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Econometrics 2 - Lecture 4

# Lag Structures, Cointegration

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# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model

# The Lüdeke Model for Germany

## 1. Consumption function

$$C_t = \alpha_1 + \alpha_2 Y_t + \alpha_3 C_{t-1} + \varepsilon_{1t}$$

## 2. Investment function

$$I_t = \beta_1 + \beta_2 Y_t + \beta_3 P_{t-1} + \varepsilon_{2t}$$

## 3. Import function

$$M_t = \gamma_1 + \gamma_2 Y_t + \gamma_3 M_{t-1} + \varepsilon_{3t}$$

## 4. Identity relation

$$Y_t = C_t + I_t - M_{t-1} + G_t$$

with  $C$ : private consumption,  $Y$ : GDP,  $I$ : investments,  $P$ : profits,  $M$ : imports,  $G$ : governmental spending

Variables:

- Endogenous:  $C, Y, I, M$
- Exogenous, predetermined:  $G, P_{-1}$

# Econometric Models

Basis is the multiple linear regression model

Model extensions

- Dynamic models, i.e., models which contain lagged variables
- Systems of regression relations, i.e., models which describe more than one dependent variable

Example: Lüdeke Model

- Consists of four dynamic equations
- for the four dependent variables  $C$ ,  $Y$ ,  $I$ ,  $M$

# Dynamic Models: Examples

Demand model: describes the quantity  $Q$  demanded of a product as a function of its price  $P$  and the income  $Y$  of households

Demand is determined by

- Current price and current income (static model):

$$Q_t = \beta_1 + \beta_2 P_t + \beta_3 Y_t + \varepsilon_t$$

- Current price and income of the previous period (dynamic model):

$$Q_t = \beta_1 + \beta_2 P_t + \beta_3 Y_{t-1} + \varepsilon_t$$

- Current price and demand of the previous period (dynamic autoregressive model):

$$Q_t = \beta_1 + \beta_2 P_t + \beta_3 Q_{t-1} + \varepsilon_t$$

# The Dynamic of Processes

Static processes: immediate reaction to changes in regressors, the adjustment of the dependent variables to the realizations of the independent variables will be completed within the current period, the process seems to be always in equilibrium

Static models are often inappropriate

- Some processes are determined by the past, e.g., energy consumption depends on past investments into energy-consuming systems and equipment
- Actors in economic processes may respond delayed, e.g., time for decision-making and procurement processes exceeds the observation period
- Expectations: e.g., consumption depends not only on current income but also on the income expectations; modeling the expectation may be based on past development

# Elements of Dynamic Models

- Lag structures, distributed lags: linear combinations of current and past values of a variable
- Models for expectations: based on lag structures, e.g., adaptive expectation model, partial adjustment model
- Autoregressive distributed lag (ADL) model: a simple but widely applicable model consisting of an autoregressive part and of a finite lag structure of the independent variables

# Contents

- Dynamic Models
- Lag Structures
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- Models for Expectations
- Models with Non-stationary Variables
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- Test for Cointegration
- Error-correction model



# Example: Demand Functions

- Demand for durable consumer goods: demand  $Q$  depends on the price  $P$  and on the income  $Y$  of the current and two previous periods:

$$Q_t = \alpha + \beta_0 Y_t + \beta_1 Y_{t-1} + \beta_2 Y_{t-2} + \gamma P_t + \varepsilon_t$$

- Demand for energy:

$$Q_t = \alpha + \beta P_t + \gamma K_t + u_t$$

with  $P$ : price of energy,  $K$ : energy-related capital stock

$$K_t = \theta_0 + \theta_1 P_{t-1} + \theta_2 P_{t-2} + \dots + \delta Y_t + v_t$$

with  $Y$ : income; substitution of  $K$  results in

$$Q_t = \alpha_0 + \alpha_1 Y_t + \beta_0 P_t + \beta_1 P_{t-1} + \beta_2 P_{t-1} + \dots + \varepsilon_t$$

with  $\varepsilon_t = u_t + \gamma v_t$ ,  $\alpha_0 = \alpha + \gamma\delta$ ,  $\beta_0 = \beta$ , and  $\beta_i = \gamma\theta_i$ ,  $i = 1, 2, \dots$

# Models with Lag Structures

Distributed lag model: describes the delayed effect of one or more regressors on the dependent variable; e.g.,

- DL(s) model

$$Y_t = \delta + \sum_{i=0}^s \varphi_i X_{t-i} + \varepsilon_t$$

distributed lag of order s model

Topics of interest

- Estimation of coefficients
- Interpretation of parameters

# Example: Consumption Function

Data for Austria (1990:1 – 2009:2), logarithmic differences:

$$\hat{C} = 0.009 + 0.621 Y$$

with  $t(Y) = 2.288$ ,  $R^2 = 0.335$

DL(2) model, same data:

$$\hat{C} = 0.006 + 0.504 Y - 0.026 Y_{-1} + 0.274 Y_{-2}$$

with  $t(Y) = 3.79$ ,  $t(Y_{-1}) = -0.18$ ,  $t(Y_{-2}) = 2.11$ ,  $R^2 = 0.370$

Effect of income on consumption:

- Short term effect, i.e., effect in the current period:

$$\Delta C = 0.504, \text{ given a change in income } \Delta Y = 1$$

- Overall effect, i.e., cumulative current and future effects

$$\Delta C = 0.504 - 0.026 + 0.274 = 0.752, \text{ given a change in income } \Delta Y = 1$$

# Multiplier

Describes the effect of a change in explanatory variable  $X_t$  by  $\Delta X = 1$  on current and future values of the dependent variable  $Y$

DL(s) model:  $Y_t = \delta + \varphi_0 X_t + \varphi_1 X_{t-1} + \dots + \varphi_s X_{t-s} + \varepsilon_t$

- Short run or impact multiplier

$$\frac{\partial Y_t}{\partial X_t} = \varphi_0$$

effect of the change in the same period, immediate effect of  $\Delta X = 1$  on  $Y$ :

$$\Delta Y = \varphi_0$$

- Long run multiplier

Effect of  $\Delta X = 1$  after 1, ..., s periods:

$$\frac{\partial Y_{t+1}}{\partial X_t} = \varphi_1, \dots, \frac{\partial Y_{t+s}}{\partial X_t} = \varphi_s$$

Cumulated effect of  $\Delta X = 1$  at  $t$  over all future on  $Y$ :  $\Delta Y = \varphi_0 + \dots + \varphi_s$

