Covariance Stationary Time Series

Stochastic Process: sequence of rv's ordered by time

$$\{Y_t\}_{-\infty}^{\infty} = \{\ldots, Y_{-1}, Y_0, Y_1, \ldots\}$$

Defn: $\{Y_t\}$ is covariance stationary if

- $E[Y_t] = \mu$ for all t
- $cov(Y_t, Y_{t-j}) = E[(Y_t - \mu)(Y_{t-j} - \mu)] = \gamma_j$ for all t and any j

Remarks

- $\gamma_j = j$th lag autocovariance; $\gamma_0 = var(Y_t)$
- $\rho_j = \gamma_j/\gamma_0 = j$th lag autocorrelation

Example: Independent White Noise ($IWN(0, \sigma^2)$)

$$\begin{aligned} Y_t &= \varepsilon_t,\ \varepsilon_t \sim \text{iid } (0, \sigma^2) \\ E[Y_t] &= 0,\ var(Y_t) = \sigma^2,\ \gamma_j = 0,\ j \neq 0 \end{aligned}$$

Example: Gaussian White Noise ($GWN(0, \sigma^2)$)

$$Y_t = \varepsilon_t,\ \varepsilon_t \sim \text{iid } N(0, \sigma^2)$$

Example: White Noise ($WN(0, \sigma^2)$)

$$\begin{aligned} Y_t &= \varepsilon_t \\ E[\varepsilon_t] &= 0,\ var(\varepsilon_t) = \sigma^2,\ cov(\varepsilon_t, \varepsilon_{t-j}) = 0 \end{aligned}$$

Nonstationary Processes

Example: Deterministically trending process

$$\begin{aligned} Y_t &= \beta_0 + \beta_1 t + \varepsilon_t,\ \varepsilon_t \sim WN(0, \sigma^2) \\ E[Y_t] &= \beta_0 + \beta_1 t \text{ depends on } t \end{aligned}$$

Note: A simple detrending transformation yield a stationary process:

$$X_t = Y_t - \beta_0 - \beta_1 t = \varepsilon_t$$

Example: Random Walk

$$\begin{aligned} Y_t &= Y_{t-1} + \varepsilon_t,\ \varepsilon_t \sim WN(0, \sigma^2),\ Y_0 \text{ is fixed} \\ &= Y_0 + \sum_{j=1}^{t} \varepsilon_j \Rightarrow var(Y_t) = \sigma^2 t \text{ depends on } t \end{aligned}$$

Note: A simple detrending transformation yield a stationary process:

$$\Delta Y_t = Y_t - Y_{t-1} = \varepsilon_t$$

Wold's Decomposition Theorem

Any covariance stationary time series $\{Y_t\}$ can be represented in the form

$$\begin{aligned} Y_t &= \mu + \sum_{j=0}^{\infty} \psi_j \varepsilon_{t-j},\ \varepsilon_t \sim WN(0, \sigma^2) \\ \psi_0 &= 1,\ \sum_{j=0}^{\infty} \psi_j^2 < \infty \end{aligned}$$

Properties:

$$\begin{aligned} E[Y_t] &= \mu \\ \gamma_0 &= var(Y_t) = \sigma^2 \sum_{j=0}^{\infty} \psi_j^2 < \infty \\ \gamma_j &= E[(Y_t - \mu)(Y_{t-j} - \mu)] \\ &= E[(\varepsilon_t + \psi_1 \varepsilon_{t-1} + \cdots + \psi_j \varepsilon_{t-j} + \cdots) \\ &\quad \times (\varepsilon_{t-j} + \psi_1 \varepsilon_{t-j-1} + \cdots) \\ &= \sigma^2(\psi_j + \psi_{j+1}\psi_1 + \cdots) \\ &= \sigma^2 \sum_{k=0}^{\infty} \psi_k \psi_{k+j} \end{aligned}$$

Autoregressive moving average models (ARMA) Models (Box-Jenkins 1976)

Idea: Approximate Wold form of stationary time series by parsimonious parametric models (stochastic difference equations)

