

# Chapter 4

## Analysis of a Single Time Series

*Note: The primary reference for these notes is Enders (2004). An alternative and more technical treatment can be found in Hamilton (1994).*

Most data used in financial econometrics occur sequentially through time. Interest rates, asset returns, and foreign exchange rates are all examples of time series. This chapter introduces time-series econometrics and focuses primarily on linear models, although some common non-linear models are described in the final section. The analysis of time-series data begins by defining two key concepts in the analysis of time series: stationarity and ergodicity. The chapter next turns to Autoregressive Moving Average models (ARMA) and covers the structure of these models, stationarity conditions, model selection, estimation, inference, and forecasting. Finally, The chapter concludes by examining nonstationary time series.

### 4.1 Stochastic Processes

A stochastic process is an arbitrary sequence of random data and is denoted

$$\{Y_t\} \tag{4.1}$$

where  $\{\cdot\}$  is used to indicate that the ys form a sequence. The simplest non-trivial stochastic process specifies that  $Y_t \overset{\text{i.i.d.}}{\sim} D$  for some distribution  $D$ , for example, normal. Another simple stochastic process is the random walk,

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

where  $\varepsilon_t$  is an i.i.d. process.

### 4.2 Stationarity, Ergodicity, and the Information Set

Stationarity is a probabilistically meaningful measure of regularity. This regularity can be exploited to estimate unknown parameters and characterize the dependence between observations across time. If the data generating process frequently changed, then constructing a meaningful model would be difficult or impossible.

Stationarity exists in two forms, strict stationarity, and covariance (also known as weak) stationarity. Covariance stationarity is important when modeling the mean of a process, although strict stationarity is useful in more complicated settings, such as non-linear models.

**Definition 4.1** (Strict Stationarity). A stochastic process  $\{Y_t\}$  is strictly stationary if the joint distribution of  $\{Y_t, Y_{t+1}, \dots, Y_{t+h}\}$  only depends only on  $h$  and not on  $t$ .

Strict stationarity requires that the *joint* distribution of a stochastic process does not depend on time and so the only factor affecting the relationship between two observations is the gap between them. Strict stationarity is weaker than i.i.d. since the process may be dependent, but it is a strong assumption and implausible for many time series, including both financial and macroeconomic data.

Covariance stationarity, on the other hand, only imposes restrictions on the first two moments of a stochastic process.

**Definition 4.2** (Covariance Stationarity). A stochastic process  $\{Y_t\}$  is covariance stationary if

$$\begin{aligned} E[Y_t] &= \mu & \text{for } t = 1, 2, \dots \\ V[Y_t] &= \sigma^2 < \infty & \text{for } t = 1, 2, \dots \\ E[(Y_t - \mu)(Y_{t-s} - \mu)] &= \gamma_s & \text{for } t = 1, 2, \dots, s = 1, 2, \dots, t-1. \end{aligned} \quad (4.2)$$

Covariance stationarity requires that both the unconditional mean and unconditional variance are finite and do not change with time. Note that covariance stationarity only applies to *unconditional moments* and not conditional moments, and so a covariance process may have a varying conditional mean (i.e. be predictable).

These two types of stationarity are related, although neither nests the other. If a process is strictly stationary *and* has finite second moments, then it is covariance stationary. If a process is covariance stationary and the joint distribution of the studentized residuals (demeaned and standardized by their standard deviation) does not depend on time, then the process is strictly stationary. However, one type can occur without the other, both can occur, or neither may apply to a particular time series. For example, if a process has higher-order moments which depend on time (e.g., time-varying kurtosis), it may be covariance stationary but not strictly stationary. Alternatively, a sequence of i.i.d. Student's  $t$  random variables with 2 degrees of freedom is strictly stationary but not covariance stationary since the variance of a  $t_2$  is infinite.

$\gamma_s = E[(Y_t - \mu)(Y_{t-s} - \mu)]$  is the covariance of  $Y_t$  with itself at a different point in time, known as the  $s^{\text{th}}$  autocovariance.  $\gamma_0$  is the lag-0 autocovariance, the same quantity as the *long-run* variance of  $Y_t$  (i.e.  $\gamma_0 = V[Y_t]$ ).<sup>1</sup>

**Definition 4.3** (Autocovariance). The autocovariance of a covariance stationary scalar process  $\{Y_t\}$  is defined

$$\gamma_s = E[(Y_t - \mu)(Y_{t-s} - \mu)] \quad (4.3)$$

where  $\mu = E[Y_t]$ . Note that  $\gamma_0 = E[(Y_t - \mu)(Y_t - \mu)] = V[Y_t]$ .

Ergodicity is another important concept in the analysis of time series and is one form of asymptotic independence.

<sup>1</sup>The use of long-run variance is used to distinguish  $V[Y_t]$  from the innovation variance,  $V[\varepsilon_t]$ , also known as the short-run variance.

**Definition 4.4** (Ergodicity). Let  $\{Y_t\}$  be a stationary sequence.  $\{Y_t\}$  is ergodic if for any two bounded functions  $f: \mathbb{R}^k \rightarrow \mathbb{R}$   $g: \mathbb{R}^l \rightarrow \mathbb{R}$

$$\lim_{j \rightarrow \infty} |E[f(Y_t, \dots, Y_{t+k})g(Y_{t+j}, \dots, Y_{t+l+j})]| = |E[f(Y_t, \dots, Y_{t+k})]| |E[g(Y_{t+j}, \dots, Y_{t+l+j})]| \quad (4.4)$$

In essence, if an ergodic stochastic process is sampled at two points far apart in time, these samples will be independent. The ergodic theorem provides a practical application of ergodicity.

**Theorem 4.1** (Ergodic Theorem). If  $\{Y_t\}$  is ergodic and its  $r^{\text{th}}$  moment  $\mu_r$  is finite, then  $T^{-1} \sum_{t=1}^T Y_t^r \xrightarrow{P} \mu_r$ .

The ergodic theorem states that averages will converge to their expectation provided the expectation exists. The intuition for this results follows from the definition of ergodicity since samples far apart in time are (effectively) independent, and so errors average across time.

Not all series are ergodic. Let  $Y_t = \eta + \varepsilon_t$  where  $\eta \sim N(0, 1)$ ,  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, 1)$  and  $\eta$  and  $\varepsilon_t$  are independent for any  $t$ . Note that  $\eta$  is drawn only once (not every  $t$ ). Clearly,  $E[Y_t] = 0$ . However,  $T^{-1} \sum_{t=1}^T Y_t \xrightarrow{P} \eta \neq 0$ , and so even though the average converges it does not converge to  $E[Y_t]$  since the effect of the initial draw of  $\eta$  is present in every observation of  $\{Y_t\}$ .

The third important building block of time-series models is white noise. White noise generalizes i.i.d. noise and allows for dependence in a series as long as three conditions are satisfied: the series is mean zero, uncorrelated and has finite second moments.

**Definition 4.5** (White Noise). A process  $\{\varepsilon_t\}$  is known as white noise if

$$\begin{aligned} E[\varepsilon_t] &= 0 & \text{for } t = 1, 2, \dots \\ V[\varepsilon_t] &= \sigma^2 < \infty & \text{for } t = 1, 2, \dots \\ E[\varepsilon_t \varepsilon_{t-j}] &= \text{Cov}(\varepsilon_t, \varepsilon_{t-j}) = 0 & \text{for } t = 1, 2, \dots, j \neq 0. \end{aligned} \quad (4.5)$$

An i.i.d. series with finite second moments is trivially white noise, but other important processes, such as residuals following an ARCH (Autoregressive Conditional Heteroskedasticity) process, may also be white noise although not independent since white noise only requires linear independence.<sup>2</sup> A white noise process is also covariance stationary since it satisfies all three conditions: the mean, variance, and autocovariances are all finite and do not depend on time.

The final important concepts are conditional expectation and the information set. The information set at time  $t$  is denoted  $\mathcal{F}_t$  and contains all time  $t$  measurable events<sup>3</sup>, and so the information set includes realization of all variables which have occurred on or before  $t$ . For example, the information set for January 3, 2020 contains all stock returns up to and including those which occurred on January 3. It also includes everything else known at this time such as interest rates, foreign exchange rates or the scores of recent football games. Many expectations will often be made conditional on the time- $t$  information set, expressed  $E[Y_{t+h}|\mathcal{F}_t]$ , or in abbreviated form as  $E_t[Y_{t+h}]$ . The conditioning information set matters when taking expectations and  $E[Y_{t+h}]$ ,  $E_t[Y_{t+h}]$  and  $E_{t+h}[Y_{t+h}]$  are not the same. Conditional variance is similarly defined,  $V[Y_{t+h}|\mathcal{F}_t] = V_t[Y_{t+h}] = E_t[(Y_{t+h} - E_t[Y_{t+h}])^2]$ .

<sup>2</sup>Residuals generated from an ARCH process have dependence in conditional variances but not mean.

<sup>3</sup>A measurable event is any event that can have probability assigned to it at time  $t$ . In general this includes any observed variable but can also include time  $t$  beliefs about latent (unobserved) variables such as volatility or the final revision of the current quarter's GDP.

## 4.3 ARMA Models

Autoregressive moving average (ARMA) processes form the core of time-series analysis. The ARMA class can be decomposed into two smaller classes, autoregressive (AR) processes and moving average (MA) processes.

### 4.3.1 Moving Average Processes

The 1<sup>st</sup> order moving average, written MA(1), is the simplest non-degenerate time-series process,

$$Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

where  $\phi_0$  and  $\theta_1$  are parameters and  $\varepsilon_t$  a white noise series. This process stipulates that the current value of  $Y_t$  depends on both a new shock and the previous shock. For example, if  $\theta$  is negative, the current realization will “bounce back” from the previous shock.

**Definition 4.6** (First Order Moving Average Process). A first order Moving Average process (MA(1)) has dynamics which follow

$$Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t \quad (4.6)$$

where  $\varepsilon_t$  is a white noise process with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

It is simple to derive both the conditional and unconditional means in this process. The conditional mean is

$$\begin{aligned} E_{t-1}[Y_t] &= E_{t-1}[\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t] \\ &= \phi_0 + \theta_1 E_{t-1}[\varepsilon_{t-1}] + E_{t-1}[\varepsilon_t] \\ &= \phi_0 + \theta_1 \varepsilon_{t-1} + 0 \\ &= \phi_0 + \theta_1 \varepsilon_{t-1} \end{aligned} \quad (4.7)$$

where  $E_{t-1}[\varepsilon_t] = 0$  follows by assumption that the shock is unpredictable using the time- $t - 1$  information set, and since  $\varepsilon_{t-1}$  is in the time- $t - 1$  information set ( $\varepsilon_{t-1} \in \mathcal{F}_{t-1}$ ), it passes through the time- $t - 1$  conditional expectation. The unconditional mean is

$$\begin{aligned} E[Y_t] &= E[\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t] \\ &= \phi_0 + \theta_1 E[\varepsilon_{t-1}] + E[\varepsilon_t] \\ &= \phi_0 + \theta_1 0 + 0 \\ &= \phi_0. \end{aligned} \quad (4.8)$$

Comparing these two results, the unconditional mean of  $Y_t$ ,  $E[Y_t]$ , is  $\phi_0$  while the conditional mean  $E_{t-1}[Y_t] = \phi_0 + \theta_1 \varepsilon_{t-1}$ . This difference reflects the persistence of the previous shock in the current period. The variances can be similarly derived,

$$\begin{aligned}
V[Y_t] &= E[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - E[\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t])^2] \\
&= E[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - \phi_0)^2] \\
&= E[(\theta_1 \varepsilon_{t-1} + \varepsilon_t)^2] \\
&= \theta_1^2 E[\varepsilon_{t-1}^2] + E[\varepsilon_t^2] + 2\theta_1 E[\varepsilon_{t-1} \varepsilon_t] \\
&= \sigma^2 \theta_1^2 + \sigma^2 + 0 \\
&= \sigma^2 (1 + \theta_1^2)
\end{aligned} \tag{4.9}$$

where  $E[\varepsilon_{t-1} \varepsilon_t]$  follows from the white noise assumption. The conditional variance is

$$\begin{aligned}
V_{t-1}[Y_t] &= E_{t-1}[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - E_{t-1}[\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t])^2] \\
&= E_{t-1}[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - \phi_0 - \theta_1 \varepsilon_{t-1})^2] \\
&= E_{t-1}[\varepsilon_t^2] \\
&= \sigma_t^2
\end{aligned} \tag{4.10}$$

where  $\sigma_t^2$  is the conditional variance of  $\varepsilon_t$ . White noise does not have to be homoskedastic, although if  $\varepsilon_t$  is homoskedastic then  $V_{t-1}[Y_t] = E[\sigma_t^2] = \sigma^2$ . Like the mean, the unconditional variance and the conditional variance are different. The unconditional variance is unambiguously larger than the average conditional variance which reflects the extra variability introduced by the moving average term.

Finally, the autocovariance can be derived

$$\begin{aligned}
E[(Y_t - E[Y_t])(Y_{t-1} - E[Y_{t-1}])] &= E[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - \phi_0)(\phi_0 + \theta_1 \varepsilon_{t-2} + \varepsilon_{t-1} - \phi_0)] \\
&= E[\theta_1 \varepsilon_{t-1}^2 + \theta_1 \varepsilon_t \varepsilon_{t-2} + \varepsilon_t \varepsilon_{t-1} + \theta_1^2 \varepsilon_{t-1} \varepsilon_{t-2}] \\
&= \theta_1 E[\varepsilon_{t-1}^2] + \theta_1 E[\varepsilon_t \varepsilon_{t-2}] + E[\varepsilon_t \varepsilon_{t-1}] + \theta_1^2 E[\varepsilon_{t-1} \varepsilon_{t-2}] \\
&= \theta_1 \sigma^2 + 0 + 0 + 0 \\
&= \theta_1 \sigma^2
\end{aligned} \tag{4.11}$$

$$\begin{aligned}
E[(Y_t - E[Y_t])(Y_{t-2} - E[Y_{t-2}])] &= E[(\phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t - \phi_0)(\phi_0 + \theta_1 \varepsilon_{t-3} + \varepsilon_{t-2} - \phi_0)] \\
&= E[(\theta_1 \varepsilon_{t-1} + \varepsilon_t)(\theta_1 \varepsilon_{t-3} + \varepsilon_{t-2})] \\
&= E[\theta_1 \varepsilon_{t-1} \varepsilon_{t-2} + \theta_1 \varepsilon_{t-3} \varepsilon_t + \varepsilon_t \varepsilon_{t-2} + \theta_1^2 \varepsilon_{t-1} \varepsilon_{t-3}] \\
&= \theta_1 E[\varepsilon_{t-1} \varepsilon_{t-2}] + \theta_1 E[\varepsilon_{t-3} \varepsilon_t] + E[\varepsilon_t \varepsilon_{t-2}] + \theta_1^2 E[\varepsilon_{t-1} \varepsilon_{t-3}] \\
&= 0 + 0 + 0 + 0 \\
&= 0
\end{aligned} \tag{4.12}$$

By inspection of eq. (4.12) it follows that  $\gamma_s = E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] = 0$  for  $s \geq 2$ .

The MA(1) can be generalized into the class of MA( $Q$ ) processes by including additional lagged errors.

**Definition 4.7** (Moving Average Process of Order  $Q$ ). A Moving Average process of order  $Q$ , abbreviated MA( $Q$ ), has dynamics which follow

$$Y_t = \phi_0 + \sum_{q=1}^Q \theta_q \varepsilon_{t-q} + \varepsilon_t \quad (4.13)$$

where  $\varepsilon_t$  is white noise series with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

The following properties hold in higher order moving averages:

- $E[Y_t] = \phi_0$
- $V[Y_t] = (1 + \sum_{q=1}^Q \theta_q^2) \sigma^2$
- $E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] = \sigma^2 \sum_{i=0}^{Q-s} \theta_i \theta_{i+s}$  for  $s \leq Q$  where  $\theta_0 = 1$ .
- $E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] = 0$  for  $s > Q$

### 4.3.2 Autoregressive Processes

The other subclass of ARMA processes is the autoregressive process.

**Definition 4.8** (First Order Autoregressive Process). A first order autoregressive process, abbreviated AR(1), has dynamics which follow

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t \quad (4.14)$$

where  $\varepsilon_t$  is a white noise process with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

Unlike the MA(1) process,  $y$  appears on both sides of the equation. However, this is only a convenience and the process can be recursively substituted to provide an expression that depends only on the errors,  $\varepsilon_t$  and an initial condition.

$$\begin{aligned} Y_t &= \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t \\ Y_t &= \phi_0 + \phi_1 (\phi_0 + \phi_1 Y_{t-2} + \varepsilon_{t-1}) + \varepsilon_t \\ Y_t &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_{t-2} + \varepsilon_t + \phi_1 \varepsilon_{t-1} \\ Y_t &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 (\phi_0 + \phi_1 Y_{t-3} + \varepsilon_{t-2}) + \varepsilon_t + \phi_1 \varepsilon_{t-1} \\ Y_t &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 \phi_0 + \phi_1^3 Y_{t-3} + \varepsilon_t + \phi_1 \varepsilon_{t-1} + \phi_1^2 \varepsilon_{t-2} \\ &\vdots \\ Y_t &= \sum_{i=0}^{t-1} \phi_1^i \phi_0 + \sum_{i=0}^{t-1} \phi_1^i \varepsilon_{t-i} + \phi_1^t Y_0 \end{aligned}$$

Using backward substitution, an AR(1) can be expressed as an MA( $t$ ). In many cases, the initial condition is unimportant, and the AR process can be assumed to have begun long ago in the past.

As long as  $|\phi_1| < 1$ ,  $\lim_{t \rightarrow \infty} \phi^t Y_0 \rightarrow 0$  and the effect of an initial condition will be small. Using the “infinite history” version of an AR(1), and assuming  $|\phi_1| < 1$ , the solution simplifies to

$$\begin{aligned} Y_t &= \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t \\ Y_t &= \sum_{i=0}^{\infty} \phi_1^i \phi_0 + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \\ Y_t &= \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \end{aligned} \quad (4.15)$$

where the identity  $\sum_{i=0}^{\infty} \phi_1^i = (1 - \phi_1)^{-1}$  is used in the final solution. This expression of an AR process is known as an MA( $\infty$ ) representation and it is useful for deriving standard properties.

The unconditional mean of an AR(1) is

$$\begin{aligned} E[Y_t] &= E \left[ \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \right] \\ &= \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i E[\varepsilon_{t-i}] \\ &= \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i 0 \\ &= \frac{\phi_0}{1 - \phi_1}. \end{aligned} \quad (4.16)$$

The unconditional mean can be alternatively derived noting that, as long as  $\{Y_t\}$  is covariance stationary, that  $E[Y_t] = E[Y_{t-1}] = \mu$ , and so

$$\begin{aligned} E[Y_t] &= E[\phi_0 + \phi_1 Y_{t-1} + \varepsilon_{t-1}] \\ E[Y_t] &= \phi_0 + \phi_1 E[Y_{t-1}] + E[\varepsilon_{t-1}] \\ \mu &= \phi_0 + \phi_1 \mu + 0 \\ \mu - \phi_1 \mu &= \phi_0 \\ \mu(1 - \phi_1) &= \phi_0 \\ E[Y_t] &= \frac{\phi_0}{1 - \phi_1} \end{aligned} \quad (4.17)$$

The  $\mathcal{F}_{t-1}$ -conditional expectation is

$$\begin{aligned} E_{t-1}[Y_t] &= E_{t-1}[\phi_0 + \phi_1 Y_{t-1} + \varepsilon_t] \\ &= \phi_0 + \phi_1 E_{t-1}[Y_{t-1}] + E_{t-1}[\varepsilon_t] \\ &= \phi_0 + \phi_1 Y_{t-1} + 0 \\ &= \phi_0 + \phi_1 Y_{t-1} \end{aligned} \quad (4.18)$$

since  $Y_{t-1} \in \mathcal{F}_{t-1}$ . The unconditional and conditional variances are

$$\begin{aligned}
 V[Y_t] &= E[(Y_t - E[Y_t])^2] \\
 &= E\left[\left(\frac{\phi_0}{1-\phi_1} + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} - \frac{\phi_0}{1-\phi_1}\right)^2\right] \\
 &= E\left[\left(\sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i}\right)^2\right] \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-i}^2 + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^{i+j} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-i}^2\right] + E\left[\sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^{i+j} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= \sum_{i=0}^{\infty} \phi_1^{2i} E[\varepsilon_{t-i}^2] + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^{i+j} E[\varepsilon_{t-i} \varepsilon_{t-j}] \\
 &= \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^{i+j} 0 \\
 &= \frac{\sigma^2}{1-\phi_1^2}
 \end{aligned} \tag{4.19}$$

where the expression for the unconditional variance uses the identity that  $\sum_{i=0}^{\infty} \phi_1^{2i} = \frac{1}{1-\phi_1^2}$  and  $E[\varepsilon_{t-i} \varepsilon_{t-j}] = 0$  follows from the white noise assumption. Again, assuming covariance stationarity and so  $V[Y_t] = V[Y_{t-1}]$ , the variance can be directly computed,

$$\begin{aligned}
 V[Y_t] &= V[\phi_0 + \phi_1 Y_{t-1} + \varepsilon_t] \\
 V[Y_t] &= V[\phi_0] + V[\phi_1 Y_{t-1}] + V[\varepsilon_t] + 2\text{Cov}[\phi_1 Y_{t-1}, \varepsilon_t] \\
 V[Y_t] &= 0 + \phi_1^2 V[Y_{t-1}] + \sigma^2 + 2 \cdot 0 \\
 V[Y_t] &= \phi_1^2 V[Y_t] + \sigma^2 \\
 V[Y_t] - \phi_1^2 V[Y_t] &= \sigma^2 \\
 V[Y_t] (1 - \phi_1^2) &= \sigma^2 \\
 V[Y_t] &= \frac{\sigma^2}{1 - \phi_1^2}
 \end{aligned} \tag{4.20}$$

where  $\text{Cov}[Y_{t-1}, \varepsilon_t] = 0$  follows from the white noise assumption since  $Y_{t-1}$  is a function of  $\varepsilon_{t-1}, \varepsilon_{t-2}, \dots$ . The conditional variance is



$$\begin{aligned}
V_{t-1}[Y_t] &= E_{t-1} \left[ (\phi_1 Y_{t-1} + \varepsilon_t - \phi_1 Y_{t-1})^2 \right] \\
&= E_{t-1} [\varepsilon_t^2] \\
&= \sigma_t^2
\end{aligned} \tag{4.21}$$

Again, the unconditional variance is uniformly larger than the average conditional variance ( $E[\sigma_t^2] = \sigma^2$ ) and the variance explodes as  $|\phi_1|$  approaches 1 or -1. Finally, the autocovariances can be derived,

$$E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] = E \left[ \left( \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} - \frac{\phi_0}{1 - \phi_1} \right) \right] \tag{4.22}$$

$$\times \left( \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} - \frac{\phi_0}{1 - \phi_1} \right) \tag{4.23}$$

$$\begin{aligned}
&= E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \\
&= E \left[ \left( \sum_{i=0}^{s-1} \phi_1^i \varepsilon_{t-i} + \sum_{i=s}^{\infty} \phi_1^i \varepsilon_{t-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \\
&= E \left[ \left( \sum_{i=0}^{s-1} \phi_1^i \varepsilon_{t-i} + \sum_{i=0}^{\infty} \phi_1^s \phi_1^i \varepsilon_{t-s-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \\
&= E \left[ \left( \sum_{i=0}^{s-1} \phi_1^i \varepsilon_{t-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right. \\
&\quad \left. + \phi_1^s \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \tag{4.24}
\end{aligned}$$

$$\begin{aligned}
&= E \left[ \left( \sum_{i=0}^{s-1} \phi_1^i \varepsilon_{t-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \\
&\quad + E \left[ \phi_1^s \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \tag{4.25} \\
&= 0 + \phi_1^s E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-s-i} \right) \right] \\
&= 0 + \phi_1^s V[Y_{t-s}] \\
&= \phi_1^s \frac{\sigma^2}{1 - \phi_1^2}
\end{aligned}$$

An alternative approach to deriving the autocovariance is to note that  $Y_t - \mu = \sum_{i=0}^{s-1} \phi_1^i \varepsilon_{t-i} + \phi_1^s (Y_{t-s} - \mu)$  where  $\mu = E[Y_t] = E[Y_{t-s}]$ . Using this identity, the autocovariance can be derived

$$\begin{aligned}
E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] &= E \left[ \left( \sum_{i=0}^{s-i} \phi_1^i \varepsilon_{t-i} + \phi^s (Y_{t-s} - \mu) \right) (Y_{t-s} - \mu) \right] \\
&= E \left[ \left( \sum_{i=0}^{s-i} \phi_1^i \varepsilon_{t-i} \right) (Y_{t-s} - \mu) + (\phi^s (Y_{t-s} - \mu) (Y_{t-s} - \mu)) \right] \\
&= E \left[ \left( \sum_{i=0}^{s-i} \phi_1^i \varepsilon_{t-i} \right) (Y_{t-s} - \mu) \right] + E[(\phi^s (Y_{t-s} - \mu) (Y_{t-s} - \mu))] \\
&= 0 + \phi^s E[(Y_{t-s} - \mu) (Y_{t-s} - \mu)] \\
&= \phi^s V[Y_{t-s}] \\
&= \phi_1^s \frac{\sigma^2}{1 - \phi_1^2}
\end{aligned} \tag{4.26}$$

where the white noise assumption is used to ensure that  $E[\varepsilon_{t-u}(Y_{t-s} - \mu)] = 0$  when  $u > s$ .

The AR(1) can be extended to the AR( $P$ ) class by including additional lags of  $Y_t$ .

**Definition 4.9** (Autoregressive Process of Order  $P$ ). An Autoregressive process of order  $P$  (AR( $P$ )) has dynamics which follow

$$Y_t = \phi_0 + \sum_{p=1}^P \phi_p Y_{t-p} + \varepsilon_t \tag{4.27}$$

where  $\varepsilon_t$  is white noise series with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

Some of the more useful properties of general AR process are:

- $E[Y_t] = \frac{\phi_0}{1 - \sum_{p=1}^P \phi_p}$
- $V[Y_t] = \frac{\sigma^2}{1 - \sum_{p=1}^P \phi_p \rho_p}$  where  $\rho_p$  is the  $p^{\text{th}}$  autocorrelation.
- $V[Y_t]$  is infinite if  $\sum_{p=1}^P \phi_p \geq 1$
- $E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])] \neq 0$  for any  $s$  (in general, although certain parameterizations may produce some 0 autocovariances).

These four properties point to some important regularities of AR processes. First, the mean is only finite if  $\sum_{p=1}^P \phi_p < 1$ . Second, the autocovariances are (generally) not zero, unlike those of an MA processes ( $\gamma_s = 0$  for  $|s| > Q$ ). This difference in the behavior of the autocovariances plays an important role in model building. Explicit expressions for the variance and autocovariance of higher order AR processes can be found in appendix 4.A.

### 4.3.3 Autoregressive-Moving Average Processes

Putting these two processes together yields the complete class of ARMA processes.

**Definition 4.10** (Autoregressive-Moving Average Process). An Autoregressive Moving Average process with orders  $P$  and  $Q$  (ARMA( $P, Q$ )) has dynamics which follow

$$Y_t = \phi_0 + \sum_{p=1}^P \phi_p Y_{t-p} + \sum_{q=1}^Q \theta_q \varepsilon_{t-q} + \varepsilon_t \quad (4.28)$$

where  $\varepsilon_t$  is a white noise process with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

Again, consider the simplest ARMA(1,1) process that includes a constant term,

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

To derive the properties of this model it is useful to convert the ARMA(1,1) into its infinite lag representation using recursive substitution,

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t \quad (4.29)$$

$$Y_t = \phi_0 + \phi_1 (\phi_0 + \phi_1 Y_{t-2} + \theta_1 \varepsilon_{t-2} + \varepsilon_{t-1}) + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

$$Y_t = \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

$$Y_t = \phi_0 + \phi_1 \phi_0 + \phi_1^2 (\phi_0 + \phi_1 Y_{t-3} + \theta_1 \varepsilon_{t-3} + \varepsilon_{t-2}) + \phi_1 \theta_1 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

$$Y_t = \phi_0 + \phi_1 \phi_0 + \phi_1^2 \phi_0 + \phi_1^3 Y_{t-3} + \phi_1^2 \theta_1 \varepsilon_{t-3} + \phi_1^2 \varepsilon_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

$$\vdots \quad \quad \quad \vdots$$

$$Y_t = \sum_{i=0}^{\infty} \phi_1^i \phi_0 + \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-i-1}$$

$$Y_t = \frac{\phi_0}{1 - \phi_1} + \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-i-1}.$$

Using the infinite lag representation, the unconditional and conditional means can be computed,

$$\begin{aligned} E[Y_t] &= E \left[ \frac{\phi_0}{1 - \phi_1} + \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-i-1} \right] \\ &= \frac{\phi_0}{1 - \phi_1} + E[\varepsilon_t] + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) E[\varepsilon_{t-i-1}] \\ &= \frac{\phi_0}{1 - \phi_1} + 0 + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) 0 \\ &= \frac{\phi_0}{1 - \phi_1} \end{aligned} \quad (4.30)$$

and

$$\begin{aligned}
 E_{t-1}[Y_t] &= E_{t-1}[\phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t] \\
 &= \phi_0 + \phi_1 E_{t-1}[Y_{t-1}] + \theta_1 E_{t-1}[\varepsilon_{t-1}] + E_{t-1}[\varepsilon_t] \\
 &= \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + 0 \\
 &= \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1}
 \end{aligned} \tag{4.31}$$

Since  $Y_{t-1}$  and  $\varepsilon_{t-1}$  are in the time- $t-1$  information set, these variables pass through the conditional expectation. The unconditional variance can be tediously derived (see appendix 4.A.2 for the complete derivation)

$$V[Y_t] = \sigma^2 \left( \frac{1 + 2\phi_1 \theta_1 + \theta_1^2}{1 - \phi_1^2} \right) \tag{4.32}$$

The conditional variance is identical to that in the AR(1) or MA(1),  $V_{t-1}[Y_t] = \sigma_t^2$ , and, if  $\varepsilon_t$  is homoskedastic,  $V_{t-1}[Y_t] = \sigma^2$ .

The unconditional mean of an ARMA is the same as an AR since the moving average terms, which are all mean zero, do not contribute to the mean. The variance of an ARMA is more complicated than that of an AR, and it may be larger or smaller than an AR(1) with the same autoregressive parameter ( $\phi_1$ ). The variance will only be smaller if  $\phi_1$  and  $\theta_1$  have opposite signs *and*  $2\phi_1 \theta_1 < \theta_1^2$ . Deriving the autocovariance is straightforward but tedious and is presented in appendix 4.A.

## 4.4 Difference Equations

Before turning to the analysis of the stationarity conditions for ARMA processes, it is useful to develop an understanding of the stability conditions in a setting without random shocks.

**Definition 4.11** (Linear Difference Equation). An equation of the form

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P} + X_t. \tag{4.33}$$

is known as a  $P^{\text{th}}$  order linear difference equation where the series  $\{X_t\}$  is known as the driving process.

Linear difference equation nest ARMA processes which can be seen by setting  $X_t$  equal to the shock plus the moving average component of the ARMA process,

$$X_t = \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \dots + \theta_Q \varepsilon_{t-Q} + \varepsilon_t.$$

Stability conditions depend crucially on the solution to the linear difference equation.

**Definition 4.12** (Solution). A solution to a linear difference equation expresses the linear difference equation

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P} + X_t. \tag{4.34}$$

as a function of only  $\{X_t\}_{t=1}^t$ , a constant and, when  $Y_t$  has finite history, an initial value  $Y_0$ .

Consider a first order linear difference equation

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + X_t.$$

Starting from an initial value  $Y_0$ ,

$$Y_1 = \phi_0 + \phi_1 Y_0 + X_1$$

$$\begin{aligned} Y_2 &= \phi_0 + \phi_1(\phi_0 + \phi_1 Y_0 + X_1) + X_2 \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_0 + X_2 + \phi_1 X_1 \end{aligned}$$

$$\begin{aligned} Y_3 &= \phi_0 + \phi_1 Y_2 + X_2 \\ &= \phi_0 + \phi_1(\phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_0 + \phi_1 X_1 + X_2) + X_2 \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 \phi_0 + \phi_1^3 Y_0 + X_3 + \phi_1 X_2 + \phi_1^2 X_1 \end{aligned}$$

Continuing these iterations, a pattern emerges:

$$Y_t = \phi_1^t Y_0 + \sum_{i=0}^{t-1} \phi_1^i \phi_0 + \sum_{i=0}^{t-1} \phi_1^i X_{t-i} \quad (4.35)$$

This is a solution since it expresses  $Y_t$  as a function of only  $\{X_t\}$ ,  $Y_0$  and constants. When no initial condition is given (or the series is assumed to be infinite), the solution can be found by solving backward

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + X_t$$

$$Y_{t-1} = \phi_0 + \phi_1 Y_{t-2} + X_{t-1} \Rightarrow$$

$$\begin{aligned} Y_t &= \phi_0 + \phi_1(\phi_0 + \phi_1 Y_{t-2} + X_{t-1}) + X_t \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_{t-2} + X_t + \phi_1 X_{t-1} \end{aligned}$$

$$Y_{t-2} = \phi_0 + \phi_1 Y_{t-3} + X_{t-2} \Rightarrow$$

$$\begin{aligned} Y_t &= \phi_0 + \phi_1 \phi_0 + \phi_1^2(\phi_0 + \phi_1 Y_{t-3} + X_{t-2}) + X_t + \phi_1 X_{t-1} \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 \phi_0 + \phi_1^3 Y_{t-3} + X_t + \phi_1 X_{t-1} + \phi_1^2 X_{t-2} \end{aligned}$$

which leads to the approximate solution

$$Y_t = \sum_{i=0}^{s-1} \phi_1^i \phi_0 + \sum_{i=0}^{s-1} \phi_1^i X_{t-i} + \phi_1^s Y_{t-s}.$$

To understand the behavior of this solution, it is necessary to take limits. If  $|\phi_1| < 1$ ,  $\lim_{s \rightarrow \infty} \phi_1^s Y_{t-s}$  goes to zero (as long as  $Y_{t-s}$  is bounded) and the solution simplifies to

$$Y_t = \phi_0 \sum_{i=0}^{\infty} \phi_1^i + \sum_{i=0}^{\infty} \phi_1^i X_{t-i}. \quad (4.36)$$

Noting that, as long as  $|\phi_1| < 1$ ,  $\sum_{i=0}^{\infty} \phi_1^i = 1/(1 - \phi_1)$ ,

$$Y_t = \frac{\phi_0}{1 - \phi_1} + \sum_{i=0}^{\infty} \phi_1^i X_{t-i} \quad (4.37)$$

is the solution to this problem with an infinite history. The solution concept is important because it clarifies the relationship between observations in the distant past and the current observation, and if  $\lim_{s \rightarrow \infty} \phi_1^s Y_{t-s}$  does not converge to zero then observations arbitrarily far in the past have an influence on the value of  $y$  today.

When  $|\phi_1| > 1$  then this system is said to be *nonconvergent* since  $\phi_1^t$  diverges as  $t$  grows large and values in the past are not only important, they will dominate when determining the current value. In the particular case where  $\phi_1 = 1$ ,

$$Y_t = \phi_0 t + \sum_{i=0}^{\infty} X_{t-i},$$

which is a random walk when  $\{X_t\}$  is a white noise process, and the influence of a single  $X_t$  never diminishes. Direct substitution can be used to find the solution of higher-order linear difference equations at the cost of more tedium. A simpler alternative focuses on the core component of a linear difference equation, the linear homogeneous equation.

