

Consider the following data generating process (DGP):

$$y = 1 + 0.5x + v$$

where $x \sim N(1, 1)$ and $v \sim N(0, 1)$. Cannot observe x but instead observes one (or two) of the following:

$$x_1^* = x + e_1 \quad \text{where } e_1 \sim N(0, 0.25)$$

$$x_2^* = x + e_2 \quad \text{where } e_2 \sim N(0, 0.5)$$

$$x_3^* = x + e_3 \quad \text{where } e_3 \sim N(0, 19).$$

1. Simulate this DGP for $N = 500$ a total of 50 times.

a.

```
# Defining Parameters
```

```
n_sims <- 50
```

```
n <- 500
```

```
# Container for Results
```

```
sim_results <- tibble(iteration = 1:n_sims, beta_hat_ols1 = NA_real_,  
                      beta_hat_iv = NA_real_)
```

```
for (i in 1:n_sims) {
```

```
  # --- A. Data Generating Process ---
```

```
  x <- rnorm(n = n, mean = 1, sd = 1)
```

```
  v <- rnorm(n = n, mean = 0, sd = 1)
```

```
  y <- 1 + 0.5 * x + v
```

```
  e1 <- rnorm(n = n, mean = 0, sd = sqrt(0.25))
```

```
  e2 <- rnorm(n = n, mean = 0, sd = sqrt(0.5))
```

```
  e3 <- rnorm(n = n, mean = 0, sd = sqrt(19))
```

```
  x1 <- x + e1
```

```
  x2 <- x + e2
```

```
  x3 <- x + e3
```

```
  # Create a temporary dataframe for this iteration
```

```
  df_iter <- tibble(y, x1, x2, x3)
```

```
}
```

2. What are the theoretical biases from a regression of y onto x_1^* , x_2^* , and x_3^* ?

a.

1. Perform OLS regression `ols_model1 <- lm(y ~ x1, data = df_iter)`

2. Extract the coefficient for x_1^* `beta_x1 <- coef(ols_model1)[["x1"]]`

3. Save to the i -th row of the results tibble `sim_results$beta_hat_ols[i] <- beta_x1`

Rinse repeat `ols_model2 <- lm(y ~ x2, data = df_iter)` `beta_x2 <- coef(ols_model)[["x2"]]`
`sim_results$beta_hat_ols[i] <- beta_x2`

`ols_model3 <- lm(y ~ x3, data = df_iter)` `beta_x3 <- coef(ols_model)[["x3"]]`
`sim_results$beta_hat_ols[i] <- beta_x3`

3. How do the empirical biases compare to the theoretical biases?

a. It was a many step process, first we would need to recreate question 1 too then account for `beta_hat_x3` and `beta_hat_x2`. From here we then would add in the information gathered from within the for loop in question 2 after the generation of the temporary dataframe. To be more specific on what was added after the for loop, I put in the `ols_model1/2/3` along with the related `sim_results` for the `beta_hat`. After the for loop I took the average for fun and resolve question 3. By this I mean that using the LLN from Ch.3 of Wooldridge and Amemiya, we can use this to average to approximate a probability limit.

4. Consider two IV regressions of y onto x_1^* . The first uses x_2^* , and the second uses x_3^* as the instrumental variable. What is the mean of both IV estimates?

a. Estimate IV regression (y on x_1^* , instrumented by x_2^*) `iv_model <- ivreg(y ~ x1 | x2, data = df_iter)`

Extract the coefficient for x_1 `beta_iv_x1 <- coef(iv_model)[["x1"]]`

Saving Results `sim_results$beta_hat_iv[i] <- beta_iv_x1`

5. What are the average first stage F-statistics from both sets of regressions?

a. Summary object creation w/ diagnostics enabled This calculates the Weak Instruments test (First-stage F-stat) `iv_summary <- summary(iv_model, diagnostics = TRUE)`

Extract F Stats Storing it in the 'diagnostics' matrix under the row "Weak instruments" and column "statistic" `f_stat <- iv_summary$diagnostics["Weak instruments", "statistic"]`

6. Using the `twoway` command, plot kernel density estimates of both simulated IV estimates in a single plot.

a. Summary object creation w/ diagnostics enabled This calculates the Weak Instruments test (First-stage F-stat) `iv_summary <- summary(iv_model, diagnostics = TRUE)`

7. What can we conclude about the IV estimates that use x_3^* as the instrument? Why does it matter?

a. `#sim_results %>% select(beta_iv_x2, beta_iv_x3) %>% pivot_longer(cols = everything(), names_to = "Instrument", values_to = "Estimate") %>% ggplot(aes(x = Estimate, fill = Instrument)) + geom_density(alpha = 0.5) + labs(title = "Kernel Density Estimates of IV Estimators", x = "Beta Hat", y = "Density") + theme_minimal()`

8. Sample Graph :