ARMA(p,q) model:

$$\begin{aligned} Y_t - \mu &= \phi_1(Y_{t-1} - \mu) + \cdots + \phi_p(Y_{t-2} - \mu) \\ &\quad + \varepsilon_t + \theta_1 \varepsilon_{t-1} + \cdots + \theta_q \varepsilon_{t-q} \\ &\quad \varepsilon_t \sim WN(0, \sigma^2) \end{aligned}$$

Lag operator notation:

$$\begin{aligned} \phi(L)(Y_t - \mu) &= \theta(L)\varepsilon_t \\ \phi(L) &= 1 - \phi_1 L - \cdots - \phi_p L^p \\ \theta(L) &= 1 + \theta_1 L + \cdots + \theta_q L^q \end{aligned}$$

Stochastic difference equation

$$\begin{aligned} \phi(L)X_t &= w_t \\ X_t &= Y_t - \mu,\ w_t = \theta(L)\varepsilon_t \end{aligned}$$

ARMA(1,0) Model (1st order SDE)

$$Y_t = \phi Y_{t-1} + \varepsilon_t,\ \varepsilon_t \sim WN(0, \sigma^2)$$

Solution by recursive substitution:

$$\begin{aligned} Y_t &= \phi^{t+1} Y_{-1} + \phi^t Y_0 + \phi^t \varepsilon_0 + \cdots + \phi \varepsilon_{t-1} + \varepsilon_t \\ &= \phi^{t+1} Y_{-1} + \sum_{i=0}^{t} \phi^i \varepsilon_{t-i} \\ &= \phi^{t+1} Y_{-1} + \sum_{i=0}^{t} \psi_i \varepsilon_{t-i},\ \psi_i = \phi^i \end{aligned}$$

Alternatively, solving forward j periods from time t :

$$\begin{aligned} Y_{t+j} &= \phi^{j+1} Y_{t-1} + \phi^j \varepsilon_t + \cdots + \phi \varepsilon_{t+j-1} + \varepsilon_{t+j} \\ &= \phi^{j+1} Y_{t-1} + \sum_{i=0}^{j} \psi_i \varepsilon_{t+j-i} \end{aligned}$$

Dynamic Multiplier:

$$\frac{dY_j}{d\varepsilon_0} = \frac{dY_{t+j}}{d\varepsilon_t} = \phi^j = \psi_j$$

Impulse Response Function (IRF)

$$\text{Plot } \psi_j \text{ vs. } j$$

Cumulative impact (up to horizon j)

$$\sum_{i=1}^{j} \psi_j$$

Long-run cumulative impact

$$\begin{aligned} \sum_{i=1}^{\infty} \psi_j &= \psi(1) \\ &= \psi(L) \text{ evaluated at } L = 1 \end{aligned}$$

Stability and Stationarity Conditions

If $|\phi| < 1$ then

$$\lim_{j\to\infty} \phi^j = \lim_{j\to\infty} \psi_j = 0$$

and the stationary solution (Wold form) for the AR(1) becomes.

$$Y_t = \sum_{j=0}^{\infty} \phi^j \varepsilon_{t-j} = \sum_{j=0}^{\infty} \psi_j \varepsilon_{t-j}$$

This is a stable (non-explosive) solution. Note that

$$\psi(1) = \sum_{j=0}^{\infty} \phi^j = \frac{1}{1-\phi} < \infty$$

If $\phi = 1$ then

$$Y_t = Y_0 + \sum_{j=0}^{t} \varepsilon_j, \ \psi_j = 1, \ \psi(1) = \infty$$

which is not stationary or stable.

AR(1) in Lag Operator Notation

$$(1-\phi L)Y_t = \varepsilon_t$$

If $|\phi| < 1$ then

$$(1-\phi L)^{-1} = \sum_{j=0}^{\infty} \phi^j L^j = 1 + \phi L + \phi^2 L^2 + \cdots$$

such that

$$(1-\phi L)^{-1}(1-\phi L) = 1$$

Trick to find Wold form:

$$\begin{aligned} Y_t &= (1-\phi L)^{-1}(1-\phi L)Y_t = (1-\phi L)^{-1}\varepsilon_t \\ &= \sum_{j=0}^{\infty} \phi^j L^j \varepsilon_t \\ &= \sum_{j=0}^{\infty} \phi^j \varepsilon_{t-j} \\ &= \sum_{j=0}^{\infty} \psi_j \varepsilon_{t-j},\ \psi_j = \phi^j \end{aligned}$$

