

CSSS 594 / POLS 559:
Time Series and Panel Data for the Social Sciences

Modeling Stationary Time Series

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The story so far

We've learned:

- how to decide whether one estimator is “better” than another under a given DGP
- why our LS models don't work well with time series
- how to obtain quantities of interest, such as $E(y|x_c)$ from an estimated model
- the basics of time series dynamics, including:
trends, autoregression, moving averages, seasonality, stationarity, and nonstationarity

What we're doing today

Next steps:

- Use ML to estimate $AR(p)$, $MA(q)$, and $ARMA(p,q)$ models for stationary series
- Use our time series knowledge & ML fitting tools to select p and q
- Use simulations to understand how \hat{y}_t changes as we vary x_t over time

An AR(1) Regression Model

To create a regression model from the AR(1), we allow the mean of the process to shift by adding c_t to the equation:

$$y_t = y_{t-1}\phi_1 + c_t + \varepsilon_t$$

We then parameterize c_t as the sum of a set of time varying covariates,

$x_{1t}, x_{2t}, x_{3t}, \dots$

and their associated parameters,

$\beta_1, \beta_2, \beta_3, \dots$

which we compactly write in matrix notation as $c_t = \mathbf{x}_t\boldsymbol{\beta}$

An AR(1) Regression Model

Substituting for c_t , we obtain the AR(1) regression model:

$$y_t = y_{t-1}\phi_1 + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Estimation is by maximum likelihood, *not* LS

(We will discuss the LS version later)

MLE accounts for dependence of y_t on past values; complex derivation

Let's focus on interpreting this model in practice

Interpreting AR(1) parameters

Suppose that a country's GDP follows this simple model

$$\text{GDP}_t = \phi_1 \text{GDP}_{t-1} + \beta_0 + \beta_1 \text{Democracy}_t + \varepsilon_t$$

Interpreting AR(1) parameters

Suppose that a country's GDP follows this simple model

$$\text{GDP}_t = \phi_1 \text{GDP}_{t-1} + \beta_0 + \beta_1 \text{Democracy}_t + \varepsilon_t$$

$$\text{GDP}_t = 0.9 \times \text{GDP}_{t-1} + 10 + 2 \times \text{Democracy}_t + \varepsilon_t$$

Suppose that at year t , $\text{GDP}_t = 100$,
and the country is a non-democracy, $\text{Democracy}_t = 0$.

What would happen if we “made” this country a democracy in period $t + 1$?

Interpreting AR(1) parameters

$$y_t = y_{t-1}\phi_1 + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Recall:

an AR(1) process can be viewed as the geometrically declining sum of all its past errors.

Interpreting AR(1) parameters

$$y_t = y_{t-1}\phi_1 + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Recall:

an AR(1) process can be viewed as the geometrically declining sum of all its past errors.

When we add the time-varying mean $\mathbf{x}_t\boldsymbol{\beta}$ to the equation, the following now holds:

$$y_t = (\mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t) + \phi_1(\mathbf{x}_{t-1}\boldsymbol{\beta} + \varepsilon_{t-1}) + \phi_1^2(\mathbf{x}_{t-2}\boldsymbol{\beta} + \varepsilon_{t-2}) + \phi_1^3(\mathbf{x}_{t-3}\boldsymbol{\beta} + \varepsilon_{t-3}) + \dots$$

That is, y_t represents the sum of all past \mathbf{x}_t 's as filtered through $\boldsymbol{\beta}$ and ϕ_1

Interpreting AR(1) parameters

Take a step back: suppose c_t is actually fixed for all time at c , so that $c = c_t$

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Now, we have

$$y_t = (c + \varepsilon_t) + \phi_1(c + \varepsilon_{t-1}) + \phi_1^2(c + \varepsilon_{t-2}) + \phi_1^3(c + \varepsilon_{t-3}) + \dots$$

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$$\begin{aligned}y_t &= (c + \varepsilon_t) + \phi_1(c + \varepsilon_{t-1}) + \phi_1^2(c + \varepsilon_{t-2}) + \phi_1^3(c + \varepsilon_{t-3}) + \dots \\ &= \frac{c}{1 - \phi_1} + \varepsilon_t + \phi_1\varepsilon_{t-1} + \phi_1^2\varepsilon_{t-2} + \phi_1^3\varepsilon_{t-3} \dots\end{aligned}$$

which follows from the limits for infinite series

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which follows from the limits for infinite series

Taking expectations removes everything but the first term:

$$E(y_t) = \frac{c}{1 - \phi_1}$$

Implication:

if, starting at time t and going forward to ∞ ,

we fix $x_t\beta$,

then y_t will converge to $x_t\beta/(1 - \phi_1)$

Interpreting AR(1) parameters

$$\text{GDP}_t = \phi_1 \text{GDP}_{t-1} + \beta_0 + \beta_1 \text{Democracy}_t + \varepsilon_t$$

$$\text{GDP}_t = 0.9 \times \text{GDP}_{t-1} + 10 + 2 \times \text{Democracy}_t + \varepsilon_t$$

If at year t , $\text{GDP}_t = 100$ and the country is a non-democracy ($\text{Democracy}_t = 0$) then:

This country is in a steady state –

it will tend to have GDP of 100 every period, with small errors from ε_t (verify this)

Interpreting AR(1) parameters

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$$\text{GDP}_t = 0.9 \times \text{GDP}_{t-1} + 10 + 2 \times \text{Democracy}_t + \varepsilon_t$$

Now suppose we make the country a democracy in period $t + 1$, so that $\text{Democracy}_{t+1} = 1$.

The model predicts that in period $t + 1$, the level of GDP will rise by $\beta = 2$, to 102.

This *appears* to be a small effect, but. . .

Interpreting AR(1) parameters

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... the effect accumulates, so long as Democracy = 1

$$\text{E}(\hat{y}_{t+2} | x_{t+2}) = 0.9 \times 102 + 10 + 2 = 103.8$$

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Interpreting AR(1) parameters

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$$\text{E}(\hat{y}_{t+3} | x_{t+3}) = 0.9 \times 103.8 + 10 + 2 = 105.42$$

$$\text{E}(\hat{y}_{t+4} | x_{t+4}) = 0.9 \times 105.42 + 10 + 2 = 106.878$$

Interpreting AR(1) parameters

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$$\text{E}(\hat{y}_{t+4} | x_{t+4}) = 0.9 \times 105.42 + 10 + 2 = 106.878$$

...

$$\text{E}(\hat{y}_{t=\infty} | x_{t=\infty}) = (10 + 2) / (1 - 0.9) = 120$$

So is this a big effect or a small effect?

Interpreting AR(1) parameters

$$E(\hat{y}_{t=\infty}|x_{t=\infty}) = (10 + 2)/(1 - 0.9) = 120$$

So is this a big effect or a small effect?

It depends on the length of time your covariates remain fixed.

Many social variables change rarely, so their effects accumulate slowly over time (e.g., institutions)

Presenting only β_1 , rather than the accumulated change in y_t after x_t changes, could drastically *understate* the relative substantive importance of our social & political covariates compared to rapidly changing covariates

This understatement gets larger the closer ϕ_1 gets to 1 —which is where our ϕ_1 's tend to be!

A catch: remember that if $\phi_1 = 1$, long-run predictions are impossible, so forecasting will produce misleading results of nonstationary processes

Interpreting AR(1) parameters

Recommendation:

Simulate the change in y_t given a change in x_t through enough periods to capture the real-world impact of your variables

If you are studying partisan effects, and new parties tend to stay in power 5 years, don't report β_1 or the one-year change in y . Iterate out to five years.

What is the confidence interval around these cumulative changes in y given a permanent change in x ?

A complex function of the se's of ϕ and β

So simulate out to y_{t+k} using draws from the estimated distributions of $\hat{\phi}$ and $\hat{\beta}$

R will help with this, using `predict()` and (in `simcf`), `ldvsimev()`

Example: UK vehicle accident deaths

Number of monthly deaths and serious injuries in UK road accidents

Data range from January 1969 to December 1984.

In February 1983, a new law requiring seat belt use took effect

Source: Harvey, 1989, p.519ff.

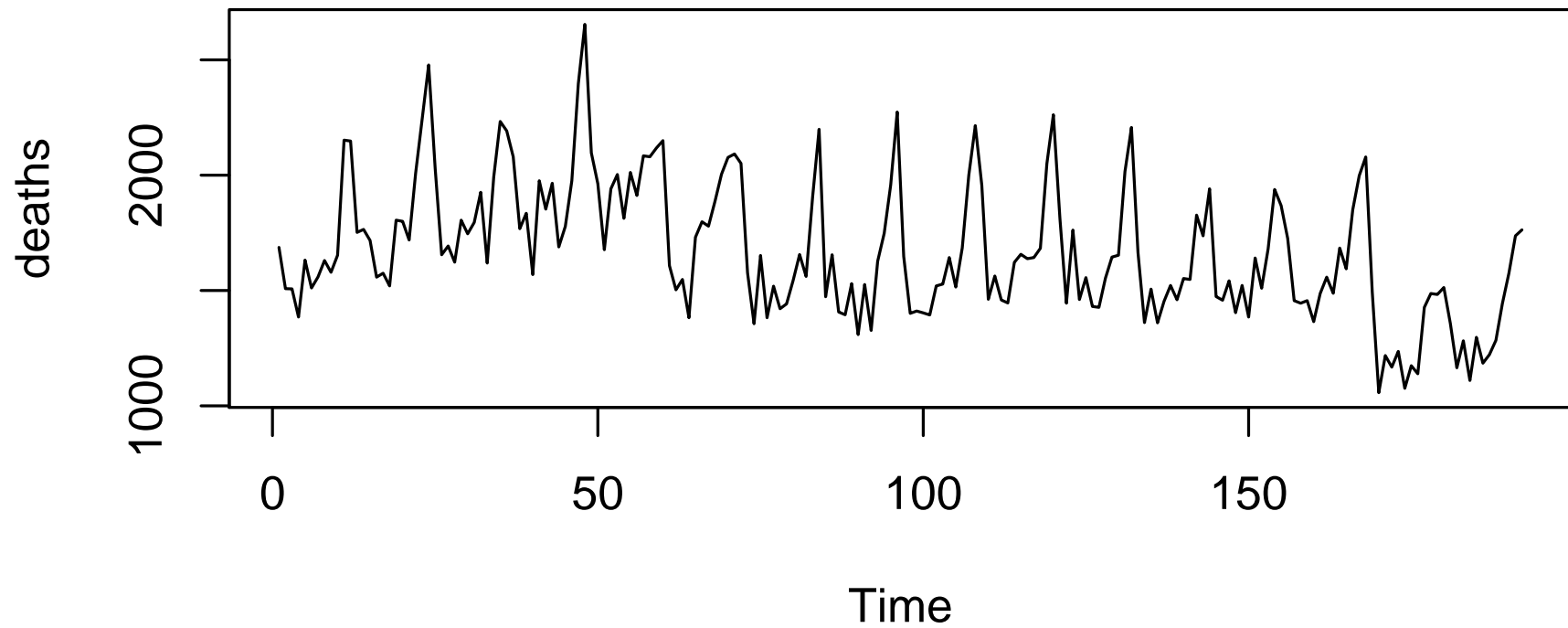
<http://www.staff.city.ac.uk/~sc397/courses/3ts/datasets.html>