# Equilibrium Multiplier

If after a change  $\Delta X$  an equilibrium occurs within a finite time: Long run multiplier is called equilibrium multiplier

- DL(s) model

$$Y_t = \delta + \varphi_0 X_t + \varphi_1 X_{t-1} + \dots + \varphi_s X_{t-s} + \varepsilon_t$$

equilibrium after s periods

- No equilibrium for models with an infinite lag structure

# Average Lag Time

## Characteristics of lag structure

- Portion of equilibrium effect in the adaptation process

- At the end of the period  $t$ :

$$w_0 = \varphi_0 / (\varphi_0 + \varphi_1 + \dots + \varphi_s)$$

- At the end of the period  $t + 1$ :

$$w_0 + w_1 = (\varphi_0 + \varphi_1) / (\varphi_0 + \varphi_1 + \dots + \varphi_s)$$

- Etc.

with weights  $w_i = \varphi_i / (\varphi_0 + \varphi_1 + \dots + \varphi_s)$

- Average lag time:  $\sum_i i w_i$

- Median lag time: time till 50% of the equilibrium effect is reached, i.e., minimal  $s^*$  with

$$w_0 + \dots + w_{s^*} \geq 0.5$$

# Consumption Function

For  $\Delta Y = 1$ , the function

$$\hat{C} = 0.006 + 0.504Y - 0.026Y_{-1} + 0.274Y_{-2}$$

gives

- Short run effect: 0.504
- Overall effect: 0.752
- Equilibrium effect : 0.752
- Average lag time: 0.694 quarters, i.e., ~ 2.3 months
- Median lag time:  $s^* = 0$ ; cumulative sums of weights are 0.671, 0.636, 1.000

# Lag Structures: Estimation

DL( $s$ ) model: problems with OLS estimation

- Loss of observations: for a sample size  $N$ , only  $N-s$  observations are available for estimation; infinite lag structure!
- Multicollinearity
- Order  $s$  (mostly) not known

Consequences:

- Large standard errors of estimates
- Low power of tests

Issues:

- Choice of  $s$
- Models for the lag structure with smaller number of parameters, e.g., polynomial structure



# Consumption Function

Fitted function

$$\hat{C} = 0.006 + 0.504Y - 0.026Y_{-1} + 0.274Y_{-2}$$

with  $p$ -value for coefficient of  $Y_{-2}$ : 0.039,  $\text{adj.}R^2 = 0.342$ ,  $\text{AIC} = -5.204$

Models for  $s \leq 7$

$s$	AIC	$p$ -Wert	adj. $R^2$
1	-5.179	0.333	0.316
2	-5.204	<b>0.039</b>	0.342
3	-5.190	0.231	0.344
4	<b>-5.303</b>	0.271	<b>0.370</b>
5	-5.264	0.476	0.364
6	-5.241	0.536	0.356
7	-5.205	0.884	0.342

# Koyck's Lag Structure

Specifies the lag structure of the DL(s) model

$$Y_t = \delta + \sum_{i=0}^s \varphi_i X_{t-i} + \varepsilon_t$$

as an infinite, geometric series (geometric lag structure)

$$\varphi_i = \lambda_0(1 - \lambda)\lambda^i$$

- For  $0 < \lambda < 1$

$$\sum_{i=0}^s \varphi_i = \lambda_0$$

- Short run multiplier:  $\lambda_0(1 - \lambda)$
- Equilibrium effect:  $\lambda_0$
- Average lag time:  $\lambda/(1 - \lambda)$
- Stability condition  $0 < \lambda < 1$

for  $\lambda > 1$ , the  $\varphi_i$  and the contributions to the multiplier are exponentially growing

$\lambda$	0.1	0.3	0.5	0.7
$\lambda/(1-\lambda)$	0.10	0.43	1.00	2.33

# The Koyck Model

- The DL (distributed lag) or MA (moving average) form of the Koyck model

$$Y_t = \delta + \lambda_0(1 - \lambda) \sum_i \lambda^i X_{t-i} + \varepsilon_t$$

- AR (autoregressive) form

$$Y_t = \delta(1 - \lambda) + \lambda Y_{t-1} + \lambda_0(1 - \lambda)X_t + u_t$$

with  $u_t = \varepsilon_t - \lambda\varepsilon_{t-1}$

# Consumption Function

Model with smallest AIC:

$$\hat{C} = 0.003 + 0.595Y - 0.016Y_{-1} + 0.107Y_{-2} + 0.003Y_{-3} \\ + 0.148Y_{-4}$$

with  $\text{adj.}R^2 = 0.370$ ,  $\text{AIC} = -5.303$ ,  $\text{DW} = 1.41$

Koyck model in AR form

$$\hat{C} = 0.004 + 0.286 C_{-1} + 0.556Y$$

with  $\text{adj.}R^2 = 0.388$ ,  $\text{AIC} = -5.290$ ,  $\text{DW} = 1.91$

# Koyck Model: Estimation Problems

Parameters to be estimated:  $\delta$ ,  $\lambda_0$ , and  $\lambda$ ; problems are

- DL form:
  - Historical values  $X_0, X_{-1}, \dots$  are unknown
  - Non-linear estimation problem
- AR form
  - Non-linear estimation problem
  - Lagged, endogenous variable used as regressor
  - Correlated error terms

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model

# The ADL(1,1) Model

- The autoregressive distributed lag (ADL) model: autoregressive model with lag structure, e.g., the ADL(1,1) model

$$Y_t = \delta + \theta Y_{t-1} + \varphi_0 X_t + \varphi_1 X_{t-1} + \varepsilon_t$$

- The error correction model:

$$\Delta Y_t = - (1 - \theta)(Y_{t-1} - \alpha - \beta X_{t-1}) + \varphi_0 \Delta X_t + \varepsilon_t$$

obtained from the ADL(1,1) model with

$$\alpha = \delta / (1 - \theta)$$

$$\beta = (\varphi_0 + \varphi_1) / (1 - \theta)$$

Example:

- Sales  $S_t$  are determined
  - by advertising  $A_t$  and  $A_{t-1}$ , but also
  - by  $S_{t-1}$ :

$$S_t = \mu + \theta S_{t-1} + \beta_0 A_t + \beta_1 A_{t-1} + \varepsilon_t$$

$$\Delta S_t = - (1 - \theta)[S_{t-1} - \mu / (1 - \theta) - (\beta_0 + \beta_1) / (1 - \theta) A_{t-1}] + \beta_0 \Delta A_t + \varepsilon_t$$