Moments of Stationary AR(1)

Mean adjusted form:

$$Y_t - \mu = \phi(Y_{t-1} - \mu) + \varepsilon_t,\ \varepsilon_t \sim WN(0, \sigma^2),\ |\phi| < 1$$

Regression form:

$$Y_t = c + \phi Y_{t-1} + \varepsilon_t,\ c = \mu(1-\phi)$$

Trick for calculating moments: use stationarity properties

$$\begin{aligned} E[Y_t] &= E[Y_{t-j}] \text{ for all } j \\ cov(Y_t, Y_{t-j}) &= cov(Y_{t-k}, Y_{t-k-j}) \text{ for all } k, j \end{aligned}$$

Mean of AR(1)

$$\begin{aligned} E[Y_t] &= c + \phi E[Y_{t-1}] + E[\varepsilon_t] \\ &= c + \phi E[Y_t] \\ &\Rightarrow E[Y_t] = \frac{c}{1-\phi} = \mu \end{aligned}$$

Variance of AR(1)

$$\begin{aligned}\gamma_0 &= var(Y_t) = E[(Y_t-\mu)^2] = E[(\phi(Y_{t-1}-\mu)+\varepsilon_t)^2] \\ &= \phi^2 E[(Y_{t-1}-\mu)^2] + 2E[(Y_{t-1}-\mu)\varepsilon_t] + E[\varepsilon_t^2] \\ &= \phi^2\gamma_0 + \sigma^2 \text{ (by stationarity)} \\ &\Rightarrow \gamma_0 = \frac{\sigma^2}{1-\phi^2}\end{aligned}$$

Note: From the Wold representation

$$\gamma_0 = var\left(\sum_{j=0}^{\infty}\phi^j\varepsilon_{t-j}\right) = \sigma^2\sum_{j=0}^{\infty}\phi^{2j} = \frac{\sigma^2}{1-\phi^2}$$

Autocovariances and Autocorrelations

Trick: multiply $Y_t-\mu$ by $Y_{t-j}-\mu$ and take expectations

$$\begin{aligned}\gamma_j &= E[(Y_t-\mu)(Y_{t-j}-\mu)] \\ &= E[\phi(Y_{t-1}-\mu)(Y_{t-j}-\mu)] + E[\varepsilon_t(Y_{t-j}-\mu)] \\ &= \phi\gamma_{j-1} \text{ (by stationarity)} \\ &\Rightarrow \gamma_j = \phi^j\gamma_0 = \phi^j\frac{\sigma^2}{1-\phi^2}\end{aligned}$$

Autocorrelations:

$$\rho_j = \frac{\gamma_j}{\gamma_0} = \frac{\phi^j\gamma_0}{\gamma_0} = \phi^j = \psi_j$$

Note: for the AR(1), $\rho_j = \psi_j$. However, this is not true for general ARMA processes.

Autocorrelation Function (ACF)

plot ρ_j vs. j

ϕ	**half-life**
0.99	68.97
0.9	6.58
0.75	2.41
0.5	1.00
0.25	0.50

Table 1: Half lives for AR(1)

Half-Life of AR(1): lag at which IRF decreases by one half

$$\begin{aligned} \gamma_j &= \phi^j = 0.5 \\ &\Rightarrow j \ln \phi = \ln(0.5) \\ &\Rightarrow j = \frac{\ln(0.5)}{\ln \phi} \end{aligned}$$

The half-life is a measure of the speed of mean reversion.

Application: Half-Life of Real Exchange Rates

The real exchange rate is defined as

$$\begin{aligned} z_t &= s_t - p_t + p_t^* \\ s_t &= \text{log nominal exchange rate} \\ p_t &= \text{log of domestic price level} \\ p_t^* &= \text{log of foreign price level} \end{aligned}$$

Purchasing power parity (PPP) suggests that z_t should be stationary.

