

Appendices

A

Vectors and Matrices

The following summary of matrix and vector algebra is not meant to be an introduction to the subject but is just a brief review of terms and rules used in the text. Most of them can be found in books such as Graybill (1969), Searle (1982), Anderson (1984, Appendix), Magnus & Neudecker (1988), Magnus (1988) or Lütkepohl (1996a). Therefore proofs or further references are only provided in exceptional cases.

A.1 Basic Definitions

A *matrix* is a rectangular array of numbers. For instance,

$$\begin{bmatrix} 3 & -5 \\ .3 & 0 \end{bmatrix}, \quad (0, 1, 0), \quad \begin{bmatrix} 3 & 5 & .3 & .3 \\ 2 & 2 & 2 & 2 \end{bmatrix}$$

are matrices. More generally,

$$A = (a_{ij}) = \begin{bmatrix} a_{11} & \dots & a_{1n} \\ \vdots & & \vdots \\ a_{m1} & \dots & a_{mn} \end{bmatrix} \tag{A.1.1}$$

is a matrix with m rows and n columns. Such a matrix is briefly called $(m \times n)$ matrix, m being the *row dimension* and n being the *column dimension*. The numbers a_{ij} are the *elements* or *components* of A . In the following, it is assumed that the elements of all matrices considered are real numbers unless otherwise stated. In other words, we will be concerned with real rather than complex matrices. If the dimensions m and n are clear from the context or if they are of no importance, the notation $A = (a_{ij})$ means that a_{ij} is a *typical element* of A , that is, A consists of elements a_{ij} , $i = 1, \dots, m, j = 1, \dots, n$.

A $(1 \times n)$ matrix is a *row vector* and an $(m \times 1)$ matrix is a *column vector* which is often denoted by a lower case letter in the text. If not otherwise

noted, all vectors will be column vectors in the following. Instead of $(m \times 1)$ matrix we sometimes say $(m \times 1)$ vector or simply m -vector or m -dimensional vector.

An $(m \times m)$ matrix with the number of rows equal to the number of columns is a *square matrix*. An $(m \times m)$ square matrix

$$\begin{bmatrix} a_{11} & 0 & \dots & 0 \\ 0 & a_{22} & & 0 \\ \vdots & & \ddots & \vdots \\ 0 & 0 & \dots & a_{mn} \end{bmatrix}$$

with zeros off the main diagonal is a *diagonal matrix*. If all the diagonal elements of a diagonal matrix are one, it is an *identity* or *unit matrix*. An $(m \times m)$ identity matrix is denoted by I_m or simply by I if the dimension is unimportant or obvious from the context. A square matrix with all elements below (above) the main diagonal being zero is called *upper (lower) triangular* or simply *triangular matrix*. A matrix consisting of zeros only is a *null matrix* or *zero matrix*. Usually, in this text, such a matrix is simply denoted by 0 and its dimensions have to be figured out from the context.

The *transpose* of the $(m \times n)$ matrix A given in (A.1.1) is the $(n \times m)$ matrix

$$A' = \begin{bmatrix} a_{11} & \dots & a_{m1} \\ \vdots & & \vdots \\ a_{1n} & \dots & a_{mn} \end{bmatrix},$$

the n rows of A' being the n columns of A . The matrix A is *symmetric* if $A' = A$. For instance,

$$\begin{bmatrix} 3 & 3 & 1 \\ 0 & 1 & 0 \end{bmatrix} \text{ is the transpose of } \begin{bmatrix} 3 & 0 \\ 3 & 1 \\ 1 & 0 \end{bmatrix}$$

and

$$\begin{bmatrix} 2 & -1 \\ -1 & 0 \end{bmatrix}$$

is a symmetric matrix.

A.2 Basic Matrix Operations

Let $A = (a_{ij})$ and $B = (b_{ij})$ be $(m \times n)$ matrices. The two matrices are *equal*, $A = B$, if $a_{ij} = b_{ij}$ for all i, j . The following matrix operations are basic:

$$A + B := (a_{ij} + b_{ij}). \quad (\text{addition})$$

$$A - B := (a_{ij} - b_{ij}). \quad (\text{subtraction})$$

For a real constant c ,

$$cA = Ac := (ca_{ij}). \quad (\text{multiplication by a scalar})$$

Let $C = (c_{ij})$ be an $(n \times r)$ matrix, then the product

$$AC := \left(\sum_{j=1}^n a_{ij}c_{jk} \right) \quad (\text{multiplication})$$

is an $(m \times r)$ matrix. For instance,

$$\begin{aligned} \begin{bmatrix} 3 & 3 \\ 2 & 1 \end{bmatrix} \begin{bmatrix} 2 & 3 & 0 \\ 2 & 4 & -1 \end{bmatrix} &= \begin{bmatrix} 3 \cdot 2 + 3 \cdot 2 & 3 \cdot 3 + 3 \cdot 4 & 3 \cdot 0 - 3 \cdot 1 \\ 2 \cdot 2 + 1 \cdot 2 & 2 \cdot 3 + 1 \cdot 4 & 2 \cdot 0 - 1 \cdot 1 \end{bmatrix} \\ &= \begin{bmatrix} 12 & 21 & -3 \\ 6 & 10 & -1 \end{bmatrix}. \end{aligned}$$

If the column dimension of A is the same as the row dimension of C so that A and C can be multiplied, the two matrices are *conformable*. In the product AC the matrix C is *premultiplied* by A and A is *postmultiplied* by C .

