

ML in Economics and Finance: Where Do We Go Now? - Part II

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- 1. What is ML, anyway?
 - 2. Causality in High Dimensions
 - 3. (Seriously) Heterogeneous Partial Effects
 - 4. Solving Large-Scale Dynamic Models
- } Yesterday
- } Today

Heterogeneous Partial Effects

Motivation

Let Y be an outcome and X, Z be features (covariates). We frequently want to approximate

$$h(x, z) \equiv \mathbb{E}[Y|X = x, Z = z]$$

and the **partial effects**

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- Approach 2: use fully nonparametric methods. Pros and cons?
- The third way is the charm: a bit of structure, a bit of ML!

Example I - Heterogenous Treatment Effects

- Outcomes Y_i depend on a treatment $X_i \in \mathbb{R}$ and covariates $Z_i \in \mathbb{R}^p$;
- The dose X_i depends on observables Z_i ;
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- The dose X_i depends on observables Z_i ;
- Potential outcomes $Y_i(x)$ for each dose $x \in \mathbb{R}$;
- The conditional average effect of increasing the dose is $\tau(x, z) \equiv \frac{\partial}{\partial x} \mathbb{E}[Y(x)|Z = z]$;
- If $\mathbb{E}[Y(x)|X = x, Z = z] = \mathbb{E}[Y(x)|Z = z]$ (common assumption in the literature), then

$$\tau(x, z) = \frac{\partial}{\partial x} \mathbb{E}[Y|X = x, Z = z] = \frac{\partial h(x, z)}{\partial x}$$

Example II - Grouped Heterogeneity

Consider the following model:

$$Y_i = \alpha(Z_i) + X'_i \beta + \varepsilon_i, \quad \mathbb{E}[\varepsilon_i | X_i, Z_i] = 0,$$

- X_i affects Y_i homogeneously;
- Intercept $\alpha(Z_i)$ varies with Z_i , maybe in a highly nonlinear way;
- Since Z_i and X_i can be correlated, this can affect inference about β ;
- [Bonhomme and Manresa \(2015\)](#) studied how democracy affects national income using this model;
- In their case: $\alpha(Z_i)$ is constant across groups but Z_i defines membership;
- In our notation: $h(z, x) = \alpha(z) + x' \beta$

How can we balance flexibility and interpretability?

🇧🇷 Masini and Medeiros (2025) 🇧🇷 proposed some middle ground:

$$h(x, z) = x^\top \beta(z), \quad \frac{\partial h(x, z)}{\partial x} = \beta(z)$$

- The partial effect of X on Y varies with Z through $\beta(z)$;
- $\beta(\cdot)$ is a Lipschitz function that can be estimated with ML methods;
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But what is a Random Forest, anyway? 🤔

Questions?

Quick Intro to Random Forests

Random Trees

Recall the general ML framework:

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- If $X \in \mathbb{R}^p$, consider a finite partition $\{S_1, S_2, \dots, S_m\}$ of \mathbb{R}^p ;
- Each S_i is a hyperrectangle defined by recursive binary splits on the covariates;
- On each S_i , f is constant: $f(x) = \mu_i$ for all $x \in S_i$;
- After a tree has been estimated (“grown”), $\hat{f}(x_i) = \mu_i$ if $x_i \in S_i$;