ARMA($p, 0$) Model

Mean-adjusted form:

$$\begin{aligned} Y_t - \mu &= \phi_1(Y_{t-1} - \mu) + \cdots + \phi_p(Y_{t-p} - \mu) + \varepsilon_t \\ & \quad \varepsilon_t \sim WN(0, \sigma^2) \\ E[Y_t] &= \mu \end{aligned}$$

Lag operator notation:

$$\begin{aligned} \phi(L)(Y_t - \mu) &= \varepsilon_t \\ \phi(L) &= 1 - \phi_1 L - \cdots \phi_p L^p \end{aligned}$$

Unobserved Components representation

$$\begin{aligned} Y_t &= \mu + X_t \\ \phi(L)X_t &= \varepsilon_t \end{aligned}$$

Regression Model formulation

$$\begin{aligned} Y_t &= c + \phi_1 Y_{t-1} + \cdots + \phi_p Y_{t-p} + \varepsilon_t \\ \phi(L)Y_t &= c + \varepsilon_t,\ c = \mu\phi(1) \end{aligned}$$

Stability and Stationarity Conditions

Trick: Write pth order SDE as a 1st order vector SDE

$$\begin{bmatrix} X_t \\ X_{t-1} \\ X_{t-2} \\ \vdots \\ X_{t-p+1} \end{bmatrix} = \begin{bmatrix} \phi_1 & \phi_2 & \cdots & \cdots & \phi_p \\ 1 & 0 & \cdots & \cdots & 0 \\ 0 & 1 & \ddots & \cdots & 0 \\ \vdots & \vdots & \ddots & \cdots & \vdots \\ 0 & 0 & \cdots & 1 & 0 \end{bmatrix} \begin{bmatrix} X_{t-1} \\ X_{t-2} \\ X_{t-3} \\ \vdots \\ X_{t-p} \end{bmatrix} + \begin{bmatrix} \varepsilon_t \\ 0 \\ 0 \\ \vdots \\ 0 \end{bmatrix}$$

or

$$\underset{(p\times 1)}{\boldsymbol{\xi}_t} = \underset{(p\times p)}{\mathbf{F}} \underset{(p\times 1)}{\boldsymbol{\xi}_{t-1}} + \underset{(p\times 1)}{\mathbf{v}_t}$$

Use insights from AR(1) to study behavior of VAR(1):

$$\begin{aligned} \boldsymbol{\xi}_{t+j} &= \mathbf{F}^{j+1}\boldsymbol{\xi}_{t-1} + \mathbf{F}^j \mathbf{v}_t + \cdots + \mathbf{F}\mathbf{v}_{t+j-1} + \mathbf{v}_t \\ \mathbf{F}^j &= \mathbf{F} \times \mathbf{F} \times \cdots \times \mathbf{F} \ (j \text{ times}) \end{aligned}$$

Intuition: Stability and stationarity requires

$$\lim_{j \to \infty} \mathbf{F}^j = \mathbf{0}$$

Initial value has no impact on eventual level of series.

Example: AR(2)

$$X_t = \phi_1 X_{t-1} + \phi_2 X_{t-2} + \varepsilon_t$$

or

$$\begin{bmatrix} X_t \\ X_{t-1} \end{bmatrix} = \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix} \begin{bmatrix} X_{t-1} \\ X_{t-2} \end{bmatrix} + \begin{bmatrix} \varepsilon_t \\ 0 \end{bmatrix}$$

Iterating j periods out gives

$$\begin{bmatrix} X_{t+j} \\ X_{t+j-1} \end{bmatrix} = \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix}^{j+1} \begin{bmatrix} X_{t-1} \\ X_{t-2} \end{bmatrix}$$

$$+ \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix}^{j} \begin{bmatrix} \varepsilon_t \\ 0 \end{bmatrix} + \cdots + \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix} \begin{bmatrix} \varepsilon_{t+j-1} \\ 0 \end{bmatrix} + \begin{bmatrix} \varepsilon_{t+j} \\ 0 \end{bmatrix}$$

First row gives X_{t+j}

$$\begin{aligned} X_{t+j} &= [f_{11}^{(j+1)} X_{t-1} + f_{12}^{(j+1} X_{t-2}] + f_{11}^{(j)} \varepsilon_t \\ &\quad + \cdots + f_{11} \varepsilon_{t+j-1} + \varepsilon_{t+j} \\ f_{11}^{(j)} &= (1,1) \text{ element of } \mathbf{F}^j \end{aligned}$$