Rules: Suppose A , B , and C are matrices with suitable dimensions so that the following operations are defined and c is a scalar.

- (1) $A + B = B + A$.
- (2) $(A + B) + C = A + (B + C)$.
- (3) $A(B + C) = AB + AC$.
- (4) $c(A + B) = cA + cB$.
- (5) $AB \neq BA$ in general.
- (6) $(AB)C = A(BC)$.
- (7) $(AB)' = B'A'$.
- (8) $AI = IA = A$.
- (9) AA' and $A'A$ are symmetric matrices.

A.3 The Determinant

The *determinant* of an $(m \times m)$ square matrix $A = (a_{ij})$ is the sum of all products

$$(-1)^p a_{1i_1} a_{2i_2} \cdots a_{mi_m}$$

consisting of precisely one element from each row and each column multiplied by -1 or 1 , depending on the permutation i_1, \dots, i_m of the subscripts. The -1

is used if the number of inversions of i_1, \dots, i_m to obtain the order $1, 2, \dots, m$ is odd and 1 is used otherwise. The sum is taken over all $m!$ permutations of the column subscripts.

For a (1×1) matrix the determinant equals the value of the single element and for $m > 1$ the determinant may be defined recursively as follows. Suppose

$$A = \begin{bmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{bmatrix}$$

is a (2×2) matrix. Then the determinant is

$$\det(A) = |A| = a_{11}a_{22} - a_{12}a_{21}. \quad (\text{A.3.1})$$

For instance,

$$\det \begin{bmatrix} 3 & 1 \\ 2 & 2 \end{bmatrix} = 4.$$

To specify the determinant of a general $(m \times m)$ matrix $A = (a_{ij})$ we define the *minor* of the ij -th element a_{ij} as the determinant of the $((m-1) \times (m-1))$ matrix that is obtained by deleting the i -th row and j -th column from A . The *cofactor* of a_{ij} , denoted by A_{ij} , is the minor multiplied by $(-1)^{i+j}$. Now

$$\det(A) = |A| = a_{i1}A_{i1} + \dots + a_{im}A_{im} = a_{1j}A_{1j} + \dots + a_{mj}A_{mj} \quad (\text{A.3.2})$$

for any i or $j \in \{1, \dots, m\}$. It does not matter which row or column is chosen in (A.3.2) because the determinant of a matrix is a unique number.

For example, for the (3×3) matrix

$$A = \begin{bmatrix} 2 & 1 & 3 \\ 0 & 2 & 1 \\ 1 & -1 & 4 \end{bmatrix} \quad (\text{A.3.3})$$

the minor of the upper right-hand corner element is

$$\det \begin{bmatrix} 0 & 2 \\ 1 & -1 \end{bmatrix} = -2.$$

The cofactor is also -2 because $(-1)^{1+3} = 1$. Developing by the first row gives

$$|A| = 2 \cdot \det \begin{bmatrix} 2 & 1 \\ -1 & 4 \end{bmatrix} - 1 \cdot \det \begin{bmatrix} 0 & 1 \\ 1 & 4 \end{bmatrix} + 3 \cdot \det \begin{bmatrix} 0 & 2 \\ 1 & -1 \end{bmatrix} = 13.$$

The same result is obtained by developing by any other row or column, e.g., using the first column gives

$$|A| = 2 \cdot \det \begin{bmatrix} 2 & 1 \\ -1 & 4 \end{bmatrix} - 0 \cdot \det \begin{bmatrix} 1 & 3 \\ -1 & 4 \end{bmatrix} + 1 \cdot \det \begin{bmatrix} 1 & 3 \\ 2 & 1 \end{bmatrix} = 13.$$

Rules: In the following rules, $A = (a_{ij})$ and $B = (b_{ij})$ are $(m \times m)$ matrices and c is a scalar.

- (1) $\det(I_m) = 1$.
- (2) If A is a diagonal matrix, $\det(A) = a_{11} \cdot a_{22} \cdots a_{mm}$.
- (3) If A is a lower or upper triangular matrix, $|A| = a_{11} \cdots a_{mm}$.
- (4) If A contains a row or column of zeros, $|A| = 0$.
- (5) If B is obtained from A by adding to one row (column) a scalar multiple of another row (column), then $|A| = |B|$.
- (6) If A has two identical rows or columns, then $|A| = 0$.
- (7) $\det(cA) = c^m \det(A)$.
- (8) $|AB| = |A||B|$.
- (9) If C is an $(m \times n)$ matrix, $\det(I_m + CC') = \det(I_n + C'C)$.

A.4 The Inverse, the Adjoint, and Generalized Inverses

A.4.1 Inverse and Adjoint of a Square Matrix

An $(m \times m)$ square matrix A is *nonsingular* or *regular* or *invertible* if there exists a unique $(m \times m)$ matrix B such that $AB = I_m$. The matrix B is denoted by A^{-1} . It is the *inverse* of A ,

$$AA^{-1} = A^{-1}A = I_m.$$

For $m > 1$, the $(m \times m)$ matrix of cofactors,

$$A^{adj} = \begin{bmatrix} A_{11} & \cdots & A_{1m} \\ \vdots & \ddots & \vdots \\ A_{m1} & \cdots & A_{mm} \end{bmatrix}'$$

is the *adjoint* of A . For a (1×1) matrix A , we define the adjoint to be 1, that is, $A^{adj} = 1$. To compute the inverse of the $(m \times m)$ matrix A , the relation

$$A^{-1} = |A|^{-1}A^{adj} \tag{A.4.1}$$

is sometimes useful. For this expression to be meaningful, $|A|$ has to be nonzero. Indeed, A is nonsingular if and only if $\det(A) \neq 0$.