Simple, likely stationary data

Possibly seasonal

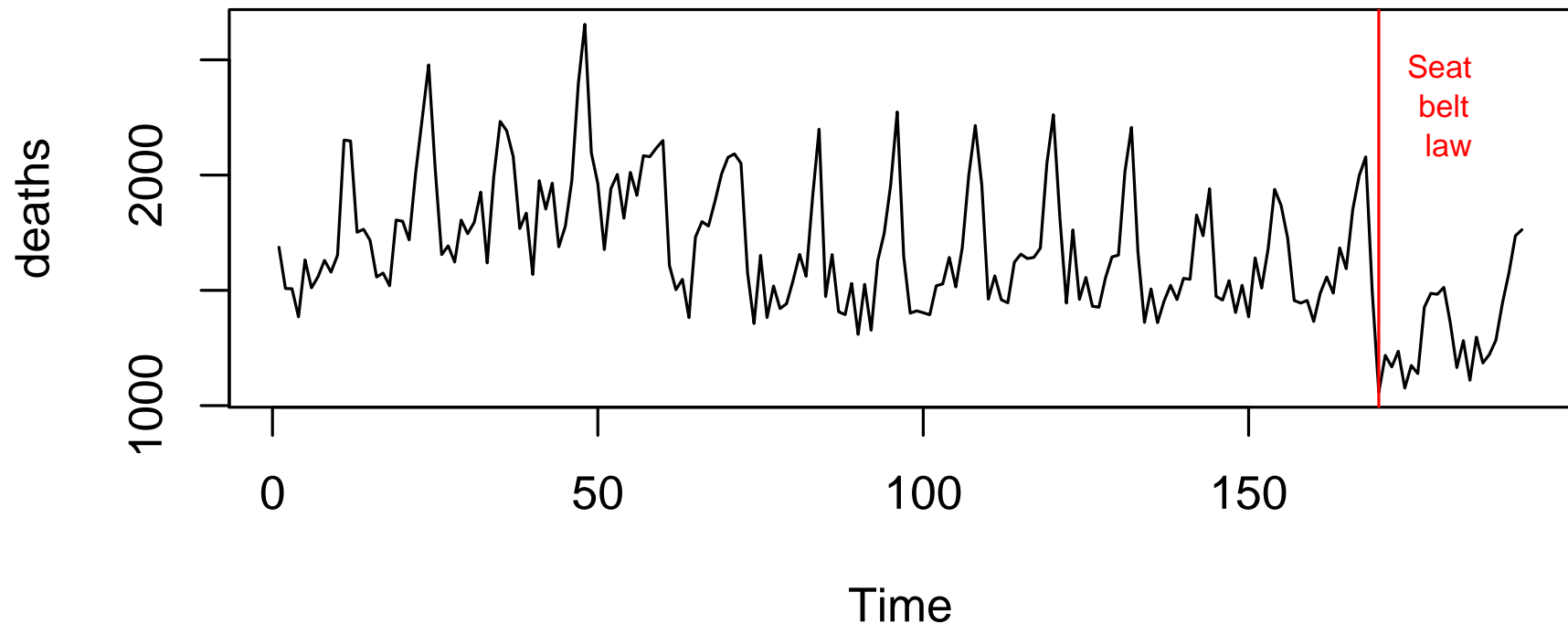
Simplest possible covariate: a single dummy

Vehicular accident deaths, UK, 1969–1984



The time series itself – looks cyclical, with a break in the series

Vehicular accident deaths, UK, 1969–1984

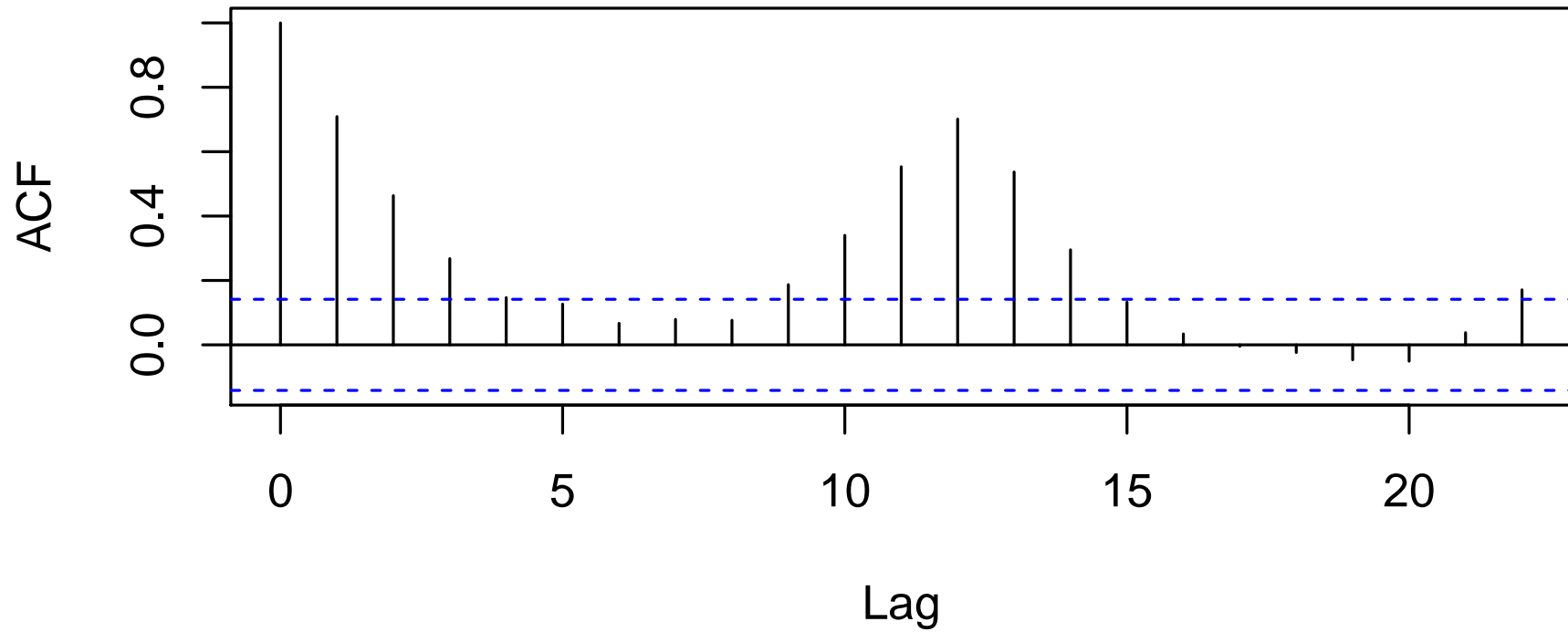


The break corresponds closely with the change in seat belt laws

In a real data analysis, everything past this point is a bit gratuitous—this time series plot is simple and persuasive

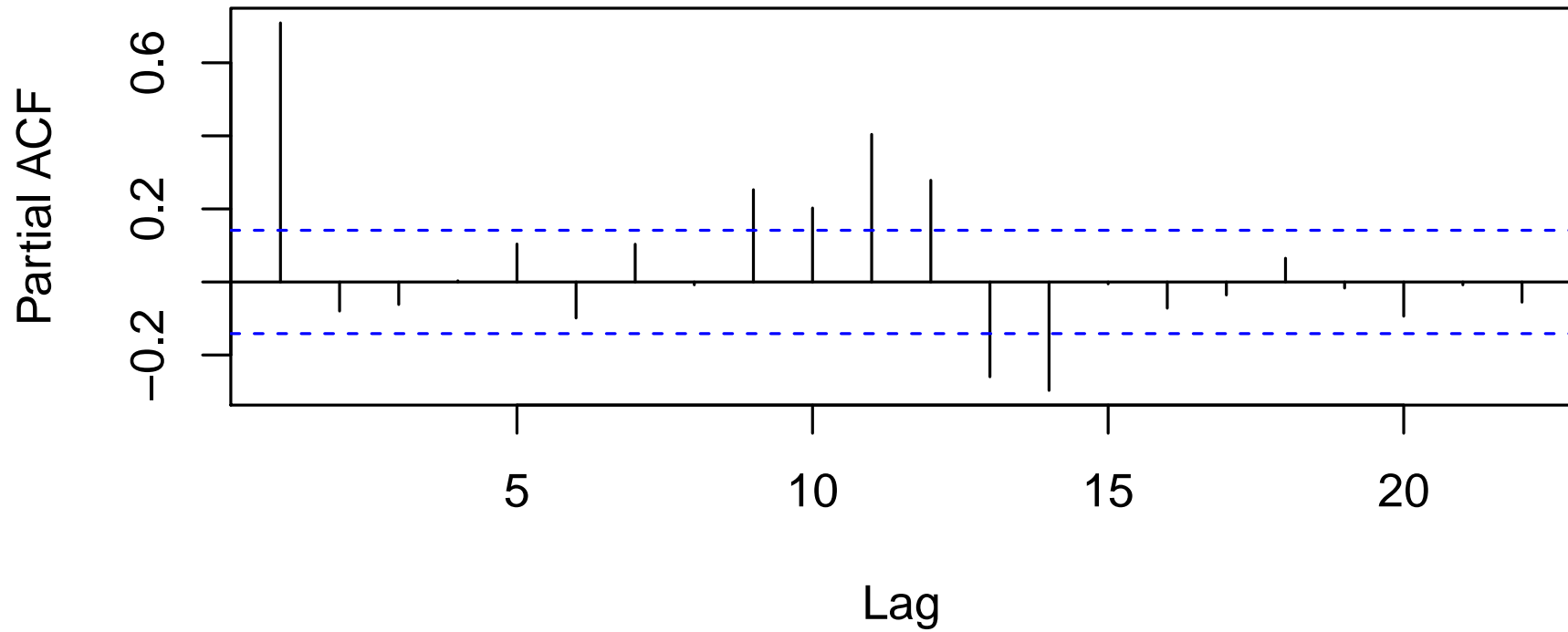
But as most data analyses are more complex, this is a good testbed to learn techniques

Series death



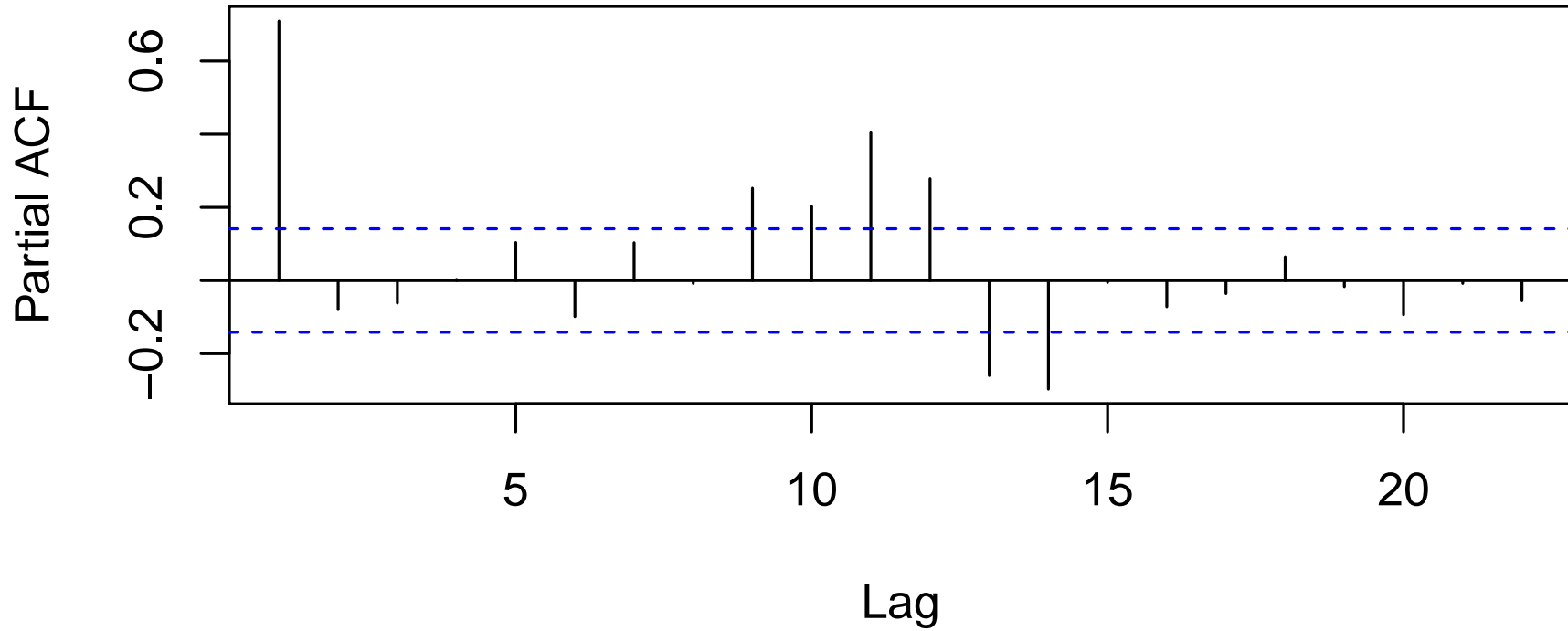
What does this suggest?

