

Preparation Exam Advanced Econometrics (4.1)

Master Econometrics and Operations Research
Faculty of Economics and Business Administration

Exam:	Advanced Econometrics (4.1)
Code:	E_EORM_AECTR
Coordinator:	dr. F. Blasques
Date:	–
Time:	–
Duration:	2 hours and 45 minutes
Calculator:	Not allowed
Graphical calculator:	Not allowed
Number of questions:	4
Type of questions:	Open
Answer in:	English
Credit score:	100 credits counts for a 10
Grades:	Made public within 10 working days
Inspection:	By appointment (send e-mail to f.blasques@vu.nl)
Number of pages:	5, including front page

- Read the entire exam carefully before you start answering the questions.
- Be clear and concise in your statements, but justify every step in your derivations.
- If you think that further information is needed to answer a question or that the question is ill-posed, then explain your reasoning.
- The questions should be handed back at the end of the exam. Do not take it home.

Good luck!

Question 1 [25 points] Stochastic Properties of Nonlinear Dynamic Models

In economics and finance, time-series may sometimes exhibit time-varying conditional mean and volatility.

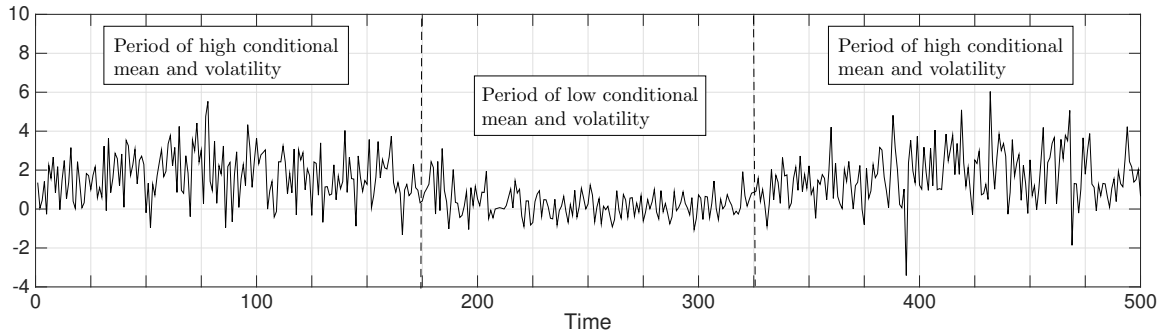


Figure 1: Time-series with time-varying conditional mean and volatility.

Let $\{x_t\}_{t \in \mathbb{Z}}$ be generated according to

$$x_t = \mu_t + \sigma_t \varepsilon_t \quad \text{for every } t \in \mathbb{Z},$$

where $\{\varepsilon_t\}_{t \in \mathbb{Z}}$ is a sequence of Gaussian iid random variables $\{\varepsilon_t\}_{t \in \mathbb{Z}} \sim \text{NID}(0, 1)$. Suppose that the time-varying conditional mean $\{\mu_t\}_{t \in \mathbb{Z}}$ satisfies

$$\mu_t = 0.2(x_{t-1} - \mu_{t-1}) + 0.7\mu_{t-1} \quad \text{for every } t \in \mathbb{Z}.$$

Furthermore, let the time-varying volatility $\{\sigma_t\}_{t \in \mathbb{Z}}$ be determined by an exogenous sequence $\{z_t\}_{t \in \mathbb{Z}}$, according to

$$\sigma_t = (1 + \tanh(z_t)) \quad \text{for every } t \in \mathbb{Z}.$$

Finally, let $\{z_t\}_{t \in \mathbb{Z}}$ be generated by the following random coefficient autoregressive model

$$z_{t+1} = \rho_t z_t + v_t \quad \text{for every } t \in \mathbb{Z},$$

where $\{\rho_t\}_{t \in \mathbb{Z}}$ is a sequence of iid random variables with uniform distribution $\{\rho_t\}_{t \in \mathbb{Z}} \sim \text{UID}(0, 1.5)$ taking values in the interval $[0, 1.5]$, and $\{v_t\}_{t \in \mathbb{Z}}$ is a sequence of Student-t iid random variables with two degrees of freedom $\{v_t\}_{t \in \mathbb{Z}} \sim \text{TID}(2)$.

Note: the acronym *iid* stands for *independent identically distributed*.

Note: the function $1 + \tanh(\cdot)$ is uniformly bounded between 0 and 2.

Note: the random variable v_t satisfies $\mathbb{E}|v_t|^n < \infty$ for $0 < n < 2$.

- Can you show that $\{\sigma_t\}_{t \in \mathbb{Z}}$ is strictly stationary and ergodic?
- Can you show that $\mathbb{E}|x_t|^2 < \infty$? Is $\{x_t\}_{t \in \mathbb{Z}}$ weakly stationary?