As an example consider the matrix given in (A.3.3). Its adjoint is

$$A^{adj} = \begin{bmatrix} \left| \begin{array}{cc} 2 & 1 \\ -1 & 4 \end{array} \right| & - \left| \begin{array}{cc} 0 & 1 \\ 1 & 4 \end{array} \right| & \left| \begin{array}{cc} 0 & 2 \\ 1 & -1 \end{array} \right| \\ - \left| \begin{array}{cc} 1 & 3 \\ -1 & 4 \end{array} \right| & \left| \begin{array}{cc} 2 & 3 \\ 1 & 4 \end{array} \right| & - \left| \begin{array}{cc} 2 & 1 \\ 1 & -1 \end{array} \right| \\ \left| \begin{array}{cc} 1 & 3 \\ 2 & 1 \end{array} \right| & - \left| \begin{array}{cc} 2 & 3 \\ 0 & 1 \end{array} \right| & \left| \begin{array}{cc} 2 & 1 \\ 0 & 2 \end{array} \right| \end{bmatrix}' = \begin{bmatrix} 9 & -7 & -5 \\ 1 & 5 & -2 \\ -2 & 3 & 4 \end{bmatrix}.$$

Consequently,

$$A^{-1} = \frac{1}{13} \begin{bmatrix} 9 & -7 & -5 \\ 1 & 5 & -2 \\ -2 & 3 & 4 \end{bmatrix}.$$

Multiplying this matrix by A is easily seen to result in the (3×3) identity matrix.

Rules:

- (1) For an $(m \times m)$ square matrix A , $AA^{adj} = A^{adj}A = |A|I_m$.
- (2) An $(m \times m)$ matrix A is nonsingular if and only if $\det(A) \neq 0$.

In the following, $A = (a_{ij})$ and B are nonsingular $(m \times m)$ matrices and $c \neq 0$ is a scalar constant.

- (3) $A^{-1} = A^{adj}/|A|$.
- (4) $(A')^{-1} = (A^{-1})'$.
- (5) $(AB)^{-1} = B^{-1}A^{-1}$.
- (6) $(cA)^{-1} = \frac{1}{c}A^{-1}$.
- (7) $I_m^{-1} = I_m$.
- (8) If A is a diagonal matrix, then A^{-1} is also diagonal with diagonal elements $1/a_{ii}$.
- (9) For an $(m \times n)$ matrix C , $(I_m + CC')^{-1} = I_m - C(I_n + C'C)^{-1}C'$.

A.4.2 Generalized Inverses

Let A be an $(m \times n)$ matrix. Any matrix B satisfying $ABA = A$ is a *generalized inverse* of A . For example, if

$$A = \begin{bmatrix} 1 & 0 \\ 0 & 0 \end{bmatrix},$$

the following matrices are generalized inverses of A :

$$\begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix}, \quad \begin{bmatrix} 1 & 0 \\ 0 & 0 \end{bmatrix}, \quad \begin{bmatrix} 1 & 0 \\ 0 & \frac{1}{2} \end{bmatrix}.$$

Obviously, a generalized inverse is not unique in general. An $(n \times m)$ matrix B is called *Moore-Penrose (generalized) inverse* of A if it satisfies the following four conditions:

$$\begin{aligned} ABA &= A, \\ BAB &= B, \\ (AB)' &= AB, \\ (BA)' &= BA. \end{aligned} \tag{A.4.2}$$

The Moore-Penrose inverse of A is denoted by A^+ , it exists for any $(m \times n)$ matrix and is unique.

Rules: (See Magnus & Neudecker (1988, p. 33, Theorem 5).)

- (1) $A^+ = A^{-1}$ if A is nonsingular.
- (2) $(A^+)^+ = A$.
- (3) $(A')^+ = (A^+)'$.
- (4) $A'AA^+ = A^+AA' = A'$.
- (5) $A'A^+A' = A^+A^+A' = A^+$.
- (6) $(A'A)^+ = A^+A^+$, $(AA')^+ = A^+A^+$.
- (7) $A^+ = (A'A)^+A' = A'(AA')^+$.

A.5 The Rank

Let x_1, \dots, x_n be $(m \times 1)$ vectors. They are *linearly independent* if, for the constants c_1, \dots, c_n ,

$$c_1x_1 + \dots + c_nx_n = 0$$

implies $c_1 = \dots = c_n = 0$. Equivalently, defining the $(n \times 1)$ vector $c = (c_1, \dots, c_n)'$ and the $(m \times n)$ matrix $X = (x_1, \dots, x_n)$, the columns of X are linearly independent if $Xc = 0$ implies $c = 0$. The columns of X are *linearly dependent* if $c_1x_1 + \dots + c_nx_n = 0$ holds with at least one $c_i \neq 0$. In that case,

$$x_i = d_1x_1 + \dots + d_{i-1}x_{i-1} + d_{i+1}x_{i+1} + \dots + d_nx_n,$$

where $d_j = -c_j/c_i$. In other words, x_1, \dots, x_n are linearly dependent if at least one of the vectors is a linear combination of the other vectors.