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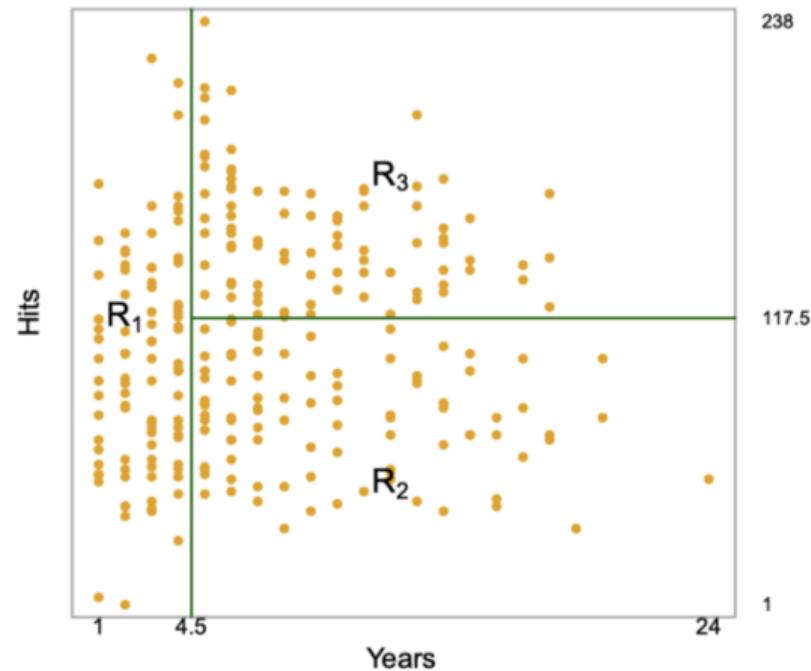
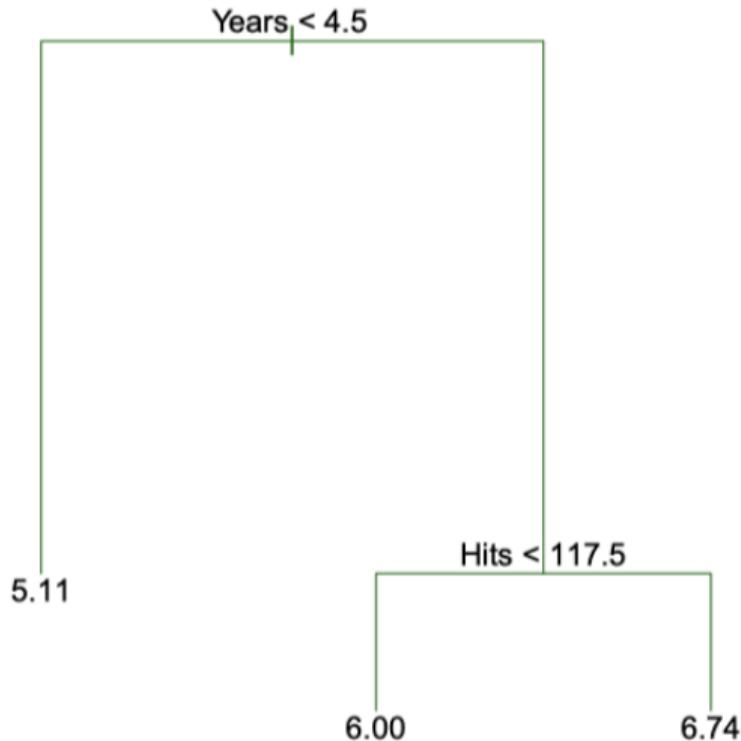
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Hyafil and Rivest (1976): this is harder than you think! The problem is NP-complete!

Example: Predicting Baseball Player Salaries



How to pick a split point? Use some greed!

Let's say you want to split on feature X_j at point δ :

$$S_1 \equiv \{x \in \mathbb{R}^p : x_j \leq \delta\}, \quad S_2 \equiv \{x \in \mathbb{R}^p : x_j > \delta\}$$

$$\mu_1(\delta) \equiv \sum_{i:x_i \in S_1} \frac{Y_i}{n_1}, \quad \mu_2(\delta) \equiv \sum_{i:x_i \in S_2} \frac{Y_i}{n_2}$$

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- Define $SSR(\delta) \equiv \sum_{i:x_i \in S_1} (Y_i - \mu_1(\delta))^2 + \sum_{i:x_i \in S_2} (Y_i - \mu_2(\delta))^2$
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- Repeat this for all features X_j and pick the best one;
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- Example: minimum number of observations per leaf;

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This is the so-called the **CART** algorithm due to Breiman et al. (1984).

