

# Neural additive VAR

## Proposal

Marc Agustí (marc.agusti@barcelonagse.eu)

Patrick Altmeyer (patrick.altmeyer@barcelonagse.eu)

Ignacio Vidal-Quadras Costa (ignacio.vidalquadrascosta@barcelonagse.eu)

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## Literature review

Does monetary policy affect the real economy? There is a large agreement among economists on the fact that monetary policy has a short-term influence on the economic activity. Friedman and Schwartz (1963) found that monetary policy actions are followed by movements in real output that may last for two years or more (Romer and Romer, 1989; Bernanke and Blinder, 1992). However, what are the forces that trigger this effect is of interest for most economists, in particular, economists aim to understand the monetary transmission mechanism. If monetary policy affects the real economy, what is the transmission mechanism by which these effects occur? This is one of the questions which is among the most important and controversial in macroeconomics.

Given the importance of this question, measuring accurately the effects of changes in monetary policy on the economy is of foremost importance. Doing this accurately has a positive impact in policy-making and also helps economists to choose the right macroeconomic theory when trying to get a better understanding of the underlying mechanisms of the economic system.

In the aftermath of the oil price shock in the 1970's, interest was raised in understanding business cycles. To do that, most economists made use of large-scale macroeconomic models, which was criticized by Lucas (1976), stating that the assumption of invariant behavioral equations was inconsistent with the dynamic maximizing behavior. Hence, New Classical economists started making use of the so-called market clearing models of economic fluctuations. With the goal of really taking into account productivity shocks, Real Business Cycle models were developed (Kydland and Prescott 1982).

After the failure of the large-scale macroeconomic models when trying to predict business cycles, the economic profession tried to solve this by means of the use of structural vector autoregression (VAR) models to analyze business cycles, which were useful to capture the impact of policy-actions. Christofer A. Sims suggested that VARs were useful to evaluate macroeconomic models. One of the advantage of VARs is that they are not a large and complicated structure, and hence are easily interpretable (do not suffer from the "black box" problem).

In the last decades the use of VAR's in order to do time series forecasting has been quite extensive. Actually, a lot of different models have been proposed with the intention to model and predict time series data. When it comes to the VAR framework, the different factors in the projected VAR models are difficult to understand, and that is why researchers rely heavily on impulse response functions (IRF) (Enders (2008)).

As for now, the models we have seen are more classical econometric based models that are not able to capture nonlinear relationships in the data, which might be sometimes a limitation. In the case of economic time series, specifically gdp, inflation and so on, nonlinear trends are likely to appear and be present in the essence of the data generating process as shown by WA Brock, DA Hsieh, BD LeBaron, WE Brock in Nonlinear dynamics, chaos, and instability: statistical theory and economic evidence.

In the past years, authors have therefore started using nonlinear techniques for forecasting. Machine Learning has contributed a lot to this field. The most popular machine learning techniques which do not assume a linear relationship between inputs and outputs are K-Nearest Neighbors (first introduced by E. Fix and J.L. Hodges in 1951 in the paper *An Important Contribution to Nonparametric Discriminant Analysis and Density Estimation*), Support Vector Machines (mostly developed by Vapnik et al. in 1997 in the paper *Support-vector Networks*), Random Forests (first introduced in 1995 by Tin Kam Ho in the paper *Random Decision Forest*) and Neural Networks (NN) (first proposed by in 1943 by Warren McCulloch and Walter Pitts, two University of Chicago researchers in the paper *A logical calculus of the ideas immanent in nervous activity*).

The most recent and complex algorithm of the ones mentioned above is NN. NN are a relatively new nonlinear technique to which a lot of authors have made contributions. One of the main advantages of NN compared to the linear models is that they can approximate any nonlinear functions without any apriori information about the properties of the data series. In our case we are interested in the application of NN to time series.

The main idea of NN is to reproduce the inner working of the human mind. NN consist of thousands or even millions of simple processing neurons that are densely interconnected. These neurons are organized in layers. A NN contains an input layer, one or more hidden layers and an output layer and information flows from one layer to another using weight. One neuron receives information from other neurons in the previous layer and passes the processed information into the next layer. This information can flow only in one direction (from the previous layer to the next layer), which means the NN is “feed-forward” or can retrieve information. Each connection between neurons is weighted. When the network is active, the neuron receives a different data (information) from each of its connections and multiplies it by the associated weight. It then adds the resulting products together and passes this output through an activation function that maps the output, yielding the final output. Finally, this output is then passed onto the next neurons. This processed is repeated until we reach the output layer.