#### 4.4.1 Homogeneous Difference Equations

When the number of lags grows large (3 or greater), solving linear difference equations by substitution is tedious. The key to understanding linear difference equations is the study of the homogeneous portion of the equation. In the general linear difference equation,

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P} + X_t$$

the homogenous portion is defined as the terms involving only  $y$ ,

$$Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P}. \quad (4.38)$$

The intuition behind studying this portion of the system is that given the sequence of  $\{X_t\}$ , all of the dynamics and the stability of the system are determined by the relationship between contemporaneous  $Y_t$  and its lagged values. This relationship then allows the parameter values to be determined where the system is stable. Again, consider the homogeneous portions of the simple 1<sup>st</sup> order system,

$$Y_t = \phi_1 Y_{t-1} + X_t$$

which has the homogeneous portion

$$Y_t = \phi_1 Y_{t-1}.$$

To find solutions to this equation, one can try trial and error: one obvious solution is 0 since  $0 = \phi \cdot 0$ . It is easy to show that

$$Y_t = \phi_1^t Y_0$$

is also a solution by examining the solution to the linear difference equation in eq. (4.35). Any solution of the form  $c\phi_1^t$  for an arbitrary constant  $c$  since

$$\begin{aligned} Y_t &= c\phi_1^t \\ Y_{t-1} &= c\phi_1^{t-1} \end{aligned}$$

and

$$Y_t = \phi_1 Y_{t-1}$$

Putting these two together shows that

$$\begin{aligned} Y_t &= \phi_1 Y_{t-1} \\ c\phi_1^t &= \phi_1 Y_{t-1} \\ c\phi_1^t &= \phi_1 c\phi_1^{t-1} \\ c\phi_1^t &= c\phi_1^t \end{aligned}$$

and there are many solutions. However, from these, it is possible to discern when the solution will converge to zero and when it will explode:

- If  $|\phi_1| < 1$  the system converges to 0. If  $\phi_1$  is also negative, the solution oscillates, while if  $\phi_1$  is greater than 0, the solution decays exponentially.
- If  $|\phi_1| > 1$  the system diverges, again oscillating if negative and growing exponentially if positive.
- If  $\phi_1 = 1$ , the system is stable and all values are solutions. For example  $1 = 1 \cdot 1$ ,  $2 = 1 \cdot 2$ , etc.
- If  $\phi_1 = -1$ , the system is *metastable*. The values, in absolute terms, are unchanged, but it oscillates between + and -.

These categories will play important roles in examining the dynamics of larger equations since they determine how past shocks will affect current values of  $Y_t$ . When the order is greater than 1, there is an easier approach to examining the system's stability. Consider the second-order linear difference system,

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + X_t$$

and again focus on the homogeneous portion,

$$Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2}.$$

This equation can be rewritten

$$Y_t - \phi_1 Y_{t-1} - \phi_2 Y_{t-2} = 0$$

so any solution of the form

$$\begin{aligned} cz^t - \phi_1 cz^{t-1} - \phi_2 cz^{t-2} &= 0 \\ cz^{t-2} (z^2 - \phi_1 z - \phi_2) &= 0 \end{aligned} \quad (4.39)$$

will solve this equation.<sup>4</sup> Dividing through by  $cz^{t-2}$ , this is equivalent to

$$z^2 - \phi_1 z - \phi_2 = 0 \quad (4.40)$$

and the solutions to this quadratic polynomial are given by the quadratic formula,

$$c_1, c_2 = \frac{\phi_1 \pm \sqrt{\phi_1^2 + 4\phi_2}}{2} \quad (4.41)$$

The roots of the equation,  $c_1$  and  $c_2$ , play the same role as  $\phi_1$  in the 1<sup>st</sup> order case.<sup>5</sup> If  $|c_1| < 1$  and  $|c_2| < 1$ , the system is convergent. With two roots both smaller than 1 there are three interesting cases:

**Case 1:** Both roots are real and positive. In this case, the system will exponentially dampen and not oscillate.

**Case 2:** Both roots are imaginary (of the form  $c + di$  where  $i = \sqrt{-1}$ ) and distinct, or real and at least one negative. In this case, the absolute value of the roots (also called the modulus, defined as  $\sqrt{c^2 + d^2}$  for an imaginary number  $c + di$ ) is less than 1, and so the system will be convergent but oscillate.

**Case 3:** Real but the same. This occurs when  $\phi_1^2 + 4\phi_2 = 0$ . Since there is only one root, the system is convergent if it is less than 1 in absolute value, which requires that  $|\phi_1| < 2$ .

If either root is greater than 1 in absolute terms, the system is divergent.

#### 4.4.2 Lag Operators

Before proceeding to higher order models, it is necessary to define the lag operator. Lag operations are a particularly useful tool in the analysis of time series and are nearly self-descriptive.<sup>6</sup>

**Definition 4.13** (Lag Operator). The lag operator is denoted  $L$  and is defined as the operator that has

<sup>4</sup>The solution can only be defined up to a constant,  $c$ , since the right hand side is 0. Thus, multiplying both by a constant, the solution will still be valid.

<sup>5</sup>In the first order case,  $Y_t = \phi_1 Y_{t-1}$ , so  $Y_t - \phi_1 Y_{t-1} = 0$ . The solution has the property that  $z^t - \phi_1 z^{t-1} = 0$  so  $z - \phi_1 = 0$ , which has the single solution  $c = \phi_1$ .

<sup>6</sup>In some texts, the lag operator is known as the backshift operator, and  $L$  is replaced with  $B$ .



the following properties:

$$\begin{aligned}
 LY_t &= Y_{t-1} \\
 L^2Y_t &= Y_{t-2} \\
 L^iY_t &= Y_{t-i} \\
 L(L(Y_t)) &= L(Y_{t-1}) = Y_{t-2} = L^2Y_t \\
 (1 - L - L^2)Y_t &= Y_t - LY_t - L^2Y_t = Y_t - Y_{t-1} - Y_{t-2}
 \end{aligned}$$

The last equation above is particularly useful when studying autoregressive processes. One additional property of the lag operator is that the lag of a constant is just the constant, i.e.  $Lc = c$ .

### 4.4.3 Higher Order Linear Homogenous Equations

Stability analysis can be applied to higher order systems by forming the characteristic equation and finding the characteristic roots.

**Definition 4.14** (Characteristic Equation). Let  $Y_t$  follow a  $P^{\text{th}}$  order linear difference equation

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P} + X_t \quad (4.42)$$

which can be rewritten as

$$\begin{aligned}
 Y_t - \phi_1 Y_{t-1} - \phi_2 Y_{t-2} - \dots - \phi_P Y_{t-P} &= \phi_0 + X_t \\
 (1 - \phi_1 L - \phi_2 L^2 - \dots - \phi_P L^P)Y_t &= \phi_0 + X_t
 \end{aligned} \quad (4.43)$$

The characteristic equation of this process is

$$z^P - \phi_1 z^{P-1} - \phi_2 z^{P-2} - \dots - \phi_{P-1} z - \phi_P = 0 \quad (4.44)$$

The characteristic roots are the solutions to this equation and most econometric packages will return the roots of the characteristic polynomial when an ARMA model is estimated.

**Definition 4.15** (Characteristic Root). Let

$$z^P - \phi_1 z^{P-1} - \phi_2 z^{P-2} - \dots - \phi_{P-1} z - \phi_P = 0 \quad (4.45)$$

be the characteristic polynomial associated with a  $P^{\text{th}}$  order linear difference equation. The  $P$  characteristic roots,  $c_1, c_2, \dots, c_P$  are defined as the solution to this polynomial

$$(z - c_1)(z - c_2) \dots (z - c_P) = 0 \quad (4.46)$$

The conditions for stability are the same for higher order systems as they were for first and second order systems: all roots  $c_p$ ,  $p = 1, 2, \dots, P$  must satisfy  $|c_p| < 1$  (again, if complex,  $|\cdot|$  means modulus). If any  $|c_p| > 1$  the system is divergent. If one or more  $|c_p| = 1$  and none are larger, the system will exhibit unit root (random walk) behavior.

These results are the key to understanding important properties of linear time-series models which turn out to be *stationary if the corresponding linear homogeneous system is convergent*, i.e.  $|c_p| < 1$ ,  $p = 1, 2, \dots, P$ .

### Dynamics of linear difference equations

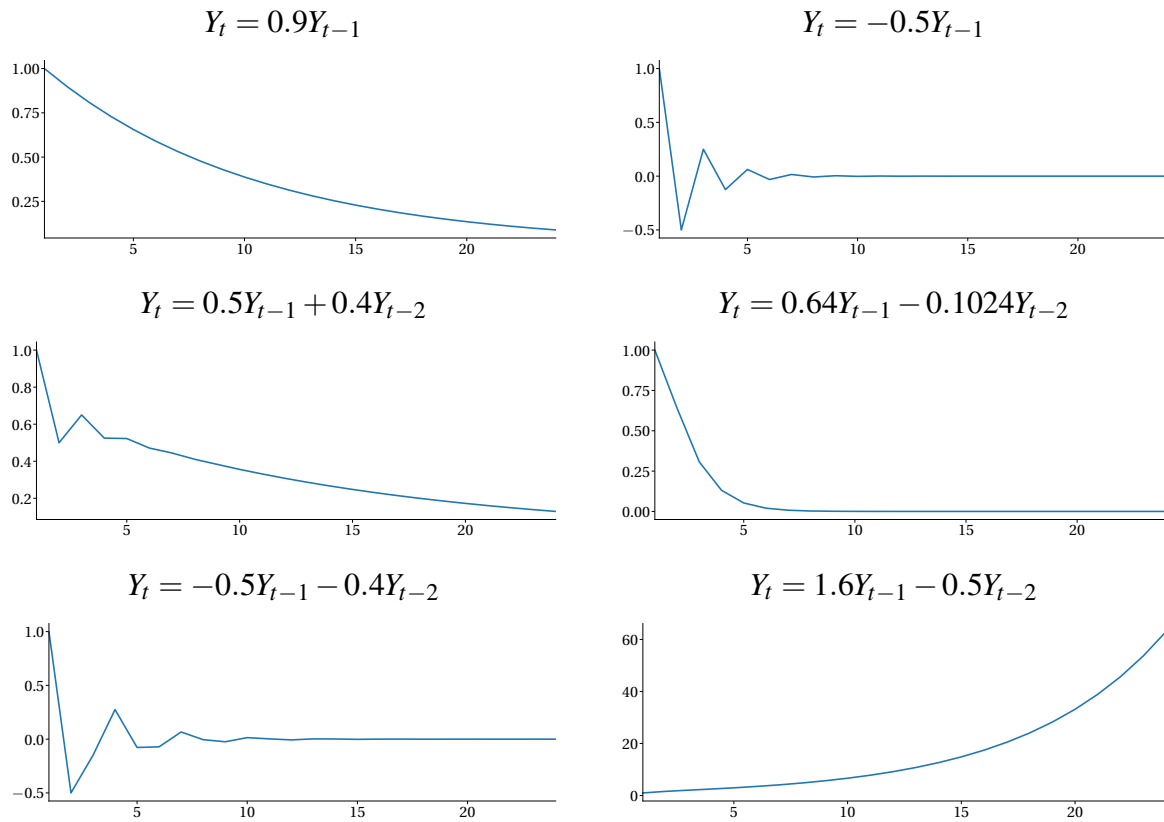


Figure 4.1: These six plots correspond to the dynamics of the six linear homogeneous systems described in the text. All processes received a unit shock at  $t = 1$  ( $X_1 = 1$ ) and no other shocks ( $X_j = 0, j \neq 1$ ). Pay close attention to the roots of the characteristic polynomial and the behavior of the system (exponential decay, oscillation and/or explosion).

#### 4.4.4 Example: Characteristic Roots and Stability

Consider 6 linear difference equations, their characteristic equation, and the roots:

- $Y_t = 0.9Y_{t-1} + X_t$ 
  - Characteristic Equation:  $z - 0.9 = 0$
  - Characteristic Root:  $z = 0.9$
- $Y_t = -0.5Y_{t-1} + X_t$ 
  - Characteristic Equation:  $z + 0.5 = 0$
  - Characteristic Root:  $z = -0.5$
- $Y_t = 0.5Y_{t-1} + 0.4Y_{t-2} + X_t$ 
  - Characteristic Equation:  $z^2 - 0.5z - 0.4 = 0$

- Characteristic Roots:  $z = 0.93, -0.43$
- $Y_t = 0.64Y_{t-1} - 0.1024Y_{t-2} + X_t$ 
  - Characteristic Equation:  $z^2 - 0.64z + 0.1024 = 0$
  - Characteristic Roots:  $z = 0.32, 0.32$  (identical)
- $Y_t = -0.5Y_{t-1} - 0.4Y_{t-2} + X_t$ 
  - Characteristic Equation:  $z^2 + 0.5z + 0.4 = 0$
  - Characteristic Roots (Modulus):  $z = -0.25 + 0.58i(0.63), -0.25 - 0.58i(0.63)$
- $Y_t = 1.6Y_{t-1} - 0.5Y_{t-2} + X_t$ 
  - Characteristic Equation:  $z^2 - 1.6z + 0.5 = 0$
  - Characteristic Roots:  $z = 1.17, 0.42$

The plots in figure 4.1 show the effect of a unit (1) shock at  $t = 1$  to the 6 linear difference systems above (all other shocks are 0). The value of the root makes a dramatic difference in the observed behavior of the series.

#### 4.4.5 Stationarity of ARMA models

Stationarity conditions for ARMA processes can be determined using the results for the convergence of linear difference equations. First, note that any ARMA process can be written using a lag polynomial

$$\begin{aligned}
 Y_t &= \phi_0 + \phi_1 Y_{t-1} + \dots + \phi_P Y_{t-P} + \theta_1 \varepsilon_{t-1} + \dots + \theta_Q \varepsilon_{t-Q} + \varepsilon_t \\
 Y_t - \phi_1 Y_{t-1} - \dots - \phi_P Y_{t-P} &= \phi_0 + \theta_1 \varepsilon_{t-1} + \dots + \theta_Q \varepsilon_{t-Q} + \varepsilon_t \\
 (1 - \phi_1 L - \phi_2 L^2 - \dots - \phi_P L^P) Y_t &= \phi_0 + (1 + \theta_1 L + \theta_2 L^2 + \dots + \theta_Q L^Q) \varepsilon_t
 \end{aligned}$$

This is a linear difference equation, and the stability conditions depend on the roots of the characteristic polynomial

$$z^P - \phi_1 z^{P-1} - \phi_2 z^{P-2} - \dots - \phi_{P-1} z - \phi_P$$

An ARMA process driven by a white noise shock will be covariance stationary as long as the characteristic roots are less than one in modulus. In the simple AR(1) case, this corresponds to  $|z_1| < 1$ . In the AR(2) case, the region is triangular with a curved bottom and corresponds to the points  $(z_1, z_2) = (-2, -1), (1, 0), (2, -2)$  (see figure 4.2). For higher-order models, stability must be checked by numerically solving the characteristic equation.

All MA processes driven by covariance stationary shocks are stationary: the homogeneous portions of an MA process have no roots and so cannot diverge.

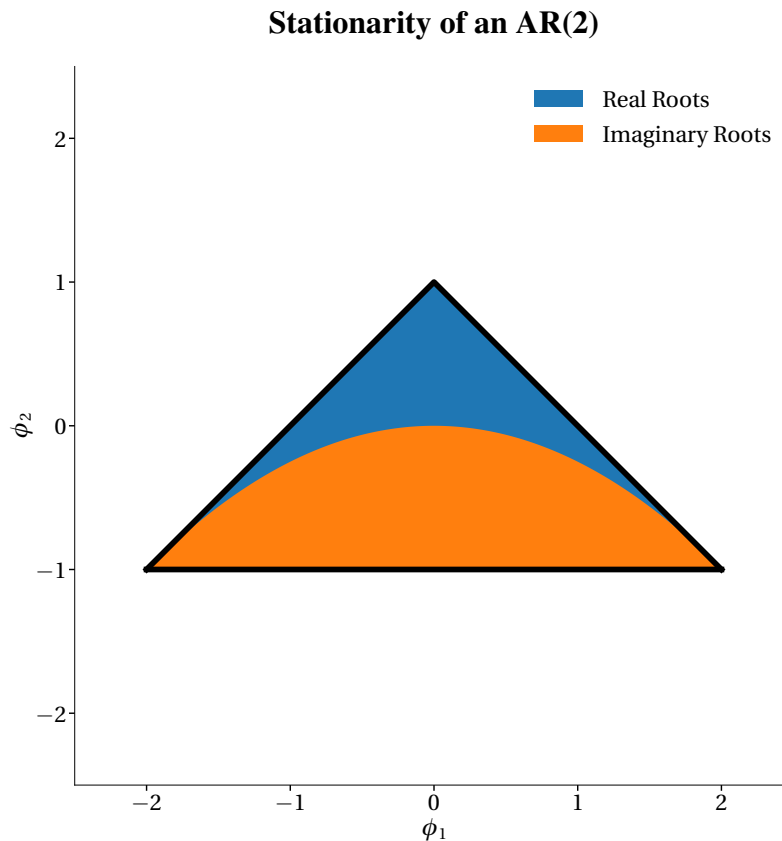


Figure 4.2: The triangular region corresponds to the values of the parameters in the AR(2)  $Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$ . The dark region corresponds to real roots and the light region corresponds to imaginary roots.

## 4.5 Data and Initial Estimates

Two series will be used throughout the stationary time-series analysis section: returns on the value-weighted market and the spread between the average interest rates on portfolios of Aaa-rated and Baa-rated corporate bonds, commonly known as the default spread or default premium. The VWM returns were taken from CRSP and are available from July 1963 through October 2020, and the bond yields are available from Moody's via FRED II and are available from January 1919 until October 2020. Both series are monthly.

Figure 4.3 contains plots of the two series. Table 4.1 contains parameter estimates for a model with only a constant mean (ARMA(0,0)), an AR(1), an MA(1) and an ARMA(1,1) for each series. The default spread exhibits a large autoregressive coefficient (.97) that is highly significant, but it also contains a significant moving average term, and in an ARMA(1,1), both parameters are significant. The market portfolio exhibits some predictability, although it is much less persistent than the default spread.<sup>7</sup>

<sup>7</sup>For information on estimating an ARMA in MATLAB, see the MATLAB supplement to this course.

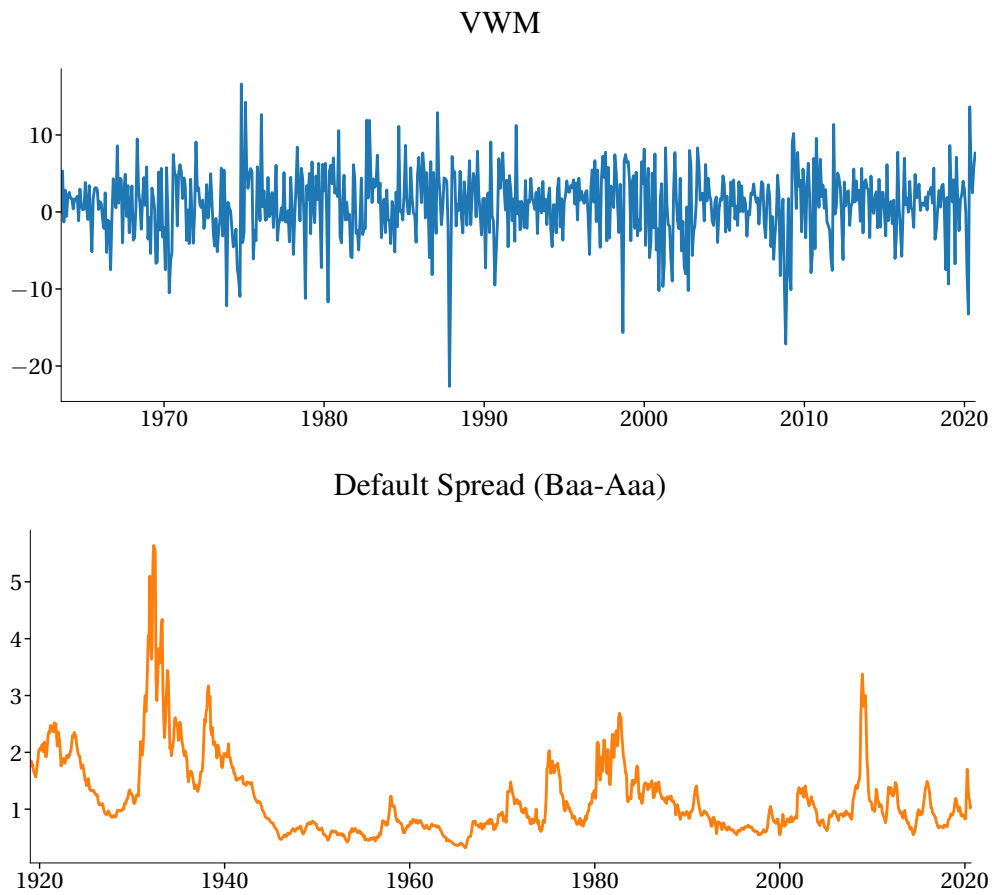


Figure 4.3: Plots of the returns on the VWM and the default spread, the spread between the yield of a portfolio of Baa-rated bonds and the yield of a portfolio of Aaa-rated bonds.

VWM				Default			
$\phi_0$	$\phi_1$	$\theta_1$	$\sigma^2$	$\phi_0$	$\phi_1$	$\theta_1$	$\sigma^2$
0.929 (0.000)			19.644	1.178 (0.000)			0.480
0.825 (0.000)	0.058 (0.073)		19.577	0.001 (0.005)	0.976 (0.000)		0.022
0.930 (0.000)		0.064 (0.053)	19.570	1.178 (0.000)		0.899 (0.000)	0.150
3.570 (0.000)	-0.960 (0.000)	0.998 (0.000)	19.283	0.001 (0.001)	0.966 (0.000)	0.241 (0.000)	0.021

Table 4.1: Parameter estimates and p-values from an a constant mean model (ARMA(0,0)), AR(1), MA(1) and ARMA(1,1) for the VWM and Baa-Aaa spread.

## 4.6 Autocorrelations and Partial Autocorrelations

Autoregressive processes, moving average processes, and ARMA processes all exhibit differences in the patterns of their autocorrelations and partial autocorrelations. These differences can be exploited to select a parsimonious model from the general class of ARMA processes.

### 4.6.1 Autocorrelations and the Autocorrelation Function

Autocorrelations are to autocovariances as correlations are to covariances. That is, the  $s^{\text{th}}$  autocorrelation is the  $s^{\text{th}}$  autocovariance divided by the product of the variance of  $Y_t$  and  $Y_{t-s}$ , and when a process is covariance stationary,  $V[Y_t] = V[Y_{t-s}]$ , and so  $\sqrt{V[Y_t]V[Y_{t-s}]} = V[Y_t]$ .

**Definition 4.16** (Autocorrelation). The autocorrelation of a covariance stationary scalar process is defined

$$\rho_s = \frac{\gamma_s}{\gamma_0} = \frac{E[(Y_t - E[Y_t])(Y_{t-s} - E[Y_{t-s}])]}{V[Y_t]} \quad (4.47)$$

where  $\gamma_s$  is the  $s^{\text{th}}$  autocovariance.

The autocorrelation function (ACF) relates the lag length ( $s$ ) and the parameters of the model to the autocorrelation.

**Definition 4.17** (Autocorrelation Function). The autocorrelation function (ACF),  $\rho(s)$ , is a function of the population parameters that defines the relationship between the autocorrelations of a process and lag length.

The variance of a covariance stationary AR(1) is  $\sigma^2(1 - \phi_1^2)^{-1}$  and the  $s^{\text{th}}$  autocovariance is  $\phi^s \sigma^2(1 - \phi_1^2)^{-1}$ , and so the ACF is

$$\rho(s) = \frac{\phi^s \sigma^2(1 - \phi^2)^{-1}}{\sigma^2(1 - \phi^2)^{-1}} = \phi^s. \quad (4.48)$$

Deriving ACFs of ARMA processes is a straightforward, albeit tedious, task. Further details on the derivation of the ACF of stationary ARMA processes are presented in appendix 4.A.

### 4.6.2 Partial Autocorrelations and the Partial Autocorrelation Function

Partial autocorrelations are similar to autocorrelations with one important difference: the  $s^{\text{th}}$  partial autocorrelation still relates  $Y_t$  and  $Y_{t-s}$  but it eliminates the effects of  $Y_{t-1}, Y_{t-2}, \dots, Y_{t-(s-1)}$ .

**Definition 4.18** (Partial Autocorrelation). The  $s^{\text{th}}$  partial autocorrelation ( $\phi_s$ ) is defined as the population value of the regression coefficient on  $\phi_s$  in

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_{s-1} Y_{t-(s-1)} + \phi_s Y_{t-s} + \varepsilon_t.$$

Like the autocorrelation function, the partial autocorrelation function (PACF) relates the partial autocorrelation to population parameters and lag length.

**Definition 4.19** (Partial Autocorrelation Function). The partial autocorrelation function (PACF),  $\phi(s)$ , defines the relationship between the partial autocorrelations of a process and lag length. The PACF is denoted.

The partial autocorrelations are directly interpretable as population regression coefficients. The  $s^{\text{th}}$  partial autocorrelations can be computed using  $s + 1$  autocorrelations. Recall that the population values of  $\phi_1, \phi_2, \dots, \phi_s$  in

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_{s-1} Y_{t-(s-1)} + \phi_s Y_{t-s} + \varepsilon_t$$

can be defined in terms of the covariance between  $Y_t, Y_{t-1}, Y_{t-2}, \dots, Y_{t-s}$ . Let  $\Gamma$  denote this covariance matrix,

$$\Gamma = \begin{bmatrix} \gamma_0 & \gamma_1 & \gamma_2 & \gamma_3 & \dots & \gamma_{s-1} & \gamma_s \\ \gamma_1 & \gamma_0 & \gamma_1 & \gamma_2 & \dots & \gamma_{s-2} & \gamma_{s-1} \\ \gamma_2 & \gamma_1 & \gamma_0 & \gamma_1 & \dots & \gamma_{s-3} & \gamma_{s-2} \\ \vdots & \vdots & \vdots & \vdots & \dots & \vdots & \vdots \\ \gamma_{s-1} & \gamma_{s-2} & \gamma_{s-3} & \gamma_{s-4} & \dots & \gamma_0 & \gamma_1 \\ \gamma_s & \gamma_{s-1} & \gamma_{s-2} & \gamma_{s-3} & \dots & \gamma_1 & \gamma_0 \end{bmatrix}$$

The matrix  $\Gamma$  is known as a Toeplitz matrix which reflects the special symmetry it exhibits which follows from stationarity, and so  $E[(Y_t - \mu)(Y_{t-s} - \mu)] = \gamma_s = \gamma_{-s} = E[(Y_t - \mu)(Y_{t+s} - \mu)]$ .  $\Gamma$  can be decomposed in terms of  $\gamma_0$  (the long-run variance) and the matrix of autocorrelations,

$$\Gamma = \gamma_0 \begin{bmatrix} 1 & \rho_1 & \rho_2 & \rho_3 & \dots & \rho_{s-1} & \rho_s \\ \rho_1 & 1 & \rho_1 & \rho_2 & \dots & \rho_{s-2} & \rho_{s-1} \\ \rho_2 & \rho_1 & 1 & \rho_1 & \dots & \rho_{s-3} & \rho_{s-2} \\ \vdots & \vdots & \vdots & \vdots & \dots & \vdots & \vdots \\ \rho_{s-1} & \rho_{s-2} & \rho_{s-3} & \rho_{s-4} & \dots & 1 & \rho_1 \\ \rho_s & \rho_{s-1} & \rho_{s-2} & \rho_{s-3} & \dots & \rho_1 & 1 \end{bmatrix}$$

directly by applying the definition of an autocorrelation. The population regression parameters can be computed by partitioning  $\Gamma$  into four blocks,  $\gamma_0$ , the long-run variance of  $Y_t$ ,  $\Gamma_{01} = \Gamma'_{10}$ , the vector of covariances between  $Y_t$  and  $Y_{t-1}, Y_{t-2}, \dots, Y_{t-s}$ , and  $\Gamma_{11}$ , the covariance matrix of  $Y_{t-1}, Y_{t-2}, \dots, Y_{t-s}$ .

$$\Gamma = \begin{bmatrix} \gamma_0 & \Gamma_{01} \\ \Gamma_{10} & \Gamma_{11} \end{bmatrix} = \gamma_0 \begin{bmatrix} 1 & \mathbf{R}_{01} \\ \mathbf{R}_{10} & \mathbf{R}_{11} \end{bmatrix}$$

where  $\mathbf{R}$  are vectors or matrices of autocorrelations. Using this formulation, the population regression parameters  $\phi = [\phi_1, \phi_2, \dots, \phi_s]'$  are defined as

$$\phi = \Gamma_{11}^{-1} \Gamma_{10} = \gamma_0^{-1} \mathbf{R}_{11}^{-1} \gamma_0 \mathbf{R}_{10} = \mathbf{R}_{11}^{-1} \mathbf{R}_{10}. \quad (4.49)$$

The  $s^{\text{th}}$  partial autocorrelation ( $\phi_s$ ) is the  $s^{\text{th}}$  element in  $\phi$  (when  $\Gamma$  is  $s$  by  $s$ ),  $\mathbf{e}_s' \mathbf{R}_{11}^{-1} \mathbf{R}_{10}$  where  $\mathbf{e}_s$  is a  $s$  by 1 vector of zeros with one in the  $s^{\text{th}}$  position.

For example, in a stationary AR(1) model,  $Y_t = \phi_1 Y_{t-1} + \varepsilon_t$ , the PACF is

$$\begin{aligned}\varphi(s) &= \phi_1^{|s|} & s = 0, 1, -1 \\ &= 0 & \text{otherwise}\end{aligned}$$

That  $\varphi_0 = \phi^0 = 1$  is obvious: the correlation of a variable with itself is 1. The first partial autocorrelation is defined as the population parameter of  $\phi_1$  in the regression  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$ . Since the data generating process is an AR(1),  $\varphi_1 = \phi_1$ , the autoregressive parameter. The second partial autocorrelation is defined as the population value of  $\phi_2$  in the regression

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t.$$

Since the DGP is an AR(1), once  $Y_{t-1}$  is included,  $Y_{t-2}$  has no effect on  $Y_t$  and the population value of both  $\phi_2$  and the second partial autocorrelation,  $\varphi_2$ , is 0. This argument holds for any higher order partial autocorrelation.

Note that the first partial autocorrelation and the first autocorrelation are both  $\phi_1$  in

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t,$$

and at the second (and higher) lag these differ. The autocorrelation at  $s = 2$  is the population value of  $\phi_2$  in the regression

$$Y_t = \phi_0 + \phi_2 Y_{t-2} + \varepsilon_t$$

while the second partial autocorrelation is the population value of  $\phi_2$  in the regression

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t.$$

If the DGP were an AR(1), the second autocorrelation would be  $\rho_2 = \phi_1^2$  while the second partial autocorrelation would be  $\varphi_2 = 0$ .

#### 4.6.2.1 Examples of ACFs and PACFs

The key to understanding the value of ACFs and PACFs lies in the distinct behavior the autocorrelations and partial autocorrelations of AR and MA processes exhibit.

- AR(P)
  - ACF dies exponentially (may oscillate, referred to as sinusoidally)
  - PACF is zero beyond P
- MA(Q)
  - ACF is zero beyond Q
  - PACF dies exponentially (may oscillate, referred to as sinusoidally)

Table 4.2 provides a summary of the ACF and PACF behavior of ARMA models and this difference forms the basis of the Box-Jenkins model selection strategy.



Process	ACF	PACF
White Noise	All 0	All 0
AR(1)	$\rho_s = \phi^s$	0 beyond lag 2
AR(P)	Decays toward zero exponentially	Non-zero through lag P, 0 thereafter
MA(1)	$\rho_1 \neq 0, \rho_s = 0, s > 1$	Decays toward zero exponentially
MA(Q)	Non-zero through lag Q, 0 thereafter	Decays toward zero exponentially
ARMA(P,Q)	Exponential Decay	Exponential Decay

Table 4.2: Behavior that the ACF and PACF for various members of the ARMA family.

### 4.6.3 Sample Autocorrelations and Partial Autocorrelations

Sample autocorrelations are computed using sample analogues of the population moments in the definition of an autocorrelation. Define  $Y_t^* = Y_t - \bar{y}$  to be the demeaned series where  $\bar{y} = T^{-1} \sum_{t=1}^T Y_t$ . The  $s^{\text{th}}$  sample autocorrelation is defined

$$\hat{\rho}_s = \frac{\sum_{t=s+1}^T Y_t^* Y_{t-s}^*}{\sum_{t=1}^T (Y_t^*)^2} \quad (4.50)$$

although the small-sample corrected versions

$$\hat{\rho}_s = \frac{\frac{\sum_{t=s+1}^T Y_t^* Y_{t-s}^*}{T-s}}{\frac{\sum_{t=1}^T (Y_t^*)^2}{T}} \quad (4.51)$$

or

$$\hat{\rho}_s = \frac{\sum_{t=s+1}^T Y_t^* Y_{t-s}^*}{\sqrt{\sum_{t=s+1}^T (Y_t^*)^2 \sum_{t=1}^{T-s} (Y_t^*)^2}}. \quad (4.52)$$

may be more accurate.

**Definition 4.20** (Sample Autocorrelogram). A plot of the sample autocorrelations against the lag index is known as a sample autocorrelogram.