Question 2 [25 points] Consistency and Asymptotic Normality of M-Estimators

Let $\mathbf{x}_T := (x_1, \dots, x_T)$ be a subset of a fat-tailed strictly stationary and ergodic sequence $\{x_t\}_{t \in \mathbb{Z}}$ satisfying $\mathbb{E}|x_t|^4 < \infty$. It is well known that the least squares estimator is sensitive to the presence of outliers in the data. Let $\hat{\boldsymbol{\theta}}_T$ be a robust M-estimator given by

$$\hat{\boldsymbol{\theta}}_T \in \arg \max_{\boldsymbol{\theta} \in \Theta} -\frac{1}{T} \sum_{t=2}^T \frac{u_t(\boldsymbol{\theta})^2}{1 + u_t(\boldsymbol{\theta})^2}$$

where $u_t(\boldsymbol{\theta})$ denotes the regression residuals of a nonlinear autoregressive model

$$u_t(\boldsymbol{\theta}) := x_t - \phi(x_{t-1}, \boldsymbol{\theta}) \quad \text{for every } t.$$

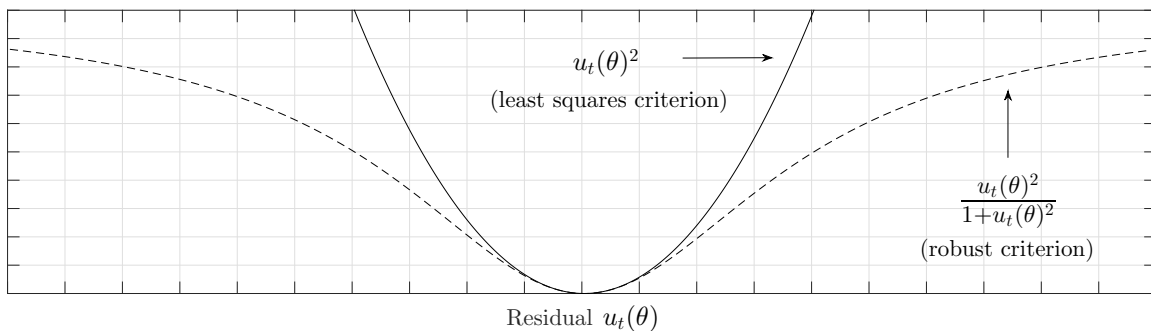


Figure 2: Comparison of the least squares and robust least squares criterion function.

Note: The function $u_t(\boldsymbol{\theta})^2 / (1 + u_t(\boldsymbol{\theta})^2)$ is uniformly bounded between 0 and 1.

- Give sufficient conditions for the existence and measurability of the estimator $\hat{\boldsymbol{\theta}}_T$.
- Give sufficient conditions for $\hat{\boldsymbol{\theta}}_T$ to be consistent for some point $\boldsymbol{\theta}_0 \in \Theta$. In other words, give conditions that ensure $\hat{\boldsymbol{\theta}}_T \xrightarrow{p} \boldsymbol{\theta}_0$ as $T \rightarrow \infty$.

Note: you can assume that certain functions are well behaved and continuously differentiable.

Question 3 [25 points] Nonlinear Dynamic Model of Dutch GDP

Some econometricians claim that the temporal dependence in the growth rate of the *Gross Domestic Product* (GDP) is stronger during economic recession periods and weaker during expansions. Figure 1 plots the *growth rate of quarterly real GDP in The Netherlands*.

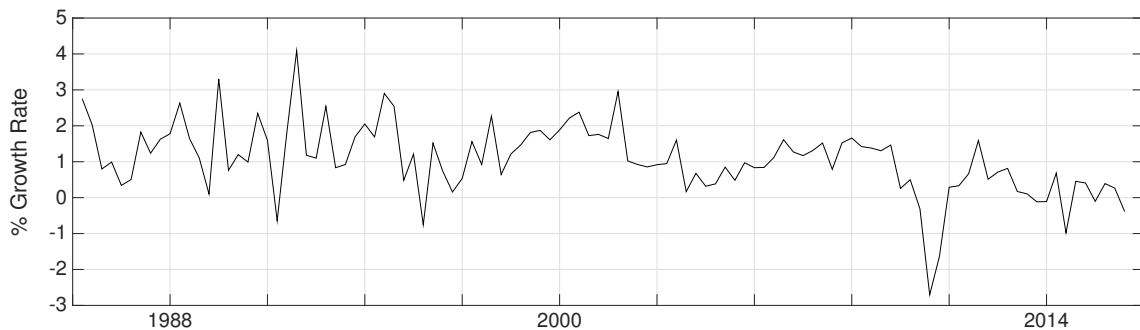


Figure 3: Real GDP growth rate for The Netherlands (in percentage).