Series death



What does this suggest?

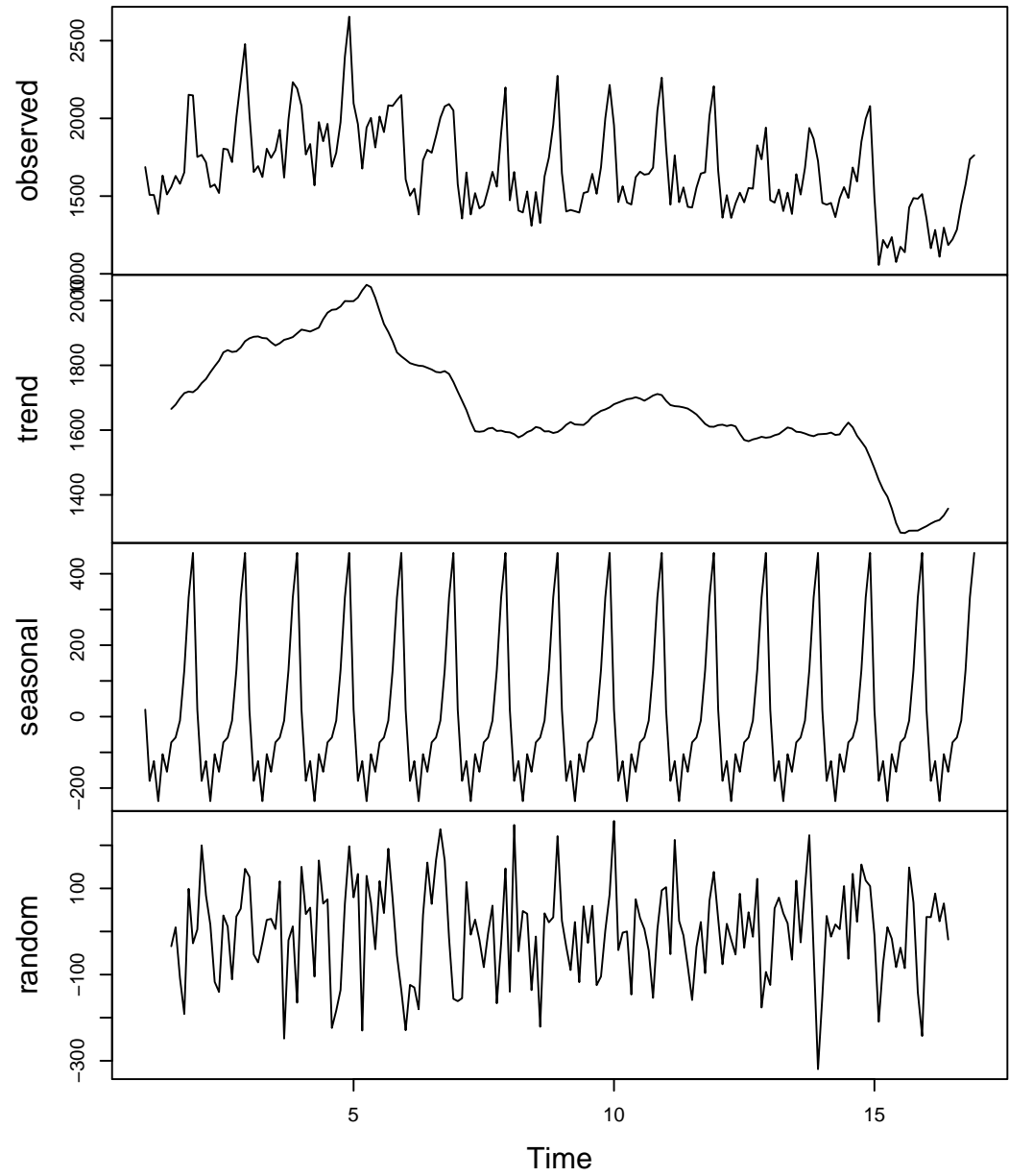
Series death



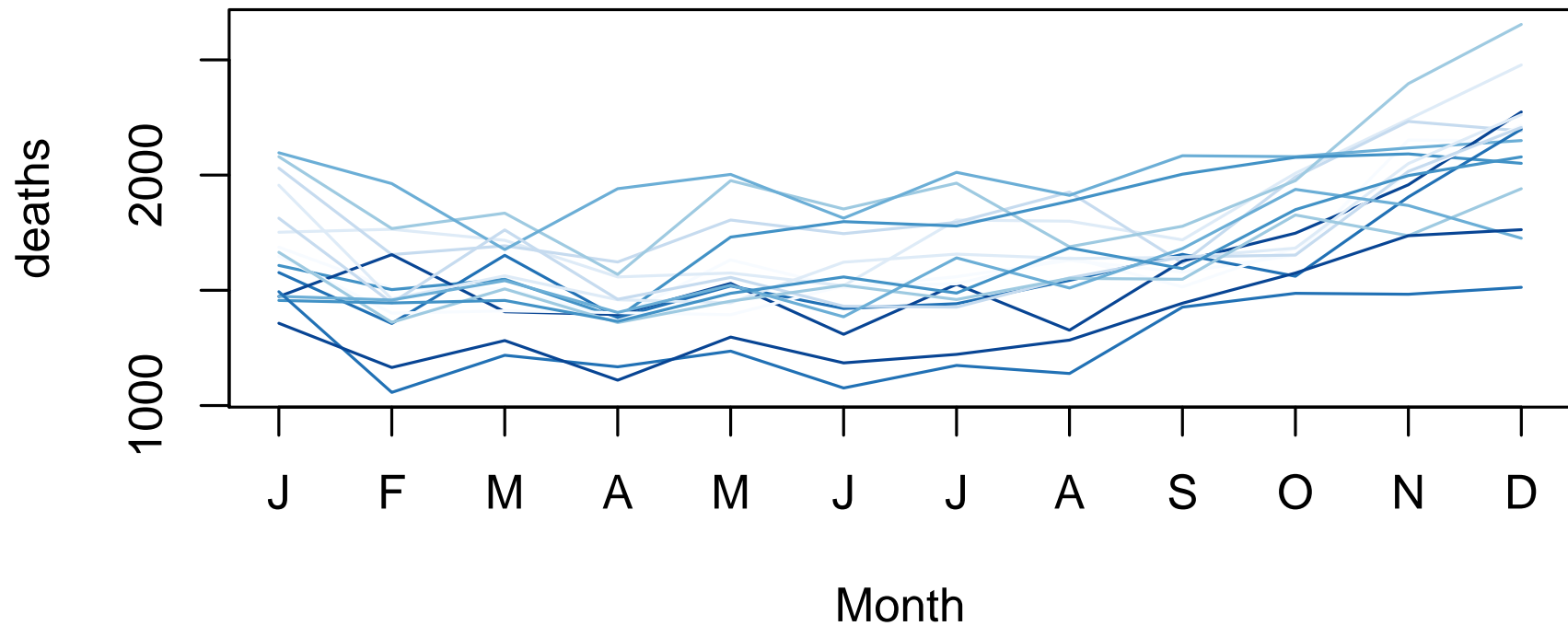
What does this suggest?

How should we model seasons?

Decomposition of additive time series



Monthly view of accident deaths, UK, 1969–1984



November and December look especially dangerous

October and January look a bit dangerous

We could control for each month, select months, or Q4

This might also depend on serial correlation

Model 1a: AR(1) specification

```
## Estimate an AR(1) using arima
xcovariates <- law
arima.res1a <- arima(death, order = c(1,0,0),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	intercept	xcovariates
	0.644	1719.19	-377.5
s.e.	0.055	42.08	107.7

sigma² estimated as 39289: log likelihood = -1288, aic = 2585

We begin with a simple model ignoring seasonality,
and controlling for one autoregressive lag

Model 1b: AR(1) specification with Q4 control

```
## Estimate an AR(1) using arima
xcovariates <- cbind(law, q4)
arima.res1b <- arima(death, order = c(1,0,0),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	intercept	law	q4
	0.5352	1638.0301	-395.6701	324.5653
s.e.	0.0636	28.1199	72.3030	34.5033

sigma² estimated as 26669: log likelihood = -1250.97, aic = 2511.93

Model 1c: AR(1) specification with all months

```
## Estimate an AR(1) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res1c <- arima(death, order = c(1,0,0),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	intercept	law	jan	feb
	0.6442	1638.6270	-370.0694	81.3021	-95.1350
s.e.	0.0550	42.9093	70.2727	54.8127	54.5036
	mar	apr	may	jun	aug
	-44.3298	-157.3445	-19.9428	-75.6674	14.7670
s.e.	53.0792	50.2149	45.0247	35.1890	35.1882
	sep	oct	nov	dec	
	67.4890	206.6686	405.9134	522.0696	
s.e.	45.0184	50.1913	53.0074	54.3054	

sigma² estimated as 16333: log likelihood = -1204, aic = 2437.99

Model 1d: AR(1) specification with select months