If $n > m$, the columns of X are linearly dependent. Consequently, if x_1, \dots, x_n are linearly independent, then $n \leq m$.

Let a_1, \dots, a_n be the columns of the $(m \times n)$ matrix $A = (a_1, \dots, a_n)$. That is, the a_i are $(m \times 1)$ vectors. The *rank* of A , briefly $\text{rk}(A)$, is the maximum number of linearly independent columns of A . Thus, if $n \leq m$ and the a_1, \dots, a_n are linearly independent, $\text{rk}(A) = n$. The maximum number of linearly independent columns of A equals the maximum number of linearly independent rows. Hence, the rank may be defined equivalently as the maximum number of linearly independent rows. If $m \geq n$ ($m \leq n$) then we say that A has *full rank* if $\text{rk}(A) = n$ ($\text{rk}(A) = m$).

Rules: Let A be an $(m \times n)$ matrix.

- (1) $\text{rk}(A) \leq \min(m, n)$.
- (2) $\text{rk}(A) = \text{rk}(A')$.
- (3) $\text{rk}(AA') = \text{rk}(A'A) = \text{rk}(A)$.
- (4) If B is a nonsingular $(n \times n)$ matrix, then $\text{rk}(AB) = \text{rk}(A)$.

- (5) If $\text{rk}(A) = m$, then $A^+ = A'(AA')^{-1}$.
 (6) If $\text{rk}(A) = n$, then $A^+ = (A'A)^{-1}A'$.
 (7) If B is an $(n \times r)$ matrix, $\text{rk}(AB) \leq \min\{\text{rk}(A), \text{rk}(B)\}$.
 (8) If A is $(m \times m)$, then $\text{rk}(A) = m$ if and only if $|A| \neq 0$.

A.6 Eigenvalues and -vectors – Characteristic Values and Vectors

The *eigenvalues* or *characteristic values* or *characteristic roots* of an $(m \times m)$ square matrix A are the roots of the polynomial in λ given by $\det(A - \lambda I_m)$ or $\det(\lambda I_m - A)$. The determinant is sometimes called the *characteristic determinant* and the polynomial is called the *characteristic polynomial* of A . Because the roots of a polynomial are complex numbers, the eigenvalues are also complex in general. A number λ_i is an eigenvalue of A , if the columns of $(A - \lambda_i I_m)$ are linearly dependent. Consequently, there exists an $(m \times 1)$ vector $v_i \neq 0$ such that

$$(A - \lambda_i I_m)v_i = 0 \quad \text{or} \quad Av_i = \lambda_i v_i.$$

A vector with this property is an *eigenvector* or *characteristic vector* of A associated with the eigenvalue λ_i . Of course, any nonzero scalar multiple of v_i is also an eigenvector of A associated with λ_i .

As an example consider the matrix

$$A = \begin{bmatrix} 1 & 0 \\ 1 & 3 \end{bmatrix}.$$

Its eigenvalues are the roots of

$$|A - \lambda I_2| = \det \begin{bmatrix} 1 - \lambda & 0 \\ 1 & 3 - \lambda \end{bmatrix} = (1 - \lambda)(3 - \lambda).$$

Hence, $\lambda_1 = 1$ and $\lambda_2 = 3$ are the eigenvalues of A . Associated eigenvectors are obtained by solving

$$\begin{bmatrix} 1 & 0 \\ 1 & 3 \end{bmatrix} \begin{bmatrix} v_{11} \\ v_{21} \end{bmatrix} = \begin{bmatrix} v_{11} \\ v_{21} \end{bmatrix} \quad \text{and} \quad \begin{bmatrix} 1 & 0 \\ 1 & 3 \end{bmatrix} \begin{bmatrix} v_{12} \\ v_{22} \end{bmatrix} = 3 \begin{bmatrix} v_{12} \\ v_{22} \end{bmatrix}.$$

Thus,

$$\begin{bmatrix} v_{11} \\ v_{21} \end{bmatrix} = \begin{bmatrix} 1 \\ -\frac{1}{2} \end{bmatrix} \quad \text{and} \quad \begin{bmatrix} v_{12} \\ v_{22} \end{bmatrix} = \begin{bmatrix} 0 \\ 1 \end{bmatrix}$$

are eigenvectors of A associated with λ_1 and λ_2 , respectively.

In the following rules, the *modulus* of a complex number $z = z_1 + iz_2$ is used. Here z_1 and z_2 are the real and imaginary parts of z , respectively, and $i = \sqrt{-1}$. The modulus $|z|$ of z is defined as

$$|z| := \sqrt{z_1^2 + z_2^2}.$$

If $z_2 = 0$ so that z is a real number, the modulus is just the absolute value of z , which justifies the notation.