Inference on estimated autocorrelation coefficients depends on the null hypothesis tested and whether the data are homoskedastic. The most common assumptions are that the data are homoskedastic and that *all* of the autocorrelations are zero. In other words,  $Y_t - E[Y_t]$  is white noise process. Under the null  $H_0 : \rho_s = 0, s \neq 0$ , inference can be made noting that  $V[\hat{\rho}_s] = T^{-1}$  using a standard  $t$ -test,

$$\frac{\hat{\rho}_s}{\sqrt{V[\hat{\rho}_s]}} = \frac{\hat{\rho}_s}{\sqrt{T^{-1}}} = T^{\frac{1}{2}} \hat{\rho}_s \xrightarrow{d} N(0, 1). \quad (4.53)$$

A alternative null hypothesis is that the autocorrelations on lags  $s$  and above are zero but that the autocorrelations on lags  $1, 2, \dots, s-1$  are unrestricted,  $H_0 : \rho_j = 0, j \geq s$ . Under this null, and again assuming homoskedasticity,

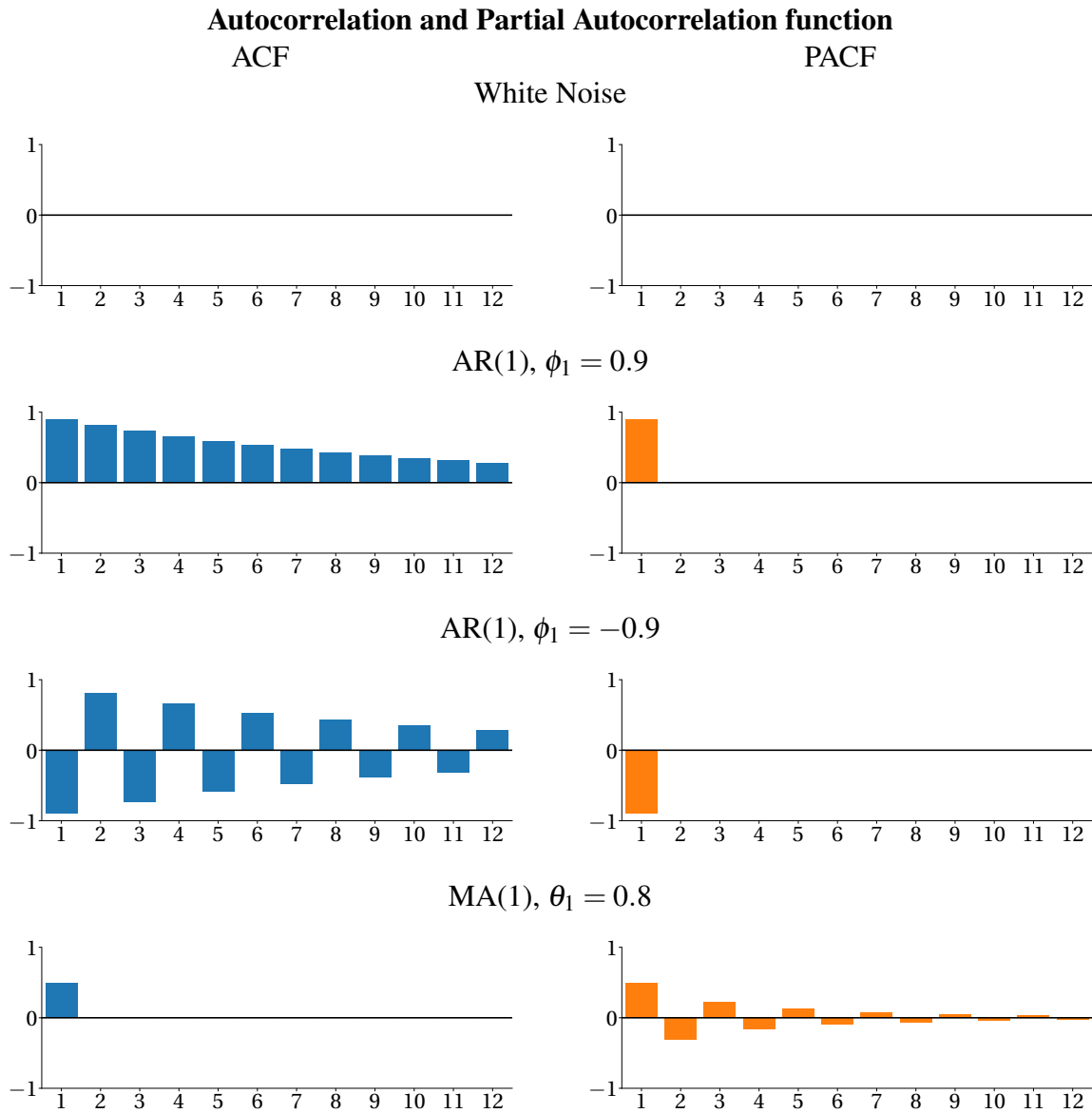


Figure 4.4: Autocorrelation function and partial autocorrelation function for 4 processes. Note the difference between how the ACF and PACF respond in AR and MA models.

$$\begin{aligned}
 V[\hat{\rho}_s] &= T^{-1} && \text{for } s = 1 \\
 &= T^{-1} \left( 1 + 2 \sum_{j=1}^{s-1} \hat{\rho}_j^2 \right) && \text{for } s > 1
 \end{aligned} \tag{4.54}$$

If the null is  $H_0 : \rho_s = 0$  with no further restrictions on the other autocorrelations, the variance of the  $s^{\text{th}}$  autocorrelation is (assuming homoskedasticity)

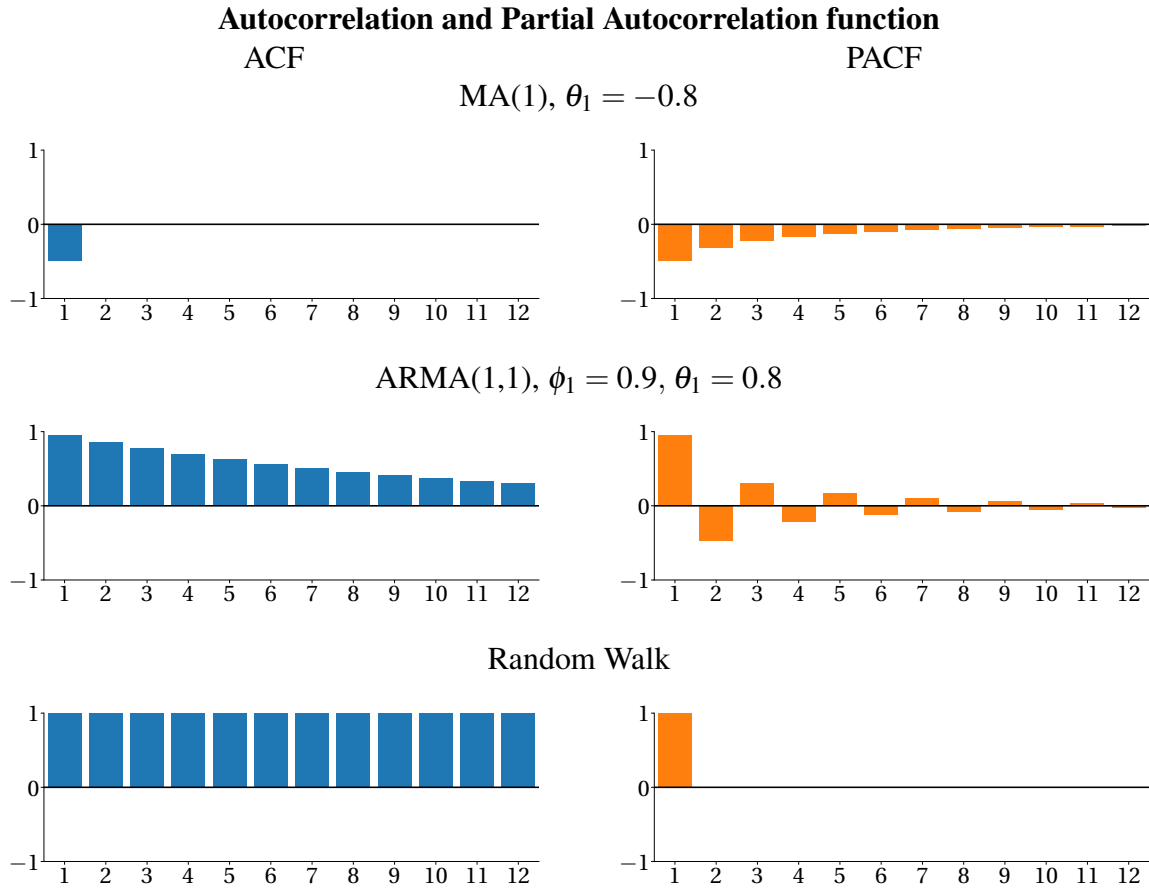


Figure 4.5: Autocorrelation function and partial autocorrelation function for 3 processes, an MA(1), and ARMA(1,1) and a random walk. Note the difference between how the ACF and PACF respond in AR and MA models.

$$V[\hat{\rho}_s] = T^{-1} \left( 1 + 2 \sum_{j=1, j \neq s}^{\infty} \hat{\rho}_j^2 \right) \quad (4.55)$$

which is infeasible. The usual practice is to truncate the variance estimator at some finite lag  $L$  where  $L$  is a function of the sample size, often assumed that  $L \propto T^{\frac{1}{3}}$  (if  $L$  is not an integer, rounding to the nearest one).<sup>8</sup>

Once the assumption of homoskedasticity is relaxed, inference becomes more complicated. First consider the most restrictive null  $H_0 : \rho_s = 0, s \neq 0$ . If  $\{Y_t\}$  is a heteroskedastic white noise process (plus possibly a non-zero mean), inference can be made using White's heteroskedasticity robust covariance estimator (see chapter 3) so that

<sup>8</sup>The choice of  $L \propto T^{\frac{1}{3}}$  is motivated by asymptotic theory where  $T^{\frac{1}{3}}$  is the optimal rate in the sense that it minimizes the asymptotic mean square error of the variance estimator.

$$\begin{aligned}
V[\hat{\rho}_s] &= T^{-1} \left( T^{-1} \sum_{t=1}^T Y_{t-s}^{*2} \right)^{-1} \left( T^{-1} \sum_{t=1}^T Y_t^{*2} Y_{t-s}^{*2} \right) \left( T^{-1} \sum_{t=1}^T Y_{t-s}^{*2} \right)^{-1} \\
&= \frac{\sum_{t=s+1}^T Y_t^{*2} Y_{t-s}^{*2}}{\left( \sum_{t=s+1}^T Y_{t-s}^{*2} \right)^2}.
\end{aligned} \tag{4.56}$$

This covariance estimator is identical to White's covariance estimator for the regression

$$Y_t = \rho_s Y_{t-s} + \varepsilon_t$$

since under the null that  $\rho_s = 0$ ,  $Y_t = \varepsilon_t$ .

To test one of the more complicated null hypotheses a Heteroskedasticity-Autocorrelation Consistent (HAC) covariance estimator is required, the most common of which is the Newey-West covariance estimator.

**Definition 4.21** (Newey-West Variance Estimator). Let  $z_t$  be a series that may be autocorrelated and define  $z_t^* = z_t - \bar{z}$  where  $\bar{z} = T^{-1} \sum_{t=1}^T z_t$ . The  $L$ -lag Newey-West variance estimator for the variance of  $\bar{z}$  is

$$\begin{aligned}
\hat{\sigma}_{NW}^2 &= T^{-1} \sum_{t=1}^T z_t^{*2} + 2 \sum_{l=1}^L w_l T^{-1} \sum_{t=l+1}^T z_t^* z_{t-l}^* \\
&= \hat{\gamma}_0 + 2 \sum_{l=1}^L w_l \hat{\gamma}_l
\end{aligned} \tag{4.57}$$

where  $\hat{\gamma}_l = T^{-1} \sum_{t=l+1}^T z_t^* z_{t-l}^*$  and  $w_l = \frac{L+1-l}{L+1}$ .

The Newey-West estimator has two important properties. First, it is always greater than 0. This is a desirable property of any variance estimator. Second, as long as  $L \rightarrow \infty$ , the  $\hat{\sigma}_{NW}^2 \xrightarrow{P} V[Y_t]$ . The only remaining choice is which value to choose for  $L$ . Unfortunately this is problem dependent and it is important to use as small a value for  $L$  as the data will permit. Newey-West estimators tend to perform poorly in small samples and are worse, often substantially, than simpler estimators such as White's heteroskedasticity-consistent covariance estimator. This said, they also work in situations where White's estimator fails: when a sequence is autocorrelated White's estimator is not consistent.<sup>9</sup> Long-run variance estimators are covered in more detail in the Multivariate Time Series chapter (chapter 5).

When used in a regression, the Newey-West estimator extends White's covariance estimator to allow  $\{Y_{t-s}\varepsilon_t\}$  to be both heteroskedastic and autocorrelated, setting  $z_t^* = Y_t^* Y_{t-s}^*$ ,

<sup>9</sup>The Newey-West estimator nests White's covariance estimator as a special case by choosing  $L = 0$ .

$$\begin{aligned}
V[\hat{\rho}_s] &= T^{-1} \left( T^{-1} \sum_{t=s+1}^T Y_{t-s}^{*2} \right)^{-1} \\
&\times \left( T^{-1} \sum_{t=s+1}^T Y_t^{*2} Y_{t-s}^{*2} + 2 \sum_{j=1}^L w_j T^{-1} \sum_{t=s+j+1}^T Y_t^* Y_{t-s}^* (Y_{t-j}^* Y_{t-s-j}^*) \right) \\
&\times \left( T^{-1} \sum_{t=s+1}^T Y_{t-s}^{*2} \right)^{-1} \\
&= \frac{\sum_{t=s+1}^T Y_t^{*2} Y_{t-s}^{*2} + 2 \sum_{j=1}^L w_j \sum_{t=s+j+1}^T Y_t^* Y_{t-s}^* (Y_{t-j}^* Y_{t-s-j}^*)}{\left( \sum_{t=s+1}^T Y_{t-s}^{*2} \right)^2}.
\end{aligned} \tag{4.58}$$

Note that only the center term has been changed and that  $L$  must diverge for this estimator to be consistent – even if  $\{Y_t\}$  follows an MA process, and the efficient choice sets  $L \propto T^{\frac{1}{3}}$ .

Tests that multiple autocorrelations are simultaneously zero can also be conducted. The standard method to test that  $s$  autocorrelations are zero,  $H_0 : \rho_1 = \rho_2 = \dots = \rho_s = 0$ , is the Ljung-Box  $Q$  statistic.

**Definition 4.22** (Ljung-Box  $Q$  statistic). The Ljung-Box  $Q$  statistic, or simply  $Q$  statistic, tests the null that the first  $s$  autocorrelations are all zero against an alternative that at least one is non-zero:  $H_0 : \rho_k = 0$  for  $k = 1, 2, \dots, s$  versus  $H_1 : \rho_k \neq 0$  for  $k = 1, 2, \dots, s$ . The test statistic is defined

$$Q = T(T+2) \sum_{k=1}^s \frac{\hat{\rho}_k^2}{T-k} \tag{4.59}$$

and  $Q$  has a standard  $\chi_s^2$  distribution.

The  $Q$  statistic is only valid under an assumption of homoskedasticity so caution is warranted when using it with financial data. A heteroskedasticity robust version of the  $Q$ -stat can be formed using an LM test.

**Definition 4.23** (LM test for serial correlation). Under the null,  $E[Y_t^* Y_{t-j}^*] = 0$  for  $1 \leq j \leq s$ . The LM-test for serial correlation is constructed by defining the score vector  $\mathbf{s}_t = Y_t^* [Y_{t-1}^* Y_{t-2}^* \dots Y_{t-s}^*]'$ ,

$$LM = T \bar{\mathbf{s}}' \hat{\mathbf{S}} \bar{\mathbf{s}} \xrightarrow{d} \chi_s^2 \tag{4.60}$$

where  $\bar{\mathbf{s}} = T^{-1} \sum_{t=1}^T \mathbf{s}_t$  and  $\hat{\mathbf{S}} = T^{-1} \sum_{t=1}^T \mathbf{s}_t \mathbf{s}_t'$ .<sup>10</sup>

Like the Ljung-Box  $Q$  statistic, this test has an asymptotic  $\chi_s^2$  distribution with the added advantage of being heteroskedasticity robust.

Partial autocorrelations can be estimated using regressions,

<sup>10</sup>Refer to chapters 2 and 3 for more on LM-tests.

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \hat{\phi}_s Y_{t-s} + \varepsilon_t$$

where  $\hat{\phi}_s = \hat{\phi}_s$ . To test whether a partial autocorrelation is zero, the variance of  $\hat{\phi}_s$ , under the null and assuming homoskedasticity, is approximately  $T^{-1}$  for any  $s$ , and so a standard  $t$ -test can be used,

$$T^{\frac{1}{2}} \hat{\phi}_s \xrightarrow{d} N(0, 1). \quad (4.61)$$

If homoskedasticity cannot be assumed, White's covariance estimator can be used to control for heteroskedasticity.

**Definition 4.24** (Sample Partial Autocorrelogram). A plot of the sample partial autocorrelations against the lag index is known as a sample partial autocorrelogram.

#### 4.6.3.1 Example: Autocorrelation, partial autocorrelation and $Q$ Statistic

Figure 4.6 contains plots of the first 20 autocorrelations and partial autocorrelations of the VWM market returns and the default spread. The market appears to have a small amount of persistence and appears to be more consistent with a moving average than an autoregression. The default spread is highly persistent, and an AR(1) appears to be a choice to model the series since the autocorrelations decay slowly, and the partial autocorrelations drop off dramatically after one lag, although an ARMA(1,1) cannot be ruled out.

### 4.6.4 Model Selection: The Box-Jenkins Methodology

The Box and Jenkins methodology is the most common approach for time-series model selection. It consists of two stages:

- Identification: Visual inspection of the series, the autocorrelations, and the partial autocorrelations.
- Estimation: By relating the sample autocorrelations and partial autocorrelations to the ACF and PACF of ARMA models, candidate models are identified. These candidates are estimated, and the residuals are tested for neglected dynamics using the residual autocorrelations, partial autocorrelations, and  $Q$  statistics or LM-tests for serial correlation. If dynamics are detected in the residuals, a new model is specified, and the procedure is repeated.

The Box-Jenkins procedure relies on two principles: parsimony and invertibility.

**Definition 4.25** (Parsimony). Parsimony is a property of a model where the specification with the fewest parameters capable of capturing the dynamics of a time series is preferred to other representations equally capable of capturing the same dynamics.

Parsimony is an intuitive principle, and using the smallest model has other benefits, particularly when forecasting. One consequence of the parsimony principle is that parameters that are not needed are excluded. For example, if the data generating process were an AR(1), selecting an AR(2) would adequately describe the process. The parsimony principle indicates the AR(1) should be referred to as an AR(2) since both are equally capable of capturing the dynamics of the data. Further, recall that an AR(1) can be reformulated as an MA( $T$ ) where  $\theta_s = \phi_1^s$ . Both the AR(1) and MA( $T$ ) are capable of

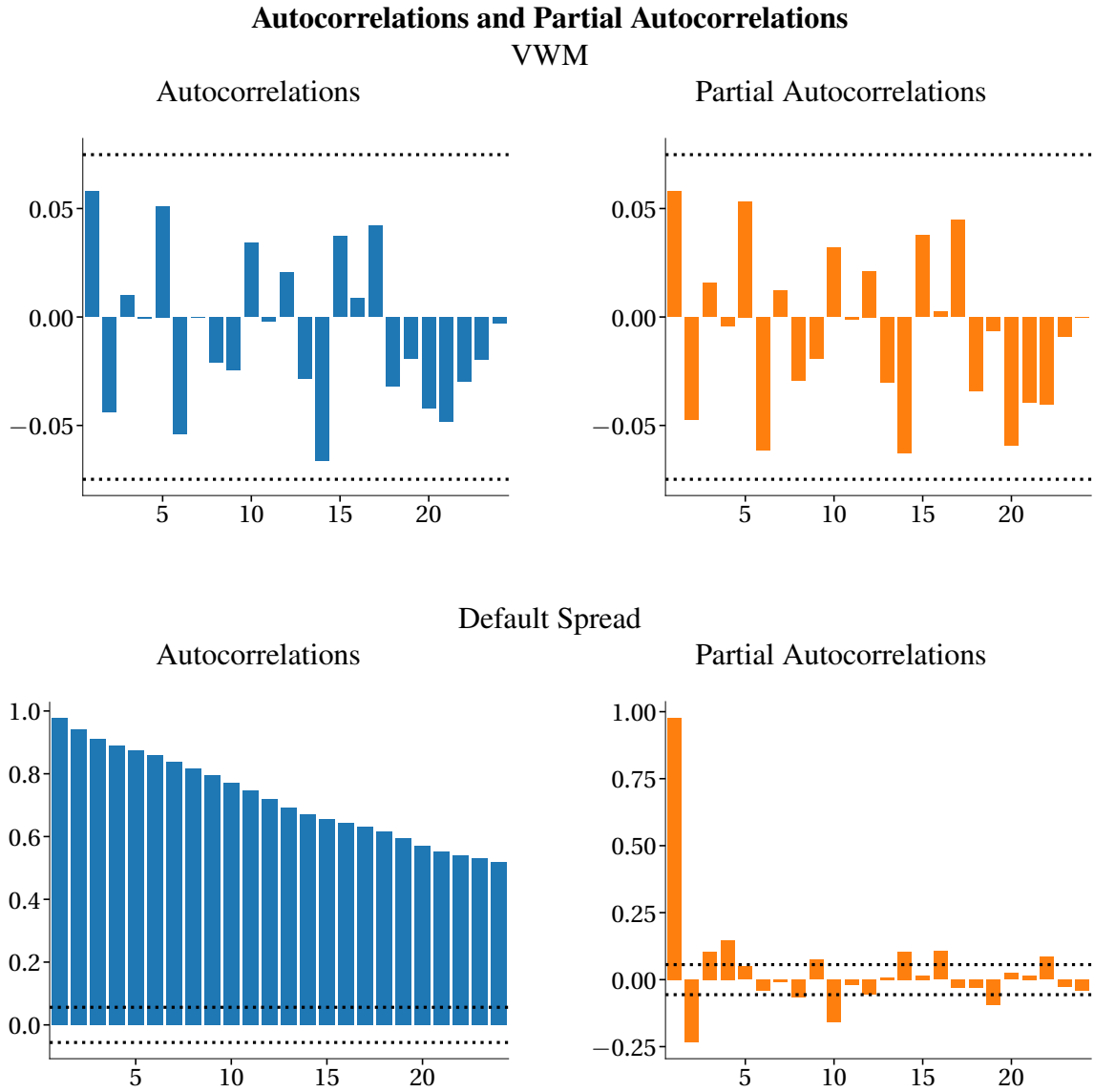


Figure 4.6: These four pictures plot the first 20 autocorrelations (left) and partial autocorrelations (right) of the VWM (top) and the Baa-Aaa spread (bottom). Approximate standard errors, assuming homoskedasticity, are in parenthesis.

capturing the dynamics of the data if the DGP is an AR(1), although the number of parameters in each is very different. The parsimony principle provides guidance on selecting the AR(1) over the MA( $T$ ) since it contains (many) fewer parameters yet provides an equivalent description of the relationship between current and past values of the data.

**Definition 4.26** (Invertibility). A moving average is invertible if it can be written as a finite or convergent autoregression. Invertibility requires the roots of

$$(1 - \theta_1 z - \theta_2 z^2 - \dots - \theta_Q z^Q) = 0$$

to be greater than one in modulus (absolute value).

Invertibility is a technical requirement stemming from the use of the autocorrelogram and partial autocorrelogram to choose the model, and it plays an important role in achieving unique identification of the MA component of a model. For example, the ACF and PACF of

$$Y_t = 2\varepsilon_{t-1} + \varepsilon_t$$

and

$$Y_t = .5\varepsilon_{t-1} + \varepsilon_t$$

are identical. The first autocorrelation is  $\theta_1/(1 + \theta_1^2)$ , and so in the first specification  $\rho_1 = 2/(1 + 2^2) = .4$  and in the second  $\rho_1 = .5/(1 + .5^2) = .4$  while all other autocorrelations are zero. The partial autocorrelations are similarly identical – partial correlation are functions of autocorrelations – and so two processes are indistinguishable. Invertibility rules out the first of these two models since the root of  $1 - 2z = 0$  is  $\frac{1}{2} < 1$ .

Information criteria such as the AIC or S/BIC can also be used to choose a model. Recall the definitions of the AIC and BIC:

**Definition 4.27** (Akaike Information Criterion). The Akaike Information Criteria (AIC) is

$$AIC = \ln \hat{\sigma}^2 + k^2/T \quad (4.62)$$

where  $\hat{\sigma}^2$  is the estimated variance of the regression error and  $k$  is the number of parameters in the model.

**Definition 4.28** (Schwarz/Bayesian Information Criterion). The Schwarz Information Criteria (SIC), also known as the Bayesian Information Criterion (BIC) is

$$BIC = \ln \hat{\sigma}^2 + k \ln T/T \quad (4.63)$$

where  $\hat{\sigma}^2$  is the estimated variance of the regression error and  $k$  is the number of parameters in the model.

ICs are often applied by estimating the largest model, which is thought to correctly capture the dynamics and then dropping lags until the AIC or S/BIC fail to decrease. Specific-to-General (StG) and General-to-Specific (GtS) are also applicable to time-series modeling and suffer from the same issues as those described in chapter 3, section 3.13.

## 4.7 Estimation

ARMA models are typically estimated using maximum likelihood (ML) estimation assuming that the errors are normal, using either conditional maximum likelihood, where the likelihood of  $Y_t$  given  $Y_{t-1}, Y_{t-2}, \dots$  is used, or exact maximum likelihood where the joint distribution of  $[Y_1, Y_2, \dots, Y_{t-1}, Y_t]$  is used.



### 4.7.1 Conditional Maximum Likelihood

Conditional maximum likelihood uses the distribution of  $Y_t$  given  $Y_{t-1}, Y_{t-2}, \dots$  to estimate the parameters of an ARMA. The data are assumed to be conditionally normal, and so the likelihood is

$$\begin{aligned} f(Y_t|Y_{t-1}, Y_{t-2}, \dots; \phi, \theta, \sigma^2) &= (2\pi\sigma^2)^{-\frac{1}{2}} \exp\left(-\frac{\varepsilon_t^2}{2\sigma^2}\right) \\ &= (2\pi\sigma^2)^{-\frac{1}{2}} \exp\left(-\frac{(Y_t - \phi_0 - \sum_{i=1}^P \phi_i Y_{t-i} - \sum_{j=1}^Q \theta_j \varepsilon_{t-j})^2}{2\sigma^2}\right) \end{aligned} \quad (4.64)$$

Since the  $\{\varepsilon_t\}$  series is assumed to be a white noise process, the joint likelihood is simply the product of the individual likelihoods,

$$f(\mathbf{y}_t|\mathbf{y}_{t-1}, \mathbf{y}_{t-2}, \dots; \phi, \theta, \sigma^2) = \prod_{t=1}^T (2\pi\sigma^2)^{-\frac{1}{2}} \exp\left(-\frac{\varepsilon_t^2}{2\sigma^2}\right) \quad (4.65)$$

and the conditional log-likelihood is

$$l(\phi, \theta, \sigma^2; \mathbf{y}_t|\mathbf{y}_{t-1}, \mathbf{y}_{t-2}, \dots) = -\frac{1}{2} \sum_{t=1}^T \ln 2\pi + \ln \sigma^2 + \frac{\varepsilon_t^2}{\sigma^2}. \quad (4.66)$$

Recall that the first-order condition for the mean parameters from a normal log-likelihood does not depend on  $\sigma^2$  and that given the parameters in the mean equation, the maximum likelihood estimate of the variance is

$$\hat{\sigma}^2 = T^{-1} \sum_{t=1}^T (Y_t - \phi_0 - \phi_1 Y_{t-1} - \dots - \phi_P Y_{t-P} - \theta_1 \varepsilon_{t-1} - \dots - \theta_Q \varepsilon_{t-Q})^2 \quad (4.67)$$

$$= T^{-1} \sum_{t=1}^T \varepsilon_t^2. \quad (4.68)$$

This transformation allows the variance to be concentrated out of the log-likelihood so that it becomes

$$\begin{aligned} l(\mathbf{y}_t|\mathbf{y}_{t-1}, \mathbf{y}_{t-2}, \dots; \phi, \theta, \sigma^2) &= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi + \ln(T^{-1} \sum_{t=1}^T \varepsilon_t^2) + \frac{\varepsilon_t^2}{T^{-1} \sum_{t=1}^T \varepsilon_t^2} \\ &= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi - \frac{1}{2} \sum_{t=1}^T \ln(T^{-1} \sum_{t=1}^T \varepsilon_t^2) - \frac{T}{2} \sum_{t=1}^T \frac{\varepsilon_t^2}{\sum_{t=1}^T \varepsilon_t^2} \\ &= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi - \frac{1}{2} \sum_{t=1}^T \ln(T^{-1} \sum_{t=1}^T \varepsilon_t^2) - \frac{T}{2} \frac{\sum_{t=1}^T \varepsilon_t^2}{\sum_{t=1}^T \varepsilon_t^2} \end{aligned} \quad (4.69)$$

$$\begin{aligned}
&= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi - \frac{1}{2} \sum_{t=1}^T \ln(T^{-1} \sum_{t=1}^T \varepsilon_t^2) - \frac{T}{2} \\
&= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi - \frac{T}{2} - \frac{1}{2} \sum_{t=1}^T \ln(T^{-1} \sum_{t=1}^T \varepsilon_t^2) \\
&= -\frac{1}{2} \sum_{t=1}^T \ln 2\pi - \frac{T}{2} - \frac{T}{2} \ln \hat{\sigma}^2.
\end{aligned}$$

Eliminating terms that do not depend on model parameters shows that maximizing the likelihood is equivalent to minimizing the error variance,

$$\max_{\phi, \theta, \sigma^2} l(\mathbf{y}_t | \mathbf{y}_{t-1}, \mathbf{y}_{t-2}, \dots; \phi, \theta, \sigma^2) = -\frac{T}{2} \ln \hat{\sigma}^2. \quad (4.70)$$

where  $\hat{\varepsilon}_t = Y_t - \phi_0 - \phi_1 Y_{t-1} - \dots - \phi_P Y_{t-P} - \theta_1 \varepsilon_{t-1} - \dots - \theta_Q \varepsilon_{t-Q}$ , and so estimation using conditional maximum likelihood is equivalent to least squares, although unlike linear regression the objective is nonlinear due to the moving average terms and so a nonlinear maximization algorithm is required. If the model does not include moving average terms ( $Q = 0$ ), then the conditional maximum likelihood estimates of an AR( $P$ ) are identical to least squares estimates from the regression

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_P Y_{t-P} + \varepsilon_t. \quad (4.71)$$

Conditional maximum likelihood estimation of ARMA models requires either backcast values or truncation since some of the observations have low indices (e.g.,  $Y_1$ ) that depend on observations not in the sample (e.g.,  $Y_0, Y_{-1}, \varepsilon_0, \varepsilon_{-1}$ , etc.). Truncation is the most common and the likelihood is only computed for  $t = P+1, \dots, T$ , and initial values of  $\varepsilon_t$  are set to 0. When using backcasts, missing values of  $y$  can be initialized at the long-run average,  $\bar{y} = T^{-1} \sum_{t=1}^T Y_t$ , and the initial values of  $\varepsilon_t$  are set to their unconditional expectation, 0. Using unconditional values works well when data are not overly persistent and  $T$  is not too small. The likelihood can then be recursively computed where estimated errors  $\hat{\varepsilon}_t$  used are using in moving average terms,

$$\hat{\varepsilon}_t = Y_t - \phi_0 - \phi_1 Y_{t-1} - \dots - \phi_P Y_{t-P} - \theta_1 \hat{\varepsilon}_{t-1} - \dots - \theta_Q \hat{\varepsilon}_{t-Q}, \quad (4.72)$$

where backcast values are used if any index is less than or equal to 0. The estimated residuals are then plugged into the conditional log-likelihood (eq. (4.69)), and the log-likelihood value is computed. The numerical maximizer will search for values of  $\phi$  and  $\theta$  that produce the largest log-likelihood. Once the likelihood optimizing values have been found, the maximum likelihood estimate of the variance is computed using

$$\hat{\sigma}^2 = T^{-1} \sum_{t=1}^T (Y_t - \hat{\phi}_0 - \hat{\phi}_1 Y_{t-1} - \dots - \hat{\phi}_P Y_{t-P} - \hat{\theta}_1 \hat{\varepsilon}_{t-1} - \dots - \hat{\theta}_Q \hat{\varepsilon}_{t-Q})^2 \quad (4.73)$$

or the truncated version which sums from  $P+1$  to  $T$ .

### 4.7.2 Exact Maximum Likelihood

Exact maximum likelihood directly utilizes the autocorrelation function of an ARMA(P,Q) to compute the correlation matrix of *all* of the  $y$  data, which allows the joint likelihood to be evaluated. Define

$$\mathbf{y} = [Y_1, Y_2, \dots, Y_{T-1}, Y_T]'$$

and let  $\Gamma$  be the  $T$  by  $T$  covariance matrix of  $\mathbf{y}$ . The joint likelihood of  $\mathbf{y}$  is given by

$$f(\mathbf{y}|\phi, \theta, \sigma^2) = (2\pi)^{-\frac{T}{2}} |\Gamma|^{-\frac{T}{2}} \exp\left(-\frac{\mathbf{y}'\Gamma^{-1}\mathbf{y}}{2}\right). \quad (4.74)$$

The log-likelihood is

$$l(\phi, \theta, \sigma^2; \mathbf{y}) = -\frac{T}{2} \ln(2\pi) - \frac{T}{2} \ln |\Gamma| - \frac{1}{2} \mathbf{y}'\Gamma^{-1}\mathbf{y}. \quad (4.75)$$

where  $\Gamma$  is the symmetric matrix of autocovariances,

$$\Gamma = \begin{bmatrix} \gamma_0 & \gamma_1 & \gamma_2 & \gamma_3 & \dots & \gamma_{T-2} & \gamma_{T-1} \\ \gamma_1 & \gamma_0 & \gamma_1 & \gamma_2 & \dots & \gamma_{T-3} & \gamma_{T-2} \\ \gamma_2 & \gamma_1 & \gamma_0 & \gamma_1 & \dots & \gamma_{T-4} & \gamma_{T-3} \\ \vdots & \vdots & \vdots & \vdots & \dots & \vdots & \vdots \\ \gamma_{T-2} & \gamma_{T-3} & \gamma_{T-4} & \gamma_{T-5} & \dots & \gamma_0 & \gamma_1 \\ \gamma_{T-1} & \gamma_{T-2} & \gamma_{T-3} & \gamma_{T-4} & \dots & \gamma_1 & \gamma_0 \end{bmatrix},$$

that are determined by the model parameters (excluding the constant),  $\phi$ ,  $\theta$ , and  $\sigma^2$ . A nonlinear maximization algorithm can be used to search for the vector of parameters that maximizes this log-likelihood. The exact maximum likelihood estimator is generally believed to be more precise than conditional maximum likelihood and does not require backcasts of data or errors.

## 4.8 Inference

Inference on ARMA parameters from stationary time series is a standard application of maximum likelihood theory. Define  $\boldsymbol{\psi} = [\phi \ \theta \ \sigma^2]'$  as the parameter vector. Recall from 2 that maximum likelihood estimates are asymptotically normal,

$$\sqrt{T}(\boldsymbol{\psi} - \hat{\boldsymbol{\psi}}) \xrightarrow{d} N(\mathbf{0}, \mathcal{I}^{-1}) \quad (4.76)$$

where

$$\mathcal{I} = -E \left[ \frac{\partial^2 l(\mathbf{y}; \boldsymbol{\psi})}{\partial \boldsymbol{\psi} \partial \boldsymbol{\psi}'} \right].$$

where  $\partial^2 l(\mathbf{y}; \boldsymbol{\psi}) / \partial \boldsymbol{\psi} \partial \boldsymbol{\psi}'$  is the second derivative matrix of the log-likelihood (or Hessian). In practice  $\mathcal{I}$  is not known and it must be replaced with a consistent estimate,

$$\hat{\mathcal{I}} = T^{-1} \sum_{t=1}^T -\frac{\partial^2 l(Y_t; \hat{\boldsymbol{\psi}})}{\partial \boldsymbol{\psi} \partial \boldsymbol{\psi}'}.$$

Wald and  $t$ -tests on the parameter estimates can be computed using the elements of  $\mathcal{I}$ , or likelihood ratio tests can be used by imposing the null on the model and comparing the log-likelihood values of the constrained and unconstrained estimators.

One important assumption in the above distribution theory is that the estimator is a maximum likelihood estimator; this requires the likelihood to be correctly specified, or, in other words, for the data to be homoskedastic and normally distributed. This assumption is generally implausible when using financial data, and a modification of the above theory is needed. When one likelihood is specified for the data, but they have a different distribution, the estimator is known as a Quasi Maximum Likelihood estimator (QML). QML estimators, like ML estimators, are asymptotically normal under mild regularity conditions on the data but with a different asymptotic covariance matrix,

$$\sqrt{T}(\psi - \hat{\psi}) \xrightarrow{d} N(\mathbf{0}, \mathcal{I}^{-1} \mathcal{J} \mathcal{I}^{-1}) \quad (4.77)$$

where

$$\mathcal{J} = E \left[ \frac{\partial l(\mathbf{y}; \psi)}{\partial \psi} \frac{\partial l(\mathbf{y}; \psi)}{\partial \psi'} \right]$$

$\mathcal{J}$  must also be estimated and the usual estimator is

$$\hat{\mathcal{J}} = T^{-1} \sum_{t=1}^T \frac{\partial l(Y_t; \psi)}{\partial \psi} \frac{\partial l(Y_t; \psi)}{\partial \psi'}$$

where  $\frac{\partial l(Y_t; \psi)}{\partial \psi}$  is the score of the log-likelihood.  $\mathcal{I}^{-1} \mathcal{J} \mathcal{I}^{-1}$  is known as a sandwich covariance estimator, White's covariance estimator.

A sandwich covariance estimator is needed when the model for the data is either incompletely specified or is misspecified, and it accounts for the failure of Information Matrix Inequality to hold (see chapters 2 and 3). As was the case in linear regression, a sufficient condition for the IME to fail in ARMA estimation is heteroskedastic residuals. Considering the prevalence of conditionally heteroskedasticity in financial data, this is nearly a given.

## 4.9 Forecasting

Forecasting is a common objective of many time-series models. The objective of a forecast is to minimize a loss function.

**Definition 4.29** (Loss Function). A loss function is a function of the observed data,  $Y_{t+h}$  and the time- $t$  constructed forecast,  $\hat{Y}_{t+h|t}$ ,  $L(Y_t, \hat{Y}_{t+h|t})$ , that has the three following properties:

- Property 1: The loss of any forecast is non-negative, so  $L(Y_{t+h}, \hat{Y}_{t+h|t}) \geq 0$ .
- Property 2: There exists a point,  $Y_{t+h}^*$ , known as the optimal forecast, where the loss function takes the value 0. That is  $L(Y_{t+h}, Y_{t+h}^*) = 0$ .
- Property 3: The loss is non-decreasing away from  $Y_{t+h}^*$ . That is if  $Y_{t+h}^B > Y_{t+h}^A > Y_{t+h}^*$ , then  $L(Y_{t+h}, Y_{t+h}^B) > L(Y_{t+h}, Y_{t+h}^A) > L(Y_{t+h}, Y_{t+h}^*)$ . Similarly, if  $Y_{t+h}^D < Y_{t+h}^C < Y_{t+h}^*$ , then  $L(Y_{t+h}, Y_{t+h}^D) > L(Y_{t+h}, Y_{t+h}^C) > L(Y_{t+h}, Y_{t+h}^*)$ .