Let the sample of GDP growth rates $\{x_t\}_{t=1}^T$ at your disposal be a subset of the realized path of a strictly stationary and ergodic time-series $\{x_t\}_{t \in \mathbb{Z}}$ with bounded moments of fourth order $\mathbb{E}|x_t|^4 < \infty$. Consider the Gaussian logistic *Self Excited Smooth Transition Autoregressive* (SESTAR) model

$$x_t = g(x_{t-1}; \boldsymbol{\theta})x_{t-1} + \varepsilon_t \quad \text{for every } t \in \mathbb{Z} \quad \text{where } \{\varepsilon_t\}_{t \in \mathbb{Z}} \sim \text{NID}(0, \sigma_\varepsilon^2)$$

$$\text{and } g(x_{t-1}; \boldsymbol{\theta}) := \frac{\gamma}{1 + \exp(\beta x_{t-1})} \quad \text{for every } t \in \mathbb{Z}.$$

Suppose that the parameters $\boldsymbol{\theta} = (\gamma, \beta, \sigma_\varepsilon^2)$ of the model are estimated by maximum likelihood (ML) on a compact parameter space Θ with $\sigma_\varepsilon^2 > 0$. Note also that $g(x; \boldsymbol{\theta})$ is uniformly bounded since $|g(x; \boldsymbol{\theta})| \leq |\gamma|$ for every $(x, \boldsymbol{\theta})$.

- Suppose that the ML estimator $\hat{\boldsymbol{\theta}}_T$ is consistent for a parameter $\boldsymbol{\theta}_0$ in the interior of Θ . Can you obtain an approximate distribution for the ML estimator?
Note: you can assume that certain functions are well behaved and continuously differentiable.
- Explain how you can use the asymptotic distribution of $\hat{\boldsymbol{\theta}}_T$ to test the claim that the temporal dependence in the growth rate of Dutch GDP is stronger during economic recession periods and weaker during expansions.
- Consider the following statement: “*The SESTAR model nests the Gaussian linear AR(1) model*”. Is this statement true or false? Justify your answer.

Question 4 [25 points] Time-varying Conditional Volatility in Stock Markets

Financial returns often exhibit ‘clusters of volatility’ and ‘leverage effects’. Figure 2 plots the time-series of *daily percentage returns* for the S&P500 stock market index.

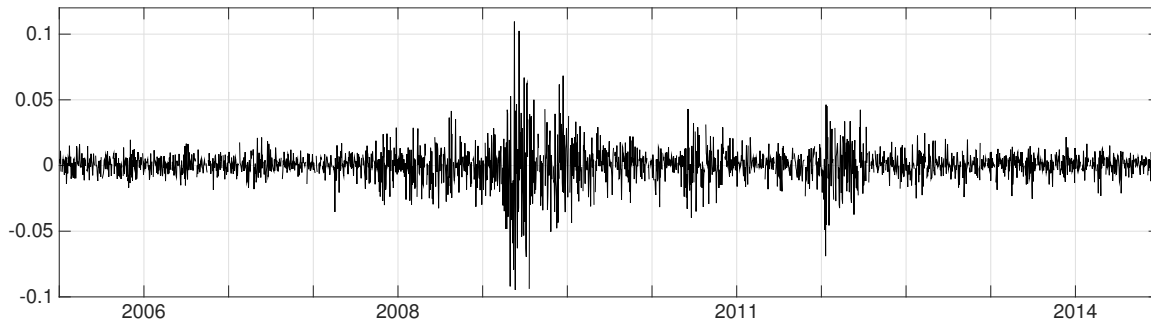


Figure 4: Daily S&P500 percentage returns.

Let the sample of S&P500 returns $\{x_t\}_{t=1}^T$ at your disposal be a subset of the realized path of a strictly stationary and ergodic time-series $\{x_t\}_{t \in \mathbb{Z}}$ satisfying $\mathbb{E}|x_t|^8 < \infty$. Consider the *Asymmetric Generalized Autoregressive Conditional Heteroscedasticity* (AGARCH) model

$$x_t = \sigma_t \varepsilon_t \quad \text{for every } t \in \mathbb{Z} \quad \text{where } \{\varepsilon_t\}_{t \in \mathbb{Z}} \sim \text{NID}(0, 1),$$

$$\text{where } \sigma_t^2 = \omega + \alpha(x_{t-1} - \delta)^2 + \beta\sigma_{t-1}^2 \quad \text{for every } t \in \mathbb{Z}.$$

Suppose that the parameters $\theta = (\omega, \alpha, \delta, \beta)$ of the model are estimated by maximum likelihood (ML) on a compact parameter space Θ with ω , α and β satisfying

$$\omega > a, \quad \alpha > a, \quad \text{and} \quad a < \beta < 1 \quad \text{for some } a > 0.$$

Note: that the parameter restrictions ensure that $\sigma_t^2 > a > 0$ for every t .

- (a) Give the expression for the log likelihood function.
- (b) Suppose that there exists a $\theta_0 \in \Theta$ that is the unique maximizer of the limit log likelihood function. Can you show that the ML estimator $\hat{\theta}_T$ is consistent for θ_0 ?

Note: you can assume that certain functions are well behaved and continuously differentiable.