Note:

$$\mathbf{F}^2 = \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix} \begin{bmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{bmatrix} = \begin{bmatrix} \phi_1^2 + \phi_2 & \phi_1 \phi_2 \\ \phi_1 & \phi_2 \end{bmatrix}$$

Result: The ARMA$(p, 0)$ model is covariance stationary and has Wold representation

$$Y_t = \mu + \sum_{j=0}^{\infty} \psi_j \varepsilon_{t-j}, \ \psi_0 = 1$$

with $\psi_j = (1,1)$ element of $\mathbf{F}^j$ provided all of the eigenvalues of $\mathbf{F}$ have modulus less than 1.

Finding Eigenvalues

λ is an eigenvalue of $\mathbf{F}$ and $\mathbf{x}$ is an eigenvector if

$$\begin{aligned} \mathbf{Fx} &= \lambda \mathbf{x} \Rightarrow (\mathbf{F} - \lambda \mathbf{I}_p)\mathbf{x} = 0 \\ &\Rightarrow \mathbf{F} - \lambda \mathbf{I}_p \text{ is singular } \Rightarrow \det(\mathbf{F} - \lambda \mathbf{I}_p) = 0 \end{aligned}$$

Example: AR(2)

$$\begin{aligned} \det(\mathbf{F} - \lambda \mathbf{I}_2) &= \det\left(\begin{pmatrix} \phi_1 & \phi_2 \\ 1 & 0 \end{pmatrix} - \begin{bmatrix} \lambda & 0 \\ 0 & \lambda \end{bmatrix} \right) \\ &= \det \begin{pmatrix} \phi_1 - \lambda & \phi_2 \\ 1 & -\lambda \end{pmatrix} \\ &= \lambda^2 - \phi_1 \lambda - \phi_2 \end{aligned}$$

The eigenvalues of $\mathbf{F}$ solve the "reverse" characteristic equation

$$\lambda^2 - \phi_1\lambda - \phi_2 = 0$$

Using the quadratic equation, the roots satisfy

$$\lambda_i = \frac{\phi_1 \pm \sqrt{\phi_1^2 + 4\phi_2}}{2},\ i = 1, 2$$

These root may be real or complex. Complex roots induce periodic behavior in y_t. Recall, if λ_i is complex then

$$\begin{aligned} \lambda_i &= a + bi \\ a &= R\cos(\theta),\ b = R\sin(\theta) \\ R &= \sqrt{a^2 + b^2} = \text{modulus} \end{aligned}$$

To see why $|\lambda_i| < \mathbf{1}$ implies $\lim_{j\to\infty} \mathbf{F}^j = \mathbf{0}$ consider the AR(2) with real-valued eigenvalues. By the spectral decomposition theorem

$$\begin{aligned} \mathbf{F} &= \mathbf{T\Lambda T}^{-1},\ \mathbf{T}^{-1} = \mathbf{T}' \\ \mathbf{\Lambda} &= \begin{bmatrix} \lambda_1 & 0 \\ 0 & \lambda_2 \end{bmatrix},\ \mathbf{T} = \begin{bmatrix} t_{11} & t_{12} \\ t_{21} & t_{22} \end{bmatrix}, \\ \mathbf{T}^{-1} &= \begin{bmatrix} t^{11} & t^{12} \\ t^{21} & t^{22} \end{bmatrix} \end{aligned}$$

Then

$$\begin{aligned} \mathbf{F}^j &= (\mathbf{T\Lambda T}^{-1}) \times \cdots \times (\mathbf{T\Lambda T}^{-1}) \\ &= \mathbf{T\Lambda}^j\mathbf{T}^{-1} \end{aligned}$$

and

$$\lim_{j\to\infty} \mathbf{F}^j = \mathbf{T} \lim_{j\to\infty} \mathbf{\Lambda}^j \mathbf{T}^{-1} = 0$$

provided $|\lambda_1| < 1$ and $|\lambda_2| < 1$.