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Key insight:

- Each tree is noisy and biased, but averaging them reduces variance dramatically;
- Randomness *decorrelates* the trees, making averaging powerful;

Questions?

Back to Partial Effects

The Main Insight

We have a random sample $\{(Y_i, X_i, Z_i)\}_{i=1}^n$ from

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Pick δ to minimize $SSR(\delta)$!

The Algorithm

Pick a number of trees B and a minimum leaf size k . For $b = 1, \dots, B$:

1. Draw a bootstrap sample of size $s \leq n$ from the data;
2. Divide the data into two halves \mathcal{A} and \mathcal{B} ;
3. Using \mathcal{B} , keep splitting at random dimensions j using the previous criterion;
4. Stop when all leaves have less than $2k - 1$ and more than k observations;
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The final estimate is

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This algorithm uses **honest trees!** Similar intuition to cross-fitting.

Cool Properties and Limitations

Cool properties:

- Highly interpretable and relatively mild assumptions on $\beta(z)$;
- Easy confidence intervals for $\beta(z)$ at any point z :

$$\Omega^{-1/2}(z) \left(\hat{\beta}(z) - \beta(z) \right) \xrightarrow{d} \mathcal{N}(0, I_q)$$

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Limitations:

- The dimension of X_i should be small relative to n ;
- The dimension of Z_i cannot be *that* large relative to n ;
- Pointwise inference only;
- It can be computationally demanding in large datasets;

Questions?

Take a deep breath... we are changing topics!



Solving Large Models Through Deep Learning

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- Traditional practice: simpler economics, simpler models;
- In practice: forget solving models with more than $\approx 10\text{-}15$ state variables;

Deep Learning to the rescue!

The Three Musketeers

Let $\mathbf{s} \in \mathbb{R}^n$ be a state vector, $\mathbf{c} \in \mathbb{R}^m$ be a control vector, and $\mathbf{u} \in \mathbb{R}^k$ be shocks:

$$V(\mathbf{s}) = \max_{\mathbf{c}} \left\{ u(\mathbf{c}) + e^{-\rho} \mathbb{E} [V(\mathbf{s}') \mid \mathbf{s}, \mathbf{c}] \right\}$$
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Following [Powell \(2011\)](#)

- **The curse of representation:** a Cartesian grid for \mathbf{s} grows exponentially with n ;
 - Ex: 100 grid points per dimension $\implies 10^{2n}$ total points;
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- **The curse of expectation:**

$$\mathbb{E} [V(\mathbf{s}') \mid \mathbf{s}, \mathbf{c}] = \int_{u_1} \int_{u_2} \cdots \int_{u_k} V(f(\mathbf{s}, \mathbf{c}(\mathbf{s}), \mathbf{u})) \phi(\mathbf{u}) du_1 du_2 \cdots du_k$$

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- **The curse of optimization:** Given $V(\cdot)$, 10^{2n} optimizations to find $\mathbf{c}(\mathbf{s})$;

Can Ito Calculus Save Us?

$$V(\mathbf{s}_t) = \sup_{\mathbf{c}} \mathbb{E}_t \left\{ \int_t^{\infty} e^{-\rho(\nu-t)} u(\mathbf{c}_{\nu}) d\nu \right\}$$

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Under some conditions, $V(\mathbf{s})$ and $\mathbf{c}(\mathbf{s})$ are such that:

$$HJB(\mathbf{s}, \mathbf{c}, V) \equiv -\rho V(\mathbf{s}) + u(\mathbf{c}) + \nabla_{\mathbf{s}} V(\mathbf{s})^\top f(\mathbf{s}, \mathbf{c}) + \frac{1}{2} \text{tr} \left(g(\mathbf{s}, \mathbf{c})^\top \nabla_{ss}^2 V(\mathbf{s}) g(\mathbf{s}, \mathbf{c}) \right)$$

$$HJB(\mathbf{s}, \mathbf{c}(\mathbf{s}), V(\mathbf{s})) = 0, \quad \forall \mathbf{s} \in \mathbb{R}^n \text{ at the optimum policy}$$