The most common loss function is Mean Square Error (MSE) which chooses the forecast to minimize

$$E[L(Y_{t+h}, \hat{Y}_{t+h|t})] = E[(Y_{t+h} - \hat{Y}_{t+h|t})^2] \quad (4.78)$$

where  $\hat{Y}_{t+h|t}$  is the time- $t$  forecast of  $Y_{t+h}$ . Notice that this is just the optimal projection problem and the optimal forecast is the conditional mean,  $Y_{t+h|t}^* = E_t[Y_{t+h}]$  (See chapter 3). It is simple to verify that this loss function satisfies the properties of a loss function. Property 1 holds by inspection and property 2 occurs when  $Y_{t+h} = \hat{Y}_{t+h|t}^*$ . Property 3 follows from the quadratic form. MSE is the most common loss function, but others, such as Mean Absolute Deviation (MAD), Quad-Quad, and Linex, are used in practice and academic literature. The MAD loss function will be revisited in chapter 6 (Value-at-Risk). The Advanced Financial Econometrics elective will study non-MSE loss functions in more detail.

The remainder of this section will focus exclusively on forecasts that minimize the MSE loss function. Fortunately, in this case, forecasting from ARMA models is an easy exercise. For simplicity, consider the AR(1) process,

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t.$$

Since the optimal forecast is the conditional mean, all that is needed is to compute  $E_t[Y_{t+h}]$  for any  $h$ . When  $h = 1$ ,

$$Y_{t+1} = \phi_0 + \phi_1 Y_t + \varepsilon_{t+1},$$

so the conditional expectation is

$$\begin{aligned} E_t[Y_{t+1}] &= E_t[\phi_0 + \phi_1 Y_t + \varepsilon_{t+1}] \\ &= \phi_0 + \phi_1 E_t[Y_t] + E_t[\varepsilon_{t+1}] \\ &= \phi_0 + \phi_1 Y_t + 0 \\ &= \phi_0 + \phi_1 Y_t \end{aligned} \quad (4.79)$$

which follows since  $Y_t$  is in the time- $t$  information set ( $\mathcal{F}_t$ ) and  $E_t[\varepsilon_{t+1}] = 0$  by assumption.<sup>11</sup> The optimal forecast for  $h = 2$  is given by  $E_t[Y_{t+2}]$ ,

$$\begin{aligned} E_t[Y_{t+2}] &= E_t[\phi_0 + \phi_1 Y_{t+1} + \varepsilon_{t+2}] \\ &= \phi_0 + \phi_1 E_t[Y_{t+1}] + E_t[\varepsilon_{t+2}] \\ &= \phi_0 + \phi_1 (\phi_0 + \phi_1 Y_t) + 0 \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_t \end{aligned}$$

which follows by substituting in the expression derived in eq. (4.79) for  $E_t[Y_{t+1}]$ . The optimal forecast for any arbitrary  $h$  uses the recursion

$$E_t[Y_{t+h}] = \phi_0 + \phi_1 E_t[Y_{t+h-1}] \quad (4.80)$$

<sup>11</sup>This requires a slightly stronger assumption than  $\varepsilon_t$  is a white noise process.

and it is easily shown that  $E_t[Y_{t+h}] = \phi_0 \sum_{i=0}^{h-1} \phi_1^i + \phi_1^h Y_t$ . If  $|\phi_1| < 1$ , as  $h \rightarrow \infty$ , the forecast of  $Y_{t+h}$  and  $E_t[Y_{t+h}]$  converges to  $\phi_0/(1 - \phi_1)$ , the unconditional expectation of  $Y_t$ . In other words, for forecasts in the distant future there is no information about the location of  $Y_{t+h}$  other than it will return to its unconditional mean. This is not surprising since  $Y_t$  is covariance stationary when  $|\phi_1| < 1$ .

Next consider forecasts from an MA(2),

$$Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t.$$

The one-step-ahead forecast is given by

$$\begin{aligned} E_t[Y_{t+1}] &= E_t[\phi_0 + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1} + \varepsilon_{t+1}] \\ &= \phi_0 + \theta_1 E_t[\varepsilon_t] + \theta_2 E_t[\varepsilon_{t-1}] + E_t[\varepsilon_{t+1}] \\ &= \phi_0 + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1} + 0 \end{aligned}$$

which follows since  $\varepsilon_t$  and  $\varepsilon_{t-1}$  are in the  $\mathcal{F}_t$  information set and  $E_t[\varepsilon_{t+1}] = 0$  by assumption. In practice the one step ahead forecast would be given by

$$E_t[Y_{t+1}] = \hat{\phi}_0 + \hat{\theta}_1 \hat{\varepsilon}_t + \hat{\theta}_2 \hat{\varepsilon}_{t-1}$$

where both the unknown parameters *and* the unknown residuals would be replaced with their estimates.<sup>12</sup> The 2-step ahead forecast is given by

$$\begin{aligned} E_t[Y_{t+2}] &= E_t[\phi_0 + \theta_1 \varepsilon_{t+1} + \theta_2 \varepsilon_t + \varepsilon_{t+2}] \\ &= \phi_0 + \theta_1 E_t[\varepsilon_{t+1}] + \theta_2 E_t[\varepsilon_t] + E_t[\varepsilon_{t+2}] \\ &= \phi_0 + \theta_1 0 + \theta_2 \varepsilon_t + 0 \\ &= \phi_0 + \theta_2 \varepsilon_t. \end{aligned}$$

Longer-horizon forecasts are then  $\phi_0$  since all future residuals have zero expectation, and so they do not alter longer horizon forecasts. Like the AR(1) forecast, the MA(2) forecast is mean-reverting. Recall the unconditional expectation of an MA(Q) process is  $\phi_0$ . For any  $h > Q$  the forecast of  $Y_{t+h}$  is just this value,  $\phi_0$ .

Finally, consider the 1 to 3-step ahead forecasts from an ARMA(2,2),

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t.$$

Conditioning on the information set  $\mathcal{F}_t$ , the expectation of  $Y_{t+1}$  is

$$\begin{aligned} E_t[Y_{t+1}] &= E_t[\phi_0 + \phi_1 Y_t + \phi_2 Y_{t-1} + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1} + \varepsilon_{t+1}] \\ &= E_t[\phi_0] + E_t[\phi_1 Y_t] + E_t[\phi_2 Y_{t-1}] + E_t[\theta_1 \varepsilon_t] + E_t[\theta_2 \varepsilon_{t-1}] + E_t[\varepsilon_{t+1}]. \end{aligned}$$

Noting that all of the elements are in  $\mathcal{F}_t$  except  $\varepsilon_{t+1}$ , which has conditional expectation 0,

<sup>12</sup>The residuals are a natural by-product of the parameter estimation stage.

$$E_t[Y_{t+1}] = \phi_0 + \phi_1 Y_t + \phi_2 Y_{t-1} + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1}$$

Note that in practice, the parameters and errors will all be replaced by their estimates (i.e.  $\hat{\phi}_1$  and  $\hat{\varepsilon}_t$ ). The 2-step ahead forecast is given by

$$\begin{aligned} E_t[Y_{t+2}] &= E_t[\phi_0 + \phi_1 Y_{t+1} + \phi_2 Y_t + \theta_1 \varepsilon_{t+1} + \theta_2 \varepsilon_t + \varepsilon_{t+2}] \\ &= E_t[\phi_0] + E_t[\phi_1 Y_{t+1}] + E_t[\phi_2 Y_t] + \theta_1 E_t[\varepsilon_{t+1}] + \theta_2 \varepsilon_t + E_t[\varepsilon_{t+2}] \\ &= \phi_0 + \phi_1 E_t[Y_{t+1}] + \phi_2 Y_t + \theta_1 E_t[\varepsilon_{t+1}] + \theta_2 \varepsilon_t + E_t[\varepsilon_{t+2}] \\ &= \phi_0 + \phi_1 (\phi_0 + \phi_1 Y_t + \phi_2 Y_{t-1} + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1}) + \phi_2 Y_t + \theta_1 0 + \theta_2 \varepsilon_t + 0 \\ &= \phi_0 + \phi_1 \phi_0 + \phi_1^2 Y_t + \phi_1 \phi_2 Y_{t-1} + \phi_1 \theta_1 \varepsilon_t + \phi_1 \theta_2 \varepsilon_{t-1} + \phi_2 Y_t + \theta_2 \varepsilon_t \\ &= \phi_0 + \phi_1 \phi_0 + (\phi_1^2 + \phi_2) Y_t + \phi_1 \phi_2 Y_{t-1} + (\phi_1 \theta_1 + \theta_2) \varepsilon_t + \phi_1 \theta_2 \varepsilon_{t-1}. \end{aligned}$$

In this case, there are three terms which are not known at time  $t$ . By assumption  $E_t[\varepsilon_{t+2}] = E_t[\varepsilon_{t+1}] = 0$  and  $E_t[Y_{t+1}]$  has been computed above, so

$$E_t[Y_{t+2}] = \phi_0 + \phi_1 \phi_0 + (\phi_1^2 + \phi_2) Y_t + \phi_1 \phi_2 Y_{t-1} + (\phi_1 \theta_1 + \theta_2) \varepsilon_t + \phi_1 \theta_2 \varepsilon_{t-1}$$

In a similar manner,

$$\begin{aligned} E_t[Y_{t+3}] &= \phi_0 + \phi_1 E_t[Y_{t+2}] + \phi_2 E_t[Y_{t+1}] + \theta_1 \varepsilon_{t+2} + \theta_2 \varepsilon_{t+1} + \varepsilon_{t+3} \\ E_t[Y_{t+3}] &= \phi_0 + \phi_1 E_t[Y_{t+2}] + \phi_2 E_t[Y_{t+1}] + 0 + 0 + 0 \end{aligned}$$

which is easily solved by plugging in the previously computed values for  $E_t[Y_{t+2}]$  and  $E_t[Y_{t+1}]$ . This pattern can be continued by iterating forward to produce the forecast for an arbitrary  $h$ .

Two things are worth noting from this discussion:

- If there is no AR component, all forecast for  $h > Q$  will be  $\phi_0$ .
- For large  $h$ , the optimal forecast converges to the unconditional expectation given by

$$\lim_{h \rightarrow \infty} E_t[Y_{t+h}] = \frac{\phi_0}{1 - \phi_1 - \phi_2 - \dots - \phi_p} \quad (4.81)$$

## 4.9.1 Forecast Evaluation

Forecast evaluation is an extensive topic, and these notes only cover two essential tests: Mincer-Zarnowitz regressions and Diebold-Mariano tests.

### 4.9.1.1 Mincer-Zarnowitz Regressions

Mincer-Zarnowitz regressions (henceforth MZ) are used to test for the optimality of the forecast and are implemented with a standard regression. If a forecast is correct, it should be the case that a regression of the realized value on its forecast and a constant should produce coefficients of 1 and 0 respectively.

**Definition 4.30** (Mincer-Zarnowitz Regression). A Mincer-Zarnowitz (MZ) regression is a regression of a forecast,  $\hat{Y}_{t+h|t}$  on the realized value of the predicted variable,  $Y_{t+h}$  and a constant,

$$Y_{t+h} = \beta_1 + \beta_2 \hat{Y}_{t+h|t} + \eta_t. \quad (4.82)$$

If the forecast is optimal, the coefficients in the MZ regression should be consistent with  $\beta_1 = 0$  and  $\beta_2 = 1$ .

For example, let  $\hat{Y}_{t+h|t}$  be the  $h$ -step ahead forecast of  $y$  constructed at time  $t$ . Then running the regression

$$Y_{t+h} = \beta_1 + \beta_2 \hat{Y}_{t+h|t} + v_t$$

should produce estimates close to 0 and 1. Testing is straightforward and can be done with any standard test (Wald, LR or LM). An augmented MZ regression can be constructed by adding time- $t$  measurable variables to the original MZ regression.

**Definition 4.31** (Augmented Mincer-Zarnowitz Regression). An Augmented Mincer-Zarnowitz regression is a regression of a forecast,  $\hat{Y}_{t+h|t}$  on the realized value of the predicted variable,  $Y_{t+h}$ , a constant and any other time- $t$  measurable variables,  $\mathbf{x}_t = [X_{1t} X_{2t} \dots X_{Kt}]$ ,

$$Y_{t+h} = \beta_1 + \beta_2 \hat{Y}_{t+h|t} + \beta_3 X_{1t} + \dots + \beta_{K+2} X_{Kt} + \eta_t. \quad (4.83)$$

If the forecast is optimal, the coefficients in the MZ regression should be consistent with  $\beta_1 = \beta_3 = \dots = \beta_{K+2} = 0$  and  $\beta_2 = 1$ .

It is crucial that the additional variables are time- $t$  measurable and are in  $\mathcal{F}_t$ . Again, any standard test statistic can be used to test the null  $H_0 : \beta_2 = 1 \cap \beta_1 = \beta_3 = \dots = \beta_{K+2} = 0$  against the alternative  $H_1 : \beta_2 \neq 1 \cup \beta_j \neq 0, j = 1, 3, 4, \dots, K-1, K-2$ .

#### 4.9.1.2 Diebold-Mariano Tests

A Diebold-Mariano test, in contrast to an MZ regression, examines the relative performance of two forecasts. Under MSE, the loss function is given by  $L(Y_{t+h}, \hat{Y}_{t+h|t}) = (Y_{t+h} - \hat{Y}_{t+h|t})^2$ . Let  $A$  and  $B$  index the forecasts from two models  $\hat{Y}_{t+h|t}^A$  and  $\hat{Y}_{t+h|t}^B$ , respectively. The losses from each can be defined as  $l_t^A = (Y_{t+h} - \hat{Y}_{t+h|t}^A)^2$  and  $l_t^B = (Y_{t+h} - \hat{Y}_{t+h|t}^B)^2$ . If the models were equally good (or bad), one would expect  $\bar{l}^A \approx \bar{l}^B$  where  $\bar{l}$  is the average loss. If model  $A$  is better, meaning it has a lower expected loss  $E[L(Y_{t+h}, \hat{Y}_{t+h|t}^A)] < E[L(Y_{t+h}, \hat{Y}_{t+h|t}^B)]$ , then, on average, it should be the case that  $\bar{l}^A < \bar{l}^B$ . Alternatively, if model  $B$  were better it should be the case that  $\bar{l}^B < \bar{l}^A$ . The DM test exploits this to construct a simple  $t$ -test of equal predictive ability.

**Definition 4.32** (Diebold-Mariano Test). Define  $d_t = l_t^A - l_t^B$ . The Diebold-Mariano test is a test of equal predictive accuracy and is constructed as

$$DM = \frac{\bar{d}}{\sqrt{\widehat{V}[\bar{d}]}}$$



where  $M$  (for modeling) is the number of observations used in the model building and estimation,  $R$  (for reserve) is the number of observations held back for model evaluation and  $\bar{d} = R^{-1} \sum_{t=M+1}^{M+R} d_t$ . Under the null that  $E[L(Y_{t+h}, \hat{Y}_{t+h|t}^A)] = E[L(Y_{t+h}, \hat{Y}_{t+h|t}^B)]$ , and under some regularity conditions on  $\{d_t\}$ ,  $DM \xrightarrow{d} N(0, 1)$ .  $V[d_t]$  is the *long-run variance* of  $d_t$  and must be computed using a HAC covariance estimator.

If the models are equally accurate, one would expect that  $E[d_t] = 0$  which forms the null of the DM test,  $H_0 : E[d_t] = 0$ . To test the null, a standard  $t$ -stat is used although the test has two alternatives:  $H_1^A : E[d_t] < 0$  and  $H_1^B : E[d_t] > 0$  which correspond to the superiority of model  $A$  or  $B$ , respectively.  $DM$  is asymptotically normally distributed. Large negative values (less than  $-2$ ) indicate model  $A$  produces less loss on average and hence is superior, while large positive values indicate the opposite. Values close to zero indicate neither is statistically superior.

In Diebold-Marino tests, the variance must be estimated using a Heteroskedasticity-Autocorrelation Consistent variance estimator.

**Definition 4.33** (Heteroskedasticity Autocorrelation Consistent Covariance Estimator). Covariance estimators which are robust to both ignored autocorrelation in residuals and heteroskedasticity are known as Heteroskedasticity-Autocorrelation Consistent (HAC) covariance. The most common example of a HAC estimator is the Newey-West (or Bartlett) covariance estimator.

The typical variance estimator cannot be used in DM tests, and a kernel estimator must be substituted (e.g., Newey-West).

Despite all of these complications, implementing a DM test is very easy. The first step is to compute the series of losses,  $\{l_t^A\}$  and  $\{l_t^B\}$ , for both forecasts. Next compute  $d_t = l_t^A - l_t^B$ . Finally, regress  $d_t$  on a constant and use Newey-West errors,

$$d_t = \beta_1 + \varepsilon_t.$$

The  $t$ -stat on  $\beta_1$  is the DM test statistic and can be compared to a critical value from a normal distribution.

## 4.10 Nonstationary Time Series

Nonstationary time series present some particular difficulties, and standard inference often fails when a process depends explicitly on  $t$ . Nonstationarities can be classified into one of four categories:

- Seasonalities
- Deterministic Trends (also known as Time Trends)
- Unit Roots (also known as Stochastic Trends)
- Structural Breaks

Each type has a unique feature. Seasonalities are technically a form of a deterministic trend, although their analysis is sufficiently similar to stationary time series that little is lost in treating a seasonal time series as if it were stationary. Processes with deterministic trends have unconditional means which depend on time, while unit-root processes have unconditional variances that grow over time. Structural breaks are an encompassing class that may result in either the mean and variance exhibiting time dependence.

### 4.10.1 Seasonality, Diurnality, and Hebdomadality

Seasonality, diurnality, and hebdomadality are pervasive in economic time series. While many data series have been *seasonally adjusted* to remove seasonalities, particularly US macroeconomic series, there are many time-series where no seasonally adjusted version is available. Ignoring seasonalities is detrimental to the precision of parameter estimates and forecasting. Model specifications are often simpler when both seasonal and nonseasonal dynamics are simultaneously modeled.

**Definition 4.34** (Seasonality). Data are seasonal if they exhibit a non-constant deterministic pattern with an annual frequency.

**Definition 4.35** (Hebdomadality). Data which exhibit day-of-week deterministic effects are said to be hebdomadal.

**Definition 4.36** (Diurnality). Data which exhibit intra-daily deterministic effects are said to be diurnal.

Seasonal data are nonstationary, although seasonally detrended data (usually referred to as deseasonalized data) may be stationary. Seasonality is frequently encountered when modeling macroeconomic time series. Diurnality is pervasive in ultra-high frequency data (tick data), and hebdomadality is often believed to be a feature of asset returns.

### 4.10.2 Deterministic Seasonality

Seasonality may be deterministic, in which case it produces in a nonstationary time series, or cyclical, in which case the time series may be stationary. Two approaches are commonly used to model seasonality. The first uses a seasonal deterministic term to express the predictable change in the model. The seasonal deterministic terms are usually modeled using seasonal dummies, although it is common to use Fourier series to model deterministic seasonality when the seasonal length is large (e.g., minutes in a day, hours in a week, or days in a year). A standard ARMA model can be augmented with seasonal dummies to capture both seasonal and cyclical behavior. For example, in a monthly time series,

$$Y_t = \phi_0 + \sum_{i=1}^{11} \gamma_i I_{[t \bmod 12 = i]} + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t,$$

is a ARMA(1, 1) with seasonal dummies. The intercept in month  $t$  is  $\phi_0 + \gamma_{t \bmod 12}$  if  $t \bmod 12$  is not zero and just  $\phi_0$  every twelfth month.

### 4.10.3 Seasonal Autoregressive Moving Average (SARMA) Models

Cyclical seasonality is modeled using a Seasonal ARMA (SARMA) which adds an additional component that has lags that occur on the seasonal frequency. SARMA models are described using two sets of indices,  $(P, Q)$  which describe the observation time model and  $(P_s, Q_s, s)$  which describe the seasonal time components and the length of the seasonality.<sup>13</sup> Seasonal ARMA models are simplest to

<sup>13</sup>It is more common to describe Seasonal ARMA using the notation of Seasonal Integrated ARMA models, or SARIMA. These models include 2 additional parameters the capture the differences used to transform a non-stationary time series to be stationary. The full description is SARIMA( $P, d, Q$ )  $\times$  ( $P_s, d_s, Q_s, s$ ) where  $d$  is the order of differencing

describe using a lag polynomial, so that a  $\text{SARMA}(1, 1) \times (1, 1, 12)$ , which is a Seasonal ARMA(1,1) with an ARMA(1,1) seasonal component, can be expressed

$$(1 - \phi_1 L)(1 - \phi_s L^{12}) Y_t = \phi_0 + (1 + \theta_1 L)(1 + \theta_s L^{12}) \varepsilon_t.$$

The polynomial can be expanded to determine the specification of the model using standard ARMA notation

$$(1 - \phi_1 L - \phi_s L^{12} + \phi_1 L^{13}) Y_t = \phi_0 + (1 + \theta_1 L + \theta_s L^{12} + \theta_1 \theta_s L^{13}) \varepsilon_t$$

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_s Y_{t-12} - \phi_1 \phi_s Y_{t-13} + \theta_1 \varepsilon_{t-1} + \theta_s \varepsilon_{t-12} + \theta_1 \theta_s \varepsilon_{t-13} + \varepsilon_t.$$

The expanded model is an restricted ARMA(13,13). The restrictions com in two forms: many of the coefficients are restricted to be 0, and the coefficients appearing on lags 13 are the product of the coefficient on the other lags. The sign of the coefficient on the lag-13 AR term is also negated. As long as the root of the characteristic polynomial associated with  $1 - \phi_1 L - \phi_s L^{12} + \phi_1 L^{13}$  are less than 1 in modulus, then the seasonal model will be stationary.

For example, consider a seasonal quarterly time series. Seasonal dynamics may occur at lags 4, 8, 12, 16, ..., while nonseasonal dynamics can occur at any lag 1, 2, 3, 4, .... Note that multiples of 4 appear in both lists, and so the identification of the seasonal and nonseasonal dynamics may be difficult (although separate identification makes little practical difference). When working with seasonal data, the standard practice is to conduct model selection over two sets of lags by choosing a maximum lag to capture the seasonal dynamics and by choosing a maximum lag to capture nonseasonal ones.

#### 4.10.3.1 Example: Seasonality

Most U.S. data series are available seasonally adjusted, which is not true for data from many areas of the world, including the Eurozone. This example uses monthly data on U.S. housing starts, a time series that tracks the construction of new homes.

Figure 4.10.3.1 contains a plot of housing starts, its growth rate (log differences), and the sample autocorrelogram and sample partial autocorrelogram of the growth rate. These figures show evidence of an annual seasonality (lags 12, 24, and 36), and applying the Box-Jenkins methodology, the seasonality appears to be a seasonal AR, or possibly a seasonal ARMA. The short-run dynamics oscillate and appear consistent with an AR since the autocorrelations are more persistent than the partial autocorrelations. Four specifications were the process were fit to the data: a nonseasonal ARMA(1,1) and three seasonal models. The AIC indicates that the seasonal component is required in the model.

#### 4.10.4 Deterministic Trends

The simplest form of nonstationarity is a deterministic trend. Models with deterministic time trends can be decomposed into three components:

$$Y_t = \text{deterministic} + \text{cyclic} + \text{noise} \quad (4.84)$$

in observation time and  $d_s$  is the order of differencing in seasonal time. The full specification is

$$(1 - \phi_1 L - \dots - \phi_P L^P)(1 - \phi_{s,1} L^2 - \dots - \phi_{s,P_s} L^{sP_s}) \Delta^d \Delta_s^{d_s} Y_t = (1 + \theta_1 L + \dots + \theta_Q L^Q)(1 + \theta_{s,1} L^s + \dots + \theta_{s,Q_s} L^{sQ_s}) \varepsilon_t.$$

The differencing terms are  $\Delta^d = (1 - L)^d$  and  $\Delta_s^{d_s} = (1 - L^s)^{d_s}$ . Normally only one of  $d$  or  $d_2$  is non-zero.

### Housing Starts, Growth, and the ACF and PACF of the Housing Start Growth Rate

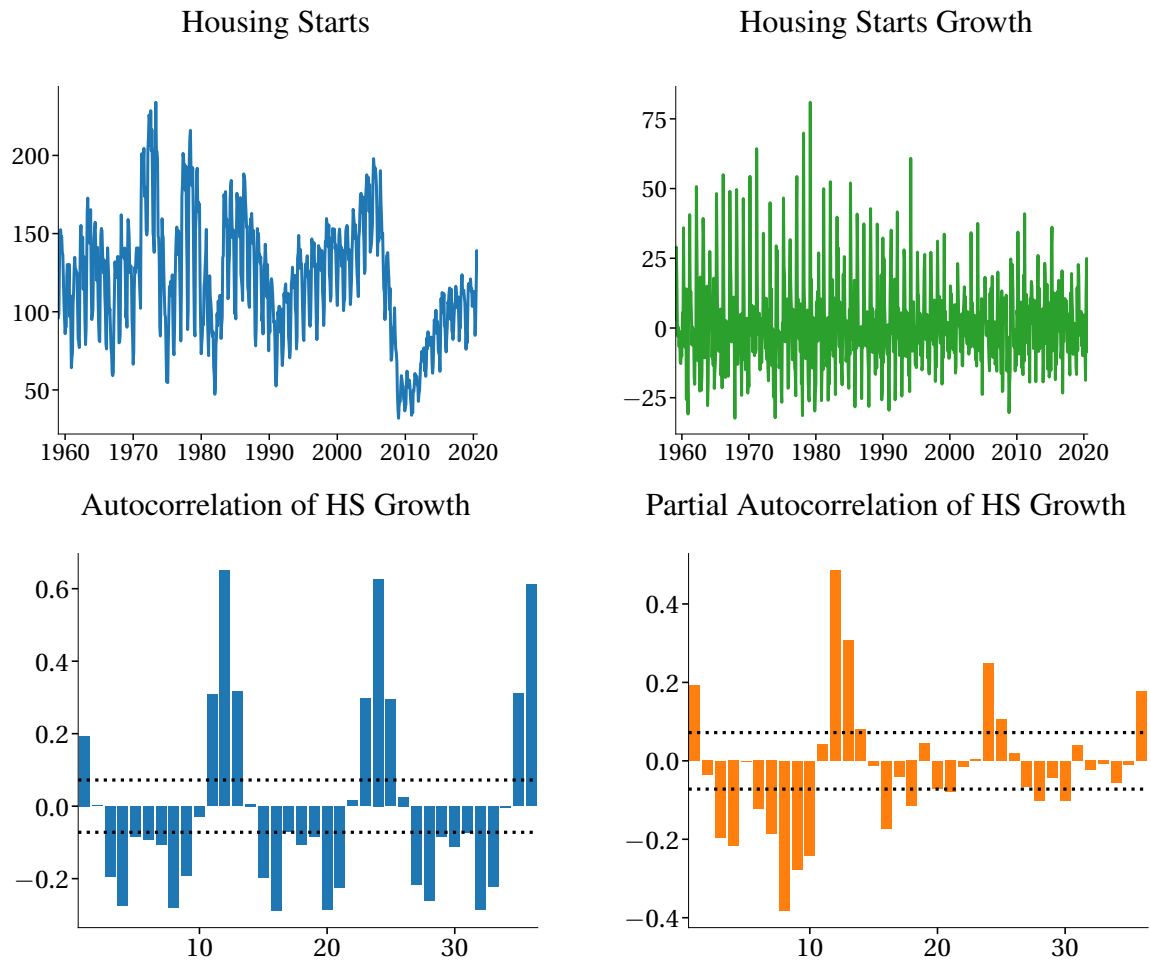


Figure 4.7: Plot of the the number of housing starts, its growth rate (log differences), and the sample autocorrelogram and sample partial autocorrelogram of the growth rate of housing starts growth. There is a clear seasonal pattern at 12 months which appears consistent with a seasonal ARMA.

SARMA Order	$\phi_0$	$\phi_1$	$\phi_{12,1}$	$\phi_{12,2}$	$\theta_1$	AIC
$(1,1) \times (0,0,0)$	1.03 (1.40)	0.13 (0.61)			0.07 (0.33)	6165.7
$(1,0) \times (1,0,12)$	0.37 (0.83)	-0.29 (-9.30)	0.74 (38.60)			5729.3
$(1,1) \times (1,0,12)$	0.30 (0.87)	-0.09 (-0.88)	0.75 (38.28)		-0.22 (-2.12)	5728.4
$(1,1) \times (2,0,12)$	0.17 (0.62)	-0.02 (-0.18)	0.46 (16.33)	0.38 (12.87)	-0.31 (-3.32)	5620.1

Table 4.3: Estimated parameters, t-stats and AIC for three models with seasonalities. The AIC prefers the largest specification.

where  $\{Y_t\}$  would be stationary if the trend were absent. The two most common forms of time trends are polynomial (e.g., linear or quadratic) and exponential. Processes with polynomial-time trends can be expressed

$$Y_t = \phi_0 + \delta_1 t + \delta_2 t^2 + \dots + \delta_S t^S + \text{cyclic} + \text{noise},$$

and linear time trend models are the most common,

$$Y_t = \phi_0 + \delta_1 t + \text{cyclic} + \text{noise}.$$

For example, consider a linear time trend model with an MA(1) stationary component,

$$Y_t = \phi_0 + \delta_1 t + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

The long-run behavior of this process is dominated by the time trend, although it may still exhibit persistent fluctuations around  $\delta_1 t$ .

Exponential trends appear as linear or polynomial trends in the log of the dependent variable; for example,

$$\ln Y_t = \phi_0 + \delta_1 t + \text{cyclic} + \text{noise}.$$

The trend is the permanent component of a nonstationary time series, and so all observations are permanently affected by the trend line irrespective of the number of observations between them. The class of deterministic trend models can be reduced to a stationary process by detrending.

**Definition 4.37** (Trend Stationary). A stochastic process,  $\{Y_t\}$  is trend stationary if there exists a nontrivial function  $g(t, \delta)$  such that  $\{Y_t - g(t, \delta)\}$  is stationary.

Detrended data may be strictly or covariance stationary (or both).

#### 4.10.4.1 Modeling the time trend in GDP

U.S. GDP data was taken from FRED II from Q1 1947 until Q2 July 2008. To illustrate the use of a time trend, consider two simple models for the level of GDP. The first models the level as a quadratic function of time, while the second models the natural log of GDP in an exponential trend model.

$$GDP_t = \phi_0 + \delta_1 t + \delta_2 t^2 + \varepsilon_t$$

and

$$\ln GDP_t = \phi_0 + \delta_1 t + \varepsilon_t.$$

Figure 4.8 presents the time series of GDP, the log of GDP, and errors from two models that include trends. Neither time trend appears to remove the extreme persistence in GDP, and the process likely contains a unit root.

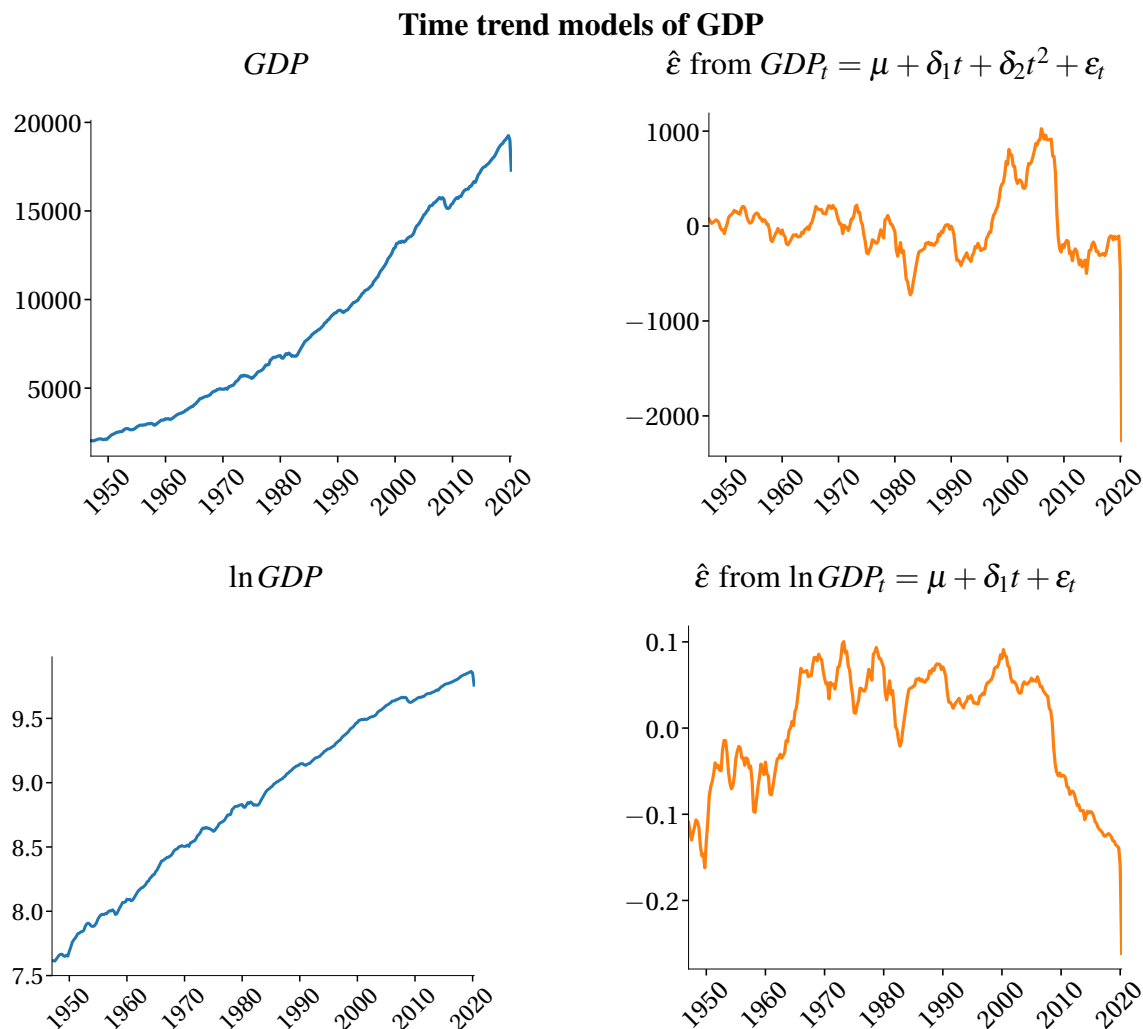


Figure 4.8: Two time trend models are presented, one on the levels of GDP and one on the natural log. Note that the detrended residuals are still highly persistent. This is a likely sign of a unit root.

### 4.10.5 Unit Roots

Unit root processes are generalizations of the classic random walk. A process is said to have a unit root if the distributed lag polynomial can be factored so that one of the roots is exactly one.

**Definition 4.38** (Unit Root). A stochastic process,  $\{Y_t\}$ , is said to contain a unit root if

$$(1 - \phi_1 L - \phi_2 L^2 - \dots - \phi_P L^P) Y_t = \phi_0 + (1 - \theta_1 L - \theta_2 L^2 - \dots - \theta_Q L^Q) \varepsilon_t \quad (4.85)$$

can be factored

$$(1 - L)(1 - \tilde{\phi}_1 L - \tilde{\phi}_2 L^2 - \dots - \tilde{\phi}_{P-1} L^{P-1}) Y_t = \phi_0 + (1 - \theta_1 L - \theta_2 L^2 - \dots - \theta_Q L^Q) \varepsilon_t. \quad (4.86)$$

The simplest example of a unit root process is a random walk.

**Definition 4.39** (Random Walk). A stochastic process  $\{Y_t\}$  is known as a random walk if

$$Y_t = Y_{t-1} + \varepsilon_t \quad (4.87)$$

where  $\varepsilon_t$  is a white noise process with the additional property that  $E_{t-1}[\varepsilon_t] = 0$ .