Note:

$$\begin{aligned} \mathbf{F}^j &= \mathbf{T}\boldsymbol{\Lambda}^j\mathbf{T}^{-1} \\ &= \begin{bmatrix} t_{11} & t_{12} \\ t_{21} & t_{22} \end{bmatrix} \begin{bmatrix} \lambda_1^j & 0 \\ 0 & \lambda_2^j \end{bmatrix} \begin{bmatrix} t^{11} & t^{12} \\ t^{21} & t^{22} \end{bmatrix} \end{aligned}$$

so that

$$\begin{aligned} f_{11}^{(j)} &= (t_{11}t^{11})\lambda_1^j + (t_{12}t^{22})\lambda_2^j \\ &= c_1\lambda_1^j + c_2\lambda_2^j = \psi_j \end{aligned}$$

where

$$c_1 + c_2 = 1$$

Then,

$$\lim_{j\to\infty} \psi_j = \lim_{j\to\infty} (c_1\lambda_1^j + c_2\lambda_2^j) = 0$$

Examples of AR(2) Processes

$$\begin{aligned} Y_t &= 0.6Y_{t-1} + 0.2Y_{t-2} + \varepsilon_t \\ \phi_1 + \phi_2 &= 0.8 < 1 \\ \mathbf{F} &= \begin{bmatrix} 0.6 & 0.2 \\ 1 & 0 \end{bmatrix} \end{aligned}$$

The eigenvalues are found using

$$\begin{aligned} \lambda_i &= \frac{\phi \pm \sqrt{\phi_1^2 + 4\phi_2}}{2} \\ \lambda_1 &= \frac{0.6 + \sqrt{(0.6)^2 + 4(0.2)}}{2} = 0.84 \\ \lambda_2 &= \frac{0.6 - \sqrt{(0.6)^2 + 4(0.2)}}{2} = -0.24 \\ \psi_j &= c_1(0.84)^j + c_2(-0.24)^j \end{aligned}$$

$$
\begin{aligned}
Y_t &= 0.5Y_{t-1} - 0.8Y_{t-2} + \varepsilon_t \\
\phi_1 + \phi_2 &= -0.3 < 1 \\
\mathbf{F} &= \begin{bmatrix} 0.5 & -0.8 \\ 1 & 0 \end{bmatrix}
\end{aligned}
$$

Note:

$$
\begin{aligned}
\phi_1^2 + 4\phi_2 &= (0.5)^2 - 4(0.8) = -2.95 \\
&\Rightarrow \text{ complex eigenvalues}
\end{aligned}
$$

Then

$$
\begin{aligned}
\lambda_i &= a \pm bi,\ i = \sqrt{-1} \\
a &= \frac{\phi_1}{2},\ b = \frac{\sqrt{-(\phi_1^2 + 4\phi_2)}}{2}
\end{aligned}
$$

Here

$$
\begin{aligned}
a &= \frac{0.5}{2} = 0.25,\ b = \frac{\sqrt{2.95}}{2} = 0.86 \\
\lambda_i &= 0.25 \pm 0.86i \\
\text{modulus} &= R = \sqrt{a^2 + b^2} = \sqrt{(0.25)^2 + (0.86)^2} = 0.895
\end{aligned}
$$

Polar co-ordinate representation:

$$
\begin{aligned}
\lambda_i &= a + bi \text{ s.t. } a = R\cos(\theta),\ b = R\sin(\theta) \\
&= R\cos(\theta) + R\sin(\theta)i = R\ e^{i\theta}
\end{aligned}
$$

Frequency θ satisfies

$$
\begin{aligned}
\cos(\theta) &= \frac{a}{R} \Rightarrow \theta = \cos^{-1}\left(\frac{a}{R}\right) \\
\text{period} &= \frac{2\pi}{\theta}
\end{aligned}
$$

Here,

$$\begin{aligned} R &= 0.895 \\ \theta &= \cos^{-1}\left(\frac{0.25}{0.985}\right) = 1.29 \\ \text{period} &= \frac{2\pi}{1.29} = 4.9 \end{aligned}$$

Note: the period is the length of time required for the process to repeat a full cycle.