Rules:

- (1) If A is symmetric, then all its eigenvalues are real numbers.
- (2) The eigenvalues of a diagonal matrix are its diagonal elements.
- (3) The eigenvalues of a triangular matrix are its diagonal elements.
- (4) An $(m \times m)$ matrix has at most m eigenvalues.
- (5) Let $\lambda_1, \dots, \lambda_m$ be the eigenvalues of the $(m \times m)$ matrix A , then $|A| = \lambda_1 \cdots \lambda_m$, that is, the determinant is the product of the eigenvalues.
- (6) Let λ_i and λ_j be *distinct* eigenvalues of A with associated eigenvectors v_i and v_j . Then v_i and v_j are linearly independent.
- (7) All eigenvalues of the $(m \times m)$ matrix A have modulus less than 1 if and only if $\det(I_m - Az) \neq 0$ for $|z| \leq 1$, that is, the polynomial $\det(I_m - Az)$ has no roots in and on the complex unit circle.

A.7 The Trace

The *trace* of an $(m \times m)$ square matrix $A = (a_{ij})$ is the sum of its diagonal elements,

$$\operatorname{tr} A = \operatorname{tr}(A) := a_{11} + \cdots + a_{mm}.$$

For example,

$$\operatorname{tr} \begin{bmatrix} 1 & 0 \\ 1 & 3 \end{bmatrix} = 4.$$

Rules: A and B are $(m \times m)$ matrices and $\lambda_1, \dots, \lambda_m$ are the eigenvalues of A .

- (1) $\operatorname{tr}(A + B) = \operatorname{tr}(A) + \operatorname{tr}(B)$.
- (2) $\operatorname{tr} A = \operatorname{tr} A'$.
- (3) If C is $(m \times n)$ and D is $(n \times m)$, $\operatorname{tr}(CD) = \operatorname{tr}(DC)$.
- (4) $\operatorname{tr} A = \lambda_1 + \cdots + \lambda_m$.

A.8 Some Special Matrices and Vectors

A.8.1 Idempotent and Nilpotent Matrices

An $(m \times m)$ matrix A is *idempotent* if $AA = A^2 = A$. Examples of idempotent matrices are $A = I_m$, $A = 0$, and

$$A = \begin{bmatrix} \frac{1}{3} & \frac{1}{3} & \frac{1}{3} \\ \frac{1}{3} & \frac{1}{3} & \frac{1}{3} \\ \frac{1}{3} & \frac{1}{3} & \frac{1}{3} \end{bmatrix}.$$

An $(m \times m)$ matrix A is *nilpotent* if there exists a positive integer i such that $A^i = 0$. For instance, the (2×2) matrices

$$A = \begin{bmatrix} 0 & 3 \\ 0 & 0 \end{bmatrix} \quad \text{and} \quad B = \begin{bmatrix} 1 & -1 \\ 1 & -1 \end{bmatrix}$$

are nilpotent because $A^2 = B^2 = 0$.

Rules: In the following rules, A is an $(m \times m)$ matrix.

- (1) If A is a diagonal matrix, it is idempotent if and only if all the diagonal elements are either zero or one.
- (2) If A is symmetric and idempotent, $\text{rk}(A) = \text{tr}(A)$.
- (3) If A is idempotent and $\text{rk}(A) = m$, then $A = I_m$.
- (4) If A is idempotent, then $I_m - A$ is idempotent.
- (5) If A is symmetric and idempotent, then $A^+ = A$.
- (6) If B is an $(m \times n)$ matrix, then BB^+ and B^+B are idempotent.
- (7) If A is idempotent, then all its eigenvalues are zero or one.
- (8) If A is nilpotent, then all its eigenvalues are zero.

A.8.2 Orthogonal Matrices and Vectors and Orthogonal Complements

Two $(m \times 1)$ vectors x and y are *orthogonal* if $x'y = 0$. They are *orthonormal* if they are orthogonal and have unit length, where the length of a vector x is $\|x\| := \sqrt{x'x}$.

An $(m \times k)$ matrix B is *orthogonal* to the $(m \times n)$ matrix A if $A'B = 0$. If A is an $(m \times n)$ matrix of full column rank, an *orthogonal complement* of A , denoted by A_\perp , is an $(m \times (m - n))$ matrix of full column rank such that $A'A_\perp = 0$. The orthogonal complement of a nonsingular square matrix is zero and the orthogonal complement of a zero matrix is an identity matrix of suitable dimension.

An $(m \times m)$ square matrix A is *orthogonal* if its transpose is its inverse, $A'A = AA' = I_m$. In other words, A is orthogonal if its rows and columns are orthonormal vectors.

Examples of orthogonal vectors are

$$x = \begin{bmatrix} 5 \\ 0 \\ 0 \end{bmatrix} \quad \text{and} \quad y = \begin{bmatrix} 0 \\ 2 \\ 0 \end{bmatrix}.$$

The following four matrices are orthogonal matrices:

$$\begin{bmatrix} 0 & 1 \\ 1 & 0 \end{bmatrix}, \quad \begin{bmatrix} \cos \varphi & \sin \varphi \\ -\sin \varphi & \cos \varphi \end{bmatrix},$$

$$\begin{bmatrix} 0 & 1 & 0 \\ 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix}, \quad \begin{bmatrix} 1/\sqrt{3} & 1/\sqrt{3} & 1/\sqrt{3} \\ 1/\sqrt{2} & -1/\sqrt{2} & 0 \\ 1/\sqrt{6} & 1/\sqrt{6} & -2/\sqrt{6} \end{bmatrix}.$$

Suppose

$$A = \begin{bmatrix} 1 & 0 \\ 1 & 1 \\ 0 & 2 \end{bmatrix},$$

then

$$\begin{bmatrix} 1 \\ -1 \\ \frac{1}{2} \end{bmatrix} \quad \text{and} \quad \begin{bmatrix} 2 \\ -2 \\ 1 \end{bmatrix}$$

are orthogonal complements of A .