The basic properties of a random walk are simple to derive. First, a random walk is a martingale since  $E_t[Y_{t+h}] = Y_t$  for any  $h$ .<sup>14</sup> The variance of a random walk can be deduced from

$$\begin{aligned} V[Y_t] &= E[(Y_t - Y_0)^2] \\ &= E[(\varepsilon_t + Y_{t-1} - Y_0)^2] \\ &= E[(\varepsilon_t + \varepsilon_{t-1} + Y_{t-2} - Y_0)^2] \\ &= E[(\varepsilon_t + \varepsilon_{t-1} + \dots + \varepsilon_1)^2] \\ &= E[\varepsilon_t^2 + \varepsilon_{t-1}^2 + \dots + \varepsilon_1^2] \\ &= t\sigma^2 \end{aligned} \quad (4.88)$$

and this relationship holds for any time index, and so  $V[Y_s] = s\sigma^2$ . The  $s^{\text{th}}$  autocovariance ( $\gamma_s$ ) of a unit root process is given by

$$\begin{aligned} V[(Y_t - Y_0)(Y_{t-s} - Y_0)] &= E[(\varepsilon_t + \varepsilon_{t-1} + \dots + \varepsilon_1)(\varepsilon_{t-s} + \varepsilon_{t-s-1} + \dots + \varepsilon_1)] \\ &= E[(\varepsilon_{t-s}^2 + \varepsilon_{t-s-1}^2 + \dots + \varepsilon_1^2)] \\ &= (t-s)\sigma^2 \end{aligned} \quad (4.89)$$

and the  $s^{\text{th}}$  autocorrelation is then

$$\rho_s = \frac{t-s}{t} \quad (4.90)$$

which tends to 1 for large  $t$  and fixed  $s$ . The autocorrelations of unit-root processes are virtually constant at 1, with only a small decline at large lags. Building from the simple unit root, one can define a unit root plus drift model,

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

which can be equivalently expressed

$$Y_t = \delta t + \sum_{i=1}^t \varepsilon_i + Y_0$$

and so the random walk plus drift process consists of both a deterministic trend and a random walk. Alternatively, a random walk model can be augmented with stationary noise so that

$$Y_t = \sum_{i=1}^t \varepsilon_i + \eta_t$$

<sup>14</sup>Since the effect of an innovation never declines in a unit root process, it is not reasonable to consider the infinite past as in a stationary AR(1).

which leads to the general class of random walk models plus stationary noise processes

$$\begin{aligned} Y_t &= \sum_{i=1}^t \varepsilon_i + \sum_{j=1}^{t-1} \theta_j \eta_{t-j} + \eta_t \\ &= \sum_{i=1}^t \varepsilon_i + \Theta(L) \eta_t \end{aligned}$$

where  $\Theta(L) \eta_t = \sum_{j=1}^{t-1} \theta_j \eta_{t-j} + \eta_t$  is a compact expression for a lag polynomial in  $\theta$ . Since  $\Theta(L) \eta_t$  can include any covariance stationary process, this class should be considered general. More importantly, this process has two components: a permanent one,  $\sum_{i=1}^t \varepsilon_i$  and a transitory one  $\Theta(L) \eta_t$ . The permanent behaves similarly to a deterministic time trend, although unlike the deterministic trend model, the permanent component of this specification depends on random increments. For this reason, it is known as a *stochastic trend*.

Like the deterministic model, where the process can be detrended, a process with a unit root can be stochastically detrended, or *differenced*,  $\Delta Y_t = Y_t - Y_{t-1}$ . Differencing a random walk produces a stationary series,

$$\begin{aligned} Y_t - Y_{t-1} &= \sum_{i=1}^t \varepsilon_i + \Theta(L) \eta_t - \sum_{i=1}^{t-1} \varepsilon_i + \Theta(L) \eta_{t-1} \\ \Delta Y_t &= \varepsilon_t + (1 - L) \Theta(L) \eta_t \end{aligned}$$

*Over-differencing* occurs when the difference operator is applied to a stationary series. While over-differencing cannot create a unit root, it does have negative consequences such as increasing the residual variance and reducing the magnitude of possibly important dynamics. Finally, unit root processes are often known as  $I(1)$  processes.

**Definition 4.40** (Integrated Process of Order 1). A stochastic process  $\{Y_t\}$  is integrated of order 1, written  $I(1)$ , if  $\{Y_t\}$  is non-covariance-stationary and if  $\{\Delta Y_t\}$  is covariance stationary. Note: A process that is already covariance stationary is said to be  $I(0)$ .

The expression integrated is derived from the presence of  $\sum_{i=1}^t \varepsilon_i$  in a unit root process where the sum operator is the discrete version of an integrator.

#### 4.10.6 Difference or Detrend?

Detrending removes nonstationarities from deterministically trending series while differencing removes stochastic trends from unit-roots. What happens if the wrong type of detrending is used? The unit root case is simple, and since the trend is stochastic, no amount of detrending can eliminate the permanent component. Only knowledge of the stochastic trend at an earlier point in time can transform the series to be stationary.

Differencing a trend-stationary series produces a series that is stationary but with a larger variance than a correctly detrended series.



$$Y_t = \delta t + \varepsilon_t$$

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

while the properly detrended series would be

$$Y_t - \delta t = \varepsilon_t$$

If  $\varepsilon_t$  is a white noise process, the differenced series's variance is twice that of the detrended series with a large negative MA component. The parsimony principle dictates that the correctly detrended series should be preferred even though differencing is a viable method of transforming a nonstationary series to be stationary. Higher orders of time trends can be eliminated by re-differencing at the cost of even higher variance.

#### 4.10.7 Testing for Unit Roots: The Dickey-Fuller Test and the Augmented DF Test

Dickey-Fuller tests (DF), and their generalization to augmented Dickey-Fuller tests (ADF) are the standard test for unit roots. Consider the case of a simple random walk,

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

so that

$$\Delta Y_t = \varepsilon_t.$$

Dickey and Fuller noted that if the null of a unit root were true, then

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

can be transformed into

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

where  $\gamma = \phi - 1$  and a test could be conducted for the null  $H_0 : \gamma = 0$  against an alternative  $H_1 : \gamma < 0$ . This test is equivalent to testing whether  $\phi = 1$  in the original model.  $\hat{\gamma}$  can be estimated using a simple regression of  $\Delta Y_t$  on  $Y_{t-1}$ , and the  $t$ -stat can be computed in the usual way. If the distribution of  $\hat{\gamma}$  were standard normal (under the null), this would be a standard hypothesis test. Unfortunately, it is non-standard since, under the null,  $Y_{t-1}$  is a unit root, and the variance increases rapidly as the number of observations increases. The solution to this problem is to use the Dickey-Fuller distribution rather than the standard normal to make inference on the  $t$ -stat of  $\hat{\gamma}$ .

Dickey and Fuller considered three separate specifications for their test,

$$\begin{aligned} \Delta Y_t &= \gamma Y_{t-1} + \varepsilon_t \\ \Delta Y_t &= \phi_0 + \gamma Y_{t-1} + \varepsilon_t \\ \Delta Y_t &= \phi_0 + \delta_1 t + \gamma Y_{t-1} + \varepsilon_t \end{aligned} \tag{4.91}$$

which corresponds to a unit root, a unit root with a linear time trend, and a unit root with a quadratic time trend. The null and alternative hypotheses are the same:  $H_0 : \gamma = 0$ ,  $H_1 : \gamma < 0$  (one-sided

alternative), and the null that  $Y_t$  contains a unit root will be rejected if  $\hat{\gamma}$  is sufficiently negative, which is equivalent to  $\hat{\phi}$  being significantly less than 1 in the original specification.

Unit root testing is further complicated since the inclusion of deterministic regressor(s) affects the asymptotic distribution. For example, if  $T = 200$ , the critical values of a Dickey-Fuller distribution are

	No trend	Constant	Linear	Quadratic
10%	-1.62	-2.57	-3.14	-3.57
5%	-1.94	-2.88	-3.43	-3.86
1%	-2.58	-3.46	-4.00	-4.43

The Augmented Dickey-Fuller (ADF) test generalized the DF to allow for short-run dynamics in the differenced dependent variable. The ADF is a DF regression augmented with lags of the differenced dependent variable to capture short-term fluctuations around the stochastic trend,

$$\Delta Y_t = \gamma Y_{t-1} + \sum_{p=1}^P \phi_p \Delta Y_{t-p} + \varepsilon_t \quad (4.92)$$

$$\Delta Y_t = \phi_0 + \gamma Y_{t-1} + \sum_{p=1}^P \phi_p \Delta Y_{t-p} + \varepsilon_t$$

$$\Delta Y_t = \phi_0 + \delta_1 t + \gamma Y_{t-1} + \sum_{p=1}^P \phi_p \Delta Y_{t-p} + \varepsilon_t$$

Neither the null and alternative hypotheses nor the critical values are changed by including lagged dependent variables. The intuition behind this result stems from the observation that the  $\Delta Y_{t-p}$  are “less integrated” than  $Y_t$  and so are asymptotically less informative.

#### 4.10.8 Higher Orders of Integration

In some situations, integrated variables are not just  $I(1)$  but have a higher-order of integration. For example, the log consumer price index ( $\ln CPI$ ) is often found to be  $I(2)$  (integrated of order 2), and so *double differencing* is required to transform the original data into a stationary series. Consequently, both the level of  $\ln CPI$  and its difference (inflation) contain unit-roots.

**Definition 4.41** (Integrated Process of Order  $d$ ). A stochastic process  $\{Y_t\}$  is integrated of order  $d$ , written  $I(d)$ , if  $\{(1-L)^d Y_t\}$  is a covariance stationary ARMA process.

Testing for higher orders of integration is simple: repeat the DF or ADF test on the differenced data. Suppose that it is not possible to reject the null that the level of a variable,  $Y_t$ , is integrated and so the data should be differenced ( $\Delta Y_t$ ). If the test applied to the differenced data rejects a unit root, the testing procedure is complete, and the series is consistent with an  $I(1)$  process. If the differenced data contains evidence of a unit root, the data should be double differenced ( $\Delta^2 Y_t$ ) and the test repeated. The null of a unit root should be rejected on the double-differenced data since no economic data are thought to be  $I(3)$ , and so if the null cannot be rejected on double-differenced data, careful checking for omitted deterministic trends or other serious problems in the data is warranted.

#### 4.10.8.1 Power of Unit Root tests

Recall that the power of a test is the probability that the null is rejected when the null is false (1 minus the probability Type II). In the case of a unit root, power is the test's ability to reject the null that the process contains a unit root when the largest characteristic root is less than 1. Many economic time-series have roots close to 1, and so it is crucial to maximize the power of a unit root test so that models apply the correct transformation to correct for the order of integration.

DF and ADF tests are known to be very sensitive to misspecification and, in particular, have little power to reject a false null if the ADF specification is not flexible enough to account for factors other than the stochastic trend. Omitted deterministic time trends or insufficient lags of the differenced dependent variable lower the power by increasing the residual variance. The same lack of power appears in any regression test when the residual variance is too large due to omitted variables.

A few recommendations can be made regarding unit root tests:

- Use a loose model selection criteria to choose the lag length of the included differenced dependent variables (e.g., AIC).
- Including extraneous deterministic regressors lowers power, but failing to include relevant deterministic regressors produces a test with no power, even asymptotically, and so be conservative when excluding deterministic regressors.
- More powerful tests than the ADF are available. Specifically, DF-GLS of Elliott, Rothenberg, and Stock (1996) is increasingly available, and it has maximum power against certain alternatives.
- Trends tend to be obvious and so always plot both the data and the differenced data.
- Use a general-to-specific search to perform unit root testing. Start from a model which should be too large. If the unit root is rejected, one can be confident that there is no unit root since this is a low power test. If a unit root cannot be rejected, reduce the model by removing insignificant deterministic components first since these lower power without affecting the  $t$ -stat. If all regressors are significant, and the null still cannot be rejected, then conclude that the data contains a unit root.

#### 4.10.9 Example: Unit root testing

Two series will be examined for unit roots: the default spread and the log U.S. consumer price index. The  $\ln CPI$ , which measures consumer prices index less energy and food costs (also known as core inflation), has been taken from FRED, consists of quarterly data, and covers the period between August 1968 and August 2008. Figure 4.9 contains plots of both series and the first and second differences of  $\ln CPI$ .

$\ln CPI$  is trending, and the spread does not have an apparent time trend. However, deterministic trends should be over-specified, and so the initial model for  $\ln CPI$  will include both a constant and a time-trend, and the model for the spread will include a constant. The lag length used in the model was automatically selected using the BIC.

Results of the unit root tests are presented in table 4.4. Based on this output, the spreads reject a unit root at the 5% level, but the  $\ln CPI$  cannot. The next step is to difference the  $\ln CPI$  to produce

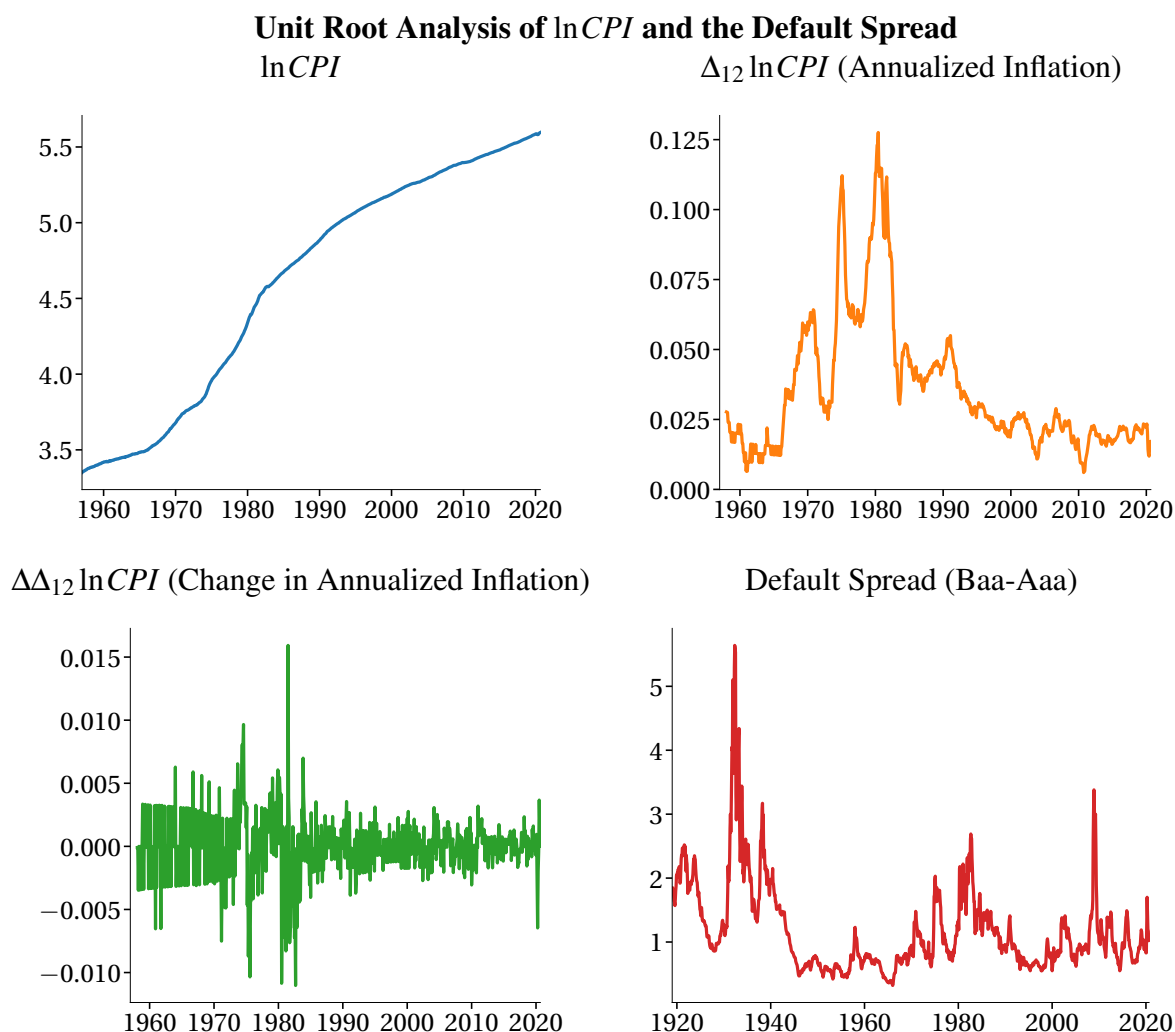


Figure 4.9: These four panels plot the log consumer price index ( $\ln CPI$ ),  $\Delta \ln CPI$ ,  $\Delta^2 \ln CPI$  and the default spread. Both  $\Delta^2 \ln CPI$  and the default spread reject the null of a unit root.

$\Delta \ln CPI$ . Rerunning the ADF test on the differenced CPI (inflation) and including either a constant or no deterministic trend, the null of a unit root still cannot be rejected. Further differencing the data,  $\Delta^2 \ln CPI_t = \delta \ln CPI_t - \ln CPI_{t-1}$ , strongly rejects, and so  $\ln CPI$  appears to be  $I(2)$ . The final row of the table indicates the number of lags used in the ADF. This value is selected using the BIC with a maximum of 12 lags for  $\ln CPI$  or 36 lags for the spread (3 years).

#### 4.10.10 Seasonal Differencing

When a time series has both a unit root and a seasonal pattern, it is common to use a seasonal difference rather than a first difference. In many cases, the model using seasonally differencing can be simpler than the model built using the first difference. Define the operator  $\Delta_s$  to be the seasonal difference defined as  $\Delta_s Y_t = Y_t - Y_{t-s} = (1 - L^s) Y_t$ . This difference is the year-over-year change, or if  $Y_t$  has been logged, the year-over-year growth rate.

	ln CPI			$\Delta_{12} \ln \text{CPI}$		$\Delta \text{Inf}$	Default	
<i>t</i> -stat	-0.981	-1.323	1.691	-2.811	-1.498	-4.935	-3.395	-1.751
p-value	0.947	0.618	0.978	0.057	0.126	0.000	0.011	0.076
Deterministic	Linear	Const	None	Const	None	None	Const	None
Num. Lags	9	9	9	20	20	19	21	21

Table 4.4: ADF results for tests that  $\ln \text{CPI}$  and the default spread have unit-roots. The null of a unit root cannot be rejected in  $\ln \text{CPI}$ , nor can the null that  $\Delta \ln \text{CPI}$  contains a unit root, and so CPI appears to be an  $I(2)$  process. The default spread rejects the null of a unit root, although it is highly persistent.

## 4.11 SARIMA Models

All of the key concepts presented for modeling time series, whether stationary or non-stationary, can be compactly expressed as a Seasonal Autoregressive Integrated Moving Averages (SARIMA) model. The SARIMA encompasses:

- $P$ : Autoregressive dynamics in observation time through  $\Phi(L) = 1 - \phi_1 L - \dots - \phi_P L^P$
- $Q$ : Moving average dynamics in observation time through  $\Theta(L) = (1 - \theta_1 L - \dots - \theta_Q L^Q)$
- $d$ : Differencing in observation time  $\Delta^d$
- $P_s$ : Autoregressive dynamics in observation time through  $\Phi(L) = 1 - \phi_{s,1} L^s - \dots - \phi_{s,P_s} L^{P_s}$
- $Q_s$ : Moving average dynamics in observation time through  $\Theta(L) = (1 - \theta_{s,1} L^s - \dots - \theta_{s,Q_s} L^{Q_s})$
- $d_s$ : Differencing in observation time  $\Delta_s^{d_s}$
- $s$ : The seasonal period
- Polynomial deterministic terms  $\delta(t) = \delta_0 + \delta_1 t + \dots + \delta_m t^m$
- Seasonal deterministic dummies<sup>15</sup>  $\gamma(t) = \sum_{i=1}^{s-1} \gamma_i I_{[t \bmod s = i]}$

These parameters, excluding the deterministic regressors, are commonly collected into a single expression:  $\text{SARIMA}(P, d, Q) \times (P_s, d_s, Q_s)$ . The full model is then

$$\Phi(L) \Phi_s(L) \Delta^d \Delta_s^{d_s} Y_t = \delta(t) + \gamma(t) + \Theta(L) \Theta_s(L) \varepsilon_t.$$

While this specification looks very complex, the both products  $\Phi(L) \Phi_s(L) \Delta^d \Delta_s^{d_s}$  and  $\Theta(L) \Theta_s(L)$  are lag polynomials so that the model is just a (parameterized and restricted) ARMA that may also contain trends and deterministic seasonal components. Forecasting SARIMA models is no different

<sup>15</sup>These can be alternatively replaced with a season Fourier series of order  $k$ ,  $\psi_k(t) = \sum_{i=1}^k \psi_{s,i} \sin(2k\pi\tau) + \psi_{c,i} \cos(2k\pi\tau)$  where  $\tau = t - s \lfloor (t-1)/s \rfloor$  cycles over the sequence  $1, 2, \dots, s$ . Including a Fourier series of order introduces  $2k$  parameters, and in many applications  $2k < s-1$  components are sufficient to model the deterministic seasonal variation.

SARIMA Order	$\phi_0$	$\phi_1$	$\phi_{12,1}$	$\theta_1$	AIC
$(1, 1, 1) \times (1, 0, 0, 12)$	0.00 (0.03)	0.19 (0.64)	0.64 (16.38)	0.00 (0.01)	-955.0
$(1, 0, 1) \times (1, 1, 0, 12)$	0.00 (0.06)	0.94 (72.95)	0.07 (1.85)	-0.39 (-12.19)	-1018.6

Table 4.5: Estimated parameters, t-stats and AIC for three models with seasonalities. The AIC prefers the seasonal difference.

from forecasting an ARMA model once the polynomials have been expanded. For example, the SARIMA(1,0,1)  $\times$  (1,1,0,4) with a time-trend can be equivalently written as

$$\begin{aligned}
 (1 - \phi_1 L) (1 - \phi_{4,1} L^4) \Delta_4 Y_t &= \delta_0 + \delta_1 t + (1 + \theta L) \varepsilon_t \\
 (1 - \phi_1 L) (1 - \phi_{4,1} L^4) (1 - L^4) Y_t &= \delta_0 + \delta_1 t + (1 + \theta L) \varepsilon_t \\
 (1 - \phi_1 L - \phi_{4,1} L^4 + \phi_1 \phi_{4,1} L^5) (1 - L^4) Y_t &= \delta_0 + \delta_1 t + (1 + \theta L) \varepsilon_t \\
 (1 - \phi_1 L - (1 + \phi_{4,1}) L^4 + (\phi_1 \phi_{4,1} + \phi_1) L^5 + \phi_{4,1} L^8 - \phi_1 \phi_{4,1} L^9) Y_t &= \delta_0 + \delta_1 t + (1 + \theta L) \varepsilon_t.
 \end{aligned}$$

When written as a standard ARMA without using the lag operator, we have

$$Y_t = \delta_0 + \delta_1 t + \phi_1 Y_{t-1} + (1 + \phi_{4,1}) Y_{t-4} - (\phi_1 \phi_{4,1} + \phi_1) Y_{t-5} - \phi_{4,1} Y_{t-8} + \phi_1 \phi_{4,1} Y_{t-9} + \theta \varepsilon_{t-1} + \varepsilon_t.$$

The model is a restricted ARMA(9,1) where many coefficients are either have cross-lag restrictions imposed or are restricted to be zero. Once the coefficient are known (or have been estimated), forecasts are computed using

$$\begin{aligned}
 E_t [Y_{t+h}] &= \hat{\delta}_0 + \hat{\delta}_1 (t+h) + \hat{\phi}_1 E_t [Y_{t+h-1}] + \hat{\phi}_4 E_t [Y_{t+h-4}] - \hat{\phi}_5 E_t [Y_{t+h-5}] \\
 &\quad - \hat{\phi}_8 E_t [Y_{t+h-8}] + \hat{\phi}_9 E_t [Y_{t+h-9}] + \hat{\theta} E_t [\varepsilon_{t+h-1}]
 \end{aligned}$$

where the estimated coefficient have been replaced for simplicity of exposition, so that, e.g.,  $\hat{\phi}_4 = 1 + \hat{\phi}_{4,1}$ .

Table 4.5 revisits the housing growth data using SARMA models. The two models are identical except that one uses the first difference, and the other uses the seasonal difference. These parameters very different and indicate very different dynamics. The AIC selects the model containing the seasonal difference.

## 4.12 Filters

Most time-series modeling's ultimate goal is to forecast a time-series in its entirety, which requires a model for both permanent and transitory components. In some situations, it may be desirable to focus on either the short-run dynamics or the long-run dynamics exclusively, for example, in technical analysis where prices are believed to be long-run unpredictable but may have some short- or medium-run predictability. Linear filters are a class of functions that can be used to “extract” a stationary cyclic

component from a time-series that contains both short-run dynamics and a permanent component. Generically, a filter for a time series  $\{Y_t\}$  is defined as

$$X_t = \sum_{i=-\infty}^{\infty} w_i Y_{t-i} \quad (4.93)$$

where  $X_t$  is the filtered time-series or filter output. In most applications, it is desirable to assign a label to  $X_t$ , either a trend, written  $\tau_t$ , or a cyclic component,  $C_t$ .

Filters are further categorized into *causal* and *non-causal*. Causal filters are restricted to depend on only the past and present of  $Y_t$ , and so as a class are defined through

$$X_t = \sum_{i=0}^{\infty} w_i Y_{t-i}. \quad (4.94)$$

Causal filters are more useful in isolating trends from cyclical behavior for forecasting purposes, while non-causal filters are more useful for historical analysis of macroeconomic and financial data.

### 4.12.1 Frequency, High- and Low-Pass Filters

This text has exclusively dealt with time series in the *time domain* – that is, understanding dynamics and building models based on the time distance between points. An alternative strategy for describing a time series is in terms of *frequencies* and the magnitude of the cycle at a given frequency. For example, suppose a time series has a cycle that repeats every four periods. This series could be equivalently described as having a cycle with a frequency of 1 in 4, or .25. A frequency description is relatively compact – it is only necessary to describe a process from frequencies of 0 to 0.5, the latter of which would be a cycle with a period of 2.<sup>16</sup>

The idea behind filtering is to choose a set of frequencies and then to isolate the cycles which occur within the selected frequency range. Filters that eliminate high-frequency cycles are known as *low-pass filters*, while filters that eliminate low-frequency cycles are known as *high-pass filters*. Moreover, high- and low-pass filters are related in such a way that if  $\{w_i\}$  is a set of weights corresponding to a high-pass filter,  $v_0 = 1 - w_0$ ,  $v_i = -w_i$   $i \neq 0$  is a set of weights corresponding to a low-pass filter. This relationship forms an identity since  $\{v_i + w_i\}$  must correspond to an *all-pass* filter since  $\sum_{i=-\infty}^{\infty} (v_i + w_i) Y_{t-i} = Y_t$  for any set of weights.

The goal of a filter is to select a particular frequency range and nothing else. The *gain function* describes the amount of attenuations which occurs at a given frequency.<sup>17</sup> A gain of 1 at a particular frequency means any signal at that frequency is passed through unmodified while a gain of 0 means that the signal at that frequency is eliminated from the filtered data. Figure 4.10 contains a graphical representation of the gain function for a set of *ideal filters*. The four panels show an all-pass (all

<sup>16</sup>The frequency  $\frac{1}{2}$  is known as the *Nyquist* frequency since it is not possible to measure any cyclic behavior at frequencies above  $\frac{1}{2}$  since these would have a cycle of 1 period and so would appear constant.

<sup>17</sup>The gain function for any filter of the form  $X_t = \sum_{i=-\infty}^{\infty} w_i Y_{t-i}$  can be computed as

$$G(f) = \left| \sum_{k=-\infty}^{\infty} w_j \exp(-ik2\pi f) \right|$$

where  $i = \sqrt{-1}$ .

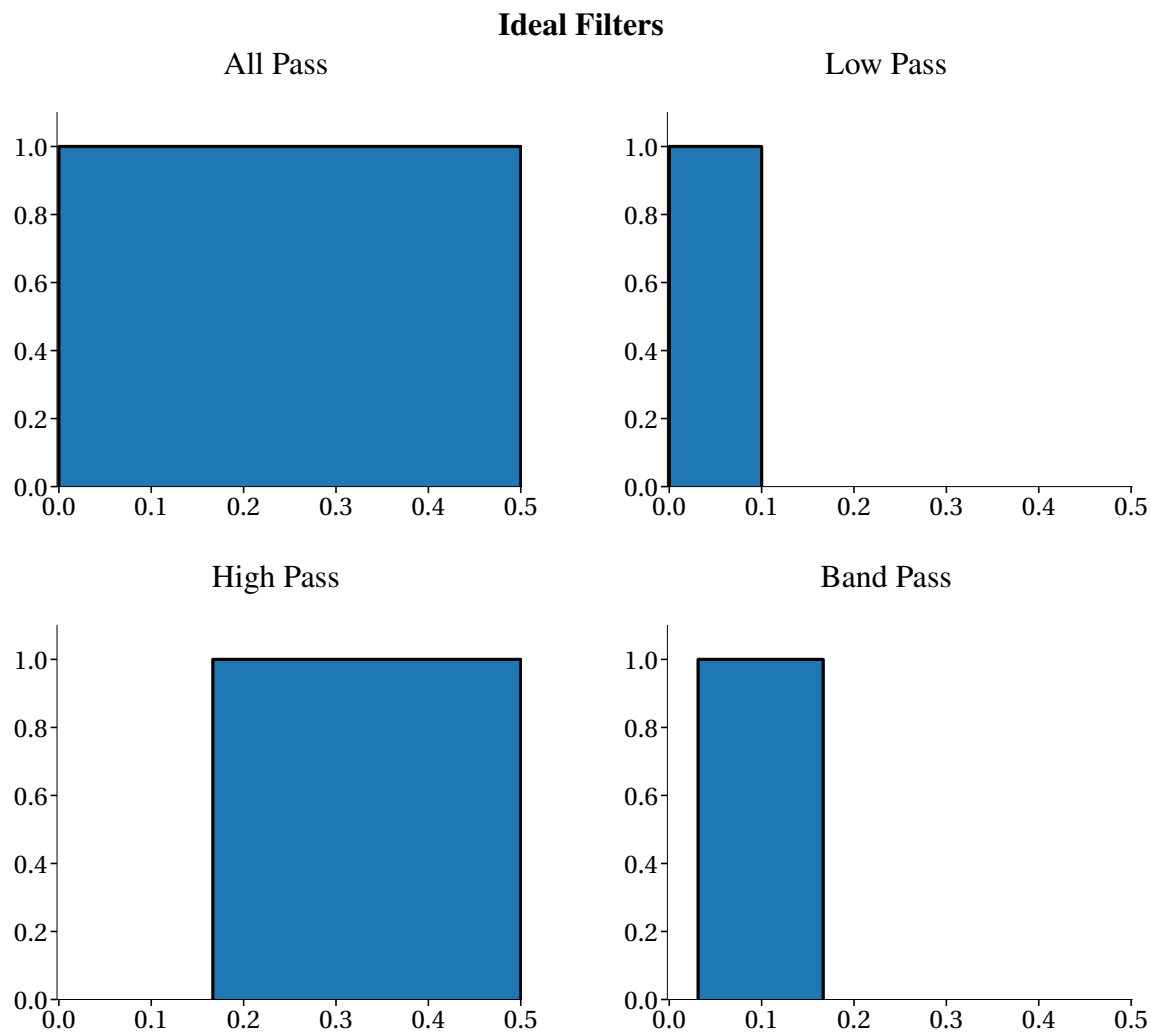


Figure 4.10: These four panels depict the gain functions from a set of *ideal filters*. The all-pass filter allows all frequencies through. The low-pass filter cuts off at  $\frac{1}{10}$ . The high-pass cuts off below  $\frac{1}{6}$  and the band-pass filter cuts off below  $\frac{1}{32}$  and above  $\frac{1}{6}$ .

frequencies unmodified), a low-pass filter with a cutoff frequency of  $\frac{1}{10}$ , a high-pass with a cutoff frequency of  $\frac{1}{6}$ , and a band-pass filter with cutoff frequencies of  $\frac{1}{6}$  and  $\frac{1}{32}$ .<sup>18</sup> In practice, only the all-pass filter (which corresponds to a filter with weights  $w_0 = 1$ ,  $w_i = 0$  for  $i \neq 0$ ) can be constructed using a finite sum, and so applied filtering must make trade-offs.

<sup>18</sup>Band-pass filters are simply the combination of two low-pass filters. Specifically, if  $\{w_i\}$  is set of weights from a low-pass filter with a cutoff frequency of  $f_1$  and  $\{v_i\}$  is a set of weights from a low-pass filter with a cutoff frequency of  $f_2$ ,  $f_2 > f_1$ , then  $\{v_i - w_i\}$  is a set of weights which corresponds to a band-pass filter with cutoffs at  $f_1$  and  $f_2$ .



### 4.12.2 Moving Average and Exponentially Weighted Moving Average (EWMA)

Moving averages are the simplest filters and are often used in technical analysis. Moving averages can be constructed as both causal and non-causal filters.

**Definition 4.42** (Causal Moving Average). A causal moving average (MA) is a function which takes the form

$$\tau_t = \frac{1}{n} \sum_{i=1}^n Y_{t-i+1}.$$

**Definition 4.43** (Centered (Non-Causal) Moving Average). A centered moving average (MA) is a function which takes the form

$$\tau_t = \frac{1}{2n+1} \sum_{i=-n}^n Y_{t-i+1}.$$

Note that the centered MA is an average over  $2n+1$  data points.

Moving averages are low-pass filters since their weights add up to 1. In other words, the moving average would contain the permanent component of  $\{Y_t\}$  and so would have the same order of integration. The cyclic component,  $C_t = Y_t - \tau_t$ , would have a lower order of integration than  $Y_t$ . Since moving averages are low-pass filters, the difference of two moving averages must be a band-pass filter. Figure 4.11 contains the gain function from the difference between a 20-day and 50-day moving average, which is commonly used in technical analysis.

Exponentially Weighted Moving Averages (EWMA) are a close cousin of the MA which places greater weight on recent data than on past data.

**Definition 4.44** (Exponentially Weighted Moving Average). An exponentially weighted moving average (EWMA) is a function which takes the form

$$\tau_t = (1 - \lambda) \sum_{i=0}^{\infty} \lambda^i Y_{t-i}$$

for some  $\lambda \in (0, 1)$ .

The name EWMA is derived from the exponential decay in the weights, and EWMA can be equivalently expressed (up to an initial condition) as

$$\tau_t = (1 - \lambda) \lambda Y_t + \lambda \tau_{t-1}.$$

Like MAs, EWMA is a low-pass filter since the sum of the weights is 1.

EWMA is commonly used in financial applications as volatility filters, where the dependent variable is chosen to be the squared return. The difference between two EWMA is often referred to as a Moving Average Convergence Divergence (MACD) filter in technical analysis. Two numbers index MACDs, a fast period and a slow period, where the number of data in the MACD can be converted to  $\lambda$  as  $\lambda = (n-1)/(n+1)$ , and so a MACD(12,26) is the difference between two EWMA with parameters .842 and .926. 4.11 contains the gain function from a MACD(12,26) (the difference between two EWMA), which is similar to, albeit smoother than, the gain function from the difference of a 20-day and a 50-day MAs.

### 4.12.3 Hodrick-Prescott Filter

The Hodrick and Prescott (1997) (HP) filter is constructed by balancing the fitting the trend to the data and the trend's smoothness. The HP filter is defined as the solution to

$$\min_{\tau_t} \sum_{t=1}^T (Y_t - \tau_t)^2 + \lambda \sum_{t=2}^{T-1} ((\tau_{t-1} - \tau_t) - (\tau_t + \tau_{t-1}))$$

where  $(\tau_{t-1} - \tau_t) - (\tau_t + \tau_{t-1})$  can be equivalently expressed as the second-difference of  $\tau_t$ ,  $\Delta^2 \tau_t$ .  $\lambda$  is a smoothness parameter: if  $\lambda = 0$  then the solution to the problem is  $\tau_t = Y_t \forall t$ , and as  $\lambda \rightarrow \infty$ , the "cost" of variation in  $\{\tau_t\}$  becomes arbitrarily high and  $\tau_t = \beta_0 + \beta_1 t$  where  $\beta_0$  and  $\beta_1$  are the least squares fit of a linear trend model to the data.

It is simple to show that the solution to this problem must have

$$\mathbf{y} = \Gamma \boldsymbol{\tau}$$

where  $\Gamma$  is a band-diagonal matrix (all omitted elements are 0) of the form

$$\Gamma = \begin{bmatrix} 1+\lambda & -2\lambda & \lambda & & & & & & & \\ -2\lambda & 1+5\lambda & -4\lambda & \lambda & & & & & & \\ \lambda & -4\lambda & 1+6\lambda & -4\lambda & \lambda & & & & & \\ & \lambda & -4\lambda & 1+6\lambda & -4\lambda & \lambda & & & & \\ & & \ddots & \ddots & \ddots & \ddots & \ddots & & & \\ & & & \lambda & -4\lambda & 1+6\lambda & -4\lambda & \lambda & & \\ & & & & \lambda & -4\lambda & 1+6\lambda & -4\lambda & \lambda & \\ & & & & & \lambda & -4\lambda & 1+5\lambda & -2\lambda & \\ & & & & & & \lambda & -2\lambda & 1+\lambda & \end{bmatrix}$$

and The solution to this set of  $T$  equations in  $T$  unknowns is

$$\boldsymbol{\tau} = \Gamma^{-1} \mathbf{y}.$$

The cyclic component is defined as  $C_t = Y_t - \tau_t$ .