# Multiplier

ADL(1,1) model:  $Y_t = \delta + \theta Y_{t-1} + \varphi_0 X_t + \varphi_1 X_{t-1} + \varepsilon_t$

Effect of a change  $\Delta X = 1$  at time  $t$

- Impact multiplier:  $\Delta Y = \varphi_0$ ; see the DL(s) model
- Long run multiplier

- Effect after one period

$$\frac{\partial Y_{t+1}}{\partial X_t} = \theta \frac{\partial Y_t}{\partial X_t} + \varphi_1 = \theta \varphi_0 + \varphi_1$$

- Effect after two periods

$$\frac{\partial Y_{t+2}}{\partial X_t} = \theta \frac{\partial Y_{t+1}}{\partial X_t} = \theta(\theta \varphi_0 + \varphi_1)$$

- Cumulated effect over all future on  $Y$

$$\varphi_0 + (\theta \varphi_0 + \varphi_1) + \theta(\theta \varphi_0 + \varphi_1) + \dots = (\varphi_0 + \varphi_1)/(1 - \theta)$$

decreasing effects requires  $|\theta| < 1$ , stability condition



# ADL(1,1) Model: Equilibrium

Equilibrium relation of the ADL(1,1) model:

- Equilibrium at time  $t$  means:  $E\{Y_t\} = E\{Y_{t-1}\}$ ,  $E\{X_t\} = E\{X_{t-1}\}$

$$E\{Y_t\} = \delta + \theta E\{Y_t\} + \varphi_0 E\{X_t\} + \varphi_1 E\{X_t\}$$

or, given the stability condition  $|\theta| < 1$ ,

$$E\{Y_t\} = \frac{\delta}{1-\theta} + \frac{\varphi_0 + \varphi_1}{1-\theta} E\{X_t\}$$

- Equilibrium relation:

$$E\{Y_t\} = \alpha + \beta E\{X_t\}$$

with  $\alpha = \delta/(1 - \theta)$ ,  $\beta = (\varphi_0 + \varphi_1)/(1 - \theta)$

- Long run multiplier: change  $\Delta X = 1$  of the equilibrium value of  $X$  increases the equilibrium value of  $Y$  by  $(\varphi_0 + \varphi_1)/(1 - \theta)$

# The Error Correction Model

ADL(1,1) model, written as error correction model

$$\Delta Y_t = \varphi_0 \Delta X_t - (1 - \theta)(Y_{t-1} - \alpha - \beta X_{t-1}) + \varepsilon_t$$

- Effects on  $\Delta Y$ 
  - due to changes  $\Delta X$
  - due to equilibrium error, i.e.,  $Y_{t-1} - \alpha - \beta X_{t-1}$
- Negative adjustment:  $Y_{t-1} < E\{Y_{t-1}\} = \alpha + \beta X_{t-1}$ , i.e., a negative equilibrium error, increases  $Y_t$  by  $-(1 - \theta)(Y_{t-1} - \alpha - \beta X_{t-1})$
- Adjustment parameter:  $(1 - \theta)$ 
  - Determines speed of adjustment

# The ADL( $p,q$ ) Model

ADL( $p,q$ ): generalizes the ADL(1,1) model

$$\theta(L)Y_t = \delta + \Phi(L)X_t + \varepsilon_t$$

with lag polynomials

$$\theta(L) = 1 - \theta_1L - \dots - \theta_pL^p, \quad \Phi(L) = \varphi_0 + \varphi_1L + \dots + \varphi_qL^q$$

Given invertibility of  $\theta(L)$ , i.e.,  $\theta_1 + \dots + \theta_p < 1$ ,

$$Y_t = \theta(1)^{-1}\delta + \theta(L)^{-1}\Phi(L)X_t + \theta(L)^{-1}\varepsilon_t$$

The coefficients of  $\theta(L)^{-1}\Phi(L)$  describe the dynamic effects of  $X$  on current and future values of  $Y$

- equilibrium multiplier

$$\theta(1)^{-1}\phi(1) = \frac{\varphi_0 + \dots + \varphi_q}{1 - \theta_1 - \dots - \theta_p}$$

ADL(0, $q$ ): coincides with the DL( $q$ ) model;  $\theta(L) = 1$

# ADL Model: Estimation

ADL( $p, q$ ) model

- error terms  $\varepsilon_t$ : white noise, independent of  $X_t, \dots, X_{t-q}$  and  $Y_{t-1}, \dots, X_{t-p}$

OLS estimators are consistent

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model

# Expectations in Economic Processes

Expectations play important role in economic processes

Examples:

- Consumption depends not only on current income but also on the income expectations; modeling the expectation may be based on past development
- Investments depend upon expected profits
- Interest rates depend upon expected development of the financial market
- Etc.

Expectations

- cannot be observed, but
- can be modeled using assumptions on the mechanism of adapting expectations

# Models for Adapting Expectations

- Naive model of adapting expectations: the (for the next period) expected value equals the actual value
- Model of adaptive expectation
- Partial adjustment model

The latter two models are based on Koyck's lag structure

# Adaptive Expectation: Concept

Models of adaptive expectation: describe the actual value  $Y_t$  as function of the value  $X_{t+1}^e$  of the regressor  $X$  that is expected for the next period

$$Y_t = \alpha + \beta X_{t+1}^e + \varepsilon_t$$

Example: Investments are a function of the expected profits

Concepts for  $X_{t+1}^e$ :

- Naive expectation:  $X_{t+1}^e = X_t$
- More realistic is a weighted sum of in the past realized profits

$$X_{t+1}^e = \beta_0 X_t + \beta_1 X_{t-1} + \dots$$

- Geometrically decreasing weights  $\beta_i$

$$\beta_i = (1-\lambda) \lambda^i$$

with  $0 < \lambda < 1$



# Adaptive Mechanism for the Expectation

With  $\beta_i = (1 - \lambda) \lambda^i$ , the expected value  $X^e_{t+1} = \beta_0 X_t + \beta_1 X_{t-1} + \dots$  results in

$$X^e_{t+1} = \lambda X^e_t + (1 - \lambda) X_t$$

or

$$X^e_{t+1} - X^e_t = (1 - \lambda)(X_t - X^e_t)$$

Interpretation: the change of expectation between  $t$  and  $t+1$  is proportional to the actual „error in expectation”, i.e., the deviation between the actual expectation and the actually realized value