Rules:

- (1) I_m is an orthogonal matrix.
- (2) If A is an orthogonal matrix, then $\det(A) = 1$ or -1 .
- (3) If A and B are orthogonal and conformable matrices, then AB is orthogonal.
- (4) If λ_i, λ_j are distinct eigenvalues of a *symmetric* matrix A , then the corresponding eigenvectors v_i and v_j are orthogonal.
- (5) For an $(m \times n)$ matrix A of full column rank and $n < m$, the matrix $[A : A_\perp]$ is invertible.

A.8.3 Definite Matrices and Quadratic Forms

Let A be a *symmetric* $(m \times m)$ matrix and x an $(m \times 1)$ vector. The function $x'Ax$ is called a *quadratic form* in x . The symmetric matrix A or the corresponding quadratic form is

- (i) *positive definite* if $x'Ax > 0$ for all m -vectors $x \neq 0$;
- (ii) *positive semidefinite* if $x'Ax \geq 0$ for all m -vectors x ;
- (iii) *negative definite* if $x'Ax < 0$ for all m -vectors $x \neq 0$;
- (iv) *negative semidefinite* if $x'Ax \leq 0$ for all m -vectors x ;
- (v) *indefinite* if $x'Ax > 0$ for some x and $x'Ax < 0$ for another x .

Rules: In the following rules, A is a symmetric $(m \times m)$ matrix.

- (1) $A = (a_{ij})$ is positive definite if and only if all its principle minors are positive, where

$$\det \begin{bmatrix} a_{11} & \cdots & a_{1i} \\ \vdots & \ddots & \vdots \\ a_{i1} & \cdots & a_{ii} \end{bmatrix}$$

is the i -th principle minor of A .

- (2) A is negative definite (semidefinite) if and only if $-A$ is positive definite (semidefinite).
 (3) If A is positive or negative definite, it is nonsingular.
 (4) All eigenvalues of a positive (negative) definite matrix are greater (smaller) than zero.
 (5) A diagonal matrix is positive (negative) definite if and only if all its diagonal elements are positive (negative).
 (6) If A is positive definite and B an $(m \times n)$ matrix, then $B'AB$ is positive semidefinite.
 (7) If A is positive definite and B an $(m \times n)$ matrix with $\text{rk}(B) = n$, then $B'AB$ is positive definite.
 (8) If A is positive definite, then A^{-1} is positive definite.
 (9) If A is idempotent, then it is positive semidefinite.

With these rules it is easy to check that

$$\begin{bmatrix} 2 & 1 \\ 1 & 1 \end{bmatrix} \quad \text{and} \quad \begin{bmatrix} 3 & 1 & 0 \\ 1 & 1 & 0 \\ 0 & 0 & 4 \end{bmatrix}$$

are positive definite matrices and

$$\begin{bmatrix} 1 & 1 \\ 1 & 1 \end{bmatrix} \quad \text{and} \quad \begin{bmatrix} 1 & 0 \\ 0 & 0 \end{bmatrix}$$

are positive semidefinite matrices.

A.9 Decomposition and Diagonalization of Matrices

A.9.1 The Jordan Canonical Form

Let A be an $(m \times m)$ matrix with eigenvalues $\lambda_1, \dots, \lambda_n$. Then there exists a nonsingular matrix P such that

$$P^{-1}AP = \begin{bmatrix} A_1 & & 0 \\ & \ddots & \\ 0 & & A_n \end{bmatrix} =: \Lambda \quad \text{or} \quad A = P\Lambda P^{-1}, \quad (\text{A.9.1})$$

where

$$A_i = \begin{bmatrix} \lambda_i & 1 & 0 & \dots & 0 \\ 0 & \lambda_i & 1 & & 0 \\ \vdots & & \ddots & \ddots & \vdots \\ 0 & 0 & & \ddots & 1 \\ 0 & 0 & \dots & \dots & \lambda_i \end{bmatrix}.$$

This decomposition of A is the *Jordan canonical form*. Because the eigenvalues of A may be complex numbers, A and P may be complex matrices. If multiple roots of the characteristic polynomial exist, they may have to appear more than once in the list $\lambda_1, \dots, \lambda_n$.

The Jordan canonical form has some important implications. For instance, it implies that

$$A^j = (PAP^{-1})^j = PA^jP^{-1}$$

and it can be shown that

$$A_i^j = \begin{bmatrix} \lambda_i^j & \binom{j}{1} \lambda_i^{j-1} & \dots & \binom{j}{r_i-1} \lambda_i^{j-r_i+1} \\ 0 & \lambda_i^j & \dots & \binom{j}{r_i-2} \lambda_i^{j-r_i+2} \\ \vdots & & \ddots & \vdots \\ 0 & 0 & \dots & \lambda_i^j \end{bmatrix},$$

where

$$\binom{p}{q} = \frac{p!}{(p-q)!q!}$$

denotes a binomial coefficient. We have the following rules.

Rules: Suppose A is a real $(m \times m)$ matrix with eigenvalues $\lambda_1, \dots, \lambda_n$ which have all modulus less than 1, that is, $|\lambda_i| < 1$ for $i = 1, \dots, n$. Furthermore, let A and P be the matrices given in (A.9.1).