Note: The IRF has the form

$$\begin{aligned} \psi_j &= c_1\lambda_1^j + c_2\lambda_2^j \\ &\propto R^j[\cos(\theta j) + \sin(\theta j)] \end{aligned}$$

Stationarity Conditions on Lag Polynomial $\phi(L)$

Consider the AR(2) model in lag operator notation

$$(1 - \phi_1 L - \phi_2 L^2)X_t = \phi(L)X_t = \varepsilon_t$$

For any variable z, consider the characteristic equation

$$\phi(z) = 1 - \phi_1 z - \phi_2 z^2 = 0$$

By the fundamental theorem of algebra

$$1 - \phi_1 z - \phi_2 z^2 = (1 - \lambda_1 z)(1 - \lambda_2 z)$$

so that

$$z_1 = \frac{1}{\lambda_1},\ z_2 = \frac{1}{\lambda_2}$$

are the roots of the characteristic equation. The values λ_1 and λ_2 are the eigenvalues of $\mathbf{F}$.

Note: If $\phi_1 + \phi_2 = 1$ then $\phi(z = 1) = 1 - (\phi_1 + \phi_2) = 0$ and $z = 1$ is a root of $\phi(z) = 0$.

Result: The inverses of the roots of the characteristic equation

$$\phi(z) = 1 - \phi_1 z - \phi_2 z^2 - \cdots \phi_p z^p = 0$$

are the eigenvalues of the companion matrix $\mathbf{F}$. Therefore, the AR(p) model is stable and stationary provided the roots of $\phi(z) = 0$ have modulus greater than unity (roots lie outside the complex unit circle).

Remarks:

1. The reverse characteristic equation for the AR(p) is

$$z^p - \phi_1 z^{p-1} - \phi_2 z^{p-2} - \cdots - \phi_{p-1} z - \phi_p = 0$$

This is the same polynomial equation used to find the eigenvalues of $\mathbf{F}$.

2. If the AR(p) is stationary, then

$$\begin{aligned} \phi(L) &= 1 - \phi_1 L - \cdots \phi_p L^p \\ &= (1 - \lambda_1 L)(1 - \lambda_2 L) \cdots (1 - \lambda_p L) \end{aligned}$$

where $|\lambda_i| < 1$. Suppose, all λ_i are all real. Then

$$\begin{aligned} (1 - \lambda_i L)^{-1} &= \sum_{j=0}^{\infty} \lambda_i^j L^j \\ \phi(L)^{-1} &= (1 - \lambda_1 L)^{-1} \cdots (1 - \lambda_p L)^{-1} \\ &= \left(\sum_{j=0}^{\infty} \lambda_1^j L^j\right) \left(\sum_{j=0}^{\infty} \lambda_2^j L^j\right) \cdots \left(\sum_{j=0}^{\infty} \lambda_2^j L^j\right) \end{aligned}$$

The Wold solution for X_t may be found using

$$\begin{aligned} X_t &= \phi(L)^{-1} \varepsilon_t \\ &= \left(\sum_{j=0}^{\infty} \lambda_1^j L^j\right) \left(\sum_{j=0}^{\infty} \lambda_2^j L^j\right) \cdots \left(\sum_{j=0}^{\infty} \lambda_2^j L^j\right) \varepsilon_t \end{aligned}$$

3. A simple algorithm exists to determine the Wold form. To illustrate, consider the AR(2) model. By definition

$$\begin{aligned} \phi(L)^{-1} &= (1-\phi_1 L-\phi_2 L^2)=\psi(L), \\ \psi(L) &= \sum_{j=0}^{\infty}\psi_j L^j \\ &\Rightarrow 1=\phi(L)\psi(L) \\ &\Rightarrow 1=(1-\phi_1 L-\phi_2 L^2) \\ &\quad \times(1+\psi_1 L+\psi_2 L^2+\cdots) \end{aligned}$$

Collecting coefficients of powers of L gives

$$1=1+(\psi_1+\phi_1)L+(\psi_2-\phi_1\psi_1-\phi_2)L^2+\cdots$$

Since all coefficients on powers of L must be equal to zero, it follows that

$$\begin{aligned} \psi_1 &= \phi_1 \\ \psi_2 &= \phi_1\psi_1+\phi_2 \\ \psi_3 &= \phi_1\psi_2+\phi_2\psi_1 \\ &\vdots \\ \psi_j &= \phi_1\psi_{j-1}+\phi_2\psi_{j-2} \end{aligned}$$