- Extent of the change (adaptation):  $100(1 - \lambda)\%$  of the error
- $\lambda$ : adaptation parameter

# Models of Adaptive Expectation

- Adaptive expectation model (AR form)

$$Y_t = \alpha(1 - \lambda) + \lambda Y_{t-1} + \beta(1 - \lambda)X_t + v_t$$

with  $v_t = \varepsilon_t - \lambda\varepsilon_{t-1}$ ; an ADL(1,0) model

- DL form

$$Y_t = \alpha + \beta(1 - \lambda)X_t + \beta(1 - \lambda)\lambda X_{t-1} + \dots + \varepsilon_t$$

Example: Investments ( $I$ ) as function of the expected profits  $P^e_{t+1}$  and interest rate ( $r$ )

$$I_t = \alpha + \beta P^e_{t+1} + \gamma r_t + \varepsilon_t$$

- Assumption of adapted expectation for the profits  $P^e_{t+1}$ :

$$P^e_{t+1} = \lambda P^e_t + (1 - \lambda)P_t$$

with adaptation parameter  $\lambda$  ( $0 < \lambda < 1$ )

- AR form of the investment function ( $v_t = \varepsilon_t - \lambda\varepsilon_{t-1}$ ):

$$I_t = \alpha(1 - \lambda) + \lambda I_{t-1} + \beta(1 - \lambda)P_t + \gamma r_t - \lambda\gamma r_{t-1} + v_t$$

# Consumption Function

Consumption as function of the expected income

$$C_t = \alpha + \beta Y_{t+1}^e + \varepsilon_t$$

expected income derived under the assumption of adapted expectation

$$Y_{t+1}^e = \lambda Y_t^e + (1 - \lambda) Y_t$$

- AR form is

$$C_t = \alpha(1 - \lambda) + \lambda C_{t-1} + \beta(1 - \lambda) Y_t + v_t$$

with  $v_t = \varepsilon_t - \lambda \varepsilon_{t-1}$

Example: the estimated model is

$$\hat{C} = 0.004 + 0.286 C_{-1} + 0.556 Y$$

- $\text{adj.}R^2 = 0.388$ ,  $\text{AIC} = -5.29$ ,  $\text{DW} = 1.91$

# Example: Desired Stock Level

Stock level  $K$  and revenues  $S$

- The desired (optimal) stock level  $K^*$  depends of the revenues  $S$

$$K_t^* = \alpha + \beta S_t + \eta_t$$

- Actual stock level  $K_{t-1}$  in period  $t-1$ : deviates from  $K_t^*$ :  $K_t^* - K_{t-1}$
- (Partial) adjustment strategy according to

$$K_t - K_{t-1} = (1 - \theta)(K_t^* - K_{t-1})$$

adaptation parameter  $\theta$  with  $0 < \theta < 1$

- Substitution for  $K_t^*$  gives the AR form of the model

$$\begin{aligned} K_t &= K_{t-1} + (1 - \theta)\alpha + (1 - \theta)\beta S_t - (1 - \theta)K_{t-1} + (1 - \theta)\eta_t \\ &= \delta + \theta K_{t-1} + \varphi_0 S_t + \varepsilon_t \end{aligned}$$

$$\delta = (1 - \theta)\alpha, \varphi_0 = (1 - \theta)\beta, \varepsilon_t = (1 - \theta)\eta_t$$

- Model for  $K_t$  is an ADL(1,0) model

# Partial Adjustment Model

Describes the process of adapting to a desired or planned value  $Y_t^*$  as a function of regressor  $X_t$

$$Y_t^* = \alpha + \beta X_t + \eta_t$$

- (Partial) adjustment of the actual  $Y_t$  according to

$$Y_t - Y_{t-1} = (1 - \theta)(Y_t^* - Y_{t-1})$$

adaptation parameter  $\theta$  with  $0 < \theta < 1$

- Actual  $Y_t$ : weighted average of  $Y_t^*$  and  $Y_{t-1}$

$$Y_t = (1 - \theta)Y_t^* + \theta Y_{t-1}$$

- AR form of the model

$$\begin{aligned} Y_t &= (1 - \theta)\alpha + \theta Y_{t-1} + (1 - \theta)\beta X_t + (1 - \theta)\eta_t \\ &= \delta + \theta Y_{t-1} + \varphi_0 X_t + \varepsilon_t \end{aligned}$$

which is an ADL(1,0) model

# Models in AR Form

Models in ADL(1,0) form

## 1. Koyck's model

$$Y_t = \alpha(1 - \lambda) + \lambda Y_{t-1} + \beta(1 - \lambda)X_t + v_t$$

with  $v_t = \varepsilon_t - \lambda\varepsilon_{t-1}$

## 2. Model of adaptive expectation

$$Y_t = \alpha(1 - \lambda) + \lambda Y_{t-1} + \beta(1 - \lambda)X_t + v_t$$

with  $v_t = \varepsilon_t - \lambda\varepsilon_{t-1}$

## 3. Partial adjustment model

$$Y_t = (1 - \theta)\alpha + \theta Y_{t-1} + (1 - \theta)\beta X_t + \varepsilon_t$$

Error terms are

- White noise for partial adjustment model
- Autocorrelated for the other two models

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model

# Regression and Time Series

Stationarity of variables is a crucial prerequisite for

- estimation methods
  - testing procedures
- applied to regression models

Specifying a relation between non-stationary variables may result in a nonsense or spurious regression



# An Illustration

Independent random walks:  $Y_t = Y_{t-1} + \varepsilon_{yt}$ ,  $X_t = X_{t-1} + \varepsilon_{xt}$

$\varepsilon_{yt}$ ,  $\varepsilon_{xt}$ : independent white noises with variances  $\sigma_y^2 = 2$ ,  $\sigma_x^2 = 1$