- (1) $A^j = PA^jP^{-1} \xrightarrow{j \rightarrow \infty} 0$.
- (2) $\sum_{j=0}^{\infty} A^j = (I_m - A)^{-1}$ exists.
- (3) The sequence $A^j, j = 0, 1, 2, \dots$, is absolutely summable, that is,

$$\sum_{j=0}^{\infty} |\alpha_{kl,j}|$$

is finite for all $k, l = 1, \dots, m$, where $\alpha_{kl,j}$ is a typical element of A^j . (See Section C.3 regarding the concept of absolute summability.)

A.9.2 Decomposition of Symmetric Matrices

If A is a symmetric ($m \times m$) matrix, then there exists an orthogonal matrix P such that

$$P'AP = \Lambda = \begin{bmatrix} \lambda_1 & & 0 \\ & \ddots & \\ 0 & & \lambda_m \end{bmatrix} \quad \text{or} \quad A = P\Lambda P', \quad (\text{A.9.2})$$

where the λ_i 's are the eigenvalues of A and the columns of P are the corresponding eigenvectors. Here all matrices are real again because the eigenvalues of a symmetric matrix are real numbers. Denoting the i -th column of P by p_i and using that $p_i'p_j = 0$ for $i \neq j$, we get

$$A = P\Lambda P' = \sum_{i=1}^m \lambda_i p_i p_i'. \quad (\text{A.9.3})$$

Moreover,

$$A^2 = P\Lambda P'P\Lambda P' = P\Lambda^2 P'$$

and, more generally,

$$A^k = P\Lambda^k P'.$$

If A is a positive definite symmetric ($m \times m$) matrix, then all eigenvalues are positive so that the notation

$$A^{1/2} := \begin{bmatrix} \sqrt{\lambda_1} & & 0 \\ & \ddots & \\ 0 & & \sqrt{\lambda_m} \end{bmatrix}$$

makes sense. Defining $Q = P\Lambda^{1/2}P'$, we get $QQ = A$. In generalization of the terminology for positive real numbers, Q may be called a *square root* of A and may be denoted by $A^{1/2}$.

A.9.3 The Choleski Decomposition of a Positive Definite Matrix

If A is a positive definite ($m \times m$) matrix, then there exists a lower (upper) triangular matrix P with positive main diagonal such that

$$P^{-1}AP^{-1} = I_m \quad \text{or} \quad A = PP'. \quad (\text{A.9.4})$$

Similarly, if A is positive semidefinite with $\text{rk}(A) = n < m$, then there exists a nonsingular matrix P such that

$$P^{-1}AP'^{-1} = \begin{bmatrix} I_n & 0 \\ 0 & 0 \end{bmatrix}. \tag{A.9.5}$$

Alternatively, $A = QQ'$, where

$$Q = P \begin{bmatrix} I_n & 0 \\ 0 & 0 \end{bmatrix}.$$

For instance,

$$\begin{aligned} \begin{bmatrix} 26 & 3 & 0 \\ 3 & 9 & 0 \\ 0 & 0 & 81 \end{bmatrix} &= \begin{bmatrix} 5 & 1 & 0 \\ 0 & 3 & 0 \\ 0 & 0 & 9 \end{bmatrix} \begin{bmatrix} 5 & 0 & 0 \\ 1 & 3 & 0 \\ 0 & 0 & 9 \end{bmatrix} \\ &= \begin{bmatrix} \sqrt{26} & 0 & 0 \\ 3/\sqrt{26} & 15/\sqrt{26} & 0 \\ 0 & 0 & 9 \end{bmatrix} \begin{bmatrix} \sqrt{26} & 3/\sqrt{26} & 0 \\ 0 & 15/\sqrt{26} & 0 \\ 0 & 0 & 9 \end{bmatrix}. \end{aligned}$$

The decomposition $A = PP'$, where P is lower triangular with positive main diagonal, is sometimes called *Choleski decomposition*. Computer programs are available to determine the matrix P for a given positive definite matrix A . If a lower triangular matrix P is supplied by the program, an upper triangular matrix Q can be obtained as follows: Define an $(m \times m)$ matrix

$$G = \begin{bmatrix} 0 & \dots & 0 & 1 \\ 0 & \dots & 1 & 0 \\ \vdots & \ddots & & \vdots \\ 1 & & 0 & 0 \end{bmatrix}$$

with ones on the diagonal from the upper right-hand corner to the lower left-hand corner and zeros elsewhere. Note that $G' = G$ and $G^{-1} = G$. Suppose a decomposition of the $(m \times m)$ matrix A is desired. Then decompose $B = GAG$ as $B = PP'$, where P is lower triangular. Hence,

$$A = GBG = GPGGP'G = QQ',$$

where $Q = GPG$ is upper triangular.

A.10 Partitioned Matrices

Let the $(m \times n)$ matrix A be *partitioned* into *submatrices* $A_{11}, A_{12}, A_{21}, A_{22}$ with dimensions $(p \times q), (p \times (n - q)), ((m - p) \times q)$, and $((m - p) \times (n - q))$, respectively, so that

$$A = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix}. \tag{A.10.1}$$

For such a partitioned matrix, a number of useful results hold.