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Can Ito Calculus Save Us?

$$V(\mathbf{s}_t) = \sup_{\mathbf{c}} \mathbb{E}_t \left\{ \int_t^{\infty} e^{-\rho(\nu-t)} u(\mathbf{c}_{\nu}) d\nu \right\}$$

$$\text{subject to } d\mathbf{s}_t = f(\mathbf{s}_t, \mathbf{c}_t) dt + g(\mathbf{s}_t, \mathbf{c}_t) d\mathbf{B}_t$$

The Stochastic Control gang is smart... give up \mathbb{E} , use Ito's lemma, and solve a PDE!

Under some conditions, $V(\mathbf{s})$ and $\mathbf{c}(\mathbf{s})$ are such that:

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- **Even worse news:** solving PDEs in high dimensions is notoriously difficult;
- Typical approach from engineering: **Finite Differences** or **Finite Elements**;
- Let $n = 1$ (scalar state) and an equally spaced grid $\{\mathbf{s}_1, \mathbf{s}_2, \dots, \mathbf{s}_M\}$. Then:

$$\frac{dV(s)}{ds}\Big|_{s=s_i} \approx \frac{V(s_{i+1}) - V(s_{i-1})}{\Delta s}, \quad \frac{d^2V(s)}{ds^2}\Big|_{s=s_i} \approx \frac{V(s_{i+1}) - 2V(s_i) + V(s_{i-1})}{\Delta s^2}$$

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- Drawback: we need very fine grids to approximate derivatives well;

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- Excellent global approximation properties (minimax interpolation error);
- **However:** if $n > 1$, the basis relies on **tensor products**:

$$V(s_1, \dots, s_n) = \sum_{k_1=0}^K \cdots \sum_{k_n=0}^K a_{k_1, \dots, k_n} \prod_{j=1}^n T_{k_j}(s_j)$$

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- Number of coefficients grows exponentially with n :

$$(K + 1)^n$$

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But why?

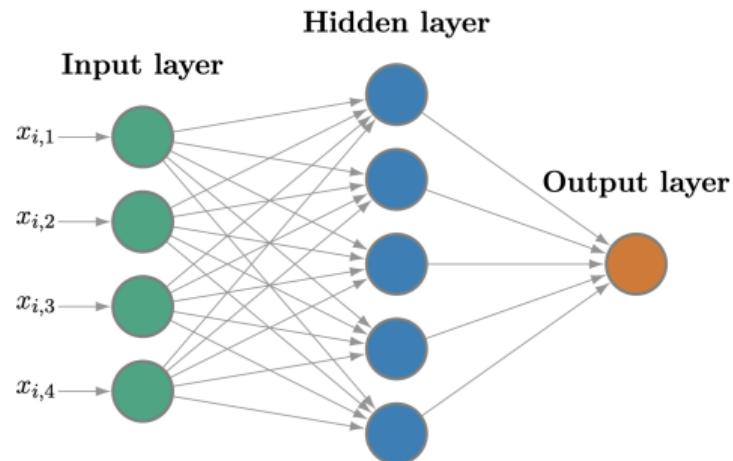
- Neural networks can approximate almost any function;
- Computing gradients is super fast due to breakthroughs in *Automatic Differentiation*;
- If we use *deep* Neural Nets, we need few parameters!

Questions?

But what is a Neural Network?

