MONASH University

MONASH BUSINESS SCHOOL

ETC3550/ETC5550
Applied forecasting

Ch9. ARIMA models

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Backshift operator notation

- B shifts the data back one period. $By_t = y_{t-1}$
- B^2 shifts the data back two periods: $B(By_t) = B^2y_t = y_{t-2}$
- A difference can be written as $(1 - B)y_t$
- A dth-order difference can be written as $(1 - B)^d y_t$
- A seasonal difference followed by a first difference can be written as $(1 - B)(1 - B^m)y_t$

AR(1) model

$$y_t = c + \phi_1 y_{t-1} + \varepsilon_t$$

- When $\phi_1 = 0$, y_t is **equivalent to WN**
- When $\phi_1 = 1$ and $c = 0$, y_t is **equivalent to a RW**
- When $\phi_1 = 1$ and $c \neq 0$, y_t is **equivalent to a RW with drift**
- When $\phi_1 < 0$, y_t tends to **oscillate between positive and negative values**.

Autoregressive models

A multiple regression with **lagged values** of y_t as predictors.

$$\begin{aligned}
y_t &= c + \phi_1 y_{t-1} + \phi_2 y_{t-2} + \cdots + \phi_p y_{t-p} + \varepsilon_t \\
&= c + (\phi_1 B + \phi_2 B^2 + \cdots + \phi_p B^p) y_t + \varepsilon_t
\end{aligned}$$

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$$\begin{aligned} (1 - \phi_1 B - \phi_2 B^2 - \cdots - \phi_p B^p) y_t &= c + \varepsilon_t \\ \phi(B) y_t &= c + \varepsilon_t \end{aligned}$$

- ε_t is white noise.
- $\phi(B) = (1 - \phi_1 B - \phi_2 B^2 - \cdots - \phi_p B^p)$

Stationarity conditions

We normally restrict autoregressive models to stationary data, and then some constraints on the values of the parameters are required.

General condition for stationarity

Complex roots of $\phi(z) = 1 - \phi_1 z - \phi_2 z^2 - \dots - \phi_p z^p$ lie outside the unit circle on the complex plane.

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- For $p = 1$: $-1 < \phi_1 < 1$.
- For $p = 2$:
  $-1 < \phi_2 < 1 \qquad \phi_2 + \phi_1 < 1 \qquad \phi_2 - \phi_1 < 1.$
- More complicated conditions hold for $p \geq 3$.
- fable takes care of this.

Moving Average (MA) models

A multiple regression with **past *errors*** as predictors.

$$
\begin{aligned}
y_t &= c + \varepsilon_t + \theta_1\varepsilon_{t-1} + \theta_2\varepsilon_{t-2} + \cdots + \theta_q\varepsilon_{t-q} \\
&= c + (1 + \theta_1 B + \theta_2 B^2 + \cdots + \theta_q B^q)\varepsilon_t \\
&= c + \theta(B)\varepsilon_t
\end{aligned}
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General condition for invertibility

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- For $q = 1$: $-1 < \theta_1 < 1$.
- For $q = 2$:

  $$-1 < \theta_2 < 1 \qquad \theta_2 + \theta_1 > -1 \qquad \theta_1 - \theta_2 < 1.$$
- More complicated conditions hold for $q \geq 3$.
- fable takes care of this.

ARIMA models

ARIMA(p, d, q) model: $\phi(B)(1-B)^d y_t = c + \theta(B)\varepsilon_t$

AR: p = order of the autoregressive part
I: d = degree of first differencing involved
MA: q = order of the moving average part.

ARIMA models

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- Conditions on AR coefficients ensure stationarity.
- Conditions on MA coefficients ensure invertibility.
- White noise model: ARIMA(0,0,0)
- Random walk: ARIMA(0,1,0) with no constant
- Random walk with drift: ARIMA(0,1,0) with const.
- AR(p): ARIMA(p,0,0)
- MA(q): ARIMA(0,0,q)

R model

Intercept form

$$(1 - \phi_1 B - \cdots - \phi_p B^p) y_t' = c + (1 + \theta_1 B + \cdots + \theta_q B^q)\varepsilon_t$$

Mean form

$$(1 - \phi_1 B - \cdots - \phi_p B^p)(y_t' - \mu) = (1 + \theta_1 B + \cdots + \theta_q B^q)\varepsilon_t$$

- $y_t' = (1 - B)^d y_t$
- μ is the mean of y_t'.
- $c = \mu(1 - \phi_1 - \cdots - \phi_p)$.
- fable uses intercept form

Understanding ARIMA models

- If $c = 0$ and $d = 0$, the long-term forecasts will go to zero.
- If $c = 0$ and $d = 1$, the long-term forecasts will go to a non-zero constant.
- If $c = 0$ and $d = 2$, the long-term forecasts will follow a straight line.
- If $c \neq 0$ and $d = 0$, the long-term forecasts will go to the mean of the data.
- If $c \neq 0$ and $d = 1$, the long-term forecasts will follow a straight line.
- If $c \neq 0$ and $d = 2$, the long-term forecasts will follow a quadratic trend.

Understanding ARIMA models

Forecast variance and d

- The higher the value of d, the more rapidly the prediction intervals increase in size.
- For $d = 0$, the long-term forecast standard deviation will go to the standard deviation of the historical data.

Cyclic behaviour

- For cyclic forecasts, $p \geq 2$ and some restrictions on coefficients are required.
- If $p = 2$, we need $\phi_1^2 + 4\phi_2 < 0$. Then average cycle of length

$$(2\pi)/\left[\text{arc cos}(-\phi_1(1-\phi_2)/(4\phi_2))\right].$$

Point forecasts

1. Rearrange ARIMA equation so y_t is on LHS.
2. Rewrite equation by replacing t by $T + h$.
3. On RHS, replace future observations by their forecasts, future errors by zero, and past errors by corresponding residuals.

Start with $h = 1$. Repeat for $h = 2, 3, \ldots$.

Prediction intervals

95% prediction interval

$$\hat{y}_{T+h|T} \pm 1.96\sqrt{v_{T+h|T}}$$

where $v_{T+h|T}$ is estimated forecast variance.

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- $v_{T+1|T} = \hat{\sigma}^2$ for all ARIMA models regardless of parameters and orders.
- Multi-step prediction intervals for ARIMA(0,0,q):

$$y_t = \varepsilon_t + \sum_{i=1}^{q} \theta_i \varepsilon_{t-i}.$$

$$v_{T|T+h} = \hat{\sigma}^2 \left[1 + \sum_{i=1}^{h-1} \theta_i^2\right], \qquad \text{for } h = 2, 3, \dots .$$

Prediction intervals

- Prediction intervals **increase in size with forecast horizon**.
- Prediction intervals can be difficult to calculate by hand
- Calculations assume residuals are **uncorrelated** and **normally distributed**.
- Prediction intervals tend to be too narrow.
  - the uncertainty in the parameter estimates has not been accounted for.
  - the ARIMA model assumes historical patterns will not change during the forecast period.
  - the ARIMA model assumes uncorrelated future errors