Fitting the model

$$Y_t = \alpha + \beta X_t + \varepsilon_t$$

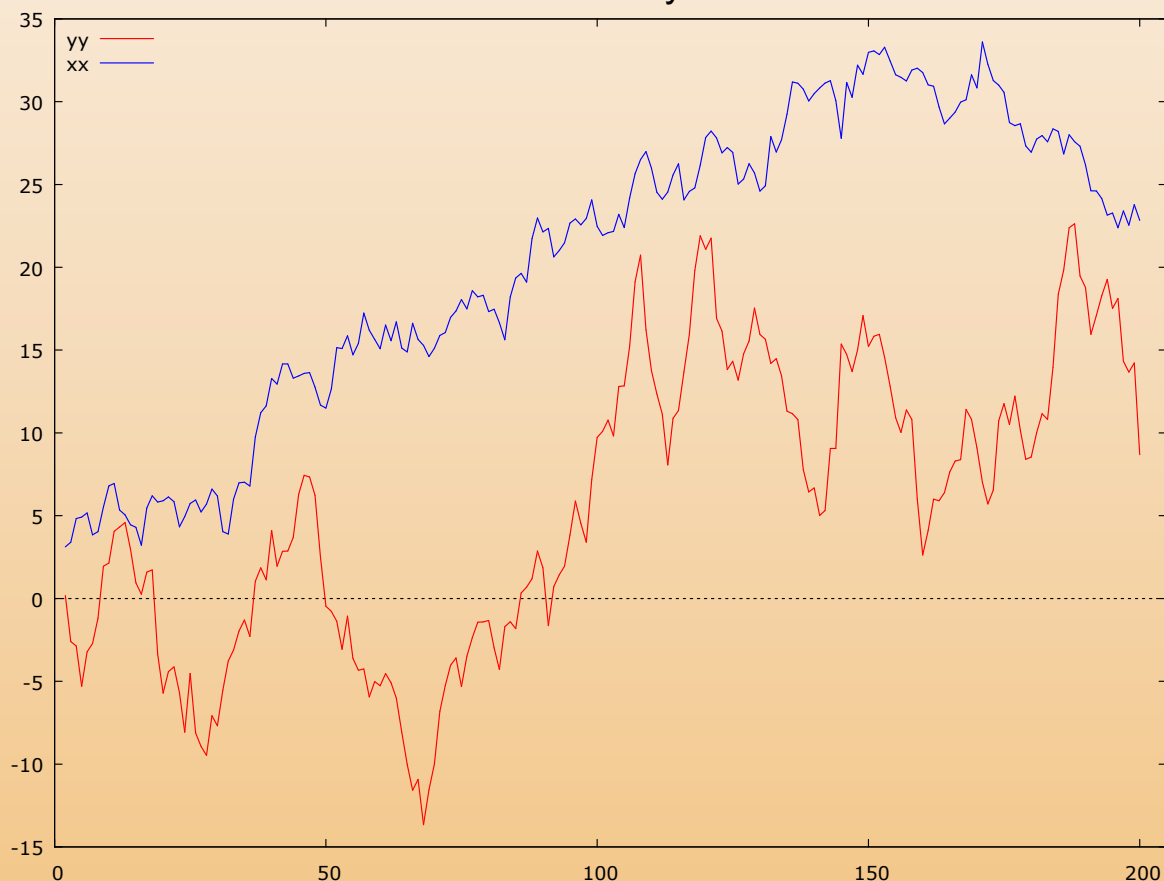
gives

$$\hat{Y}_t = -8.18 + 0.68X_t$$

$t$ -statistic for  $X$ :  $t = 17.1$

$p$ -value = 1.2 E-40

$R^2 = 0.50$ ,  $DW = 0.11$



# Models in Non-stationary Time Series

Given that  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$  and the model

$$Y_t = \alpha + \beta X_t + \varepsilon_t$$

it follows in general that  $\varepsilon_t \sim I(1)$ , i.e., the error terms are non-stationary

Consequences for OLS estimation of  $\alpha$  and  $\beta$

- (Asymptotic) distributions of  $t$ - and  $F$ -statistics are different from those for stationarity
- $R^2$  indicates explanatory potential
- Highly autocorrelated residuals, DW statistic converges for growing  $N$  to zero

Nonsense or spurious regression (Granger & Newbold, 1974)

- Non-stationary time series are trended; this causes an apparent relationship

# Avoiding Spurious Regression

- Identification of non-stationarity: unit-root tests
- Models for non-stationary variables
  - Elimination of stochastic trends: specifying the model for differences
  - Inclusion of lagged variables may result in stationary error terms
  - Explained and explanatory variables may have a common stochastic trend, are cointegrated: equilibrium relation, error-correction models

# An Example: ADL(1,1) Model

ADL(1,1) model with  $Y_t \sim I(1)$ ,  $X_t \sim I(1)$

$$Y_t = \delta + \theta Y_{t-1} + \varphi_0 X_t + \varphi_1 X_{t-1} + \varepsilon_t$$

- The error terms are stationary if  $\theta = 1$ ,  $\varphi_0 = \varphi_1 = 0$

$$\varepsilon_t = Y_t - (\delta + \theta Y_{t-1} + \varphi_0 X_t + \varphi_1 X_{t-1}) \sim I(0)$$

- Common trend implies an equilibrium relation, i.e.,

$$Y_{t-1} - \beta X_{t-1} \sim I(0)$$

error-correction form of the ADL(1,1) model

$$\Delta Y_t = \varphi_0 \Delta X_t - (1 - \theta)(Y_{t-1} - \alpha - \beta X_{t-1}) + \varepsilon_t$$

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model

# The Drunk and her Dog

M. P. Murray, A drunk and her dog: An illustration of cointegration and error correction. *The American Statistician*, **48** (1997), 37-39

drunk:  $x_t - x_{t-1} = u_t$

dog:  $y_t - y_{t-1} = w_t$

Cointegration:

$$x_t - x_{t-1} = u_t + c(y_{t-1} - x_{t-1})$$

$$y_t - y_{t-1} = w_t + d(x_{t-1} - y_{t-1})$$

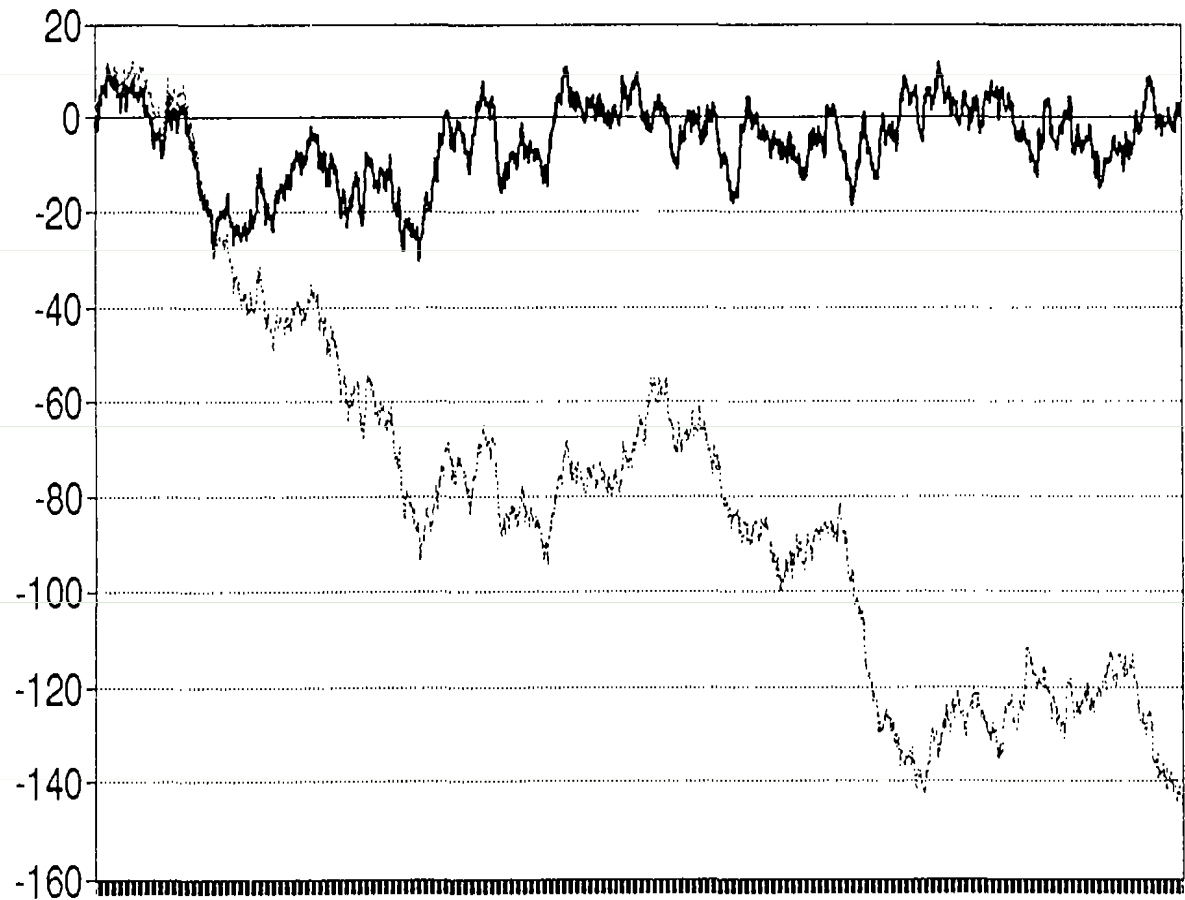


Figure 1. A drunk and two dogs: How close are the dogs to her? — Her dog. --- My dog.

# Cointegrated Variables

Non-stationary variables  $X$ ,  $Y$ :

$$X_t \sim I(1), Y_t \sim I(1)$$

if a  $\beta$  exists such that

$$Z_t = Y_t - \beta X_t \sim I(0)$$

- $X_t$  and  $Y_t$  have a common stochastic trend
- $X_t$  and  $Y_t$  are called “cointegrated”
- $\beta$ : cointegration parameter
- $(1, -\beta)'$ : cointegration vector

Cointegration implies a long-run equilibrium; cf. Granger's Representation Theorem

# Error-correction Model

Granger's Representation Theorem (Engle & Granger, 1987): If a set of variables is cointegrated, then an error-correction (EC) relation of the variables exists

non-stationary processes  $Y_t \sim I(1)$ ,  $X_t \sim I(1)$  with cointegrating vector  $(1, -\beta)'$ : error-correction representation

$$\theta(L)\Delta Y_t = \delta + \Phi(L)\Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \alpha(L)\varepsilon_t$$

with white noise  $\varepsilon_t$ , lag polynomials  $\theta(L)$  (with  $\theta_0=1$ ),  $\Phi(L)$ , and  $\alpha(L)$

- Error-correction model: describes
  - the short-run behaviour
  - consistently with the long-run equilibrium
- Long-run equilibrium:  $Y_t = \beta X_t$ , deviations from equilibrium:  $Y_t - \beta X_t$
- Converse statement: if  $Y_t \sim I(1)$ ,  $X_t \sim I(1)$  have an error-correction representation, then they are cointegrated



# Long-run Equilibrium

Equilibrium defined by

$$Y_t = \alpha + \beta X_t$$

Equilibrium error:  $z_t = Y_t - \beta X_t - \alpha = Z_t - \alpha$

Two cases:

1.  $z_t \sim I(0)$ : equilibrium error stationary, fluctuating around zero
  - $Y_t, \beta X_t$  cointegrated
  - $Y_t = \alpha + \beta X_t$  describes an equilibrium
2.  $z_t \sim I(1)$ ,  $Y_t, \beta X_t$  not integrated
  - $z_t \sim I(1)$  non-stationary process
  - $Y_t = \alpha + \beta X_t$  does not describe an equilibrium, spurious regression

Cointegration, i.e., existence of an equilibrium vector, implies a long-run equilibrium relation

# Example: Purchasing Power Parity (PPP)

Verbeek's dataset PPP: price indices and exchange rates for France and Italy,  $T = 186$  (1/1981-6/1996)

- Variables: LNIT (log price index Italy), LNFR (log price index France), LNX (log exchange rate France/Italy)
- LNIT, LNFR, LNX non-stationary (DF-test)
- $LNP_t = LNIT_t - LNFR_t$ , i.e., log of price index ratio, non-stationary

Purchasing power parity (PPP): exchange rate between the currencies (Franc, Lira) equals the ratio of price levels of the countries

- Relative PPP: equality fulfilled only in the long run; equilibrium or cointegrating relation

$$LN X_t = \alpha + \beta LNP_t + \varepsilon_t$$

# PPP: The Variables

Test for unit roots (non-stationarity) of

- **LN<sub>X</sub>** (log exchange rate France/Italy)
- **LN<sub>P</sub>** = LNIT – LNFR, i.e., the log of the price index ratio France/Italy

Results from DF tests:

		const.	+trend
LN <sub>P</sub>	DF stat	-0.99	-2.96
	p-value	0.76	0.14
LN <sub>X</sub>	DF stat	-0.33	-1.90
	p-value	0.92	0.65