Moments of Stationary AR(p) Model

$$\begin{aligned} Y_t-\mu &= \phi_1(Y_{t-1}-\mu)+\cdots+\phi_p(Y_{t-p}-\mu)+\varepsilon_t \\ & \quad \varepsilon_t\sim WN(0,\sigma^2) \end{aligned}$$

or

$$\begin{aligned} Y_t &= c+\phi_1 Y_{t-1}+\cdots+\phi_p Y_{t-p}+\varepsilon_t \\ c &= \mu(1-\pi) \\ \pi &= \phi_1+\phi_2+\cdots+\phi_p \end{aligned}$$

Note: if $\pi=1$ then $\phi(1)=1-\pi=0$ and $z=1$ is a root of $\phi(z)=0$. In this case we say that the AR(p) process has a unit root and the process is nonstationary.

Straightforward algebra shows that

$$
\begin{aligned}
E[Y_t] &= \mu \\
\gamma_0 &= \phi_1\gamma_1 + \phi_2\gamma_2 + \cdots + \phi_p\gamma_p + \sigma^2 \\
\gamma_j &= \phi_1\gamma_{j-1} + \phi_2\gamma_{j-2} + \cdots + \phi_p\gamma_{j-p} \\
\rho_j &= \phi_1\rho_{j-1} + \phi_2\rho_{j-2} + \cdots + \phi_p\rho_{j-p}
\end{aligned}
$$

The recursive equations for ρ_j are called the Yule-Walker equations.

Result: $(\gamma_0, \gamma_1, \ldots, \gamma_{p-1})$ is determined from the first p elements of the first column of the $(p^2 \times p^2)$ matrix

$$\sigma^2[\mathbf{I}_{p^2} - (\mathbf{F} \otimes \mathbf{F})]^{-1}$$

where $\mathbf{F}$ is the state space companion matrix for the AR(p) model.

ARMA(0,1) Process (MA(1) Process)

$$
\begin{aligned}
Y_t &= \mu + \varepsilon_t + \theta\varepsilon_{t-1} = \mu + \theta(L)\varepsilon_t \\
\theta(L) &= 1 + \theta L,\ \varepsilon_t \sim WN(0, \sigma^2)
\end{aligned}
$$

Moments:

$$
\begin{aligned}
E[Y_t] &= \mu \\
var(Y_t) &= \gamma_0 = E[(Y_t - \mu)^2] \\
&= E[(\varepsilon_t + \theta\varepsilon_{t-1})^2] \\
&= \sigma^2(1 + \theta^2) \\
\gamma_1 &= E[(Y_t - \mu)(Y_{t-1} - \mu)] \\
&= E[(\varepsilon_t + \theta\varepsilon_{t-1})(\varepsilon_t + \theta\varepsilon_{t-1})] \\
&= \sigma^2\theta \\
\rho_1 &= \frac{\gamma_1}{\gamma_0} = \frac{\theta}{1 + \theta^2} \\
\gamma_j &= 0,\ j > 1
\end{aligned}
$$

Remark: There is an identification problem for

$$-0.5 < \rho_1 < 0.5$$

The values θ and θ^{-1} produce the same value of ρ_1. For example, $\theta = 0.5$ and $\theta^{-1} = 2$ both produce $\rho_1 = 0.4$.

Invertibility Condition: The MA(1) is invertible if $|\theta| < 1$

Result: Invertible MA models have infinite order AR representations

$$\begin{aligned}
(Y_t - \mu) &= (1 + \theta L)\varepsilon_t,\ |\theta| < 1 \\
&= (1 - \theta^* L)\varepsilon_t,\ \theta^* = -\theta \\
&\Rightarrow (1 - \theta^* L)^{-1}(Y_t - \mu) = \varepsilon_t \\
&\Rightarrow \sum_{j=0}^{\infty} (\theta^*)^j L^j (Y_t - \mu) = \varepsilon_t
\end{aligned}$$

so that

$$\varepsilon_t = (Y_t - \mu) + \theta^*(Y_{t-1} - \mu) + (\theta^*)^2 (Y_{t-2} - \mu) + \cdots$$