Hodrick and Prescott (1997) recommend values of 100 for annual data, 1600 for quarterly data, and 14400 for monthly data. The HP filter is non-causal and so is not appropriate for prediction. The gain function of the cyclic component of the HP filter with  $\lambda = 1600$  is illustrated in figure 4.11. While the filter attempts to eliminate components with a frequency below ten years of quarterly data ( $\frac{1}{40}$ ), there is some gain until about  $\frac{1}{50}$  and the gain is not unity until approximately  $\frac{1}{25}$ .

### 4.12.4 Baxter-King Filter

Baxter and King (1999) consider the problem of designing a filter to be close to the ideal filter subject to using a finite number of points.<sup>19</sup> They further argue that extracting the cyclic component requires the use of both a high-pass and a low-pass filter – the high-pass filter is to cutoff the most persistent components while the low-pass filter is used to eliminate high-frequency noise. The BK filter is

<sup>19</sup>Ideal filters, except for the trivial all-pass, require an infinite number of points to implement, and so are infeasible.

defined by a triple, two-period lengths (inverse frequencies) and the number of points used to construct the filter ( $k$ ), and is written as  $BK_k(p, q)$  where  $p < q$  are the period lengths.

Baxter and King suggest using a band-pass filter with cutoffs at  $\frac{1}{32}$  and  $\frac{1}{6}$  for quarterly data. The final choice for their approximate ideal filter is the number of nodes, for which they suggest 12. The number of points has two effects. First, the BK filter cannot be used in the first and last  $k$  points. Second, a higher number of nodes will produce a more accurate approximation to the ideal filter.

Implementing the BK filter is simple. Baxter and King show that the optimal weights for a low-pass filter at a particular frequency  $f$  satisfy

$$\tilde{w}_0 = 2f \quad (4.95)$$

$$\tilde{w}_i = \frac{\sin(2i\pi f)}{i\pi}, \quad i = 1, 2, \dots, k \quad (4.96)$$

$$\theta = [2k + 1]^{-1} \left( 1 - \sum_{i=-k}^k \tilde{w}_i \right) \quad (4.97)$$

$$w_i = \tilde{w}_i + \theta, \quad i = 0, 1, \dots, k \quad (4.98)$$

$$w_i = w_{-i}. \quad (4.99)$$

The BK filter is constructed as the difference between two low-pass filters, and so

$$\tau_t = \sum_{i=-k}^k w_i Y_{t-i} \quad (4.100)$$

$$C_t = \sum_{i=-k}^k (v_i - w_i) Y_{t-i} \quad (4.101)$$

where  $\{w_i\}$  and  $\{v_i\}$  are both weights from low-pass filters where the period used to construct  $\{w_i\}$  is longer than the period used to construct  $\{v_i\}$ . The gain function of the  $BK_{12}(6, 32)$  is illustrated in the upper right panel of figure 4.11. The approximation is reasonable, with near unit gain between  $\frac{1}{32}$  and  $\frac{1}{6}$  and little gain outside.

### 4.12.5 First Difference

Another very simple filter to separate a “trend” from a “cyclic” component is the first difference. Note that if  $Y_t$  is an  $I(1)$  series, then the first difference which contains the “cyclic” component,  $C_t = \frac{1}{2}\Delta Y_t$ , is an  $I(0)$  series and so the first difference is a causal filter. The “trend” is measured using an  $MA(2)$ ,  $\tau_t = \frac{1}{2}(Y_t + Y_{t-1})$  so that  $Y_t = C_t + \tau_t$ . The FD filter is not sharp – it allows for most frequencies to enter the cyclic component – and so is not recommended in practice.

### 4.12.6 Beveridge-Nelson Decomposition

The Beveridge and Nelson (1981) decomposition extends the first-order difference decomposition to include any predictable component in the future trend as part of the current trend. The idea behind the

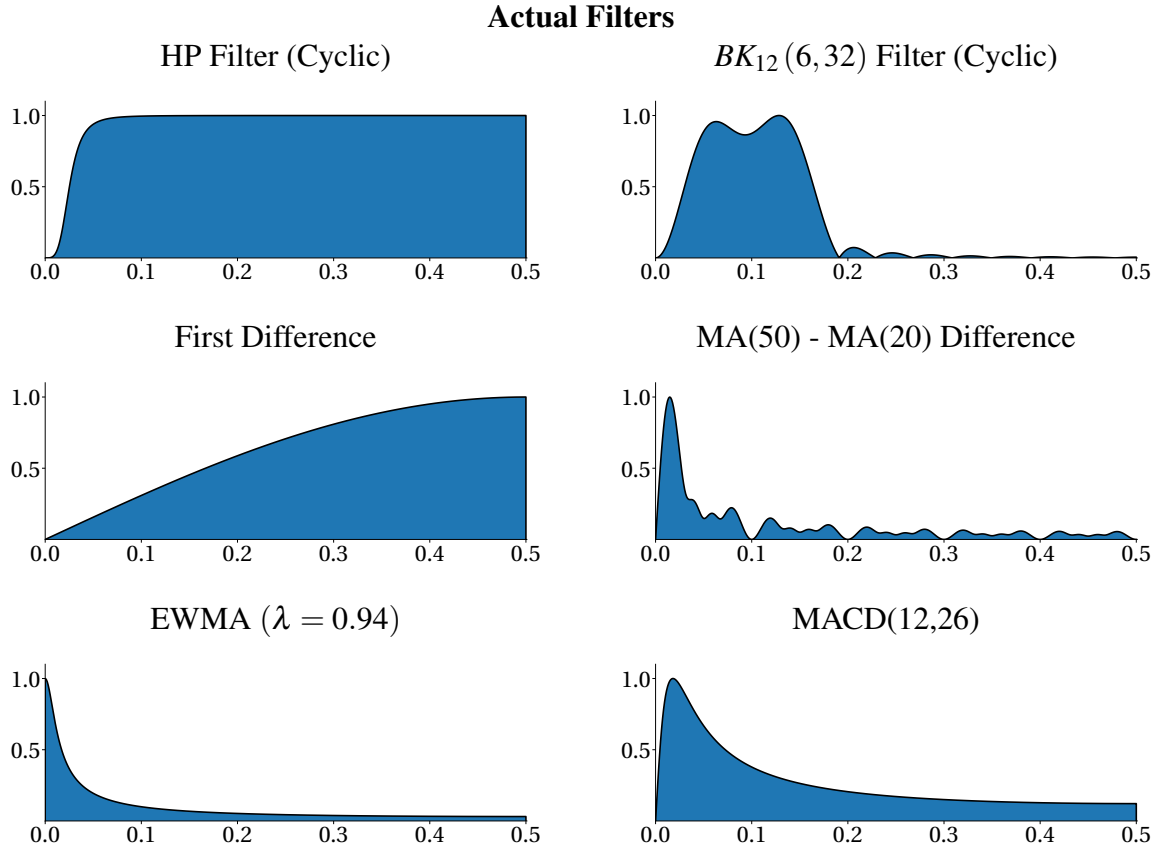


Figure 4.11: These six panels contain the standard HP filter, the  $BK_{12}(6,32)$  filter, the first difference filter, an EWMA with  $\lambda = .94$ , a MACD(12,26) and the difference between a 20-day and a 50-day moving average. The gain functions in the right hand column have been normalized so that the maximum weight is 1. This is equivalent to scaling all of the filter weights by a constant, and so is simply a change in variance of the filter output.

BN decomposition is simple: if the predictable part of the long-run component places the long-run component above its current value, then the cyclic component should be negative. Similarly, if the predictable part of the long-run component expects that the long-run component should trend lower, then the cyclic component should be positive. Formally the BN decomposition is defined as

$$\tau_t = \lim_{h \rightarrow \infty} \hat{Y}_{t+h|t} - h\mu \quad (4.102)$$

$$C_t = Y_t - \tau_t$$

where  $\mu$  is the drift in the trend, if any. The trend can be equivalently expressed as the current level of  $Y_t$  plus the expected increments minus the drift,

$$\tau_t = Y_t + \lim_{h \rightarrow \infty} \sum_{i=1}^h E[\Delta \hat{Y}_{t+i|t} - \mu] \quad (4.103)$$

where  $\mu$  is the unconditional expectation of the increments to  $Y_t$ ,  $E[\Delta\hat{Y}_{t+j|t}]$ . The trend component contains the persistent component, and so the filter applied must be a low-pass filter, while the cyclic component is stationary and so must be the output of a high-pass filter. The gain of the filter applied when using the BN decomposition depends crucially on the forecasting model for the short-run component.

Suppose  $\{Y_t\}$  is an I(1) series which has both a permanent and transitive component. Since  $\{Y_t\}$  is I(1),  $\Delta Y_t$  must be I(0) and so can be described by a stationary ARMA(P,Q) process. For simplicity, suppose that  $\Delta Y_t$  follows an MA(3) so that

$$\Delta Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \theta_3 \varepsilon_{t-3} + \varepsilon_t$$

In this model,  $\mu = \phi_0$ , and the  $h$ -step ahead forecast is given by

$$\begin{aligned}\Delta\hat{Y}_{t+1|t} &= \mu + \theta_1 \varepsilon_t + \theta_2 \varepsilon_{t-1} + \theta_3 \varepsilon_{t-2} \\ \Delta\hat{Y}_{t+2|t} &= \mu + \theta_2 \varepsilon_t + \theta_3 \varepsilon_{t-1} \\ \Delta\hat{Y}_{t+3|t} &= \mu + \theta_3 \varepsilon_t \\ \Delta\hat{Y}_{t+h|t} &= \mu \quad h \geq 4,\end{aligned}$$

and so

$$\tau_t = Y_t + (\theta_1 + \theta_2 + \theta_3) \varepsilon_t + (\theta_2 + \theta_3) \varepsilon_{t-1} + \theta_3 \varepsilon_{t-2}$$

and

$$C_t = -(\theta_1 + \theta_2 + \theta_3) \varepsilon_t - (\theta_2 + \theta_3) \varepsilon_{t-1} - \theta_3 \varepsilon_{t-2}.$$

Alternatively, suppose that  $\Delta Y_t$  follows an AR(1) so that

$$\Delta Y_t = \phi_0 + \phi_1 \Delta Y_{t-1} + \varepsilon_t.$$

This model can be equivalently defined in terms of deviations around the long-run mean,  $\Delta\tilde{y}_t = \Delta Y_t - \phi_0/(1 - \phi_1)$ , as

$$\begin{aligned}\Delta Y_t &= \phi_0 + \phi_1 \Delta Y_{t-1} + \varepsilon_t \\ \Delta Y_t &= \phi_0 \frac{1 - \phi_1}{1 - \phi_1} + \phi_1 \Delta Y_{t-1} + \varepsilon_t \\ \Delta Y_t &= \frac{\phi_0}{1 - \phi_1} - \phi_1 \frac{\phi_0}{1 - \phi_1} + \phi_1 \Delta Y_{t-1} + \varepsilon_t \\ \Delta Y_t - \frac{\phi_0}{1 - \phi_1} &= \phi_1 \left( \Delta Y_{t-1} - \frac{\phi_0}{1 - \phi_1} \right) + \varepsilon_t \\ \Delta\tilde{y}_t &= \phi_1 \Delta\tilde{y}_{t-1} + \varepsilon_t.\end{aligned}$$

In this transformed model,  $\mu = 0$  which simplifies finding the expression for the trend. The  $h$ -step ahead forecast if  $\Delta\tilde{y}_t$  is given by

$$\Delta\hat{\tilde{y}}_{t+h|t} = \phi_1^h \Delta\tilde{y}_t$$

and so

$$\begin{aligned}
 \tau_t &= Y_t + \lim_{h \rightarrow \infty} \sum_{i=1}^h \Delta \hat{y}_{t+i|t} \\
 &= Y_t + \lim_{h \rightarrow \infty} \sum_{i=1}^h \phi_1^i \Delta \tilde{y}_t \\
 &= Y_t + \lim_{h \rightarrow \infty} \Delta \tilde{y}_t \sum_{i=1}^h \phi_1^i \\
 &= Y_t + \lim_{h \rightarrow \infty} \Delta \tilde{y}_t \frac{\phi_1}{1 - \phi_1}
 \end{aligned}$$

which follows since  $\lim_{h \rightarrow \infty} \sum_{i=1}^h \phi_1^i = -1 + \lim_{h \rightarrow \infty} \sum_{i=0}^h \phi_1^i = 1/(1 - \phi_1) - 1$ . The main criticism of the Beveridge-Nelson decomposition is that the trend and the cyclic component are perfectly (negatively) correlation.

#### 4.12.7 Extracting the cyclic components from Real US GDP

The cyclic component was extracted from log real US GDP data taken from the Federal Reserve Economics Database using alternative filters. Data were available from 1947 Q1 to Q2 2020. Figure 4.12 contains the cyclical component extracted using four methods. The top panel contains the standard HP filter with  $\lambda = 1600$ . The middle panel contains  $BK_{12}(6, 32)$  (solid) and  $BK_{12}(1, 32)$  (dashed) filters, the latter of which is a high pass-filter since the faster frequency is 1. Note that the first and last 12 points of the cyclic component are set to 0. The bottom panel contains the cyclic component extracted using a Beveridge-Nelson decomposition based on an AR(1) estimated on GDP growth data. For the BN decomposition, the first 2 points are zero, reflecting the loss of data due to the first difference and fitting the AR(1) to the first difference.<sup>20</sup>

The HP filter and the  $BK_{12}(1, 32)$  are remarkably similar with a correlation of over 99%. The correlation between the  $BK_{12}(6, 32)$  and the HP filter is 96%. The key difference between the two is in the lack of a high-frequency component in the HP filter. The cyclic component from the BN decomposition has a small negative correlation with the other three filters, although choosing a different model for GDP growth would change the decomposition.

### 4.13 Nonlinear Models for Time-Series Analysis

While this chapter has exclusively focused on linear time-series processes, many non-linear time-series processes have been found to provide parsimonious descriptions of the dynamics in financial data. Two which have proven particularly useful in the analysis of financial data are Markov Switching Autoregressions (MSAR) and Threshold Autoregressions (TAR), especially the subclass of Self-Exciting Threshold Autoregressions (SETAR).<sup>21</sup>

<sup>20</sup>The AR(1) was chosen from a model selection search of AR models with an order up to 8 using the SBIC.

<sup>21</sup>There are many nonlinear models frequently used in financial econometrics for modeling quantities *other* than the conditional mean. For example, both the ARCH (conditional volatility) and CaViaR (conditional Value-at-Risk) models

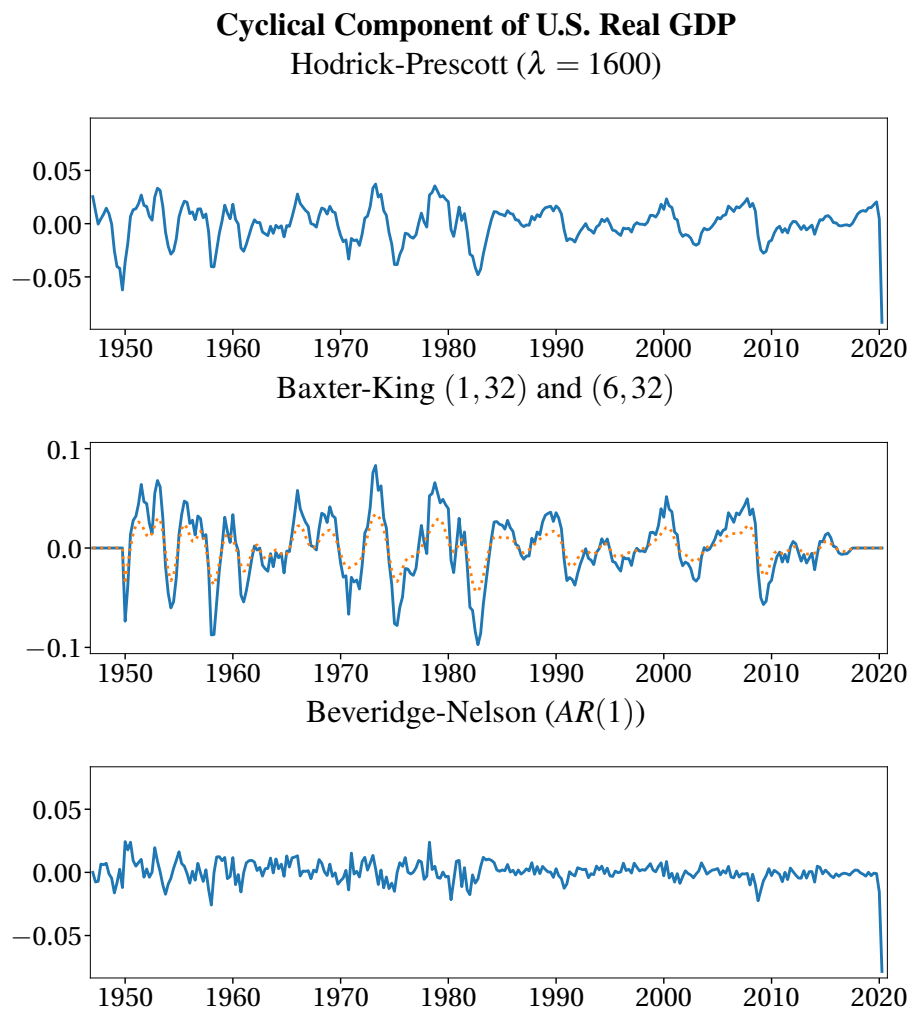


Figure 4.12: The top panel contains the filtered cyclic component from a HP filter with  $\lambda = 1600$ . The middle panel contains the cyclic component from  $BK_{12}(6, 32)$  (solid) and  $BK_{12}(1, 32)$  (dashed) filters. The bottom panel contains the cyclic component from a Beveridge-Nelson decomposition based on an AR(1) model for GDP growth rates.

### 4.13.1 Markov Switching Autoregression

Markov switching autoregression, introduced into econometrics in Hamilton (1989), uses a composite model which evolves according to both an autoregression and a latent state which determines the value of the autoregressive parameters. In financial applications using low-frequency asset returns, an MSAR that allows the mean and the variance to be state-dependent has been found to outperform linear models (Perez-Quiros and Timmermann, 2000).

**Definition 4.45** (Markov Switching Autoregression). A  $k$ -state Markov switching autoregression (MSAR) is a stochastic process which has dynamics that evolve through both a Markovian state process and an autoregression where the autoregressive parameters are state dependent. The states,

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are nonlinear in the original data.

labeled  $1, 2, \dots, k$ , are denoted  $s_t$  and follow a  $k$ -state latent Markov Chain with transition matrix  $\mathbf{P}$ ,

$$\mathbf{P} = \begin{bmatrix} p_{11} & p_{12} & \dots & p_{1k} \\ p_{21} & p_{22} & \dots & p_{2k} \\ \vdots & \vdots & \ddots & \vdots \\ p_{k1} & p_{k2} & \dots & p_{kk} \end{bmatrix} \quad (4.104)$$

where  $p_{ij} = \Pr(s_{t+1} = i | s_t = j)$ . Note that the columns must sum to 1 since  $\sum_{i=1}^k \Pr(s_{t+1} = i | s_t = j) = 1$ . Data are generated according to a  $P^{\text{th}}$  order autoregression,

$$Y_t = \phi_0^{(s_t)} + \phi_1^{(s_t)} Y_{t-1} + \dots + \phi_P^{(s_t)} Y_{t-P} + \sigma^{(s_t)} \varepsilon_t \quad (4.105)$$

where  $\phi^{(s_t)} = [\phi_0^{(s_t)} \phi_1^{(s_t)} \dots \phi_P^{(s_t)}]'$  are state-dependent autoregressive parameters,  $\sigma^{(s_t)}$  is the state-dependent standard deviation and  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, 1)$ .<sup>22</sup> The unconditional state probabilities ( $\Pr(s_t = i)$ ), known as the ergodic probabilities, are denoted  $\pi = [\pi_1 \pi_2 \dots \pi_k]'$  and are the solution to

$$\pi = \mathbf{P}\pi. \quad (4.106)$$

The ergodic probabilities can also be computed as the normalized eigenvector of  $\mathbf{P}$  corresponding to the only unit eigenvalue.

Rather than attempting to derive properties of an MSAR, consider a simple specification with two states, no autoregressive terms, and where only the mean of the process varies<sup>23</sup>

$$Y_t = \begin{cases} \phi^H + \varepsilon_t \\ \phi^L + \varepsilon_t \end{cases} \quad (4.107)$$

where the two states are indexed by  $H$  (high) and  $L$  (low). The transition matrix is

$$\mathbf{P} = \begin{bmatrix} p_{HH} & p_{HL} \\ p_{LH} & p_{LL} \end{bmatrix} = \begin{bmatrix} p_{HH} & 1 - p_{LL} \\ 1 - p_{HH} & p_{LL} \end{bmatrix} \quad (4.108)$$

and the unconditional probabilities of being in the high and low state,  $\pi_H$  and  $\pi_L$ , respectively, are

$$\pi_H = \frac{1 - p_{LL}}{2 - p_{HH} - p_{LL}} \quad (4.109)$$

$$\pi_L = \frac{1 - p_{HH}}{2 - p_{HH} - p_{LL}}. \quad (4.110)$$

This simple model is useful for understanding the data generation in a Markov Switching process:

1. At  $t = 0$  an initial state,  $s_0$ , is chosen according to the ergodic (unconditional) probabilities. With probability  $\pi_H$ ,  $s_0 = H$  and with probability  $\pi_L = 1 - \pi_H$ ,  $s_0 = L$ .

<sup>22</sup>The assumption that  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, 1)$  can be easily relaxed to include other i.i.d. processes for the innovations.

<sup>23</sup>See Hamilton (1994, chapter 22) or Krolzig (1997) for further information on implementing MSAR models.



2. The state probabilities evolve independently from the observed data according to a Markov Chain. If  $s_0 = H$ ,  $s_1 = H$  with probability  $p_{HH}$ , the probability  $s_{t+1} = H$  given  $s_t = H$  and  $s_1 = L$  with probability  $p_{LH} = 1 - p_{HH}$ . If  $s_0 = L$ ,  $s_1 = H$  with probability  $p_{HL} = 1 - p_{LL}$  and  $s_1 = L$  with probability  $p_{LL}$ .
3. Once the state at  $t = 1$  is known, the value of  $Y_1$  is chosen according to

$$Y_1 = \begin{cases} \phi^H + \varepsilon_1 & \text{if } s_1 = H \\ \phi^L + \varepsilon_t & \text{if } s_1 = L \end{cases}.$$

4. Steps 2 and 3 are repeated for  $t = 2, 3, \dots, T$ , to produce a time series of Markov Switching data.

#### 4.13.1.1 Markov Switching Examples

Using the 2-state Markov Switching Autoregression described above, four systems were simulated for 100 observations.

- Pure mixture
  - $\mu_H = 4, \mu_L = -2, V[\varepsilon_t] = 1$  in both states
  - $p_{HH} = .5 = p_{LL}$
  - $\pi_H = \pi_L = .5$
  - Remark: This is a “pure” mixture model where the probability of each state does not depend on the past. This occurs because the probability of going from high to high is the same as the probability of going from low to high, 0.5.
- Two persistent States
  - $\mu_H = 4, \mu_L = -2, V[\varepsilon_t] = 1$  in both states
  - $p_{HH} = .9 = p_{LL}$  so the average duration of each state is 10 periods.
  - $\pi_H = \pi_L = .5$
  - Remark: Unlike the first parameterization this is not a simple mixture. Conditional on the current state being  $H$ , there is a 90% chance that the next state will remain  $H$ .
- One persistent state, on transitory state
  - $\mu_H = 4, \mu_L = -2, V[\varepsilon_t] = 1$  if  $s_t = H$  and  $V[\varepsilon_t] = 2$  if  $s_t = L$
  - $p_{HH} = .9, p_{LL} = .5$
  - $\pi_H = .83, \pi_L = .16$
  - Remark: This type of model is consistent with quarterly data on U.S. GDP where booms ( $H$ ) typically last 10 quarters while recessions die quickly, typically in 2 quarters.
- Mixture with different variances
  - $\mu_H = 4, \mu_L = -2, V[\varepsilon_t] = 1$  if  $s_t = H$  and  $V[\varepsilon_t] = 16$  if  $s_t = L$

- $p_{HH} = .5 = p_{LL}$
- $\pi_H = \pi_L = .5$
- Remark: This is another “pure” mixture model, but the variances differ between the states. One nice feature of mixture models (MSAR is a member of the family of mixture models) is that the unconditional distribution of the data may be non-normal even though the shocks are conditionally normally distributed.<sup>24</sup>

Figure 4.13 contains plots of 100 data points generated from each of these processes. The first (MSAR(1)) produces a mixture with modes at -2 and 4 each with equal probability, and the states (top panel, bottom right) are i.i.d.. The second process produced a similar unconditional distribution, but the state evolution is very different. Each state is very persistent and, conditional on the current state being high or low, the next state is likely to remain the same. The third process had one very persistent state and one with much less persistence. These dynamics produced a large skew in the unconditional distribution since the state where  $\mu = -2$  was visited less frequently than the state with  $\mu = 4$ . The final process (MSAR(4)) has state dynamics similar to the first but produces a very different unconditional distribution. The difference occurs since the variance depends on the state of the Markov process.

### 4.13.2 Threshold Autoregression and Self-Exciting Threshold Autoregression

A second class of nonlinear models that have gained considerable traction in financial applications are Threshold Autoregressions (TAR), and in particular, the subfamily of Self-Exciting Threshold Autoregressions (SETAR).<sup>25</sup>

**Definition 4.46** (Threshold Autoregression). A threshold autoregression is a  $P^{\text{th}}$  Order autoregressive process with state-dependent parameters where the state is determined by the lagged level of an exogenous variable  $X_{t-k}$  for some  $k \geq 1$ .

$$Y_t = \phi_0^{(s_t)} + \phi_1^{(s_t)} Y_{t-1} + \dots + \phi_P^{(s_t)} Y_{t-P} + \sigma^{(s_t)} \varepsilon_t \quad (4.111)$$

Let  $-\infty = X_0 < X_1 < X_2 < \dots < X_N < X_{N+1} = \infty$  be a partition of  $x$  in to  $N + 1$  distinct bins.  $s_t = j$  if  $X_{t-k} \in (x_j, x_{j+1})$ .

Self-exciting threshold autoregressions, introduced in Tong (1978), are similarly defined. The only change is in the definition of the threshold variable; rather than relying on an exogenous variable to determine the state, the state in SETARs is determined by lagged values of the dependent variable.

**Definition 4.47** (Self Exciting Threshold Autoregression). A self exciting threshold autoregression is a  $P^{\text{th}}$  Order autoregressive process with state-dependent parameters where the state is determined by the lagged level of the dependent variable,  $Y_{t-k}$  for some  $k \geq 1$ .

$$Y_t = \phi_0^{(s_t)} + \phi_1^{(s_t)} Y_{t-1} + \dots + \phi_P^{(s_t)} Y_{t-P} + \sigma^{(s_t)} \varepsilon_t \quad (4.112)$$

<sup>24</sup>Mixtures of finitely many normals, each with different means and variances, can be used approximate many non-normal distributions.

<sup>25</sup>See Fan and Yao (2005) for a comprehensive treatment of non-linear time-series models.

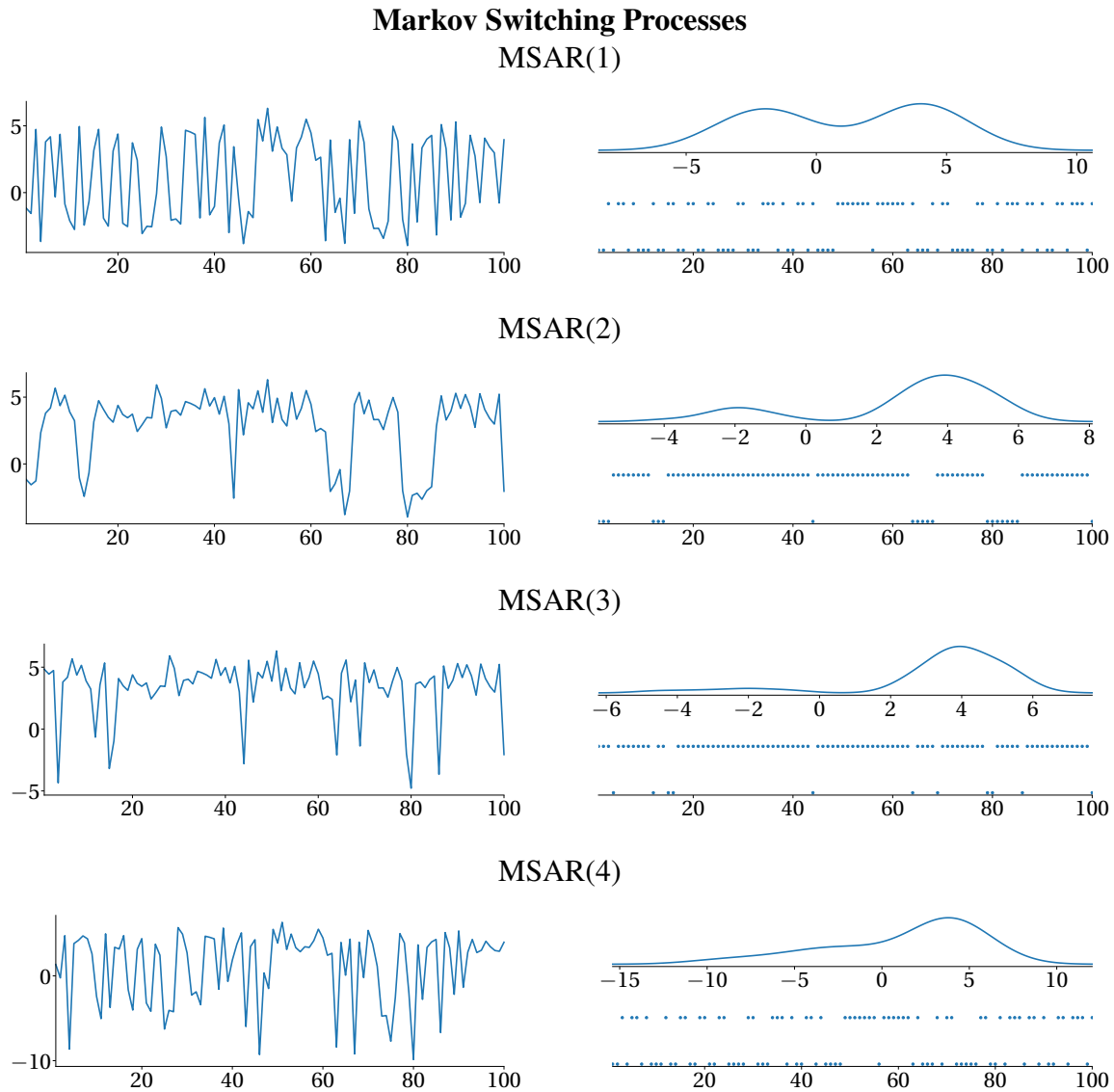


Figure 4.13: The four panels of this figure contain simulated data generated by the 4 Markov switching processes described in the text. In each panel, the large subpanel contains the generated data, the top right subpanel contains a kernel density estimate of the unconditional density and the bottom right subpanel contains the time series of the state values (high points correspond to the high state).

Let  $-\infty = Y_0 < Y_1 < Y_2 < \dots < Y_N < Y_{N+1} = \infty$  be a partition of  $y$  into  $N + 1$  distinct bins.  $s_t = j$  is  $Y_{t-k} \in (Y_j, Y_{j+1})$ .

The primary application of SETAR models in finance has been to exchange rates which often exhibit a behavior that is difficult to model with standard ARMA models: many FX rates exhibit random-walk-like behavior in a range yet remain within the band longer than would be consistent with a simple random walk. A symmetric SETAR is a parsimonious model that can describe this behavior and is parameterized

$$\begin{aligned}
Y_t &= Y_{t-1} + \varepsilon_t \text{ if } C - \delta < Y_t < C + \delta \\
Y_t &= C(1 - \phi) + \phi Y_{t-1} + \varepsilon_t \text{ if } Y_t < C - \delta \text{ or } Y_t > C + \delta
\end{aligned} \tag{4.113}$$

where  $C$  is the “target” exchange rate. The first equation is a standard random walk, and when  $Y_t$  is within the target band, it behaves like a random walk. The second equation is only relevant when  $Y_t$  is outside of its target band and ensures that  $Y_t$  is mean-reverting towards  $C$  as long as  $|\phi| < 1$ .<sup>26</sup>  $\phi$  is usually assumed to lie between 0 and 1 which produces a smooth mean reversion back towards the band.

To illustrate this process’s behavior and highlight the differences between it and a random walk, 200 data points were generated with different values of  $\phi$  using standard normal innovations. The mean was set to 100 and the used  $\delta = 5$ , and so  $Y_t$  follows a random walk when between 95 and 105. The lag value of the threshold variable ( $k$ ) was set to one. Four values for  $\phi$  were used: 0, 0.5, 0.9 and 1. The extreme cases represent a process which is immediately mean-reverting ( $\phi = 0$ ), in which case as soon as  $Y_t$  leaves the target band it is immediately returned to  $C$ , and a process that is a pure random walk ( $\phi = 1$ ) since  $Y_t = Y_{t-1} + \varepsilon_t$  for any value of  $Y_{t-1}$ . The two interior cases represent smooth reversion back to the band; when  $\phi = .5$ , the reversion is quick, and when  $\phi = .9$ , the reversion is slow. When  $\phi$  is close to 1, it is challenging to differentiate a band SETAR from a pure random walk, which is one of the explanations for the poor performance of unit root tests where tests often fail to reject a unit root despite clear economic theory predicting that a time series should be mean reverting.

## 4.A Computing Autocovariance and Autocorrelations

This appendix covers the derivation of the ACF for the MA(1), MA(Q), AR(1), AR(2), AR(3), and ARMA(1,1). Throughout this appendix,  $\{\varepsilon_t\}$  is assumed to be a white noise process, and the processes parameters are always assumed to be consistent with covariance stationarity. All models are assumed to be mean 0, an assumption made without loss of generality since autocovariances are defined using demeaned time series,

$$\gamma_s = E[(Y_t - \mu)(Y_{t-s} - \mu)]$$

where  $\mu = E[Y_t]$ . Recall that the autocorrelation is simply the of the  $s^{\text{th}}$  autocovariance to the variance,

$$\rho_s = \frac{\gamma_s}{\gamma_0}.$$

This appendix presents two methods for deriving the autocorrelations of ARMA processes: backward substitution and the Yule-Walker equations, a set of  $k$  equations with  $k$  unknowns where  $\gamma_0, \gamma_1, \dots, \gamma_{k-1}$  are the solution.

### 4.A.1 Yule-Walker

The Yule-Walker equations are a linear system of  $\max(P, Q) + 1$  equations (in an ARMA(P, Q)) where the solution to the system is the long-run variance and the first  $k - 1$  autocovariances. The Yule-Walker

<sup>26</sup>Recall the mean of an AR(1)  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$  is  $\phi_0 / (1 - \phi_1)$  where  $\phi_0 = C(1 - \phi)$  and  $\phi_1 = \phi$  in this SETAR.