With this new algorithm coming into play, Guoqiang Zhang, B. Eddy Patuwo, Michael Y. Hu used NN for forecasting in their paper *Forecasting with artificial neural networks: The state of the art*. Recently, artificial neural networks (ANN) have played attention enhancing devotions in the field of time series predicting (Hamzacebi, (2008), Zhang, Patuwo and Hu (1998), Kihoro, et al. (2006)). In particular, ANNs have the advantage of not assuming the statistical distribution followed by the values, being able of proficiently capturing non-linearities. That is, they are self-adaptive (Zhang, Patuwo and Hu (1998), Zhang (2003)).

A class of ANN is the called recurrent neural network (RNN). RNN allows to use previous outputs as inputs, this allows the model to retain information about the past, making it very efficient for time series. This has been shown by *Neural Networks for Time Series Processing* by Georg Dorner. In this article, the author highlights the power of RNN for forecasting compared with standard linear models.

For this reason, a lot of authors interested to forecast economic series have compared linear models with nonlinear models. In economic time series, in the short run, the series is expected to behave more or less the same way it has been behaving up to this point, but on the other hand, if we are interested in forecasting at a big window, then then is when chaos and instability appear, meaning that nonlinear relations may arise, making it more appealing to use ANN as they are capable of identifying these turning points as they do not assume a linear relationship of inputs and outputs.

This was shown by a recent paper of the Bank of England, *Forecasting UK inflation bottom up* by Andreas Joseph, Eleni Kalamara, George Kapetanios and Galina Potjagailo. In this paper they run a horse race for forecasting inflation among different horizons comparing the performance of linear and nonlinear algorithms. The results support out hypothesis that NN and other nonlinear Machine Learning algorithms are useful for forecasting at a longer horizon given that, the longer the horizon, the more likely it is to find the chaos and instability WA Brock, DA Hsieh, BD LeBaron, WE Brock talked about. And, as previously exposed, these turning points are hard to spot with linear relationships of inputs and outputs, while they might be easier to spot with nonlinear models, like SVM or NN.

One of the problems of RNN is the long-term dependency. To illustrate it with an example, some decisions are made taking into account information that happened way back in the past. RNN struggle to keep this very old information therefore limiting its forecasting power. In order to solve this problem, Hochreiter &

Schmidhuber (1997) introduced the LSTM in the paper Long Short-Term Memory. This is the reason why a lot of authors use this type of RNN when forecasting any kind of time series.

Yet, when we are interested in the monetary transition mechanism, we are not just interested in the forecasting accuracy of the model we use but we are also interested in the inference. Central banks need to know if rates granger cause one variable or not or they also need to know the IRF in order to implement the correct monetary policy.

The linear additive relationship of linear models allows the model to observe which variable granger cause another and what are the IRF of each variable with respect to another. Unfortunately, in the case of nonlinear models, its nature makes it impossible to recover these insights because the outputs and the inputs do not have a linear additive structure.

Therefore, on the one hand, the nonlinear structure of NN helps us for forecasting in the case that there are some nonlinear relationships in the series, but on the other hand we lose the interpretability of the model, making it impossible to recover IRF or to even to assess if one variable granger causes another. This problem is also known as the black box problem. This is because the data fed into the input layer passes through the succeeding layers, getting multiplied, added together and transformed in complex and different ways, until it finally arrives, radically transformed, at the output layer. Therefore, it is impossible to assess what happened with one input and how it affected the output.

Whether neural networks can do the job that so far has been done by VARs (and its extensions) is not so clear. In the past years some part of the research in this field has been put towards the study of neural networks for time series modelling. The research question investigated in this article is that whether and how the newly developed deep learningbased algorithms for forecasting time series data, such as LSTM are superior to the traditional algorithms such as VAR. Therefore, assessing the accuracy of forecasts is necessary when employing various forms of forecasting methods, and more specifically forecasting using regression analysis as they have several limitations in applications