```
## Estimate an AR(1) using arima
xcovariates <- cbind(law, jan, sep, oct, nov, dec)
arima.res1d <- arima(death, order = c(1,0,0),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	intercept	law	jan	sep
	0.6045	1589.4405	-377.7457	154.7288	80.7422
s.e.	0.0575	29.4161	69.7719	35.7336	35.8534
	oct	nov	dec		
	238.3880	451.3567	579.9770		
s.e.	42.6836	44.3474	42.6108		

sigma² estimated as 18989: log likelihood = -1218.42, aic = 2454.83

Model 1e: AR(1)AR(1)₁₂ specification

```
## Estimate an AR(1)AR(1)_12 using arima
xcovariates <- cbind(law)
arima.res1e <- arima(death, order = c(1,0,0),
                    seasonal = list(order = c(1,0,0), period = 12),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	sar1	intercept	law
	0.4446	0.6511	1710.1531	-347.6812
s.e.	0.0695	0.0564	53.3648	73.0634

sigma² estimated as 23693: log likelihood = -1242.86, aic = 2495.71

Model 1e: $AR(1)AR(1)_{12}$ specification

Two questions:

1. Which model to select?

Additive or multiplicative seasonality?

A full set of month dummies, or a selection?

2. What is the effect of adding the law?

In period $t + 1?$ $t + 12?$ $t + 60$

How “significant” is this effect over those periods?

Summary of fit so far

Model	Components	AIC	$\hat{\beta}_{\text{Law}}$	$\text{se}(\hat{\beta}_{\text{Law}})$
1a	AR(1)	2585	-377	108
1b	AR(1), q4	2512	-396	72
1c	AR(1), all months	2438	-370	70
1d	AR(1), sep to jan	2455	-378	70
1e	AR(1)AR(1) ₁₂	2496	-348	73

Which is the best fitting approach to seasonality?

Why did I use AIC to select models? What might be better?

What substantive difference does it make?

And what about higher order serial correlation?

An AR(p) Regression Model

The AR(p) regression model is a straightforward extension of the AR(1)

$$y_t = y_{t-1}\phi_1 + y_{t-2}\phi_2 + \dots + y_{t-p}\phi_p + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Note that for fixed mean, y_t now converges to

$$E(y_t) = \frac{c}{1 - \phi_1 - \phi_2 - \phi_3 - \dots - \phi_p}$$

Implication:

if, starting at time t and going forward to ∞ , we fix $\mathbf{x}_i\boldsymbol{\beta}$,
then y_t will converge to $\mathbf{x}_i\boldsymbol{\beta}/(1 - \phi_1 - \phi_2 - \phi_3 - \dots - \phi_p)$

Estimation and interpretation similar to above & uses same R functions

MA(1) Models

To create a regression model from the MA(1):

$$y_t = \varepsilon_{t-1}\rho_1 + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Estimation is again by maximum likelihood

Once again a complex procedure, but still a generalization of the Normal case

Any dynamic effects in this model are quickly mean reverting

ARMA(p,q): Putting it all together

To create a regression model from the ARMA(p,q):

$$y_t = y_{t-1}\phi_1 + y_{t-2}\phi_2 + \dots + y_{t-p}\phi_p + \varepsilon_{t-1}\rho_1 + \varepsilon_{t-2}\rho_2 + \dots + \varepsilon_{t-q}\rho_q + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

Will need a MLE to obtain $\hat{\phi}$, $\hat{\rho}$, and $\hat{\boldsymbol{\beta}}$

Once again a complex procedure, but still a generalization of the Normal case

Note the AR(p) process dominates in two senses:

- Stationarity determined just by AR(p) part of ARMA(p,q)
- Long-run level determined just by AR(p) terms: still $\mathbf{x}_i\boldsymbol{\beta}/(1 - \sum_p \phi_p)$

Model 2a: AR(2) specification

```
## Estimate an AR(2) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2a <- arima(death, order = c(2,0,0),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	ar2	intercept	law	jan
	0.4696	0.2711	1635.0869	-347.9213	83.7469
s.e.	0.0692	0.0694	45.6076	80.5683	46.9299
	feb	mar	apr	may	jun
	-94.9882	-44.0442	-157.2316	-19.8376	-75.5957
s.e.	46.5145	45.0452	42.8448	37.9719	35.0631
	aug	sep	oct	nov	dec
	14.8059	67.5047	206.7362	406.0569	522.4596
s.e.	35.0623	37.9640	42.8242	44.9760	46.4368

sigma² estimated as 15118: log likelihood = -1196.65, aic = 2425.3

Model 2b: MA(1) specification

```
## Estimate an MA(1) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2b <- arima(death, order = c(0,0,1),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ma1	intercept	law	jan	feb
	0.4539	1641.4834	-391.7280	79.9732	-94.6320
s.e.	0.0538	39.7814	45.5288	55.5797	55.6807
	mar	apr	may	jun	aug
	-44.0097	-157.2155	-19.8754	-75.6604	14.8400
s.e.	55.6807	55.6807	55.6807	43.9719	43.9719
	sep	oct	nov	dec	
	67.6897	207.0297	406.5988	522.4457	
s.e.	55.6807	55.6807	55.6807	55.5411	

sigma² estimated as 20566: log likelihood = -1225.97, aic = 2481.93

Model 2c: ARMA(1,1) specification

```
## Estimate an ARMA(1,1) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2c <- arima(death, order = c(1,0,1),
                    xreg = xcovariates, include.mean = TRUE
                    )
```

Coefficients:

	ar1	ma1	intercept	law	jan
	0.9349	-0.5994	1629.5549	-323.4929	85.7471
s.e.	0.0383	0.1076	58.6795	83.2081	40.4544
	feb	mar	apr	may	jun
	-94.0923	-43.6000	-156.8606	-19.6467	-75.5028
s.e.	40.2349	39.7247	38.8954	37.7225	36.1673
	aug	sep	oct	nov	dec
	14.7339	67.3872	206.5916	405.9572	522.3735
s.e.	36.1671	37.7207	38.8896	39.7111	40.2083

sigma² estimated as 14568: log likelihood = -1193.18, aic = 2418.37

Model 2d: ARMA(2,1) specification

```
## Estimate an ARMA(2,1) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2d <- arima(death, order = c(2,0,1),
                    xreg = xcovariates, include.mean = TRUE)
```

Coefficients:

	ar1	ar2	ma1	intercept	law
	1.1899	-0.2157	-0.7950	1626.1862	-321.2201
s.e.	0.1071	0.0976	0.0724	68.6982	78.8301
	jan	feb	mar	apr	may
	84.8843	-94.5311	-43.8782	-157.0544	-19.7871
s.e.	41.3869	41.3010	41.0435	40.5352	39.3222
	jun	aug	sep	oct	nov
	-75.5646	14.8208	67.5749	206.8634	406.3691
s.e.	35.1484	35.1483	39.3216	40.5327	41.0341
	dec				
	522.9159				
s.e.	41.2487				

```
sigma^2 estimated as 14284: log likelihood = -1191.33, aic = 2416.66
```

Model 2e: ARMA(1,2) specification

```
## Estimate an ARMA(1,2) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2e <- arima(death, order = c(1,0,2),
                    xreg = xcovariates, include.mean = TRUE)
```

Coefficients:

	ar1	ma1	ma2	intercept	law
	0.9620	-0.5892	-0.1228	1627.146	-322.6854
s.e.	0.0253	0.0752	0.0705	66.814	79.2449
	jan	feb	mar	apr	may
	85.1562	-94.1511	-43.6591	-156.9126	-19.6915
s.e.	40.7504	40.6400	40.3701	39.9498	39.3736
	jun	aug	sep	oct	nov
	-75.5237	14.7645	67.4691	206.7084	406.1477
s.e.	35.5453	35.5453	39.3730	39.9476	40.3650
	dec				
	522.6613				
s.e.	40.5994				

```
sigma^2 estimated as 14356: log likelihood = -1191.82, aic = 2417.63
```

Model 2f: ARMA(2,2) specification

