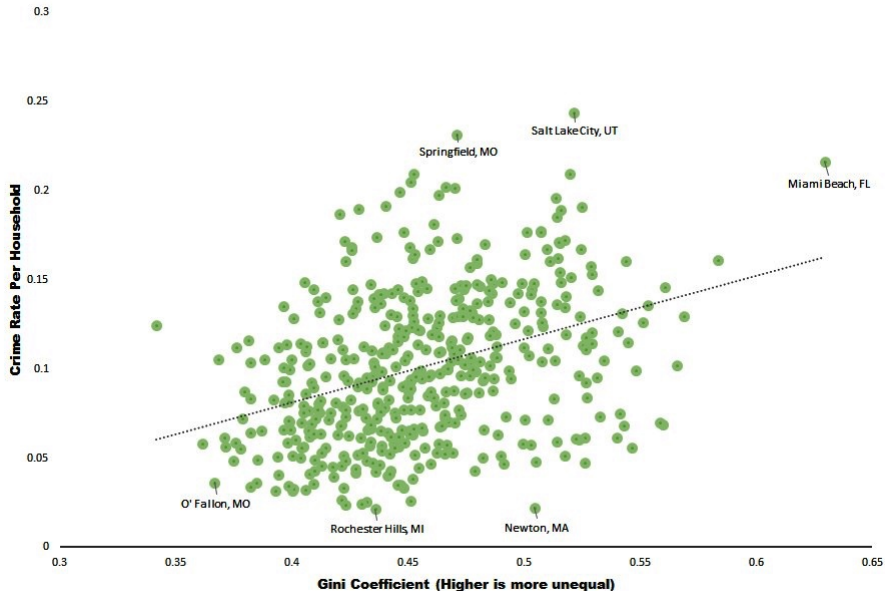
# Describing Data

*How do we summarize the information contained in a variable?*

- Empirical distribution, histogram, percentiles
- Measures of central tendency: mean, median, mode
- Measures of variance: range, variance, standard deviation

*How do we summarize the relationship between two variables?*

# INCOME INEQUALITY VS CRIME RATE BY CITY



# Describing Relationships

- Scatterplot: a graph where each point represents an observation of two variables
- Can see the relationship between two variables
- Positive relationship if when  $X$  is high  $Y$  is high (and when  $X$  is low  $Y$  is low)
- Negative relationship if when  $X$  is high  $Y$  is low (and when  $X$  is low  $Y$  is high)
- *How to construct a statistic to capture this?*

# Covariance

Covariance indicates whether there is a positive or negative relationship between two variables.

$$\sigma_{XY} = \frac{1}{N} \sum_{i=1}^N (X_i - \mu_X)(Y_i - \mu_Y) \quad (\textit{Population})$$

$$S_{XY} = \frac{1}{n-1} \sum_{i=1}^n (X_i - \bar{X})(Y_i - \bar{Y}) \quad (\textit{Sample})$$

# Example

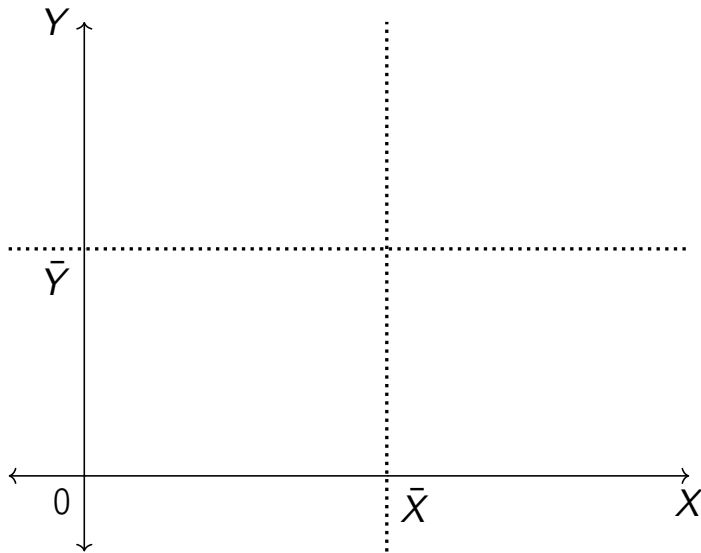
$X_i$ : sleep in hours,  $Y_i$ : exercise in hours

Week	$X_i$	$Y_i$	$(X_i - \mu_X)(Y_i - \mu_Y)$
1	6	0.5	
2	9	0.3	
3	9	1	
Total			

$$\sigma_{XY} = \frac{1}{N} \sum_{i=1}^N (X_i - \mu_X)(Y_i - \mu_Y) =$$



# Why does the formula work?



# Correlation

Correlation also indicates the *strength* of the relationship in addition to the *direction*.

$$\rho_{XY} = \frac{\sigma_{XY}}{\sigma_X \sigma_Y} \quad (\text{Population}) \qquad r_{XY} = \frac{S_{XY}}{S_X S_Y} \quad (\text{Sample})$$

Bounded between -1 and 1.

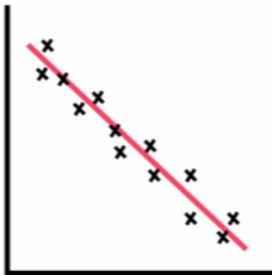
- $\rho = 0$ , no linear relationship
- $\rho = 1$ , perfect positive linear relationship
- $\rho = -1$ , perfect negative linear relationship

# Correlation

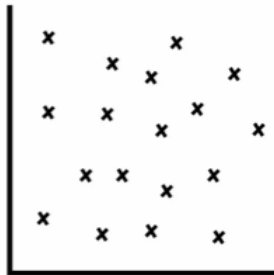
Correlation in Statistics: Meaning, Types, Examples & coefficient 4



Positive  
Correlation



Negative  
Correlation



No  
Correlation

# Example

$X_i$ : sleep in hours,  $Z_i$ : exercise in minutes

Week	$X_i$	$Z_i$	$(X_i - \mu_X)(Z_i - \mu_Z)$
1	6	30	
2	9	18	
3	9	60	
Total			

$$\sigma_{XZ} = \frac{1}{N} \sum_{i=1}^N (X_i - \mu_X)(Z_i - \mu_Z) =$$

# Finally... Correlation is not causation

A positive correlation between inequality and crime doesn't suggest that inequality  $\rightarrow$  crime. This is for two reasons:

- *Reverse causality*: crime  $\rightarrow$  inequality (unlikely here but a concern in many situations)
- *Other confounding factors*: larger, more congested cities tend to be more unequal and also have higher crime rates

# Things to do next

- Install R and R Studio on your computers if you haven't already (instructions on the course website)
- Please read Chapter 1 from Stock & Watson (uploaded on Canvas). We will discuss it on Tuesday.
- Finalize the research project team by end of the day
- Coming up: Problem Set 1 (Due on Tues)