DF test indicates:  
LN<sub>X</sub> ~ I(1), LN<sub>P</sub> ~ I(1)

# PPP: Equilibrium Relations

As discussed by Verbeek:

1. If PPP holds in long run, real exchange rate is stationary

$$\text{LN}X_t - (\text{LN}I_t - \text{LN}R_t) = \varepsilon_t$$

2. Change of relative prices corresponds to the change of exchange rate, i.e., short run deviations are stationary

$$\text{LN}X_t - \beta (\text{LN}I_t - \text{LN}R_t) = \varepsilon_t$$

3. Generalization of case 2:

$$\text{LN}X_t = \alpha + \beta_1 \text{LN}I_t - \beta_2 \text{LN}R_t + \varepsilon_t$$

with  $\varepsilon_t \sim I(0)$

# PPP: Equilibrium Relation 2

OLS estimation of

$$\text{LN}X_t = \alpha + \beta \text{LNP}_t + \varepsilon_t$$

Model 2: OLS, using observations 1981:01-1996:06 (T = 186)  
Dependent variable: LNX

	coefficient	std. error	t-ratio	p-value	
const	5,48720	0,00677678	809,7	0,0000	***
LNP	0,982213	0,0513277	19,14	1,24e-045	***
Mean dependent var		5,439818	S.D. dependent var		0,148368
Sum squared resid		1,361936	S.E. of regression		0,086034
R-squared		0,665570	Adjusted R-squared		0,663753
F(1, 184)		366,1905	P-value(F)		1,24e-45
Log-likelihood		193,3435	Akaike criterion		-382,6870
Schwarz criterion		-376,2355	Hannan-Quinn		-380,0726
rho		0,967239	Durbin-Watson		0,055469

# Estimation of Cointegration Parameter

Cointegrating relation,  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$ ,  $\varepsilon_t \sim I(0)$

$$Y_t = \beta X_t + \varepsilon_t$$

OLS estimate  $b$  of  $\beta$

- Estimate  $b$  is super consistent
  - Converges faster to  $\beta$  than standard asymptotic says
  - Converges to  $\beta$  in spite of omission of relevant regressors (short-term dynamics)
  - For  $b \neq \beta$ : non-stationary OLS residuals with much larger variance than for  $b$  close to  $\beta$
  - Bias of  $b$  may be substantial!
- Non-standard theory
  - Asymptotic distribution of  $\sqrt{T}(b - \beta)$  degenerate, not normal (cf. standard theory)
  - $t$ -statistic may be misleading

# Estimation of Spurious Regression Parameter

Non-stationary processes  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$

$$Y_t = \beta X_t + \varepsilon_t$$

If  $\varepsilon_t \sim I(1)$ , i.e.,  $Y_t$  and  $X_t$  not cointegrated: spurious regression

OLS estimate  $b$  of  $\beta$

- Non-standard distribution
- Large values of  $R^2$ ,  $t$ -statistic
- Highly autocorrelated residuals
- DW statistic close to zero

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- Error-correction model



# Identification of Cointegration

Information about cointegration:

- Economic theory
- Visual inspection of data
- Statistical tests

# Testing for Cointegration

Non-stationary variables  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$

$$Y_t = \alpha + \beta X_t + \varepsilon_t$$

- $X_t$  and  $Y_t$  are cointegrated:  $\varepsilon_t \sim I(0)$
- $X_t$  and  $Y_t$  are not cointegrated:  $\varepsilon_t \sim I(1)$

Tests for cointegration:

- If  $\beta$  is known, unit root test based on differences  $Y_t - \beta X_t$
- Test procedures
  - Unit root test (DF or ADF) based on residuals  $e_t$
  - Cointegrating regression Durbin-Watson (CRDW) test: DW statistic
  - Johansen technique: extends the cointegration technique to the multivariate case

# DF Test for Cointegration

Non-stationary variables  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$

$$Y_t = \alpha + \beta X_t + \varepsilon_t$$

- $X_t$  and  $Y_t$  are cointegrated:  $\varepsilon_t \sim I(0)$
- Residuals  $e_t$  represent  $\varepsilon_t$ , show similar pattern,  $e_t \sim I(0)$ , residuals are stationary

Tests for cointegration based on residuals  $e_t$

$$\Delta e_t = \gamma_0 + \gamma_0 e_{t-1} + u_t$$

- $H_0: \gamma_0 = 0$ , i.e., residuals have a unit root,  $e_t \sim I(1)$
- $H_0$  implies
  - $X_t$  and  $Y_t$  are not cointegrated
  - Rejection of  $H_0$  suggests that  $X_t$  and  $Y_t$  are cointegrated

# DF Test for Cointegration, cont'd

## Critical values of DF test for residuals

- are smaller than those of DF test for observations
- depend upon (see Verbeek, Tab. 9.2)
  - number of elements of cointegrating vector,  $K+1$
  - number of observations  $T$
  - significance level

some asymptotic

critical values for the DF-  
test with constant term

	1%	5%
Observations	-3.43	-2.86
Residuals, $K=1$	-3.90	-3.34

# Cointegrating Regression

## Durbin-Watson (CRDW) Test

Non-stationary variables  $X_t \sim I(1)$ ,  $Y_t \sim I(1)$

$$Y_t = \alpha + \beta X_t + \varepsilon_t$$

Cointegrating regression Durbin-Watson (CRDW) test: DW statistic from OLS-fitting  $Y_t = \alpha + \beta X_t + \varepsilon_t$

- Null hypothesis: residuals  $e_t$  have a unit root, i.e.,  $e_t \sim I(1)$ , i.e.,  $X_t$  and  $Y_t$  are not cointegrated
- DW statistic converges with  $T$  to zero for not cointegrated variables
- Critical values from Monte Carlo simulations, which depend upon (see Verbeek, Tab. 9.4)
  - Number of regressors plus 1 (dependent variable)
  - Number of observations  $T$
  - Significance level

# PPP: Equilibrium Relation 2

OLS estimation of

$$\text{LN}X_t = \alpha + \beta \text{LNP}_t + \varepsilon_t$$

Model 2: OLS, using observations 1981:01-1996:06 (T = 186)  
Dependent variable: LNX

	coefficient	std. error	t-ratio	p-value	
const	5,48720	0,00677678	809,7	0,0000	***
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Schwarz criterion		-376,2355	Hannan-Quinn		-380,0726
rho		0,967239	Durbin-Watson		0,055469