```
## Estimate an ARMA(2,2) using arima
xcovariates <- cbind(law, jan, feb, mar, apr, may, jun, aug, sep, oct,
                    nov, dec)
arima.res2f <- arima(death, order = c(2,0,2),
                    xreg = xcovariates, include.mean = TRUE)
```

Coefficients:

	ar1	ar2	ma1	ma2	intercept		
	0.0526	0.8449	0.3497	-0.6503	1625.7793		
s.e.	0.0538	0.0413	0.1006	0.0998	61.5565		
	law	jan	feb	mar	apr		
	-312.2308	86.0931	-91.7482	-43.7677	-154.3960		
s.e.	81.8335	40.9421	38.1258	40.4084	36.9053		
	may	jun	aug	sep	oct		
	-19.6984	-72.8430	17.6629	67.3856	209.8757		
s.e.	38.9443	34.4385	34.4299	38.9431	36.8765		
	nov	dec					
	405.8869	526.1152					
s.e.	40.3991	38.0647					

sigma² estimated as 13794: log likelihood = -1189.2, aic = 2414.39

Whew!

This gets tedious fast. . .

To have R search automatically for a low AIC model, try `auto.arima()` in the `forecast` library.

This gets complicated if the series is potentially seasonal and/or nonstationary

My practice: search/diagnose manually where feasible, automatically where many runs are needed (e.g., 1 million time series analyses?)

More on this in lab. . .

Summary of fit

Model	Components	AIC	$\hat{\beta}_{\text{Law}}$	$\text{se}(\hat{\beta}_{\text{Law}})$
1a	AR(1)	2585	-377	108
1b	AR(1), q4	2512	-396	72
1c	AR(1), all months	2438	-370	70
1d	AR(1), sep to jan	2455	-378	70
1e	AR(1)AR(1) ₁₂	2496	-348	73
2a	AR(2), all months	2425	-348	81
2b	MA(1), all months	2482	-392	46
2c	ARMA(1,1), all months	2418	-323	83
2d,3a	ARMA(2,1), all months	2417	-321	79
2e	ARMA(1,2), all months	2418	-323	79
2f	ARMA(2,2), all months	2414	-321	79

Which model looks best?

What might be a better way to judge than AIC?

Cross-validation

Out of sample tests of fit are more reliable than in sample tests

But what is out-of-sample in time series?

Can't just pull random observations out of sequence:
best CV method for time series is a rolling forecast window

Issue for all cross-validation:
danger of collinearity if you have binary covariates that change rarely!

Summary of fit

Model	Components	AIC	cv1-MAE	β_{Law}	$\text{se}(\beta_{\text{Law}})$
1a	AR(1)	2585	120.4	-377	108
1b	AR(1), q4	2512	108.5	-396	72
1c	AR(1), all months	2438	83.9	-370	70
1d	AR(1), sep to jan	2455	119.7	-378	70
1e	AR(1)AR(1) ₁₂	2496	119.7	-348	73
2a	AR(2), all months	2425	92.6	-348	81
2b	MA(1), all months	2482	79.9	-392	46
2c	ARMA(1,1), all months	2418	89.5	-323	83
2d,3a	ARMA(2,1), all months	2417	83.5	-321	79
2e	ARMA(1,2), all months	2418	84.8	-323	79
2f	ARMA(2,2), all months	2414	85.5	-321	79

We could look at the one-period-ahead out-of-sample forecast

cv1-MAE shows the mean absolute error in this prediction

Note we have fairly few periods left to forecast, as we need a long window to estimate the effect of the law (which doesn't start until period 170)

Summary of fit

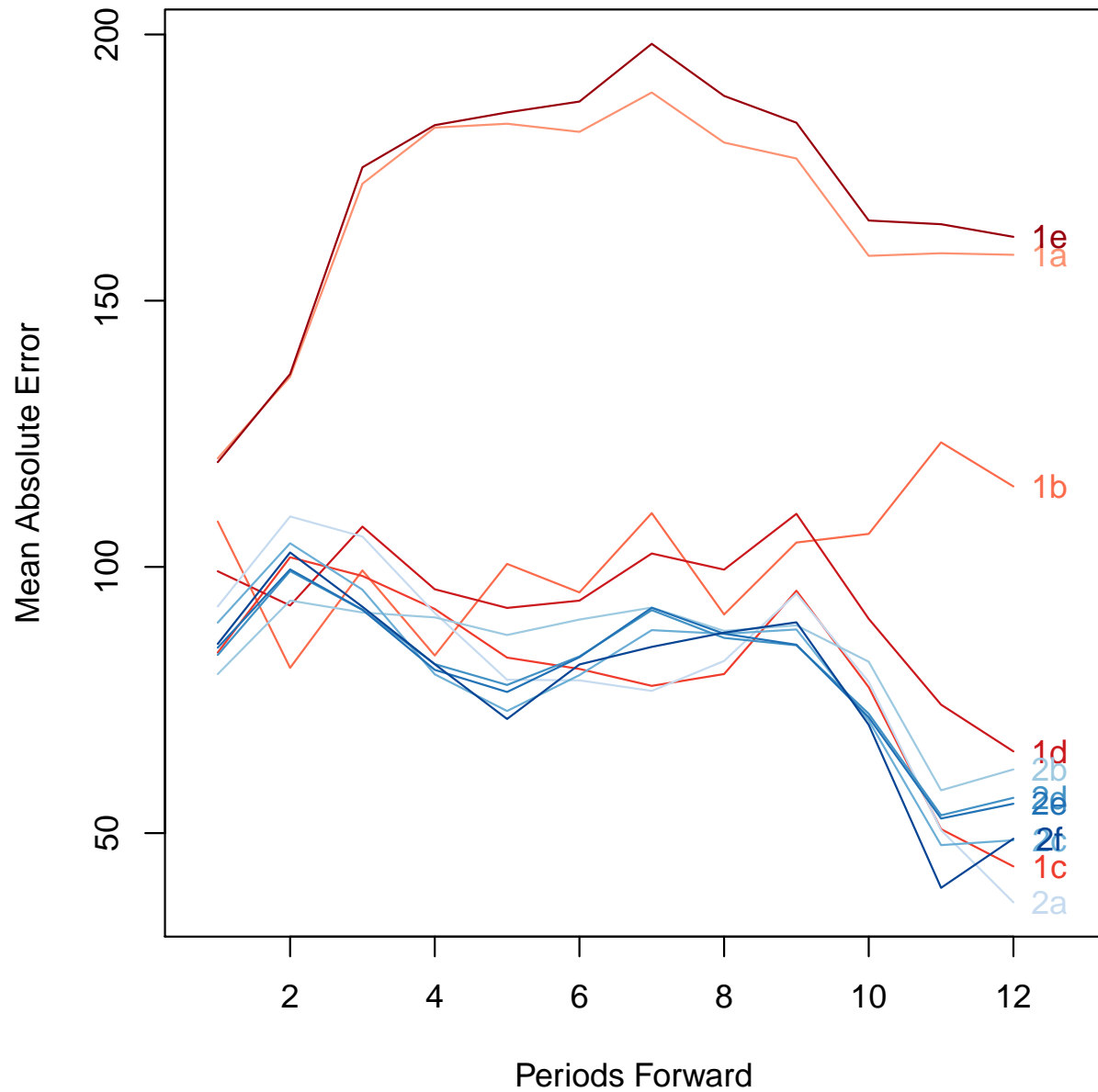
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2e	ARMA(1,2), all months	2418	84.8	-323	79
2f	ARMA(2,2), all months	2414	85.5	-321	79

Is MA(1) really the best fitting model, against the in-sample evidence?

Perhaps we should look at forecasts beyond one period ahead. . .

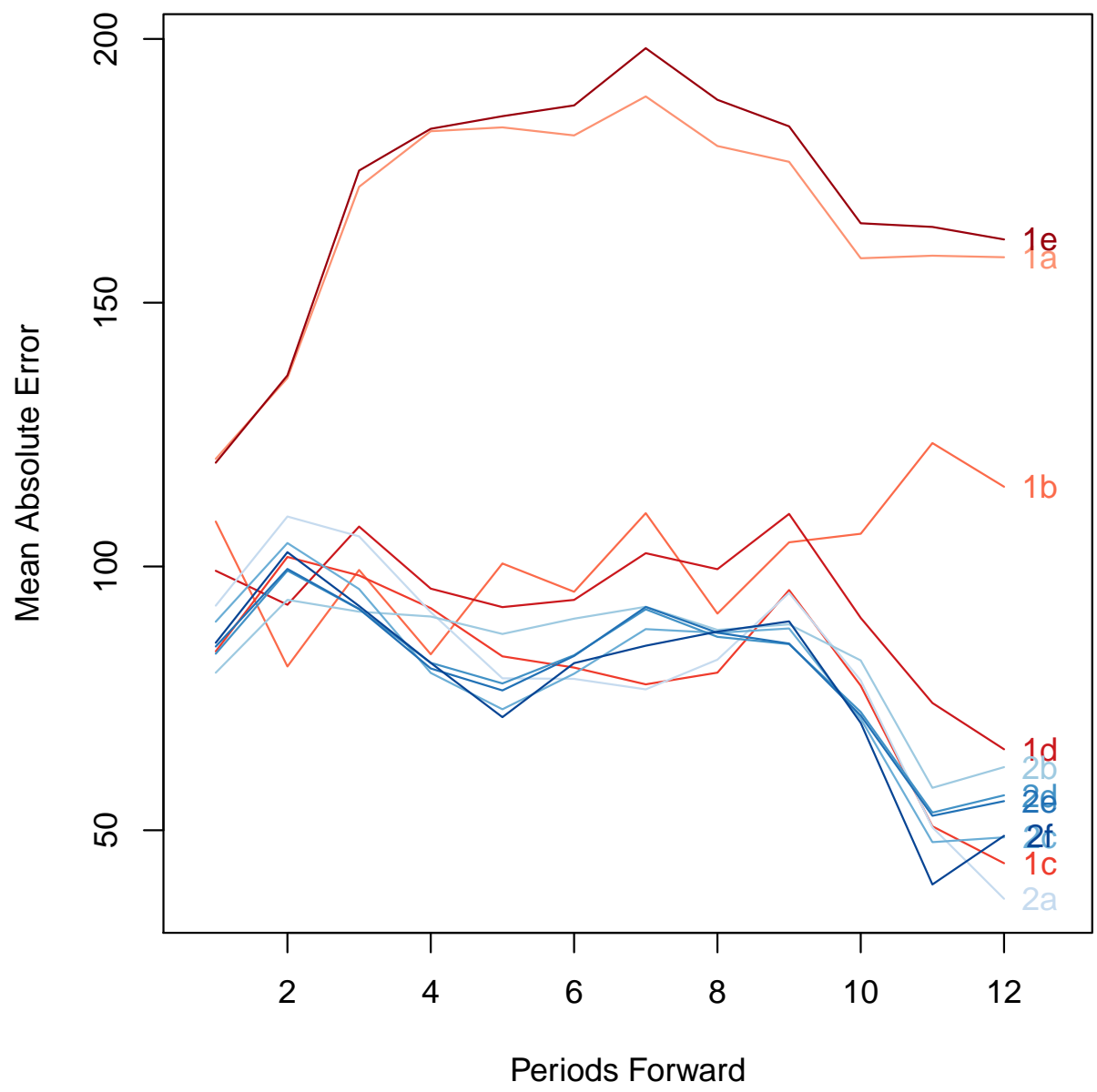
A graphic helps. . .

Cross-validation of accident deaths models



Some models seem easy to reject, but which is/are best?

Cross-validation of accident deaths models



Do we trust the predictions out at 10–12 months? Why or why not?

Summary of fit

Model	Components	AIC	cv12-MAE	β_{Law}	$\text{se}(\beta_{\text{Law}})$
1a	AR(1)	2585	166.4	-377	108
1b	AR(1), q4	2512	101.5	-396	72
1c	AR(1), all months	2438	80.4	-370	70
1d	AR(1), sep to jan	2455	93.6	-378	70
1e	AR(1)AR(1) ₁₂	2496	170.7	-348	73
2a	AR(2), all months	2425	81.4	-348	81
2b	MA(1), all months	2482	83.7	-392	46
2c	ARMA(1,1), all months	2418	79.5	-323	83
2d,3a	ARMA(2,1), all months	2417	80.3	-321	79
2e	ARMA(1,2), all months	2418	80.1	-323	79
2f	ARMA(2,2), all months	2414	78.1	-321	79

We might summarize the prior figure with the average MAE averaged over the 12 month forecast

This suggests similar performance for most ARMA models, except MA(1), which is poorer

Summary of fit

Model	Components	AIC	cv8-MAE	β_{Law}	$\text{se}(\beta_{\text{Law}})$
1a	AR(1)	2585	168.0	-377	108
1b	AR(1), q4	2512	96.2	-396	72
1c	AR(1), all months	2438	87.2	-370	70
1d	AR(1), sep to jan	2455	97.9	-378	70
1e	AR(1)AR(1) ₁₂	2496	171.7	-348	73
2a	AR(2), all months	2425	89.5	-348	81
2b	MA(1), all months	2482	89.1	-392	46
2c	ARMA(1,1), all months	2418	87.2	-323	83