A Smart Way of Composing Functions

- Each node is equipped with weights w , a bias b , and an activation function $\sigma(\cdot)$;
- Hidden nodes compute $\sigma(w^\top x + b)$;
- Examples of $\sigma(\cdot)$: $\underbrace{\max\{0, x\}}_{\text{ReLU}}$, $\tanh(x)$;
- Output of hidden layer:
$$\mathbf{h}(\mathbf{x}, \theta) = \sigma(W\mathbf{x} + \mathbf{b});$$
- Final output: $\hat{y} = w_{out}^\top \mathbf{h}(\mathbf{x}, \theta) + b_{out}$;
- Abuse notation: $\theta \equiv (W, b, w_{out}, b_{out})$
- *Shallow neural network* = 1 hidden layer;



Does it have good properties?

Cybenko (1989), Hornik et al. (1989), and Hornik (1991) proved that this basis of functions is rich:

Theorem (Universal Approximation)

Any continuous function on a compact subset of \mathbb{R}^n can be approximated to arbitrary precision by a shallow neural network with any non-polynomial activation function.

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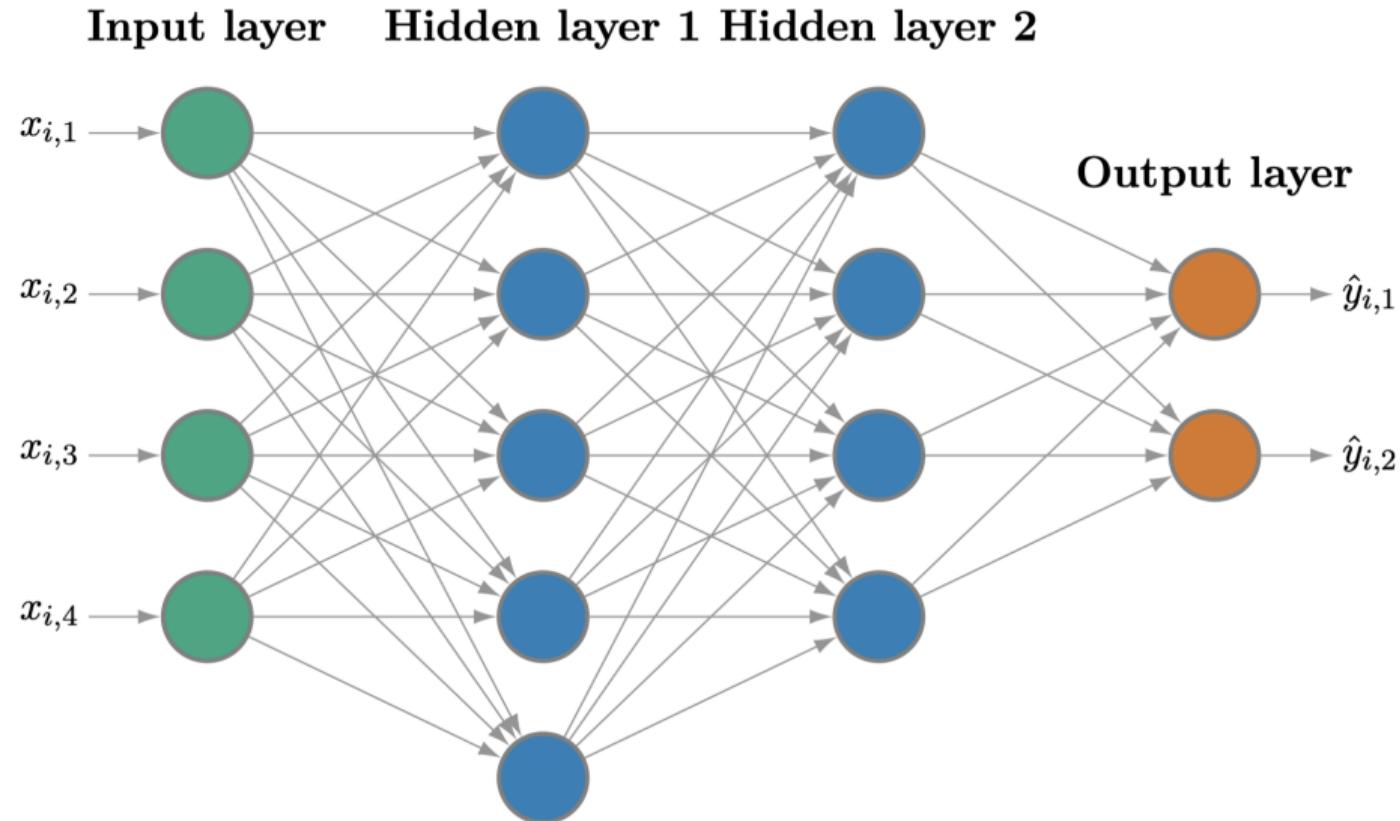
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Theorem (Lu et al. (2017))