DF test statistic for residuals (constant): -1.90,  $p$ -value: 0.33

$H_0$  cannot be rejected: no evidence for cointegration

# Testing for Cointegration

Residuals from  $\text{LN}X_t = \alpha + \beta \text{LNP}_t + \varepsilon_t$ :

- Time series plot indicates non-stationarity of residuals

Time series plot  
of residuals



# Testing for Cointegration, cont'd

Residuals from  $\text{LN}X_t = \alpha + \beta \text{LNP}_t + \varepsilon_t$ :

- Time series plot indicates non-stationary residuals
- Tests for cointegration,  $H_0$ : residuals have unit root, no cointegration
  - DF test statistic (with constant): -1.90, 5% critical value: -3.37
  - CRDW test: DW statistic:  $0.055 < 0.20$ , the 5% critical value for two variables, 200 observations
- Both tests suggest:  $H_0$  cannot be rejected, no evidence for cointegration

Same result for equilibrium relations 1 and 3; reasons could be:

- Time series too short
- No PPP between France and Italy

Attention: equilibrium relation 3 has three variables; two cointegration relations are possible



# Cointegration Test in GRET

- Model > Time series > Cointegration tests > Engle-Granger  
Performs the
  - DL test for each of the variables
  - Estimation of the cointegrating regression
  - DF test for the residuals of the cointegrating regression
- Model > Time series > Cointegration tests > Johansen  
See next lecture

# Contents

- Dynamic Models
- Lag Structures
- ADL Models
- Models for Expectations
- Models with Non-stationary Variables
- Cointegration
- Test for Cointegration
- **Error-correction model**

# Error-correction Model

Granger's Representation Theorem (Engle & Granger, 1987): If a set of variables is cointegrated, then an error-correction relation of the variables exists

non-stationary processes  $Y_t \sim I(1)$ ,  $X_t \sim I(1)$  with cointegrating vector  $(1, -\beta)'$ : error-correction representation

$$\theta(L)\Delta Y_t = \delta + \Phi(L)\Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \alpha(L)\varepsilon_t$$

with lag polynomials  $\theta(L)$  (with  $\theta_0=1$ ),  $\Phi(L)$ , and  $\alpha(L)$

E.g.,  $\Delta Y_t = \delta + \varphi_1\Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \varepsilon_t$

Error-correction model: describes

- the short-run behavior
- consistently with the long-run equilibrium

Converse statement: if  $Y_t \sim I(1)$ ,  $X_t \sim I(1)$  have an error-correction representation, then they are cointegrated

# EC Model and Equilibrium Relation

The EC model

$$\Delta Y_t = \delta + \varphi_1 \Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \varepsilon_t$$

is a special case of

$$\theta(L)\Delta Y_t = \delta + \Phi(L)\Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \alpha(L)\varepsilon_t$$

with  $\theta(L) = 1$ ,  $\Phi(L) = \varphi_1 L$ , and  $\alpha(L) = 1$

- “No change” steady state equilibrium: for  $\Delta Y_t = \Delta X_{t-1} = 0$

$$Y_t - \beta X_t = \delta/\gamma \text{ or } Y_t = \alpha + \beta X_t \text{ if } \alpha = \delta/\gamma$$

the EC model can be written as

$$\Delta Y_t = \varphi_1 \Delta X_{t-1} - \gamma(Y_{t-1} - \alpha - \beta X_{t-1}) + \varepsilon_t$$

- Steady state growth: If  $\alpha = \delta/\gamma + \lambda$ ,  $\lambda \neq 0$ ,

$$\Delta Y_t = \lambda + \varphi_1 \Delta X_{t-1} - \gamma(Y_{t-1} - \alpha - \beta X_{t-1}) + \varepsilon_t$$

deterministic trends for  $Y_t$  and  $X_t$ , long run equilibrium corresponding to growth paths  $\Delta Y_t = \Delta X_{t-1} = \lambda/(1 - \varphi_1)$

# Analysis of EC Models

## Model specification

- Unit-root testing
- Testing for cointegration
- Specification of EC-model: choice of orders of lag polynomials, specification analysis

## Estimation of model parameters

# EC Model: Estimation

Model for cointegrated variables  $X_t, Y_t$

$$\Delta Y_t = \delta + \varphi_1 \Delta X_{t-1} - \gamma(Y_{t-1} - \beta X_{t-1}) + \varepsilon_t \quad (\text{A})$$

with cointegrating relation

$$Y_{t-1} = \beta X_{t-1} + u_t \quad (\text{B})$$

- Cointegration vector  $(1, -\beta)'$  known: OLS estimation of  $\delta, \varphi_1$ , and  $\gamma$  from (A), standard properties
- Unknown cointegration vector  $(1, -\beta)'$ :
  - Parameter  $\beta$  from (B) super consistently estimated by OLS
  - OLS estimation of  $\delta, \varphi_1$ , and  $\gamma$  from (A) is not affected by use of the estimate for  $\beta$

# Your Homework

1. Use Verbeek's data set INCOME containing quarterly data INCOME (total disposable income) and CONSUM (consumer expenditures) for 1/1971 to 2/1985 in the UK.
  - a. Specify a DL(s) model in  $sd\_INCOME$  (seasonal differences) and choose an appropriate  $s$ , using (i)  $R^2$  and (ii) BIC.
  - b. Assuming that DL(4) is an appropriate lag structure, calculate (i) the short run and (ii) the long run multiplier as well as (iii) the average and (iv) the median lag time.
  - c. Specify a consumption function with the actual expected income as explanatory variable; estimate the AR form of the model under the assumption of adapted expectation.
  - d. Test (i) whether CONSUM and INCOME are  $I(1)$ ; (ii) estimate the simple linear regression of CONSUM on INCOME and test (iii) whether this is an equilibrium relation; show (iv) the corresponding time series plots.

# Your Homework, cont'd

2. Generate 500 random numbers (a) from a random walk with trend:  $x_t = 0.1 + x_{t-1} + \varepsilon_t$ ; and (b) from an AR(1) process:  $y_t = 0.2 + 0.7y_{t-1} + \eta_t$ ; for  $\varepsilon_t$  and  $\eta_t$  use Monte Carlo random numbers from  $N(0,1)$ . Estimate regressions of  $x_t$  and  $y_t$  on  $t$ ; report the values for  $R^2$ .