2d,3a	ARMA(2,1), all months	2417	87.0	-321	79
2e	ARMA(1,2), all months	2418	87.0	-323	79
2f	ARMA(2,2), all months	2414	86.0	-321	79

Even discounting the forecasts past 8 months, model 2f comes out slightly ahead. . .

But all of the models with monthly controls and at least one AR term do roughly equally well

Selected model: ARMA(2,2)

Coefficients:

	ar1	ar2	ma1	ma2	intercept	
	0.0526	0.8449	0.3497	-0.6503	1625.7793	
s.e.	0.0538	0.0413	0.1006	0.0998	61.5565	
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	nov	dec				
	405.8869	526.1152				
s.e.	40.3991	38.0647				

σ^2 estimated as 13794: log likelihood = -1189.2, aic = 2414.39

We have a model – but what does it mean?

Where does this series go over time, with or without the law?

Counterfactual forecasting

We consider two algorithms for forecasting:

Both assume we have point estimates and the variance covariance matrix of the model parameters, $\hat{\beta}$, $\hat{\phi}$, $\hat{\rho}$

Both compute forecast over the next K periods given hypothetical values of the covariates, $\mathbf{x}_{c,t+1}, \dots, \mathbf{x}_{c,t+k}$

Both forecasts are uncertain due to uncertainty in model parameter estimates

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Both forecasts are uncertain due to uncertainty in model parameter estimates

Approach 1: **predicted values** \tilde{y}_{t+k} , which include the uncertainty due to shocks, $\varepsilon_{t+1}, \dots, \varepsilon_{t+K}$

For this approach, we also need the estimated variance of these shocks, $\hat{\sigma}^2$

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For this approach, we also need the estimated variance of these shocks, $\hat{\sigma}^2$

Approach 2: **expected values** \hat{y}_{t+k} , which average over the anticipated shocks

Expected values show the expected path of the outcome over the next K periods, given the counterfactual covariates

Counterfactual forecasting: Predicted Values

1. Start in period t with the observed y_t and \mathbf{x}_t ;
choose hypothetical $\mathbf{x}_{c,t+k}$'s for each period $t + 1, \dots, t + k, \dots, t + K$ forecast.

Counterfactual forecasting: Predicted Values

1. Start in period t with the observed y_t and \mathbf{x}_t ;
choose hypothetical $\mathbf{x}_{c,t+k}$'s for each period $t + 1, \dots, t + k, \dots, t + K$ forecast.
2. Draw a vector of simulated parameters from their asymptotic distribution:
$$\text{vec} \left(\tilde{\beta}, \tilde{\phi}, \tilde{\rho} \right) \sim \mathcal{MVN} \left(\text{vec} \left(\hat{\beta}, \hat{\phi}, \hat{\rho} \right), \text{Var} \left(\text{vec} \left(\hat{\beta}, \hat{\phi}, \hat{\rho} \right) \right) \right).$$

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 - (a) Draw a new random shock $\tilde{\varepsilon}_{t+1} \sim \mathcal{N}(0, \hat{\sigma}^2)$.

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 - (a) Draw a new random shock $\tilde{\varepsilon}_{t+1} \sim \mathcal{N}(0, \hat{\sigma}^2)$.
 - (b) Calculate one simulated predicted value, \tilde{y}_{t+k} using

$$\tilde{y}_{t+k} = \sum_{p=1}^P y_{t+k-p} \tilde{\phi}_p + \mathbf{x}_{c,t+k} \tilde{\beta} + \sum_{q=1}^Q \tilde{\varepsilon}_{t+k-q} \tilde{\rho}_q + \tilde{\varepsilon}_{t+k}.$$

This formula uses past values of y and ε ,
which may be simulated from prior iterations of the forecast.

Counterfactual forecasting: Predicted Values

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choose hypothetical $\mathbf{x}_{c,t+k}$'s for each period $t+1, \dots, t+k, \dots, t+K$ forecast.
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This formula uses past values of y and ε ,
which may be simulated from prior iterations of the forecast.

4. Repeat steps 2 and 3 `sims` times to construct `sims` simulated forecasts.
Summarize these predicted values by means and quantiles (predictive intervals).

Counterfactual forecasting: Expected Values

1. Start in period t with the observed y_t and \mathbf{x}_t ;
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Counterfactual forecasting: Expected Values

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$$\text{vec} \left(\tilde{\beta}, \tilde{\phi}, \tilde{\rho} \right) \sim \mathcal{MVN} \left(\text{vec} \left(\hat{\beta}, \hat{\phi}, \hat{\rho} \right), \text{Var} \left(\text{vec} \left(\hat{\beta}, \hat{\phi}, \hat{\rho} \right) \right) \right).$$

Counterfactual forecasting: Expected Values

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3. Iterate over the following step for forecast period k in $1, \dots, K$:
 - (a) Calculate one simulated expected value of y_{t+k} using

$$\mathbb{E}\left(\tilde{y}_{t+k} \mid \tilde{\beta}, \tilde{\phi}, \tilde{\rho}, \mathbf{x}_{c,t}, \dots, \mathbf{x}_{c,t+k}, \mathbf{y}_t\right) = \sum_{p=1}^P y_{t+k-p} \tilde{\phi}_p + \mathbf{x}_{c,t+k} \tilde{\beta}.$$

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which may be simulated from prior iterations of the forecast.

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This formula uses past values of y and ε ,
which may be simulated from prior iterations of the forecast.

4. Repeat steps 2 and 3 `sims` times to construct `sims` simulated forecasts.
Summarize these expected values by means and quantiles (confidence intervals).

Effect of repealing seatbelt law?

What does the model predict would happen if we repealed the law?

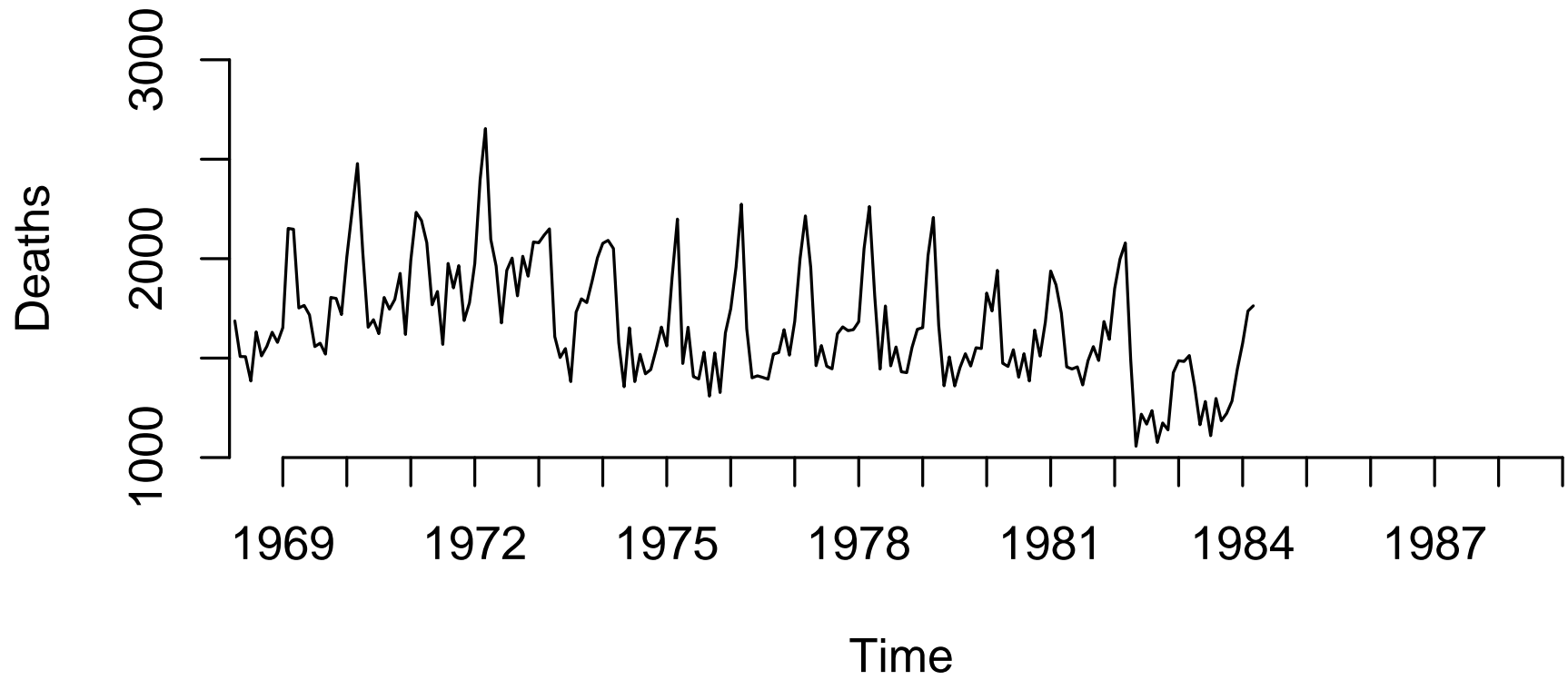
How much would deaths increase after one month? One year? Five years?

If we run this experiment, how much might the results vary from model expectations?

Need forecast deaths—no law for the next 60 periods, plus predictive intervals

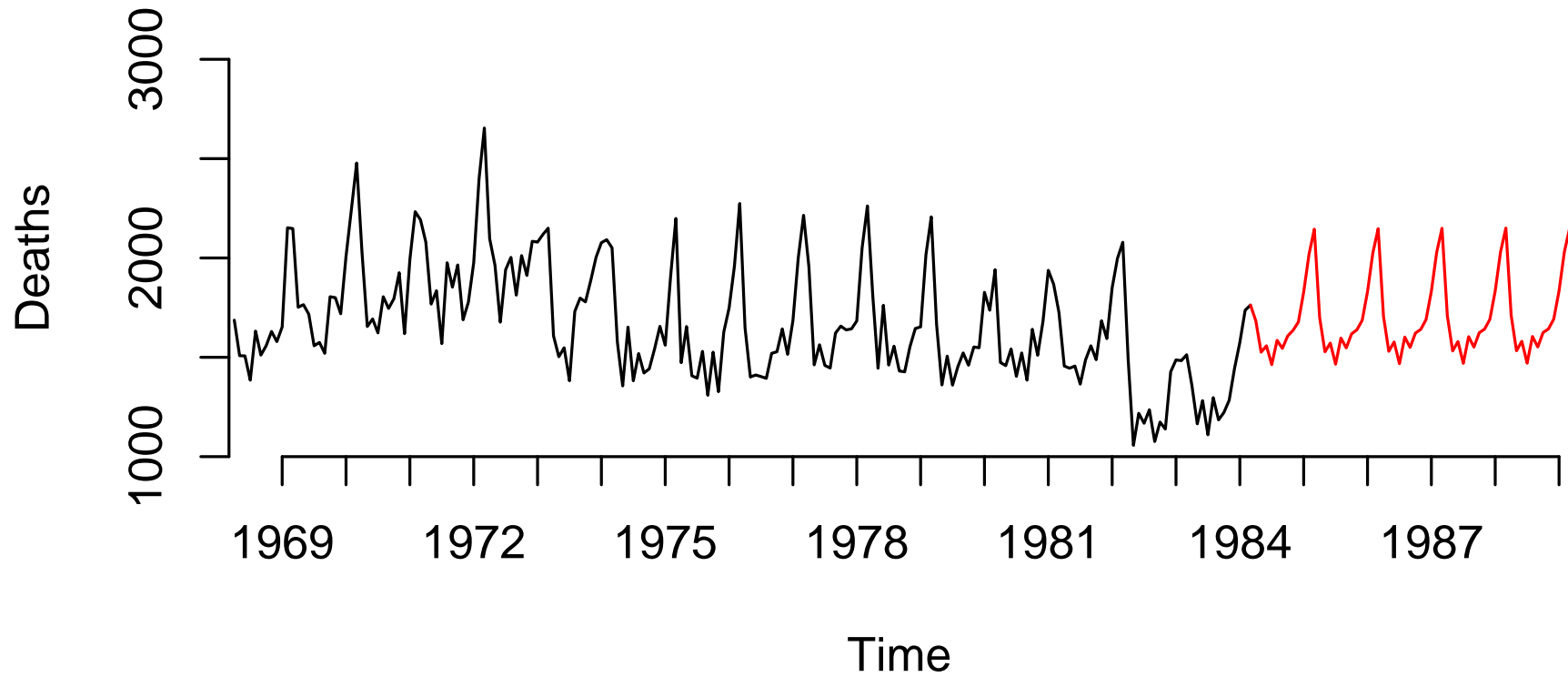
```
predict(arima.res1,          # The model
        n.ahead = 60,      # predict out 60 periods
        newxreg = newdata) # using these counterfactual x's
```

Predicted effect of reversing seat belt law



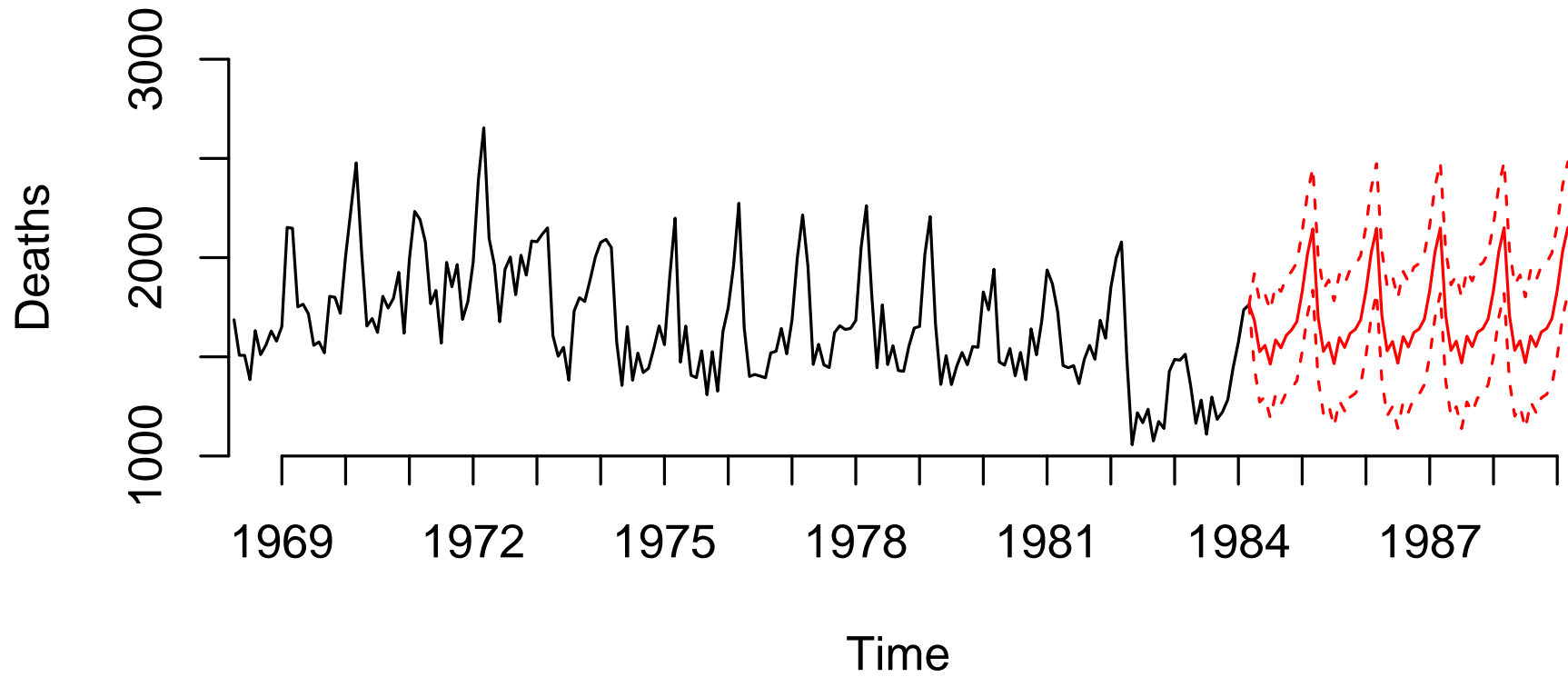
The observed time series

Predicted effect of reversing seat belt law



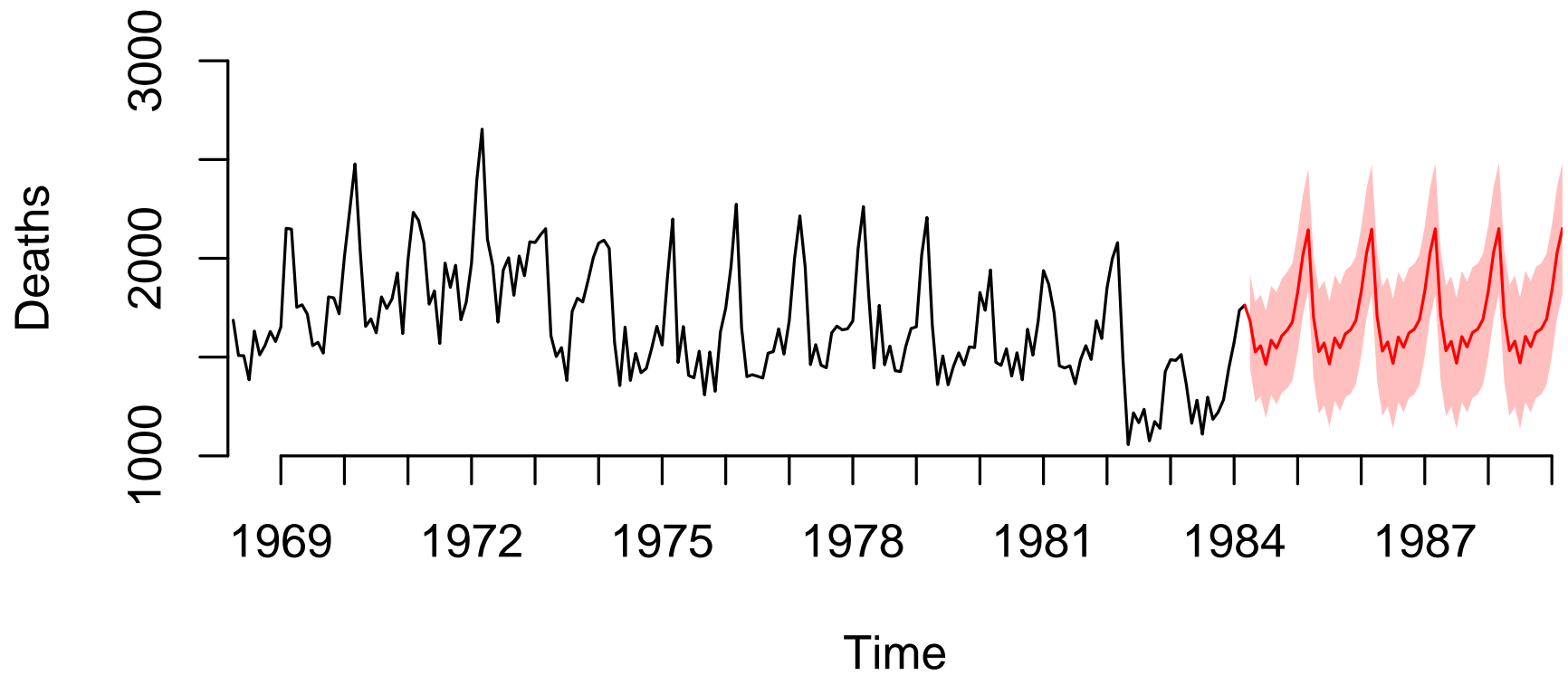
What the model predicts would happen if the seat belt requirement is *repealed*

Predicted effect of reversing seat belt law



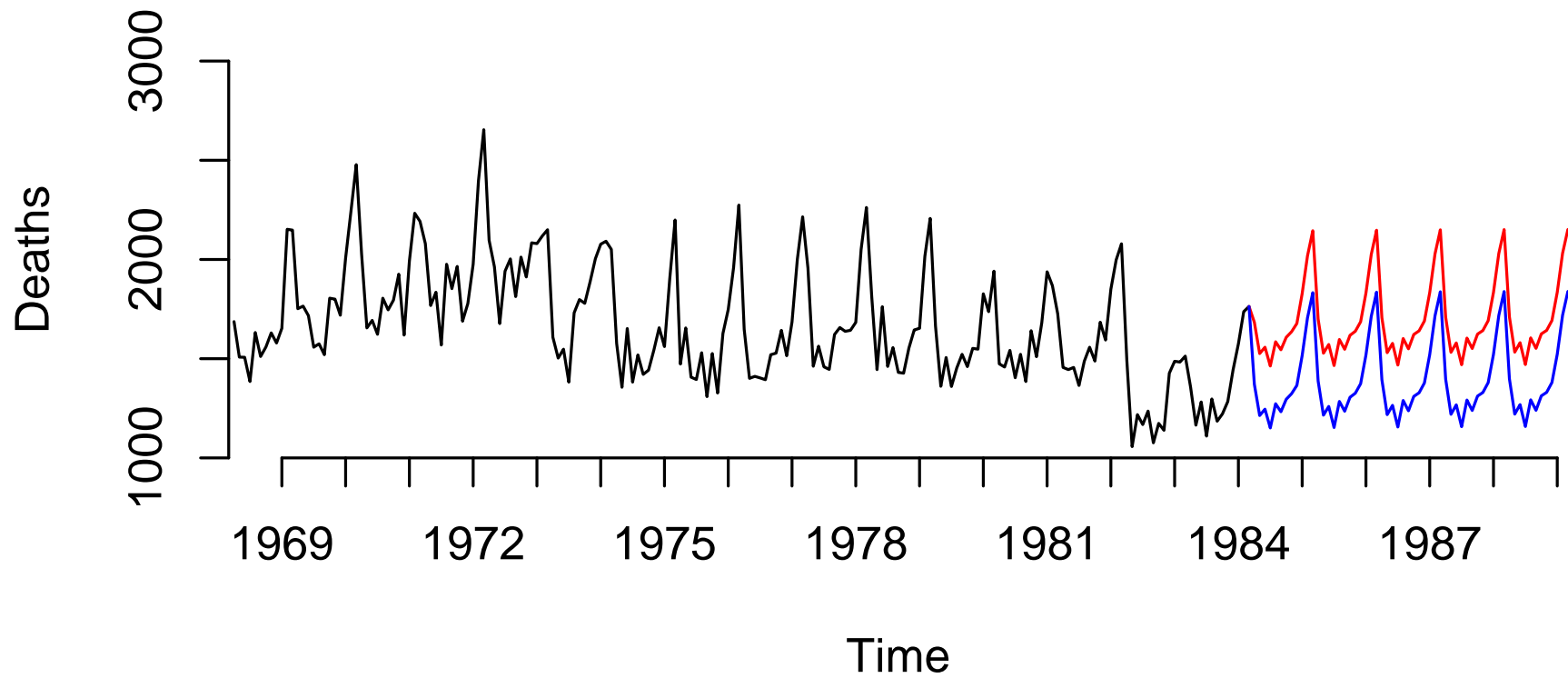
adding the 95 % predictive interval

Predicted effect of reversing seat belt law



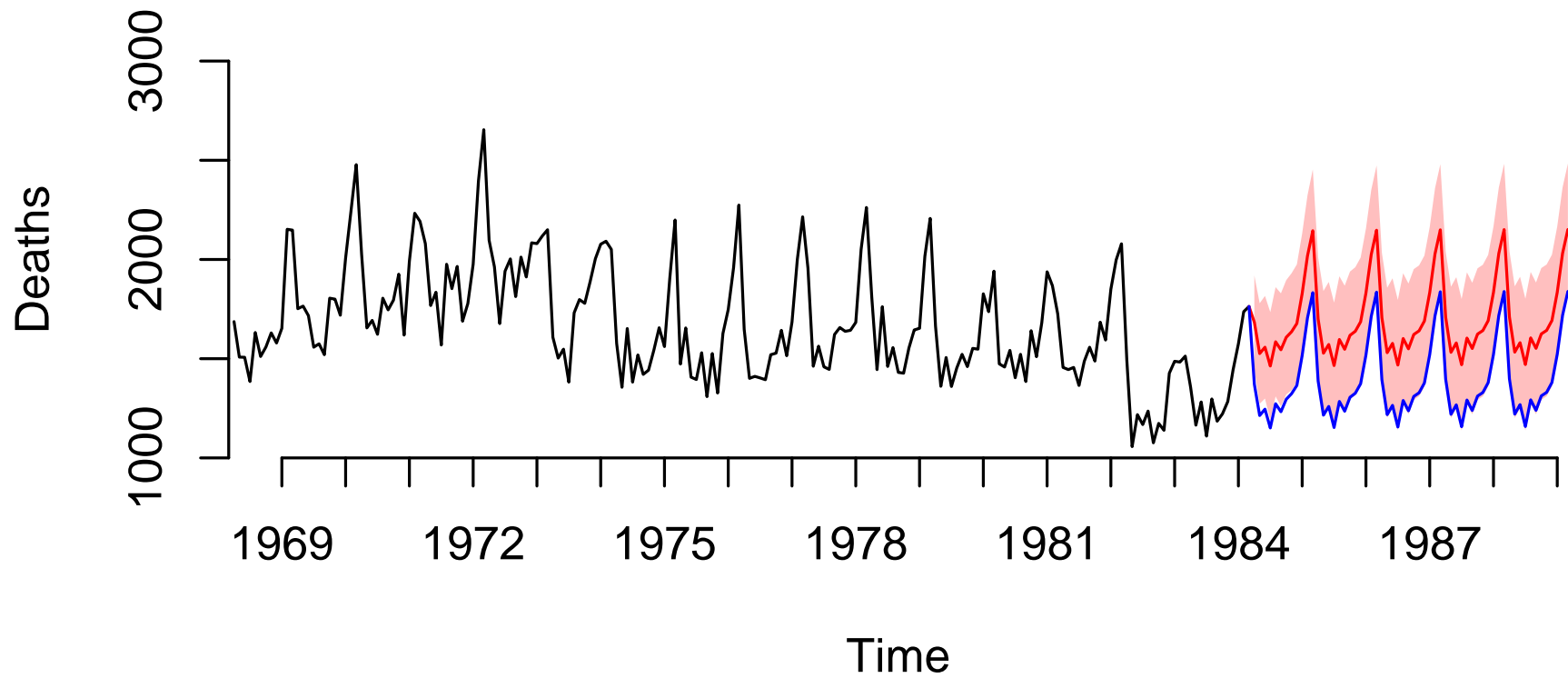
which is easier to read as a polygon

Predicted effect of reversing seat belt law



comparing to what would happen with the law left intact

Predicted effect of reversing seat belt law



comparing to what would happen with the law left intact

Confidence intervals vs. Predictive Intervals

Suppose we want *confidence intervals* instead of *predictive intervals*

CIs just show the uncertainty from estimation

Analog to $se(\beta)$ and significance tests

`predict.arima()` *won't* give us CIs

Need to use another package,
like `Zelig` (currently under revision)
or `simcf` (later in the course)

Neat. But is ARMA(p,q) appropriate for our data?

ARMA(p,q) an extremely flexible, broadly applicable model of single time series y_t

But ONLY IF y_t is stationary

If data are non-stationary (have a unit root), then:

- Results may be spurious
- Long-run predictions impossible

Can assess stationarity through two methods:

1. Examine the data: time series, ACF, and PACF plots
2. Statistical tests for a unit root

Unit root tests: Basic notion

- If y_t is stationary, large negative shifts should be followed by large positive shifts, and vice versa (mean-reversion)
- If y_t is non-stationary (has a unit root), large negative shifts should be uncorrelated with large positive shifts

Thus if we regress $y_t - y_{t-1}$ on y_{t-1} , we should get a negative coefficient if and only if the series is stationary

To do this:

Augmented Dickey-Fuller test `adf.test()` in the `tseries` library

Phillips-Perron test: `PP.test()`

Tests differ in how they model heteroskedasticity, serial correlation, and the number of lags

Unit root tests: Limitations

Form of unit root test: rejecting the null of a unit root.

Will tend to fail to reject for many non-unit roots with high persistence

Very hard to distinguish near-unit roots from unit roots with test statistics

Famously low power tests

Unit root tests: Limitations

Analogy: Using polling data to predict a very close election

Null Hypothesis: Left Party will get 50.01% of the vote

Alternative Hypothesis: Left will get $< 50\%$ of the vote

We're okay with a 3% CI if we're interested in alternatives like 45% of the vote

But suppose we need to compare the Null to 49.99%

To confidently reject the Null in favor of a very close alternative like this, we'd need a CI of about 0.005% or less

Unit root tests: Limitations

In comparative politics, we usually ask whether $\phi = 1$ or, say, $\phi = 0.99$

Small numerical difference makes a huge difference for modeling

And unit root tests are weak, and poorly discriminate across these cases

Simply not much use to us

Unit root tests: usage