For any Lebesgue integrable function $f \in L^1(\mathbb{R}^n)$, there exists a ReLU deep neural network with width at most $n + 4$ in every hidden layer that approximates f to arbitrary precision.

What is a Deep Neural Network?



How do we find these parameters?

Training the network = picking θ to minimize some loss function:

$$\mathcal{L}(\theta) = \frac{1}{n} \sum_{i=1}^n (y_i - f(\mathbf{x}_i, \theta))^2$$

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$$\begin{aligned}\theta_{k+1} &= \theta_k - \gamma \nabla_{\theta} \mathcal{L}(\theta_k) \\&= \theta_k + \frac{2\gamma}{n} \sum_{i=1}^n (y_i - f(\mathbf{x}_i, \theta_k)) \nabla_{\theta} f(\mathbf{x}_i, \theta_k) \\&= \theta_k + \tilde{\gamma} \sum_{i=1}^n \hat{\varepsilon}_i(\theta_k) \nabla_{\theta} f(\mathbf{x}_i, \theta_k)\end{aligned}$$

Questions?

Back to Solving Models!

Big Picture

Recall that we need to find $V(\mathbf{s})$ and $\mathbf{c}(\mathbf{s})$ such that:

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- Key insight in [Duarte et al. \(2024\)](#): approximate $V(\mathbf{s})$ and $\mathbf{c}(\mathbf{s})$ using DNNs;
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- Derivatives of $V(\cdot)$ are super fast to compute using Automatic Differentiation;
- We look for a pair (θ_V, θ_c) that solves minimizes the HJB residuals!
- Notation: $HJB(\mathbf{s}, \mathbf{c}(\mathbf{s}, \theta_c), V(\mathbf{s}, \theta_V)) \equiv HJB(\mathbf{s}, \theta_c, \theta_V)$;

The Algorithm

Step 1: sample l points $\{\mathbf{s}_i\}_{i=1}^l$ from the state space \mathcal{S} (for example, uniformly);

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$$\boldsymbol{\theta}_c^{(j)} = \boldsymbol{\theta}_c^{(j-1)} + \frac{\gamma}{I} \left(\sum_{i=1}^I \nabla_{\boldsymbol{\theta}_c} HJB \left(\mathbf{s}_i, \boldsymbol{\theta}_c^{(j-1)}, \boldsymbol{\theta}_V^{(j-1)} \right) \right)$$

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$$\mathcal{L}(\boldsymbol{\theta}_V) \equiv \frac{1}{2I} \sum_{i=1}^I \left(HJB \left(\mathbf{s}_i, \boldsymbol{\theta}_c^{(j)}, \boldsymbol{\theta}_V \right) \right)^2$$

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The Algorithm (continued)

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Summarizing:

- DNNs are a rich basis of functions with cheap derivatives and not so many parameters;
- They are an extremely flexible class;

Wrap-Up

In two days, we covered a lot of ground!

- Always think about ML methods as an array of *functional bases*;
- A bit of LASSO and how to use it when we have many controls
- A bit of Random Forests and how to use them to estimate heterogeneous partial effects;
- A tiny drop of Deep Learning and how to tweak it to solve HJB equations;
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Important: I hope you had fun!

Thank you! 🙏

Scan below to get in touch!



Appendix and References

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