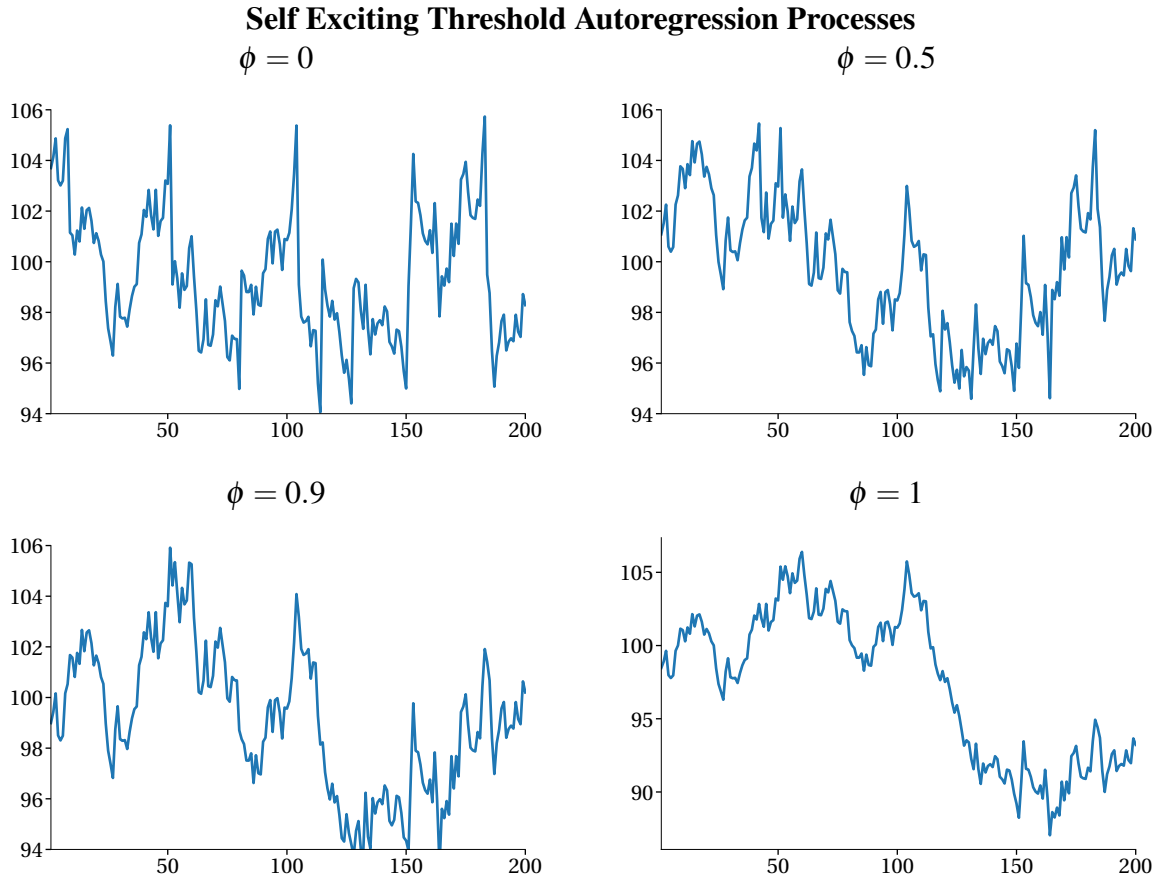


Figure 4.14: The four panels of this figure contain simulated data generated by a SETAR with different values of  $\phi$ . When  $\phi = 0$  the process is immediately returned to its unconditional mean  $C = 100$ . Larger values of  $\phi$  increase the amount of time spent outside of the “target band” (95–105) and when  $\phi = 1$ , the process is a pure random walk.

equations are formed by equating the definition of an autocovariance with an expansion produced by substituting for the contemporaneous value of  $Y_t$ . For example, suppose  $Y_t$  follows an AR(2) process,

$$Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$$

The variance must satisfy

$$\begin{aligned} E[Y_t Y_t] &= E[Y_t (\phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t)] \\ E[Y_t^2] &= E[\phi_1 Y_t Y_{t-1} + \phi_2 Y_t Y_{t-2} + Y_t \varepsilon_t] \\ V[Y_t] &= \phi_1 E[Y_t Y_{t-1}] + \phi_2 E[Y_t Y_{t-2}] + E[Y_t \varepsilon_t]. \end{aligned} \tag{4.114}$$

In the final equation above, terms of the form  $E[Y_t Y_{t-s}]$  are replaced by their population values,  $\gamma_s$  and  $E[Y_t \varepsilon_t]$  is replaced with its population value,  $\sigma^2$ .

$$V[Y_t] = \phi_1 E[Y_t Y_{t-1}] + \phi_2 E[Y_t Y_{t-2}] + E[Y_t \varepsilon_t] \tag{4.115}$$

becomes

$$\gamma_0 = \phi_1 \gamma_1 + \phi_2 \gamma_2 + \sigma^2 \quad (4.116)$$

and so the long run variance is a function of the first two autocovariances, the model parameters, and the innovation variance. This can be repeated for the first autocovariance,

$$E[Y_t Y_{t-1}] = \phi_1 E[Y_{t-1} Y_{t-1}] + \phi_2 E[Y_{t-1} Y_{t-2}] + E[Y_{t-1} \varepsilon_t]$$

becomes

$$\gamma_1 = \phi_1 \gamma_0 + \phi_2 \gamma_1, \quad (4.117)$$

and for the second autocovariance,

$$E[Y_t Y_{t-2}] = \phi_1 E[Y_{t-2} Y_{t-1}] + \phi_2 E[Y_{t-2} Y_{t-2}] + E[Y_{t-2} \varepsilon_t] \text{ becomes}$$

becomes

$$\gamma_2 = \phi_1 \gamma_1 + \phi_2 \gamma_0. \quad (4.118)$$

Together eqs. (4.116), (4.117) and (4.118) form a system of three equations with three unknowns. The Yule-Walker method relies heavily on the covariance stationarity and so  $E[Y_t Y_{t-j}] = E[Y_{t-h} Y_{t-h-j}]$  for any  $h$ . This property of covariance stationary processes was repeatedly used in forming the producing the Yule-Walker equations since  $E[Y_t Y_t] = E[Y_{t-1} Y_{t-1}] = E[Y_{t-2} Y_{t-2}] = \gamma_0$  and  $E[Y_t Y_{t-1}] = E[Y_{t-1} Y_{t-2}] = \gamma_1$ . The Yule-Walker method will be demonstrated for several models, starting from a simple MA(1) and working up to an ARMA(1,1).

#### 4.A.1.1 MA(1)

The autocorrelations of the MA(1) are simple to derive.

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

The Yule-Walker equations are

$$E[Y_t Y_t] = E[\theta_1 \varepsilon_{t-1} Y_t] + E[\varepsilon_t Y_t] \quad (4.119)$$

$$E[Y_t Y_{t-1}] = E[\theta_1 \varepsilon_{t-1} Y_{t-1}] + E[\varepsilon_t Y_{t-1}]$$

$$E[Y_t Y_{t-2}] = E[\theta_1 \varepsilon_{t-1} Y_{t-2}] + E[\varepsilon_t Y_{t-2}]$$

$$\gamma_0 = \theta_1^2 \sigma^2 + \sigma^2 \quad (4.120)$$

$$\gamma_1 = \theta_1 \sigma^2$$

$$\gamma_2 = 0$$

Additionally, both  $\gamma_s$  and  $\rho_s$ ,  $s \geq 2$  are 0 by the white noise property of the residuals, and so the autocorrelations are

$$\rho_1 = \frac{\theta_1 \sigma^2}{\theta_1^2 \sigma^2 + \sigma^2}$$

$$= \frac{\theta_1}{1 + \theta_1^2},$$

$$\rho_2 = 0.$$

### 4.A.1.2 MA(Q)

The Yule-Walker equations can be constructed and solved for any MA( $Q$ ), and the structure of the autocovariance is simple to detect by constructing a subset of the full system.

$$E[Y_t Y_t] = E[\theta_1 \varepsilon_{t-1} Y_t] + E[\theta_2 \varepsilon_{t-2} Y_t] + E[\theta_3 \varepsilon_{t-3} Y_t] + \dots + E[\theta_Q \varepsilon_{t-Q} Y_t] \quad (4.121)$$

$$\begin{aligned} \gamma_0 &= \theta_1^2 \sigma^2 + \theta_2^2 \sigma^2 + \theta_3^2 \sigma^2 + \dots + \theta_Q^2 \sigma^2 + \sigma^2 \\ &= \sigma^2 (1 + \theta_1^2 + \theta_2^2 + \theta_3^2 + \dots + \theta_Q^2) \end{aligned}$$

$$E[Y_t Y_{t-1}] = E[\theta_1 \varepsilon_{t-1} Y_{t-1}] + E[\theta_2 \varepsilon_{t-2} Y_{t-1}] + E[\theta_3 \varepsilon_{t-3} Y_{t-1}] + \dots + E[\theta_Q \varepsilon_{t-Q} Y_{t-1}] \quad (4.122)$$

$$\begin{aligned} \gamma_1 &= \theta_1 \sigma^2 + \theta_1 \theta_2 \sigma^2 + \theta_2 \theta_3 \sigma^2 + \dots + \theta_{Q-1} \theta_Q \sigma^2 \\ &= \sigma^2 (\theta_1 + \theta_1 \theta_2 + \theta_2 \theta_3 + \dots + \theta_{Q-1} \theta_Q) \end{aligned}$$

$$E[Y_t Y_{t-2}] = E[\theta_1 \varepsilon_{t-1} Y_{t-2}] + E[\theta_2 \varepsilon_{t-2} Y_{t-2}] + E[\theta_3 \varepsilon_{t-3} Y_{t-2}] + \dots + E[\theta_Q \varepsilon_{t-Q} Y_{t-2}] \quad (4.123)$$

$$\begin{aligned} \gamma_2 &= \theta_2 \sigma^2 + \theta_1 \theta_3 \sigma^2 + \theta_2 \theta_4 \sigma^2 + \dots + \theta_{Q-2} \theta_Q \sigma^2 \\ &= \sigma^2 (\theta_2 + \theta_1 \theta_3 + \theta_2 \theta_4 + \dots + \theta_{Q-2} \theta_Q) \end{aligned}$$

The pattern that emerges shows,

$$\gamma_s = \theta_s \sigma^2 + \sum_{i=1}^{Q-s} \sigma^2 \theta_i \theta_{i+s} = \sigma^2 \left( \theta_s + \sum_{i=1}^{Q-s} \theta_i \theta_{i+s} \right).$$

and so,  $\gamma_s$  is a sum of  $Q - s + 1$  terms. The autocorrelations are

$$\begin{aligned} \rho_1 &= \frac{\theta_1 + \sum_{i=1}^{Q-1} \theta_i \theta_{i+1}}{1 + \theta_s + \sum_{i=1}^Q \theta_i^2} \\ \rho_2 &= \frac{\theta_2 + \sum_{i=1}^{Q-2} \theta_i \theta_{i+2}}{1 + \theta_s + \sum_{i=1}^Q \theta_i^2} \\ &\vdots = \vdots \\ \rho_Q &= \frac{\theta_Q}{1 + \theta_s + \sum_{i=1}^Q \theta_i^2} \\ \rho_{Q+s} &= 0, \quad s \geq 0 \end{aligned} \quad (4.124)$$

### 4.A.1.3 AR(1)

The Yule-Walker method requires  $\max(P, Q) + 1$  equations to compute the autocovariance for an ARMA( $P, Q$ ) process and in an AR(1), two are required (the third is included to establish this point).

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

$$E[Y_t Y_t] = E[\phi_1 Y_{t-1} Y_t] + E[\varepsilon_t Y_t] \quad (4.125)$$

$$E[Y_t Y_{t-1}] = E[\phi_1 Y_{t-1} Y_{t-1}] + E[\varepsilon_t Y_{t-1}]$$

$$E[Y_t Y_{t-2}] = E[\phi_1 Y_{t-1} Y_{t-2}] + E[\varepsilon_t Y_{t-2}]$$

These equations can be rewritten in terms of the autocovariances, model parameters and  $\sigma^2$  by taking expectation and noting that  $E[\varepsilon_t Y_t] = \sigma^2$  since  $Y_t = \varepsilon_t + \phi_1 \varepsilon_{t-1} + \phi_1^2 \varepsilon_{t-2} + \dots$  and  $E[\varepsilon_t Y_{t-j}] = 0$ ,  $j > 0$  since  $\{\varepsilon_t\}$  is a white noise process.

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \sigma^2 \\ \gamma_1 &= \phi_1 \gamma_0 \\ \gamma_2 &= \phi_1 \gamma_1\end{aligned}\tag{4.126}$$

The third is redundant since  $\gamma_2$  is fully determined by  $\gamma_1$  and  $\phi_1$ , and higher autocovariances are similarly redundant since  $\gamma_s = \phi_1 \gamma_{s-1}$  for any  $s$ . The first two equations can be solved for  $\gamma_0$  and  $\gamma_1$ ,

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \sigma^2 \\ \gamma_1 &= \phi_1 \gamma_0 \\ \Rightarrow \gamma_0 &= \phi_1^2 \gamma_0 + \sigma^2 \\ \Rightarrow \gamma_0 - \phi_1^2 \gamma_0 &= \sigma^2 \\ \Rightarrow \gamma_0(1 - \phi_1^2) &= \sigma^2 \\ \Rightarrow \gamma_0 &= \frac{\sigma^2}{1 - \phi_1^2}\end{aligned}$$

and

$$\begin{aligned}\gamma_1 &= \phi_1 \gamma_0 \\ \gamma_0 &= \frac{\sigma^2}{1 - \phi_1^2} \\ \Rightarrow \gamma_1 &= \phi_1 \frac{\sigma^2}{1 - \phi_1^2}.\end{aligned}$$

The remaining autocovariances can be computed using the recursion  $\gamma_s = \phi_1 \gamma_{s-1}$ , and so

$$\gamma_s = \phi_1^s \frac{\sigma^2}{1 - \phi_1^2}.$$

Finally, the autocorrelations can be computed as ratios of autocovariances,

$$\begin{aligned}\rho_1 &= \frac{\gamma_1}{\gamma_0} = \phi_1 \frac{\sigma^2}{1 - \phi_1^2} \bigg/ \frac{\sigma^2}{1 - \phi_1^2} \\ \rho_1 &= \phi_1 \\ \rho_s &= \frac{\gamma_s}{\gamma_0} = \phi_1^s \frac{\sigma^2}{1 - \phi_1^2} \bigg/ \frac{\sigma^2}{1 - \phi_1^2} \\ \rho_s &= \phi_1^s.\end{aligned}$$



## 4.A.1.4 AR(2)

The autocorrelations in an AR(2)

$$Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$$

can be similarly computed using the  $\max(P, Q) + 1$  equation Yule-Walker system,

$$\begin{aligned} E[Y_t Y_t] &= \phi_1 E[Y_{t-1} Y_t] + \phi_2 E[Y_{t-2} Y_t] + E[\varepsilon_t Y_t] \\ E[Y_t Y_{t-1}] &= \phi_1 E[Y_{t-1} Y_{t-1}] + \phi_2 E[Y_{t-2} Y_{t-1}] + E[\varepsilon_t Y_{t-1}] \\ E[Y_t Y_{t-2}] &= \phi_1 E[Y_{t-1} Y_{t-2}] + \phi_2 E[Y_{t-2} Y_{t-2}] + E[\varepsilon_t Y_{t-2}] \end{aligned} \quad (4.127)$$

and then replacing expectations with their population counterparts,  $\gamma_0, \gamma_1, \gamma_2$  and  $\sigma^2$ .

$$\begin{aligned} \gamma_0 &= \phi_1 \gamma_1 + \phi_2 \gamma_2 + \sigma^2 \\ \gamma_1 &= \phi_1 \gamma_0 + \phi_2 \gamma_1 \\ \gamma_2 &= \phi_1 \gamma_1 + \phi_2 \gamma_0 \end{aligned} \quad (4.128)$$

Further, it must be the case that  $\gamma_s = \phi_1 \gamma_{s-1} + \phi_2 \gamma_{s-2}$  for  $s \geq 2$ . To solve this system of equations, divide the autocovariance equations by  $\gamma_0$ , the long run variance. Omitting the first equation, the system reduces to two equations in two unknowns,

$$\begin{aligned} \rho_1 &= \phi_1 \rho_0 + \phi_2 \rho_1 \\ \rho_2 &= \phi_1 \rho_1 + \phi_2 \rho_0 \end{aligned}$$

since  $\rho_0 = \gamma_0/\gamma_0 = 1$ .

$$\begin{aligned} \rho_1 &= \phi_1 + \phi_2 \rho_1 \\ \rho_2 &= \phi_1 \rho_1 + \phi_2 \end{aligned}$$

Solving this system,

$$\begin{aligned} \rho_1 &= \phi_1 + \phi_2 \rho_1 \\ \rho_1 - \phi_2 \rho_1 &= \phi_1 \\ \rho_1(1 - \phi_2) &= \phi_1 \\ \rho_1 &= \frac{\phi_1}{1 - \phi_2} \end{aligned}$$

and

$$\begin{aligned} \rho_2 &= \phi_1 \rho_1 + \phi_2 \\ &= \phi_1 \frac{\phi_1}{1 - \phi_2} + \phi_2 \\ &= \frac{\phi_1 \phi_1 + (1 - \phi_2) \phi_2}{1 - \phi_2} \\ &= \frac{\phi_1^2 + \phi_2 - \phi_2^2}{1 - \phi_2} \end{aligned}$$

Since  $\rho_s = \phi_1 \rho_{s-1} + \phi_2 \rho_{s-2}$ , these first two autocorrelations are sufficient to compute the other autocorrelations,

$$\begin{aligned}\rho_3 &= \phi_1 \rho_2 + \phi_2 \rho_1 \\ &= \phi_1 \frac{\phi_1^2 + \phi_2 - \phi_2^2}{1 - \phi_2} + \phi_2 \frac{\phi_1}{1 - \phi_2}\end{aligned}$$

and the long run variance of  $Y_t$ ,

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \phi_2 \gamma_2 + \sigma^2 \\ \gamma_0 - \phi_1 \gamma_1 - \phi_2 \gamma_2 &= \sigma^2 \\ \gamma_0(1 - \phi_1 \rho_1 - \phi_2 \rho_2) &= \sigma^2 \\ \gamma_0 &= \frac{\sigma^2}{1 - \phi_1 \rho_1 - \phi_2 \rho_2}\end{aligned}$$

The final solution is computed by substituting for  $\rho_1$  and  $\rho_2$ ,

$$\begin{aligned}\gamma_0 &= \frac{\sigma^2}{1 - \phi_1 \frac{\phi_1}{1 - \phi_2} - \phi_2 \frac{\phi_1^2 + \phi_2 - \phi_2^2}{1 - \phi_2}} \\ &= \frac{1 - \phi_2}{1 + \phi_2} \left( \frac{\sigma^2}{(\phi_1 + \phi_2 - 1)(\phi_2 - \phi_1 - 1)} \right)\end{aligned}$$

#### 4.A.1.5 AR(3)

Begin by constructing the Yule-Walker equations,

$$\begin{aligned}\mathbb{E}[Y_t Y_t] &= \phi_1 \mathbb{E}[Y_{t-1} Y_t] + \phi_2 \mathbb{E}[Y_{t-2} Y_t] + \phi_3 \mathbb{E}[Y_{t-3} Y_t] + \mathbb{E}[\varepsilon_t Y_t] \\ \mathbb{E}[Y_t Y_{t-1}] &= \phi_1 \mathbb{E}[Y_{t-1} Y_{t-1}] + \phi_2 \mathbb{E}[Y_{t-2} Y_{t-1}] + \phi_3 \mathbb{E}[Y_{t-3} Y_{t-1}] + \mathbb{E}[\varepsilon_t Y_{t-1}] \\ \mathbb{E}[Y_t Y_{t-2}] &= \phi_1 \mathbb{E}[Y_{t-1} Y_{t-2}] + \phi_2 \mathbb{E}[Y_{t-2} Y_{t-2}] + \phi_3 \mathbb{E}[Y_{t-3} Y_{t-2}] + \mathbb{E}[\varepsilon_t Y_{t-2}] \\ \mathbb{E}[Y_t Y_{t-3}] &= \phi_1 \mathbb{E}[Y_{t-1} Y_{t-3}] + \phi_2 \mathbb{E}[Y_{t-2} Y_{t-3}] + \phi_3 \mathbb{E}[Y_{t-3} Y_{t-3}] + \mathbb{E}[\varepsilon_t Y_{t-3}].\end{aligned}$$

Replacing the expectations with their population values,  $\gamma_0, \gamma_1, \dots$  and  $\sigma^2$ , the Yule-Walker equations can be rewritten

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \phi_2 \gamma_2 + \phi_3 \gamma_3 + \sigma^2 \\ \gamma_1 &= \phi_1 \gamma_0 + \phi_2 \gamma_1 + \phi_3 \gamma_2 \\ \gamma_2 &= \phi_1 \gamma_1 + \phi_2 \gamma_0 + \phi_3 \gamma_1 \\ \gamma_3 &= \phi_1 \gamma_2 + \phi_2 \gamma_1 + \phi_3 \gamma_0\end{aligned}\tag{4.129}$$

and the recursive relationship  $\gamma_s = \phi_1 \gamma_{s-1} + \phi_2 \gamma_{s-2} + \phi_3 \gamma_{s-3}$  can be observed for  $s \geq 3$ . Omitting the first condition and dividing by  $\gamma_0$ ,

$$\begin{aligned}\rho_1 &= \phi_1 \rho_0 + \phi_2 \rho_1 + \phi_3 \rho_2 \\ \rho_2 &= \phi_1 \rho_1 + \phi_2 \rho_0 + \phi_3 \rho_1 \\ \rho_3 &= \phi_1 \rho_2 + \phi_2 \rho_1 + \phi_3 \rho_0.\end{aligned}$$

leaving three equations in three unknowns since  $\rho_0 = \gamma_0/\gamma_0 = 1$ .

$$\rho_1 = \phi_1 + \phi_2\rho_1 + \phi_3\rho_2$$

$$\rho_2 = \phi_1\rho_1 + \phi_2 + \phi_3\rho_1$$

$$\rho_3 = \phi_1\rho_2 + \phi_2\rho_1 + \phi_3$$

Following some tedious algebra, the solution to this system is

$$\begin{aligned}\rho_1 &= \frac{\phi_1 + \phi_2\phi_3}{1 - \phi_2 - \phi_1\phi_3 - \phi_3^2} \\ \rho_2 &= \frac{\phi_2 + \phi_1^2 + \phi_3\phi_1 - \phi_2^2}{1 - \phi_2 - \phi_1\phi_3 - \phi_3^2} \\ \rho_3 &= \frac{\phi_3 + \phi_1^3 + \phi_1^2\phi_3 + \phi_1\phi_2^2 + 2\phi_1\phi_2 + \phi_2^2\phi_3 - \phi_2\phi_3 - \phi_1\phi_3^2 - \phi_3^3}{1 - \phi_2 - \phi_1\phi_3 - \phi_3^2}.\end{aligned}$$

Finally, the unconditional variance can be computed using the first three autocorrelations,

$$\begin{aligned}\gamma_0 &= \phi_1\gamma_1 + \phi_2\gamma_2 + \phi_3\gamma_3\sigma^2 \\ \gamma_0 - \phi_1\gamma_1 - \phi_2\gamma_2 - \phi_3\gamma_3 &= \sigma^2 \\ \gamma_0(1 - \phi_1\rho_1 + \phi_2\rho_2 + \phi_3\rho_3) &= \sigma^2 \\ \gamma_0 &= \frac{\sigma^2}{1 - \phi_1\rho_1 - \phi_2\rho_2 - \phi_3\rho_3} \\ \gamma_0 &= \frac{\sigma^2(1 - \phi_2 - \phi_1\phi_3 - \phi_3^2)}{(1 - \phi_2 - \phi_3 - \phi_1)(1 + \phi_2 + \phi_3\phi_1 - \phi_3^2)(1 + \phi_3 + \phi_1 - \phi_2)}\end{aligned}$$

#### 4.A.1.6 ARMA(1,1)

Deriving the autocovariances and autocorrelations of an ARMA process is more complicated than for a pure AR or MA process. An ARMA(1,1) is specified as

$$Y_t = \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

and since  $P = Q = 1$ , the Yule-Walker system requires two equations, noting that the third or higher autocovariance is a trivial function of the first two autocovariances.

$$\begin{aligned}E[Y_t Y_t] &= E[\phi_1 Y_{t-1} Y_t] + E[\theta_1 \varepsilon_{t-1} Y_t] + E[\varepsilon_t Y_t] \\ E[Y_t Y_{t-1}] &= E[\phi_1 Y_{t-1} Y_{t-1}] + E[\theta_1 \varepsilon_{t-1} Y_{t-1}] + E[\varepsilon_t Y_{t-1}]\end{aligned}\tag{4.130}$$

The presence of the  $E[\theta_1 \varepsilon_{t-1} Y_t]$  term in the first equation complicates solving this system since  $\varepsilon_{t-1}$  appears in  $Y_t$  directly through  $\theta_1 \varepsilon_{t-1}$  and indirectly through  $\phi_1 Y_{t-1}$ . The non-zero relationships can be determined by recursively substituting  $Y_t$  until it consists of only  $\varepsilon_t$ ,  $\varepsilon_{t-1}$  and  $Y_{t-2}$  (since  $Y_{t-2}$  is uncorrelated with  $\varepsilon_{t-1}$  by the WN assumption).

$$\begin{aligned}Y_t &= \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \phi_1(\phi_1 Y_{t-2} + \theta_1 \varepsilon_{t-2} + \varepsilon_{t-1}) + \theta_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \phi_1^2 Y_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \phi_1^2 Y_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t\end{aligned}\tag{4.131}$$

and so  $E[\theta_1 \varepsilon_{t-1} Y_t] = \theta_1 (\phi_1 + \theta_1) \sigma^2$  and the Yule-Walker equations can be expressed using the population moments and model parameters.

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \theta_1 (\phi_1 + \theta_1) \sigma^2 + \sigma^2 \\ \gamma_1 &= \phi_1 \gamma_0 + \theta_1 \sigma^2\end{aligned}$$

These two equations in two unknowns which can be solved,

$$\begin{aligned}\gamma_0 &= \phi_1 \gamma_1 + \theta_1 (\phi_1 + \theta_1) \sigma^2 + \sigma^2 \\ &= \phi_1 (\phi_1 \gamma_0 + \theta_1 \sigma^2) + \theta_1 (\phi_1 + \theta_1) \sigma^2 + \sigma^2 \\ &= \phi_1^2 \gamma_0 + \phi_1 \theta_1 \sigma^2 + \theta_1 (\phi_1 + \theta_1) \sigma^2 + \sigma^2 \\ \gamma_0 - \phi_1^2 \gamma_0 &= \sigma^2 (\phi_1 \theta_1 + \phi_1 \theta_1 + \theta_1^2 + 1) \\ \gamma_0 &= \frac{\sigma^2 (1 + \theta_1^2 + 2\phi_1 \theta_1)}{1 - \phi_1^2}\end{aligned}$$

$$\begin{aligned}\gamma_1 &= \phi_1 \gamma_0 + \theta_1 \sigma^2 \\ &= \phi_1 \left( \frac{\sigma^2 (1 + \theta_1^2 + 2\phi_1 \theta_1)}{1 - \phi_1^2} \right) + \theta_1 \sigma^2 \\ &= \phi_1 \left( \frac{\sigma^2 (1 + \theta_1^2 + 2\phi_1 \theta_1)}{1 - \phi_1^2} \right) + \frac{(1 - \phi_1^2) \theta_1 \sigma^2}{1 - \phi_1^2} \\ &= \frac{\sigma^2 (\phi_1 + \phi_1 \theta_1^2 + 2\phi_1^2 \theta_1)}{1 - \phi_1^2} + \frac{(\theta_1 - \theta_1 \phi_1^2) \sigma^2}{1 - \phi_1^2} \\ &= \frac{\sigma^2 (\phi_1 + \phi_1 \theta_1^2 + 2\phi_1^2 \theta_1 + \theta_1 - \phi_1^2 \theta_1)}{1 - \phi_1^2} \\ &= \frac{\sigma^2 (\phi_1^2 \theta_1 + \phi_1 \theta_1^2 + \phi_1 + \theta_1)}{1 - \phi_1^2} \\ &= \frac{\sigma^2 (\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{1 - \phi_1^2}\end{aligned}$$

and so the 1<sup>st</sup> autocorrelation is

$$\rho_1 = \frac{\frac{\sigma^2 (\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{1 - \phi_1^2}}{\frac{\sigma^2 (1 + \theta_1^2 + 2\phi_1 \theta_1)}{1 - \phi_1^2}} = \frac{(\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{(1 + \theta_1^2 + 2\phi_1 \theta_1)}.$$

Returning to the next Yule-Walker equation,

$$E[Y_t Y_{t-2}] = E[\phi_1 Y_{t-1} Y_{t-2}] + E[\theta_1 \varepsilon_{t-1} Y_{t-2}] + E[\varepsilon_t Y_{t-2}]$$

and so  $\gamma_2 = \phi_1 \gamma_1$ , and, dividing both sides by  $\gamma_0$ ,  $\rho_2 = \phi_1 \rho_1$ . Higher order autocovariances and autocorrelation follow  $\gamma_s = \phi_1 \gamma_{s-1}$  and  $\rho_s = \phi_1 \rho_{s-1}$  respectively, and so  $\rho_s = \phi_1^{s-1} \rho_1$ ,  $s \geq 2$ .

## 4.A.2 Backward Substitution

Backward substitution is a direct but tedious method to derive the ACF and long-run variance.

### 4.A.2.1 AR(1)

The AR(1) process,

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

is stationary if  $|\phi_1| < 1$  and  $\{\varepsilon_t\}$  is white noise. To compute the autocovariances and autocorrelations using backward substitution,  $Y_t = \phi_1 Y_{t-1} + \varepsilon_t$  must be transformed into a pure MA process by recursive substitution,

$$\begin{aligned} Y_t &= \phi_1 Y_{t-1} + \varepsilon_t \\ &= \phi_1 (\phi_1 Y_{t-2} + \varepsilon_{t-1}) + \varepsilon_t \\ &= \phi_1^2 Y_{t-2} + \phi_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \phi_1^2 (\phi_1 Y_{t-3} + \varepsilon_{t-2}) + \phi_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \phi_1^3 Y_{t-3} + \phi_1^2 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \varepsilon_t \\ &= \varepsilon_t + \phi_1 \varepsilon_{t-1} + \phi_1^2 \varepsilon_{t-2} + \phi_1^3 \varepsilon_{t-3} + \dots \\ Y_t &= \sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i}. \end{aligned} \tag{4.132}$$

The variance is the expectation of the square,

$$\begin{aligned} \gamma_0 &= V[Y_t] = E[Y_t^2] \\ &= E\left[\left(\sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i}\right)^2\right] \\ &= E[(\varepsilon_t + \phi_1 \varepsilon_{t-1} + \phi_1^2 \varepsilon_{t-2} + \phi_1^3 \varepsilon_{t-3} + \dots)^2] \\ &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-i}^2 + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^i \phi_1^j \varepsilon_{t-i} \varepsilon_{t-j}\right] \\ &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-i}^2\right] + E\left[\sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^i \phi_1^j \varepsilon_{t-i} \varepsilon_{t-j}\right] \\ &= \sum_{i=0}^{\infty} \phi_1^{2i} E[\varepsilon_{t-i}^2] + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^i \phi_1^j E[\varepsilon_{t-i} \varepsilon_{t-j}] \\ &= \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j}^{\infty} \phi_1^i \phi_1^j 0 \\ &= \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 \\ &= \frac{\sigma^2}{1 - \phi_1^2} \end{aligned} \tag{4.133}$$

The difficult step in the derivation is splitting up the  $\varepsilon_{t-i}$  into those that are matched to their own lag ( $\varepsilon_{t-i}^2$ ) to those which are not ( $\varepsilon_{t-i}\varepsilon_{t-j}$ ,  $i \neq j$ ). The remainder of the derivation follows from the assumption that  $\{\varepsilon_t\}$  is a white noise process, and so  $E[\varepsilon_{t-i}^2] = \sigma^2$  and  $E[\varepsilon_{t-i}\varepsilon_{t-j}] = 0$ ,  $i \neq j$ . Finally, the identity that  $\lim_{n \rightarrow \infty} \sum_{i=0}^n \phi_1^{2i} = \lim_{n \rightarrow \infty} \sum_{i=0}^n (\phi_1^2)^i = \frac{1}{1-\phi_1^2}$  for  $|\phi_1| < 1$  was used to simplify the expression. The 1st autocovariance can be computed using the same steps on the MA( $\infty$ ) representation,

$$\begin{aligned}
 \gamma_1 &= E[Y_t Y_{t-1}] & (4.134) \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \sum_{i=1}^{\infty} \phi_1^{i-1} \varepsilon_{t-i}\right] \\
 &= E[(\varepsilon_t + \phi_1 \varepsilon_{t-1} + \phi_1^2 \varepsilon_{t-2} + \phi_1^3 \varepsilon_{t-3} + \dots)(\varepsilon_{t-1} + \phi_1 \varepsilon_{t-2} + \phi_1^2 \varepsilon_{t-3} + \phi_1^3 \varepsilon_{t-4} + \dots)] \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i+1} \varepsilon_{t-1-i}^2 + \sum_{i=0}^{\infty} \sum_{j=1, i \neq j}^{\infty} \phi_1^i \phi_1^{j-1} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= E\left[\phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-1-i}^2\right] + E\left[\sum_{i=0}^{\infty} \sum_{j=1, i \neq j}^{\infty} \phi_1^i \phi_1^{j-1} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= \phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} E[\varepsilon_{t-1-i}^2] + \sum_{i=0}^{\infty} \sum_{j=1, i \neq j}^{\infty} \phi_1^i \phi_1^{j-1} E[\varepsilon_{t-i} \varepsilon_{t-j}] \\
 &= \phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 + \sum_{i=0}^{\infty} \sum_{j=1, i \neq j}^{\infty} \phi_1^i \phi_1^{j-1} 0 \\
 &= \phi_1 \left( \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 \right) \\
 &= \phi_1 \frac{\sigma^2}{1 - \phi_1^2} \\
 &= \phi_1 \gamma_0
 \end{aligned}$$

and the  $s^{\text{th}}$  autocovariance can be similarly determined.

$$\begin{aligned}
 \gamma_s &= E[Y_t Y_{t-s}] & (4.135) \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^i \varepsilon_{t-i} \sum_{i=s}^{\infty} \phi_1^{i-s} \varepsilon_{t-i}\right] \\
 &= E\left[\sum_{i=0}^{\infty} \phi_1^{2i+s} \varepsilon_{t-s-i}^2 + \sum_{i=0}^{\infty} \sum_{j=s, i \neq j}^{\infty} \phi_1^i \phi_1^{j-s} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= E\left[\phi_1^s \sum_{i=0}^{\infty} \phi_1^{2i} \varepsilon_{t-s-i}^2\right] + E\left[\sum_{i=0}^{\infty} \sum_{j=s, i \neq j}^{\infty} \phi_1^i \phi_1^{j-s} \varepsilon_{t-i} \varepsilon_{t-j}\right] \\
 &= \phi_1^s \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 + \sum_{i=0}^{\infty} \sum_{j=s, i \neq j}^{\infty} \phi_1^i \phi_1^{j-s} 0
 \end{aligned}$$

$$\begin{aligned}
&= \phi_1^s \left( \sum_{i=0}^{\infty} \phi_1^{2i} \sigma^2 \right) \\
&= \phi_1^s \gamma_0
\end{aligned}$$

Finally, the autocorrelations can be computed from ratios of autocovariances,  $\rho_1 = \gamma_1/\gamma_0 = \phi_1$  and  $\rho_s = \gamma_s/\gamma_0 = \phi_1^s$ .