```
> # Check for a unit root  
> PP.test(death)
```

Phillips-Perron Unit Root Test

```
data: death  
Dickey-Fuller = -6.435, Truncation lag parameter = 4, p-value = 0.01
```

```
> adf.test(death)
```

Augmented Dickey-Fuller Test

```
data: death  
Dickey-Fuller = -6.537, Lag order = 5, p-value = 0.01  
alternative hypothesis: stationary
```

Linear regression with Y_{t-1}

A popular model in comparative politics & political science is:

$$y_t = y_{t-1}\phi_1 + \mathbf{x}_t\boldsymbol{\beta} + \varepsilon_t$$

estimated by least squares, rather than maximum likelihood

That is, treat y_{t-1} as “just another covariate”, rather than a special term

Danger of this approach: y_{t-1} and ε_t are almost certainly correlated

Violates G-M condition 3: Bias in $\boldsymbol{\beta}$, incorrect s.e.'s

When can you use a lagged y ?

My recommendation:

1. Estimate an LS model with the lagged DV
2. Check for remaining serial correlation (Breusch-Godfrey)
3. Compare your results to the corresponding AR(p) estimated by ML
4. Use LS only if it make no statistical or substantive difference

Upshot: You can use LS in cases where it works just as well as ML

If you model the right number of lags, and need no MA(q) terms, LS often not far off

Still need to interpret the β 's and ϕ 's dynamically

Testing for serial correlation in errors

In LS models, serial correlation makes estimates inefficient (like heteroskedasticity)

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If the model includes a lagged dependent variable, serial correlation \rightarrow inconsistent estimates ($E(x\epsilon) \neq 0$)

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In LS models, serial correlation makes estimates inefficient (like heteroskedasticity)

If the model includes a lagged dependent variable, serial correlation \rightarrow inconsistent estimates ($E(x\epsilon) \neq 0$)

So we need to be able to test for serial correlation.

A general test that will work for single time series or panel data is based on the Lagrange Multiplier

Called Breusch-Godfrey test, or the LM test

Lagrange Multiplier test for serial correlation

1. Run your time series regression by least squares, regressing

$$y_t = \beta_0 + \beta_1 x_{1t} + \dots + \beta_k x_{kt} + \phi_1 y_{t-1} + \dots + \phi_p y_{t-p} + u_t$$

Lagrange Multiplier test for serial correlation

1. Run your time series regression by least squares, regressing

$$y_t = \beta_0 + \beta_1 x_{1t} + \dots + \beta_k x_{kt} + \phi_1 y_{t-1} + \dots + \phi_k y_{t-p} + u_t$$

2. Regress (using LS) \hat{u}_t on a constant,
the explanatory variables $x_1, \dots, x_k, y_{t-1}, \dots, y_{t-m}$,
and the lagged residuals, $\hat{u}_{t-1}, \dots, \hat{u}_{t-m}$

Be sure to choose $m \leq p$. If you choose $m = 1$, you have a test for 1st degree autocorrelation; if you choose $m = 2$, you have a test for 2nd degree autocorrelation, etc.

Lagrange Multiplier test for serial correlation

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$$y_t = \beta_0 + \beta_1 x_{1t} + \dots + \beta_k x_{kt} + \phi_1 y_{t-1} + \dots + \phi_k y_{t-p} + u_t$$

2. Regress (using LS) \hat{u}_t on a constant, the explanatory variables $x_1, \dots, x_k, y_{t-1}, \dots, y_{t-m}$, and the lagged residuals, $\hat{u}_{t-1}, \dots, \hat{u}_{t-m}$

Be sure to choose $m \leq p$. If you choose $m = 1$, you have a test for 1st degree autocorrelation; if you choose $m = 2$, you have a test for 2nd degree autocorrelation, etc.

3. Compute the test-statistic $(T - m)R^2$, where R^2 is the coefficient of determination from the regression in step 2. This test statistic is distributed χ^2 with m degrees of freedom.

Lagrange Multiplier test for serial correlation

1. Run your time series regression by least squares, regressing

$$y_t = \beta_0 + \beta_1 x_{1t} + \dots + \beta_k x_{kt} + \phi_1 y_{t-1} + \dots + \phi_p y_{t-p} + u_t$$

2. Regress (using LS) \hat{u}_t on a constant, the explanatory variables $x_1, \dots, x_k, y_{t-1}, \dots, y_{t-m}$, and the lagged residuals, $\hat{u}_{t-1}, \dots, \hat{u}_{t-m}$

Be sure to choose $m \leq p$. If you choose $m = 1$, you have a test for 1st degree autocorrelation; if you choose $m = 2$, you have a test for 2nd degree autocorrelation, etc.

3. Compute the test-statistic $(T - m)R^2$, where R^2 is the coefficient of determination from the regression in step 2. This test statistic is distributed χ^2 with m degrees of freedom.
4. Rejecting the null for this test statistic is equivalent to rejecting no autocorrelation.

Regression with lagged DV for Accidents

Call:

```
lm(formula = death ~ lagdeath + jan + feb + mar + apr + may +  
    jun + aug + sep + oct + nov + dec + law)
```

Residuals:

Min	1Q	Median	3Q	Max
-323.58	-84.45	-3.80	80.97	404.88

Coefficients:

	Estimate	Std. Error	t value	Pr(> t)	
(Intercept)	635.11393	96.64706	6.571	5.38e-10	***
lagdeath	0.64313	0.05787	11.114	< 2e-16	***
jan	-302.58936	59.33982	-5.099	8.71e-07	***
feb	-211.00947	48.46926	-4.353	2.26e-05	***
mar	-31.82070	47.33602	-0.672	0.502314	
apr	-177.52653	47.35870	-3.749	0.000241	***
may	32.58040	47.55810	0.685	0.494199	
jun	-111.47957	47.43316	-2.350	0.019863	*
aug	-33.76181	47.52523	-0.710	0.478393	
sep	9.48411	47.61220	0.199	0.842339	
oct	114.89374	48.04444	2.391	0.017832	*

nov	224.81981	50.07068	4.490	1.28e-05	***
dec	213.09991	54.93824	3.879	0.000148	***
law	-145.31036	37.36477	-3.889	0.000142	***

Signif. codes:

0 *** 0.001 ** 0.01 * 0.05 . 0.1 1

Residual standard error: 133.9 on 177 degrees of freedom

(1 observation deleted due to missingness)

Multiple R-squared: 0.802, Adjusted R-squared: 0.7875

F-statistic: 55.17 on 13 and 177 DF, p-value: < 2.2e-16

Tests for serial correlation

Breusch-Godfrey test for serial correlation of order up to 1

data: lm.res1f

LM test = 11.5457, df = 1, p-value = 0.000679

Breusch-Godfrey test for serial correlation of order up to 2

data: lm.res1f

LM test = 11.9843, df = 2, p-value = 0.002498

Clear evidence of residual serial correlation

Regression with two lags of DV for Accidents

Call:

```
lm(formula = death ~ lagdeath + lag2death + jan + feb + mar +  
    apr + may + jun + aug + sep + oct + nov + dec + law)
```

Residuals:

Min	1Q	Median	3Q	Max
-378.22	-88.29	-5.04	89.71	308.44

Coefficients:

	Estimate	Std. Error	t value	Pr(> t)	
(Intercept)	475.12645	103.68324	4.582	8.71e-06	***
lagdeath	0.47250	0.07332	6.445	1.09e-09	***
lag2death	0.26362	0.07284	3.619	0.000387	***
jan	-311.45937	57.62112	-5.405	2.09e-07	***
feb	-329.58156	57.96856	-5.686	5.37e-08	***
mar	-68.08737	46.99905	-1.449	0.149212	
apr	-152.44095	46.46031	-3.281	0.001248	**
may	25.02334	46.18114	0.542	0.588610	
jun	-65.76811	47.71466	-1.378	0.169851	
aug	-6.16090	46.72852	-0.132	0.895259	
sep	19.68658	46.27238	0.425	0.671032	

oct	130.18618	46.79714	2.782	0.005997	**
nov	249.97112	49.06743	5.094	9.00e-07	***
dec	235.55993	53.65766	4.390	1.96e-05	***
law	-111.47166	37.45979	-2.976	0.003336	**

Signif. codes:

0 *** 0.001 ** 0.01 * 0.05 . 0.1 1

Residual standard error: 129.8 on 175 degrees of freedom
(2 observations deleted due to missingness)

Multiple R-squared: 0.8155, Adjusted R-squared: 0.8008

F-statistic: 55.26 on 14 and 175 DF, p-value: < 2.2e-16

Tests for serial correlation

Breusch-Godfrey test for serial correlation of order up to 1

```
data: lm.res1g
```

```
LM test = 0.6961, df = 1, p-value = 0.4041
```

```
> bgtest(lm.res1g,2)
```

Breusch-Godfrey test for serial correlation of order up to 2

```
data: lm.res1g
```

```
LM test = 3.2256, df = 2, p-value = 0.1993
```

Perhaps some weak evidence of residual serial correlation, but as with other tests, hard to be sure if we need to go beyond AR(2)