#### 4.A.2.2 MA(1)

The MA(1) model is the simplest non-degenerate time-series model considered in this course,

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

and the derivation of its autocorrelation function is trivial since there no backward substitution is required. The variance is

$$\begin{aligned}
\gamma_0 &= V[Y_t] = E[Y_t^2] \\
&= E[(\theta_1 \varepsilon_{t-1} + \varepsilon_t)^2] \\
&= E[\theta_1^2 \varepsilon_{t-1}^2 + 2\theta_1 \varepsilon_t \varepsilon_{t-1} + \varepsilon_t^2] \\
&= E[\theta_1^2 \varepsilon_{t-1}^2] + E[2\theta_1 \varepsilon_t \varepsilon_{t-1}] + E[\varepsilon_t^2] \\
&= \theta_1^2 \sigma^2 + 0 + \sigma^2 \\
&= \sigma^2 (1 + \theta_1^2)
\end{aligned} \tag{4.136}$$

and the 1st autocovariance is

$$\begin{aligned}
\gamma_1 &= E[Y_t Y_{t-1}] \\
&= E[(\theta_1 \varepsilon_{t-1} + \varepsilon_t)(\theta_1 \varepsilon_{t-2} + \varepsilon_{t-1})] \\
&= E[\theta_1^2 \varepsilon_{t-1} \varepsilon_{t-2} + \theta_1 \varepsilon_{t-1}^2 + \theta_1 \varepsilon_t \varepsilon_{t-2} + \varepsilon_t \varepsilon_{t-1}] \\
&= E[\theta_1^2 \varepsilon_{t-1} \varepsilon_{t-2}] + E[\theta_1 \varepsilon_{t-1}^2] + E[\theta_1 \varepsilon_t \varepsilon_{t-2}] + E[\varepsilon_t \varepsilon_{t-1}] \\
&= 0 + \theta_1 \sigma^2 + 0 + 0 \\
&= \theta_1 \sigma^2
\end{aligned} \tag{4.137}$$

The 2<sup>nd</sup>(and higher) autocovariance is

$$\begin{aligned}
\gamma_2 &= E[Y_t Y_{t-2}] \\
&= E[(\theta_1 \varepsilon_{t-1} + \varepsilon_t)(\theta_1 \varepsilon_{t-3} + \varepsilon_{t-2})] \\
&= E[\theta_1^2 \varepsilon_{t-1} \varepsilon_{t-3} + \theta_1 \varepsilon_{t-1} \varepsilon_{t-2} + \theta_1 \varepsilon_t \varepsilon_{t-3} + \varepsilon_t \varepsilon_{t-2}] \\
&= E[\theta_1^2 \varepsilon_{t-1} \varepsilon_{t-3}] + E[\theta_1 \varepsilon_{t-1} \varepsilon_{t-2}] + E[\theta_1 \varepsilon_t \varepsilon_{t-3}] + E[\varepsilon_t \varepsilon_{t-2}] \\
&= 0 + 0 + 0 + 0 \\
&= 0
\end{aligned} \tag{4.138}$$

and the autocorrelations are  $\rho_1 = \theta_1/(1 + \theta_1^2)$ ,  $\rho_s = 0$ ,  $s \geq 2$ .

#### 4.A.2.3 ARMA(1,1)

An ARMA(1,1) process,

$$Y_t = \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

is stationary if  $|\phi_1| < 1$  and  $\{\varepsilon_t\}$  is white noise. The derivation of the variance and autocovariances is more tedious than for the AR(1) process. It should be noted that derivation is longer and more complex than solving the Yule-Walker equations. Begin by computing the MA( $\infty$ ) representation,

$$\begin{aligned} Y_t &= \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t & (4.139) \\ Y_t &= \phi_1 (\phi_1 Y_{t-2} + \theta_1 \varepsilon_{t-2} + \varepsilon_{t-1}) + \theta_1 \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^2 Y_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + \phi_1 \varepsilon_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^2 (\phi_1 Y_{t-3} + \theta_1 \varepsilon_{t-3} + \varepsilon_{t-2}) + \phi_1 \theta_1 \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^3 Y_{t-3} + \phi_1^2 \theta_1 \varepsilon_{t-3} + \phi_1^2 \varepsilon_{t-2} + \phi_1 \theta_1 \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^3 (\phi_1 Y_{t-4} + \theta_1 \varepsilon_{t-4} + \varepsilon_{t-3}) + \phi_1^2 \theta_1 \varepsilon_{t-3} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^4 Y_{t-4} + \phi_1^3 \theta_1 \varepsilon_{t-4} + \phi_1^3 \varepsilon_{t-3} + \phi_1^2 \theta_1 \varepsilon_{t-3} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \phi_1^4 Y_{t-4} + \phi_1^3 \theta_1 \varepsilon_{t-4} + \phi_1^2 (\phi_1 + \theta_1) \varepsilon_{t-3} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + (\phi_1 + \theta_1) \varepsilon_{t-1} + \varepsilon_t \\ Y_t &= \varepsilon_t + (\phi_1 + \theta_1) \varepsilon_{t-1} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + \phi_1^2 (\phi_1 + \theta_1) \varepsilon_{t-3} + \dots \\ Y_t &= \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \end{aligned}$$

The primary issue is that the backward substitution form, unlike in the AR(1) case, is not completely symmetric. Specifically,  $\varepsilon_t$  has a different weight than the other shocks and does not follow the same pattern.

$$\begin{aligned} \gamma_0 &= V[Y_t] = E[Y_t^2] & (4.140) \\ &= E \left[ \left( \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right)^2 \right] \\ &= E \left[ \left( \varepsilon_t + (\phi_1 + \theta_1) \varepsilon_{t-1} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + \phi_1^2 (\phi_1 + \theta_1) \varepsilon_{t-3} + \dots \right)^2 \right] \\ &= E \left[ \varepsilon_t^2 + 2\varepsilon_t \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} + \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right)^2 \right] \\ &= E[\varepsilon_t^2] + E \left[ 2\varepsilon_t \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right] + E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right)^2 \right] \\ &= \sigma^2 + 0 + E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right)^2 \right] \\ &= \sigma^2 + E \left[ \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 \varepsilon_{t-1-i}^2 + \sum_{i=0}^{\infty} \sum_{j=0, j \neq i}^{\infty} \phi_1^i \phi_1^j (\phi_1 + \theta_1)^2 \varepsilon_{t-1-i} \varepsilon_{t-1-j} \right] \end{aligned}$$



$$\begin{aligned}
&= \sigma^2 + \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 E[\varepsilon_{t-1-i}^2] + \sum_{i=0}^{\infty} \sum_{j=0, j \neq i}^{\infty} \phi_1^i \phi_1^j (\phi_1 + \theta_1)^2 E[\varepsilon_{t-1-i} \varepsilon_{t-1-j}] \\
&= \sigma^2 + \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 \sigma^2 + \sum_{i=0}^{\infty} \sum_{j=0, j \neq i}^{\infty} \phi_1^i \phi_1^j (\phi_1 + \theta_1)^2 0 \\
&= \sigma^2 + \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 \sigma^2 \\
&= \sigma^2 + \frac{(\phi_1 + \theta_1)^2 \sigma^2}{1 - \phi_1^2} \\
&= \sigma^2 \frac{1 - \phi_1^2 + (\phi_1 + \theta_1)^2}{1 - \phi_1^2} \\
&= \sigma^2 \frac{1 + \theta_1^2 + 2\phi_1\theta_1}{1 - \phi_1^2}
\end{aligned}$$

The difficult step in this derivations is in aligning the  $\varepsilon_{t-i}$  since  $\{\varepsilon_t\}$  is a white noise process. The autocovariance derivation is reasonably involved (and presented in full detail).

$$\gamma_1 = E[Y_t Y_{t-1}] \quad (4.141)$$

$$\begin{aligned}
&= E \left[ \left( \varepsilon_t + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right) \left( \varepsilon_{t-1} + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-2-i} \right) \right] \\
&= E \left[ (\varepsilon_t + (\phi_1 + \theta_1) \varepsilon_{t-1} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-2} + \phi_1^2 (\phi_1 + \theta_1) \varepsilon_{t-3} + \dots) \times \right. \\
&\quad \left. (\varepsilon_{t-1} + (\phi_1 + \theta_1) \varepsilon_{t-2} + \phi_1 (\phi_1 + \theta_1) \varepsilon_{t-3} + \phi_1^2 (\phi_1 + \theta_1) \varepsilon_{t-4} + \dots) \right] \\
&= E \left[ \varepsilon_t \varepsilon_{t-1} + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_t \varepsilon_{t-2-i} + \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1} \varepsilon_{t-1-i} \right. \\
&\quad \left. + \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-2-i} \right) \right] \\
&= E[\varepsilon_t \varepsilon_{t-1}] + E \left[ \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_t \varepsilon_{t-2-i} \right] + E \left[ \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1} \varepsilon_{t-1-i} \right] \\
&\quad + E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-2-i} \right) \right] \\
&= 0 + 0 + (\phi_1 + \theta_1) \sigma^2 + E \left[ \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1-i} \right) \left( \sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-2-i} \right) \right] \\
&= (\phi_1 + \theta_1) \sigma^2 + E \left[ \sum_{i=0}^{\infty} \phi_1^{2i+1} (\phi_1 + \theta_1)^2 \varepsilon_{t-2-i}^2 + \sum_{i=0}^{\infty} \sum_{j=0, i \neq j+1}^{\infty} \phi_1^i \phi_1^j (\phi_1 + \theta_1)^2 \varepsilon_{t-1-i} \varepsilon_{t-2-i} \right] \\
&= (\phi_1 + \theta_1) \sigma^2 + E \left[ \sum_{i=0}^{\infty} \phi_1^{2i+1} (\phi_1 + \theta_1)^2 \varepsilon_{t-2-i}^2 \right] + E \left[ \sum_{i=0}^{\infty} \sum_{j=0, i \neq j+1}^{\infty} \phi_1^i \phi_1^j (\phi_1 + \theta_1)^2 \varepsilon_{t-1-i} \varepsilon_{t-2-i} \right]
\end{aligned}$$

$$\begin{aligned}
&= (\phi_1 + \theta_1) \sigma^2 + E \left[ \phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 \varepsilon_{t-2-i}^2 \right] + 0 \\
&= (\phi_1 + \theta_1) \sigma^2 + \phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 E [\varepsilon_{t-2-i}^2] \\
&= (\phi_1 + \theta_1) \sigma^2 + \phi_1 \sum_{i=0}^{\infty} \phi_1^{2i} (\phi_1 + \theta_1)^2 \sigma^2 \\
&= (\phi_1 + \theta_1) \sigma^2 + \phi_1 \frac{(\phi_1 + \theta_1)^2 \sigma^2}{1 - \phi_1^2} \\
&= \frac{\sigma^2 \left[ (1 - \phi_1^2) (\phi_1 + \theta_1) + \phi_1 (\phi_1 + \theta_1)^2 \right]}{1 - \phi_1^2} \\
&= \frac{\sigma^2 (\phi_1 + \theta_1 - \phi_1^3 - \phi_1^2 \theta_1 + \phi_1^3 + 2\phi_1^2 \theta_1 - \phi_1 \theta_1^2)}{1 - \phi_1^2} \\
&= \frac{\sigma^2 [\phi_1 + \theta_1 + \phi_1^2 \theta_1 - \phi_1 \theta_1^2]}{1 - \phi_1^2} \\
&= \frac{\sigma^2 (\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{1 - \phi_1^2}
\end{aligned}$$

The most difficult step in this derivation is in showing that  $E[\sum_{i=0}^{\infty} \phi_1^i (\phi_1 + \theta_1) \varepsilon_{t-1} \varepsilon_{t-1-i}] = \sigma^2 (\phi_1 + \theta_1)$  since there is one  $\varepsilon_{t-1-i}$  which is aligned to  $\varepsilon_{t-1}$  (i.e. when  $i = 0$ ), and so the autocorrelations may be derived,

$$\begin{aligned}
\rho_1 &= \frac{\frac{\sigma^2 (\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{1 - \phi_1^2}}{\frac{\sigma^2 (1 + \theta_1^2 + 2\phi_1 \theta_1)}{1 - \phi_1^2}} \\
&= \frac{(\phi_1 + \theta_1) (\phi_1 \theta_1 + 1)}{(1 + \theta_1^2 + 2\phi_1 \theta_1)}
\end{aligned} \tag{4.142}$$

and the remaining autocorrelations can be computed using the recursion,  $\rho_s = \phi_1 \rho_{s-1}$ ,  $s \geq 2$ .

## Exercises

**Exercise 4.1.** Is the sum of two white noise processes,  $\varepsilon_t = \eta_t + v_t$  necessarily a white noise process?

**Exercise 4.2.** Suppose that  $Y_t$  follows a random walk then  $\Delta Y_t = Y_t - Y_{t-1}$  is stationary.

1. Is  $Y_t - Y_{t-j}$  for and  $j \geq 2$  stationary?
2. If it is and  $\{\varepsilon_t\}$  is an i.i.d. sequence of standard normals, what is the distribution of  $Y_t - Y_{t-j}$ ?
3. What is the joint distribution of  $Y_t - Y_{t-j}$  and  $Y_{t-h} - Y_{t-j-h}$  (Note: The derivation for an arbitrary  $h$  is challenging)?

**Note:** If it helps in this problem, consider the case where  $j = 2$  and  $h = 1$ .

**Exercise 4.3.** Precisely describe the two types of stationarity.

**Exercise 4.4.** Why is stationarity a useful property?

**Exercise 4.5.** Write the AR(1)  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$  as an MA( $\infty$ ) assuming  $|\phi_1| < 1$ .

**Exercise 4.6.** Write the MA(1)  $Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$  as an AR( $\infty$ ) assuming  $|\theta_1| < 1$ . Hint:  $Y_{t-1} = \phi_0 + \theta_2 \varepsilon_{t-2} + \varepsilon_{t-1} \Rightarrow \varepsilon_{t-1} = Y_{t-1} - \phi_0 - \theta_2 \varepsilon_{t-2}$ .

**Exercise 4.7.** What are the 1-step and 2-step optimal forecasts for the conditional mean when  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$  where  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, 1)$ ?

**Exercise 4.8.** What is the optimal 3-step forecast from the ARMA(1,2),  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t$ , where  $\varepsilon_t$  is a mean 0 white noise process?

**Exercise 4.9.** What are the 1-step and 2-step optimal mean square forecast errors when  $Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t$  where  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, 1)$ ?

**Exercise 4.10.** Assume  $\{\varepsilon_t\}$  is a mean zero i.i.d. sequence.

1. For each of the following processes, find  $E_t[Y_{t+1}]$ .

- (a)  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$
- (b)  $Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$
- (c)  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$
- (d)  $Y_t = \phi_0 + \phi_2 Y_{t-2} + \varepsilon_t$
- (e)  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$

2. For (a), (d) and (e), derive the  $h$ -step ahead forecast,  $E_t[Y_{t+h}]$ . What is the long run behavior of the forecast in each case?

**Exercise 4.11.** Write down the characteristic equations for the systems listed below, find the roots, and classify each as convergent, explosive, stable or metastable.

- 1.  $Y_t = 1 + .6Y_{t-1} + X_t$
- 2.  $Y_t = 3 + .8Y_{t-2} + X_t$
- 3.  $Y_t = .6Y_{t-1} + .3Y_{t-2} + X_t$
- 4.  $Y_t = 2.7 + 1.2Y_{t-1} + .2Y_{t-2} + X_t$
- 5.  $Y_t = 0.4 + 1.4Y_{t-1} + .24Y_{t-2} + X_t$
- 6.  $Y_t = 10 - .8Y_{t-1} + .2Y_{t-2} + X_t$

**Exercise 4.12.** Under what conditions on the parameters are the following processes covariance stationary when  $\varepsilon_t \sim WN(0, \sigma^2)$  is a white noise process?

- 1.  $Y_t = \phi_0 + \varepsilon_t$

2.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$
3.  $Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$
4.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$
5.  $Y_t = \phi_0 + \phi_2 Y_{t-2} + \varepsilon_t$
6.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \theta_1 \varepsilon_{t-1} + \varepsilon_t$

**Exercise 4.13.** In which of the following models are the  $\{Y_t\}$  covariance stationary, assuming  $\{\varepsilon_t\}$  is a mean-zero white noise process. If the answer is conditional, explain the conditions required. In any case, explain your answer:

1.  $\Delta Y_t = -0.2Y_{t-1} + \varepsilon_t$
2.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$
3.  $Y_t = \phi_0 + 0.1X_{t-1} + \varepsilon_t, X_t = X_{t-1} + \varepsilon_t$
4.  $Y_t = 0.8Y_{t-1} + \varepsilon_t$

**Exercise 4.14.** Which of the following models are covariance stationary, assuming  $\{\varepsilon_t\}$  is a mean-zero white noise process. If the answer is conditional, explain the conditions required. In any case, explain your answer:

1.  $Y_t = \phi_0 + 0.8Y_{t-1} + 0.2Y_{t-2} + \varepsilon_t$
2.  $Y_t = \phi_0 + \phi_1 I_{[t > 200]} + \varepsilon_t$
3.  $Y_t = \alpha t + 0.8\varepsilon_{t-1} + \varepsilon_t$
4.  $Y_t = 4\varepsilon_{t-1} + 9\varepsilon_{t-2} + \varepsilon_t$
5.  $Y_t = \varepsilon_t + \sum_{j=1}^{\infty} \gamma_j \varepsilon_{t-j}$

1. Compute long-run mean
2. Compute long-run variance for AR(1), AR(2) and MA(Q)

**Exercise 4.15.** Compute the ACF and PACF for:

1.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$
2.  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$

**Exercise 4.16.** Consider an AR(1)

$$Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$$

What are the values of the following quantities?

1.  $E[Y_{t+1}]$ ,  $E_t[Y_{t+1}]$ , and  $E_t[Y_{t+2}]$

2.  $V[Y_{t+1}]$ ,  $V_t[Y_{t+1}]$ , and  $V_t[Y_{t+2}]$
3.  $\rho_{-1}$  and  $\rho_2$

**Exercise 4.17.** Consider an MA(1)

$$Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$$

1. What is a minimal set of assumptions sufficient to ensure  $\{Y_t\}$  is covariance stationary if  $\{\varepsilon_t\}$  is an i.i.d. sequence?
2. What are the values of the following quantities?
  - (a)  $E[Y_{t+1}]$ ,  $E_t[Y_{t+1}]$  and  $E_t[Y_{t+2}]$
  - (b)  $V[Y_{t+1}]$ ,  $V_t[Y_{t+1}]$ , and  $V_t[Y_{t+2}]$
  - (c)  $\rho_{-1}$  and  $\rho_2$

**Exercise 4.18.** Consider an MA(2)

$$Y_t = \mu + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t$$

1. What is a minimal set of assumptions sufficient to ensure  $\{Y_t\}$  is covariance stationary if  $\{\varepsilon_t\}$  is an i.i.d. sequence?
2. What are the values of the following quantities?
  - (a)  $E[Y_{t+1}]$ ,  $E_t[Y_{t+1}]$  and  $E_t[Y_{t+2}]$
  - (b)  $V[Y_{t+1}]$ ,  $V_t[Y_{t+1}]$ ,  $V_t[Y_{t+2}]$
  - (c)  $\rho_h$ ,  $h = 1, 2, 3, 4, \dots$

**Exercise 4.19.** Suppose you observe the three sets of ACF/PACF in figure 4.15. What ARMA specification would you expect in each case. Note: Dashed line indicates the 95% confidence interval for a test that the autocorrelation or partial autocorrelation is 0.

**Exercise 4.20.** Justify a reasonable model for each of these time series in Figure 4.16 using information in the autocorrelation and partial autocorrelation plots. In each set of plots, the left most panel shows that data ( $T = 100$ ). The middle panel shows the sample autocorrelation with 95% confidence bands. The right panel shows the sample partial autocorrelation for the data with 95% confidence bands.

**Exercise 4.21.** Describe two methods that are used to estimate the parameters of ARMA models. Are there any limitations of either estimation method?

**Exercise 4.22.** Explain difference between what the ACF and PACF measure, and how each is useful.

**Exercise 4.23.** Suppose you model the difference  $\Delta Y_t = \phi_0 + \phi_1 \Delta Y_{t-1} + \varepsilon_t$  where  $\varepsilon_t \stackrel{\text{i.i.d.}}{\sim} N(0, \sigma^2)$ . What are:

1.  $E_t[\Delta Y_{t+1}]$ ,  $E_t[\Delta Y_{t+2}]$

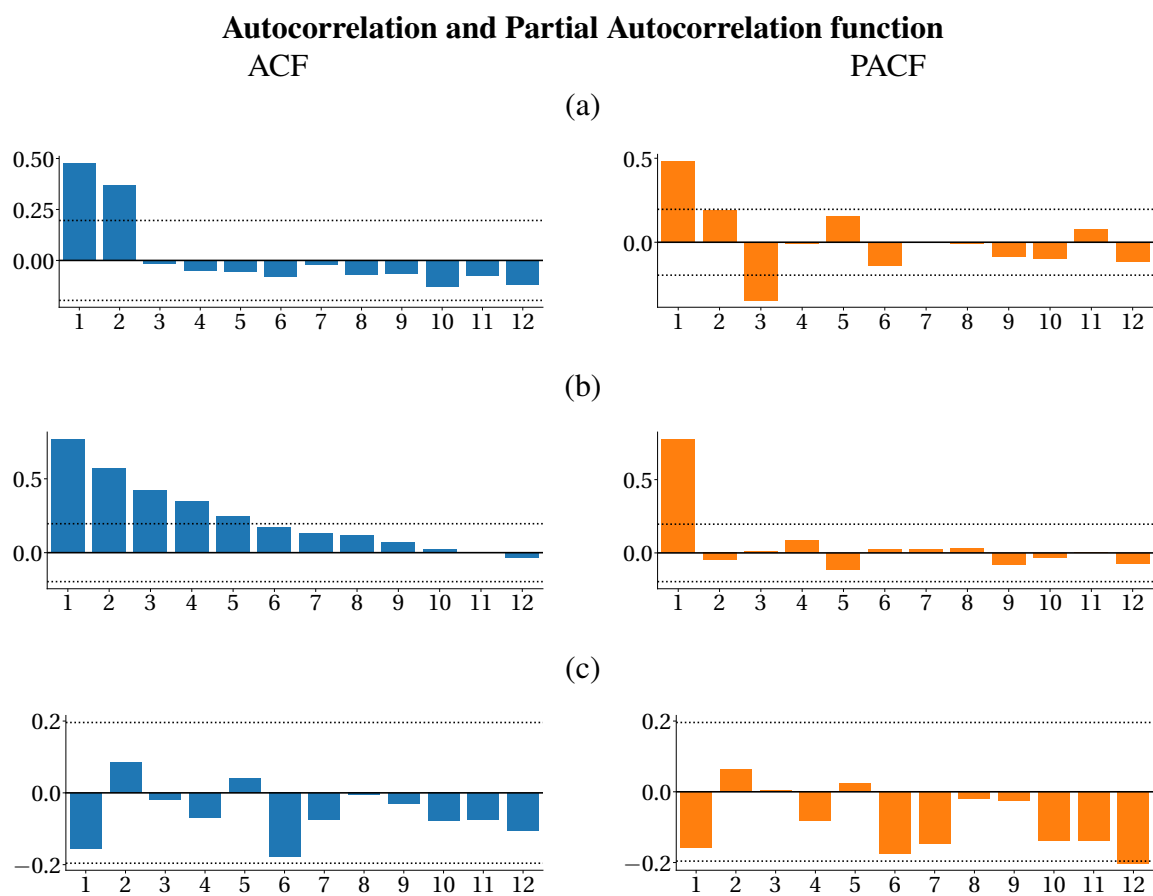


Figure 4.15: The ACF and PACF of three stochastic processes. Use these to answer question 4.19.

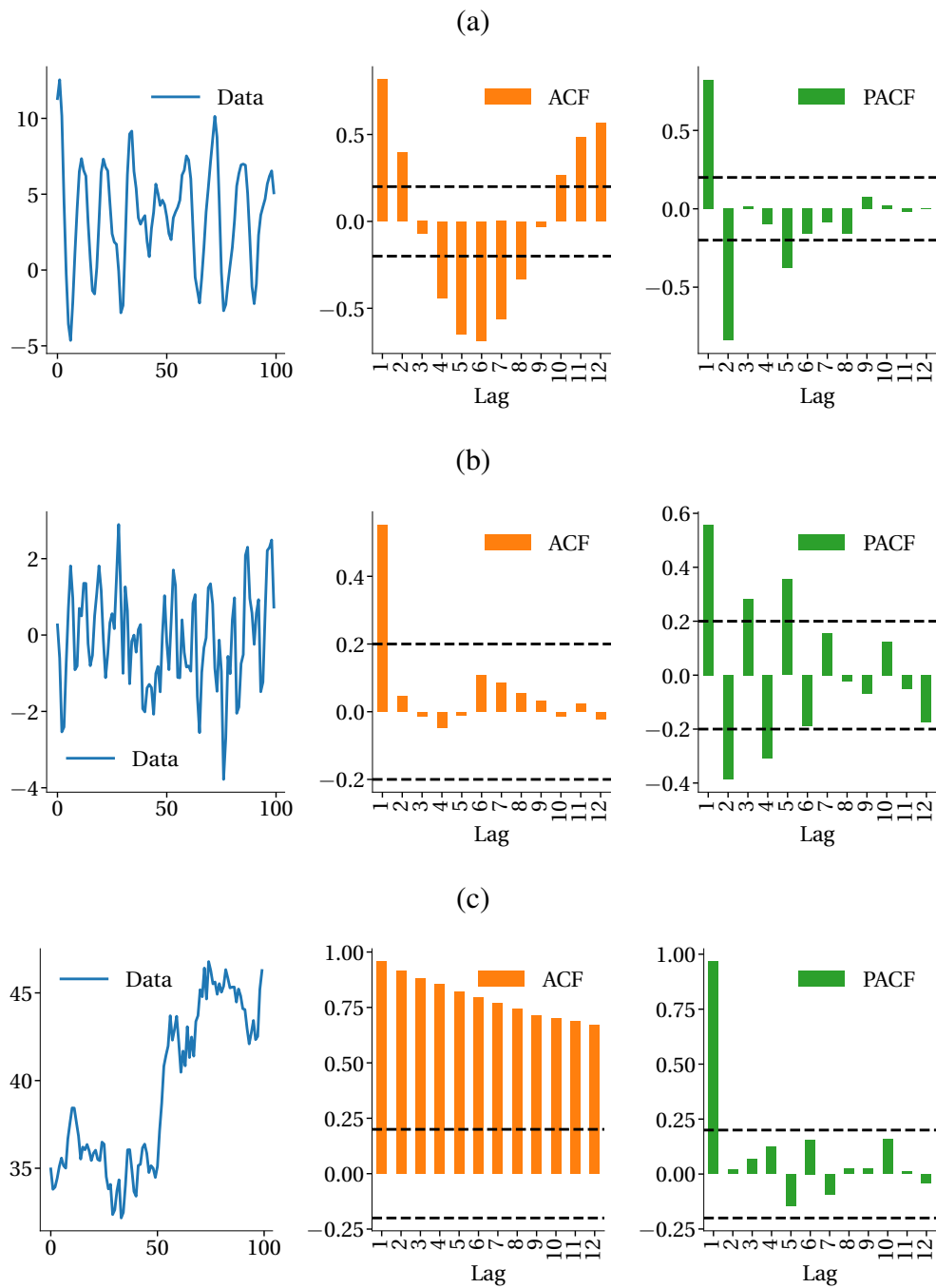


Figure 4.16: Plots for question problem 4.20.

2.  $E_t[Y_{t+1}], E_t[Y_{t+2}]$
3.  $E_t[\Delta Y_{t+h}]$  and  $E_t[Y_{t+h}]$  for an arbitrary  $h$
4.  $V_t[\Delta Y_{t+1}], V_t[\Delta Y_{t+2}]$
5.  $V_t[Y_{t+1}], V_t[Y_{t+2}]$
6.  $V_t[\Delta Y_{t+h}]$  and  $V_t[Y_{t+h}]$  for an arbitrary  $h$

Determine which of the models below are covariance stationary. If not, explain which property of covariance stationarity they violate

1.  $Y_t = Y_{t-1} + \varepsilon_t$
2.  $Y_t = \phi_0 + 0.9Y_{t-1} - 0.3Y_{t-1}I_{[t > 2020]} + \varepsilon_t$
3.  $Y_t = 0.33 + 1.4Y_{t-1} - 0.45Y_{t-2} + \varepsilon_t$
4.  $Y_t = \phi_0 + \sum_{i=2}^4 \gamma_i I_{[\text{Quarter}=i]} + \varepsilon_t$  where data is observed quarterly
5.  $Y_t = \phi_0 + 1.33\varepsilon_{t-1} + \varepsilon_t$
6.  $Y_t = \phi_0 + \delta t + 0.5Y_{t-1} + \varepsilon_t$

**Exercise 4.24.** Describe the four key types of non-stationarity in data and provide a model that exemplifies each type.

**Exercise 4.25.** What are the 1-step and 2-step forecasts  $E_t[Y_{t+h}]$  from the models:

1.  $Y_t = \phi_0 + \delta t + \varepsilon_t$
2.  $Y_t = \phi_0 + \delta t + \phi_1 Y_{t-1} + \varepsilon_t$
3.  $Y_t = \phi_0 + \delta_1 t + \delta_2 t^2 + \theta_1 \varepsilon_{t-1} + \varepsilon_t$
4.  $\ln Y_t = \phi_0 + \delta t + \varepsilon_t, \varepsilon \stackrel{\text{i.i.d.}}{\sim} N(0, \sigma^2)$  (use properties of Lognormal random variables)
5.  $\ln Y_t = Y_{t-1} + \varepsilon_t, \varepsilon \stackrel{\text{i.i.d.}}{\sim} N(0, \sigma^2)$  (use properties of Lognormal random variables)

**Exercise 4.26.** Write the following models using both lag notation and as the standard ARMA representation where  $Y_t$  is the left-hand-side variable:

1. SARIMA(1,0,0)  $\times$  (1,0,0,4)
2. SARIMA(0,0,2)  $\times$  (1,1,0,12)
3. SARIMA(2,0,2)  $\times$  (0,0,0,0)
4. SARIMA(1,2,1)  $\times$  (0,0,0,0)
5. SARIMA(0,0,0)  $\times$  (1,1,1,24)



**Exercise 4.27.** What are the  $E_t [Y_{t+h}|t]$  for  $h = 1, 2, 3, 4, 5$  for the following models:

1. SARIMA(1, 0, 1)  $\times$  (1, 0, 1, 4)
2. SARIMA(1, 1, 1)  $\times$  (1, 0, 1, 4)
3. SARIMA(1, 0, 1)  $\times$  (1, 1, 1, 4)

**Exercise 4.28.** What are the  $E_t [Y_{t+h}|t]$  for  $h = 1, 2, 3, 4, 5$  for the model  $(1 - \phi_1 L)(1 - \phi_s L^4) \Delta_4 Y_t = \phi_0 + (1 + \theta_1 L)(1 + \theta_s L^4) \varepsilon_t$ ? Note that the model is a SARIMA(1, 0, 1)  $\times$  (1, 1, 1, 4) with a non-zero constant  $\phi_0$ .

**Exercise 4.29.** Suppose you were trying to differentiate between an AR(1) and an MA(1) but could not estimate any regressions. What would you do?

**Exercise 4.30.** How are the autocorrelations and partial autocorrelations useful in building a model?

**Exercise 4.31.** Describe the three methods of model selection discussed in class: general-to-specific, specific-to-general and the use of information criteria (Schwarz/Bayesian Information Criteria and/or Akaike Information Criteria). When might each be preferred to the others?

**Exercise 4.32.** Consider the AR(2)

$$Y_t = \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \varepsilon_t$$

1. Rewrite the model with  $\Delta Y_t$  on the left-hand side and  $Y_{t-1}$  and  $\Delta Y_{t-1}$  on the right-hand side.
2. What restrictions are needed on  $\phi_1$  and  $\phi_2$  for this model to collapse to an AR(1) in the first differences?
3. When the model collapses, what does this tell you about  $Y_t$ ?

**Exercise 4.33.** Discuss the important issues when testing for unit roots in economic time-series.

**Exercise 4.34.** Outline the steps needed to determine whether a time series  $\{Y_t\}$  contains a unit root. Be certain to discuss the important considerations at each step, if any.

**Exercise 4.35.** Determine the order integration of each of the three time series using the ADF test results in the table below. The column difference indicates the number of times the series was differenced before running the test. The included trend was one of none, a constant (Const), a constant and time-trend (Time), or a constant and linear and quadratic time trends (Quad). The table reports the test statistic and its p-value.

Difference	Trend	Series 1		Series 2		Series 3	
		ADF Stat	P-value	ADF Stat	P-value	ADF Stat	P-value
	None	6.269	1.000	1.123	0.932	1.939	0.988
	Const	0.620	0.988	0.988	0.994	9.490	1.000
	Time	-3.624	0.028	-1.691	0.755	0.221	0.996
	Quad	-3.620	0.086	-3.219	0.202	-3.695	0.071
$\Delta$	None	-1.331	0.170	0.044	0.699	0.655	0.858
$\Delta$	Const	-7.806	0.000	-1.954	0.307	-1.651	0.457
$\Delta$	Time	-7.829	0.000	-2.273	0.449	-11.12	0.000
$\Delta$	Quad	-7.813	0.000	-2.263	0.699	-11.10	0.000
$\Delta^2$	None	-7.892	0.000	-15.10	0.000	-12.87	0.000
$\Delta^2$	Const	-7.876	0.000	-15.09	0.000	-12.87	0.000
$\Delta^2$	Time	-7.858	0.000	-15.06	0.000	-12.85	0.000
$\Delta^2$	Quad	-7.845	0.000	-15.03	0.000	-12.85	0.000

**Exercise 4.36.** Outline the steps needed to perform a unit root test on as time-series of FX rates. Be sure to detail the any important considerations that may affect the test.

**Exercise 4.37.** Based on the results in the table below that contains model estimates that are nested by the augmented Mincer-Zarnowitz regression

$$Y_{t+h} = \alpha + \beta \hat{Y}_{t+h|t} + \gamma Z_t + \eta_t$$

The table reports coefficients and their  $t$ -stats. Missing coefficient indicate that the variable was excluded from the model. The covariance estimator used in the MZ regression is reported in the final column.

$h$	$\alpha$	$\beta$	$\gamma$	Cov. Est.
1	0.06 (1.34)	1.08 (29.6)		White
1	-0.05 (-1.43)	1.00 (34.7)	2.36 (4.58)	Newey-West
3	-0.17 (-0.87)	1.02 (12.4)		White
3	-0.17 (-2.03)	1.02 (37.8)		Newey-West

**Exercise 4.38.** What are the expected values for  $\alpha$ ,  $\beta$  and  $\gamma$  when a forecasting model is well specified in the Mincer-Zarnowitz regression,

$$Y_{t+h} = \alpha + \beta \hat{Y}_{t+h|t} + \gamma X_t + \eta_{t+h}.$$

Provide an explanation for why these values should be expected.

**Exercise 4.39.** Let  $Y_t = \phi_0 + \phi_1 Y_{t-1} + \varepsilon_t$  where  $\{\varepsilon_t\}$  is a WN process.

1. Derive an explicit expression for the 1-step and 2-step ahead forecast errors,  $e_{t+h|t} = Y_{t+h} - \hat{Y}_{t+h|t}$  where  $\hat{Y}_{t+h|t}$  is the MSE optimal forecast where  $h = 1$  or  $h = 2$ .

2. What is the autocorrelation function of a time-series of forecast errors  $\{e_{t+h|t}\}$  for  $h = 1$  and  $h = 2$ ?
3. Generalize the above to a generic  $h$  (In other words, leave the solution as a function of  $h$ ).
4. How could you test whether the forecast has excess dependence using an ARMA model?

**Exercise 4.40.** Let  $Y_t = \phi_0 + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \varepsilon_t$  with the usual assumptions on  $\{\varepsilon_t\}$ .

1. Derive an explicit expression for the 1-step and 2-step ahead forecast errors,  $e_{t+h|t} = Y_{t+h} - \hat{Y}_{t+h|t}$  where  $\hat{Y}_{t+h|t}$  is the MSE optimal forecast where  $h = 1$  or  $h = 2$  (what is the MSE optimal forecast?).
2. What is the autocorrelation function of a time-series of forecast errors  $\{e_{t+h|t}\}$ ,  $h = 1$  or  $h = 2$ . (Hint: Use the formula you derived above)
3. Can you generalize the above to a generic  $h$ ? (In other words, leave the solution as a function of  $h$ ).
4. How could you test whether the forecast has excess dependence using an ARMA model?

**Exercise 4.41.** When should you use a Diebold-Mariano test statistic instead of a Mincer-Zarnowitz test when evaluating forecasts?

**Exercise 4.42.** Outline the steps needed to perform a Diebold-Mariano test that two models for the conditional mean are equivalent (in the MSE sense).

**Exercise 4.43.** A Diebold-Mariano test statistic is defined using  $\delta_t = l_t^A - l_t^B$  where  $l_t^i$  is the loss produced using the forecasts from model  $i$ . How do you interpret a Diebold-Mariano test statistic when the test statistic is significant and negative? What is the interpretation if the test statistic is significant and positive? And what if it is not significant?

**Exercise 4.44.** What are the consequences of using White or Newey-West to estimate the covariance in a linear regression when the errors are serially uncorrelated and homoskedastic?