Rules:

$$(1) A' = \begin{bmatrix} A'_{11} & A'_{21} \\ A'_{12} & A'_{22} \end{bmatrix}.$$

(2) If $n = m$ and $q = p$ and A, A_{11} , and A_{22} are nonsingular, then

$$\begin{aligned} A^{-1} &= \begin{bmatrix} D & -DA_{12}A_{22}^{-1} \\ -A_{22}^{-1}A_{21}D & A_{22}^{-1} + A_{22}^{-1}A_{21}DA_{12}A_{22}^{-1} \end{bmatrix} \\ &= \begin{bmatrix} A_{11}^{-1} + A_{11}^{-1}A_{12}GA_{21}A_{11}^{-1} & -A_{11}^{-1}A_{12}G \\ -GA_{21}A_{11}^{-1} & G \end{bmatrix}, \end{aligned}$$

where $D := (A_{11} - A_{12}A_{22}^{-1}A_{21})^{-1}$ and $G := (A_{22} - A_{21}A_{11}^{-1}A_{12})^{-1}$.

(3) Under the conditions of (2),

$$(A_{11} - A_{12}A_{22}^{-1}A_{21})^{-1} = A_{11}^{-1} + A_{11}^{-1}A_{12}(A_{22} - A_{21}A_{11}^{-1}A_{12})^{-1}A_{21}A_{11}^{-1}.$$

(4) Under the conditions of (2), if A_{12} and A_{21} are null matrices,

$$A^{-1} = \begin{bmatrix} A_{11}^{-1} & 0 \\ 0 & A_{22}^{-1} \end{bmatrix}.$$

(5) If A is a square matrix ($n = m$) and A_{11} is square and nonsingular, then $|A| = |A_{11}| \cdot |A_{22} - A_{21}A_{11}^{-1}A_{12}|$.

(6) If A is a square matrix and A_{22} is square and nonsingular, then $|A| = |A_{22}| \cdot |A_{11} - A_{12}A_{22}^{-1}A_{21}|$.

A.11 The Kronecker Product

Let $A = (a_{ij})$ and $B = (b_{ij})$ be $(m \times n)$ and $(p \times q)$ matrices, respectively. The $(mp \times nq)$ matrix

$$A \otimes B := \begin{bmatrix} a_{11}B & \dots & a_{1n}B \\ \vdots & & \vdots \\ a_{m1}B & \dots & a_{mn}B \end{bmatrix} \quad (\text{A.11.1})$$

is the *Kronecker product* or *direct product* of A and B . For example, the Kronecker product of

$$A = \begin{bmatrix} 3 & 4 & -1 \\ 2 & 0 & 0 \end{bmatrix} \quad \text{and} \quad B = \begin{bmatrix} 5 & -1 \\ 3 & 3 \end{bmatrix} \quad (\text{A.11.2})$$

is

$$A \otimes B = \begin{bmatrix} 15 & -3 & 20 & -4 & -5 & 1 \\ 9 & 9 & 12 & 12 & -3 & -3 \\ 10 & -2 & 0 & 0 & 0 & 0 \\ 6 & 6 & 0 & 0 & 0 & 0 \end{bmatrix}$$

and

$$B \otimes A = \begin{bmatrix} 15 & 20 & -5 & -3 & -4 & 1 \\ 10 & 0 & 0 & -2 & 0 & 0 \\ 9 & 12 & -3 & 9 & 12 & -3 \\ 6 & 0 & 0 & 6 & 0 & 0 \end{bmatrix}.$$

Rules: In the following rules, suitable dimensions are assumed.

- (1) $A \otimes B \neq B \otimes A$ in general.
- (2) $(A \otimes B)' = A' \otimes B'$.
- (3) $A \otimes (B + C) = A \otimes B + A \otimes C$.
- (4) $(A \otimes B)(C \otimes D) = AC \otimes BD$.
- (5) If A and B are invertible, then $(A \otimes B)^{-1} = A^{-1} \otimes B^{-1}$.
- (6) If A and B are square matrices with eigenvalues λ_A, λ_B , respectively, and associated eigenvectors v_A, v_B , then $\lambda_A \lambda_B$ is an eigenvalue of $A \otimes B$ with eigenvector $v_A \otimes v_B$.
- (7) If A and B are $(m \times m)$ and $(n \times n)$ square matrices, respectively, then $|A \otimes B| = |A|^n |B|^m$.
- (8) If A and B are square matrices,

$$\text{tr}(A \otimes B) = \text{tr}(A)\text{tr}(B).$$

- (9) $(A \otimes B)^+ = A^+ \otimes B^+$.

A.12 The vec and vech Operators and Related Matrices

A.12.1 The Operators

Let $A = (a_1, \dots, a_n)$ be an $(m \times n)$ matrix with $(m \times 1)$ columns a_i . The *vec operator* transforms A into an $(mn \times 1)$ vector by stacking the columns, that is,

$$\text{vec}(A) = \begin{bmatrix} a_1 \\ \vdots \\ a_n \end{bmatrix}.$$

For instance, if A and B are as in (A.11.2), then

$$\text{vec}(A) = \begin{bmatrix} 3 \\ 2 \\ 4 \\ 0 \\ -1 \\ 0 \end{bmatrix} \quad \text{and} \quad \text{vec}(B) = \begin{bmatrix} 5 \\ 3 \\ -1 \\ 3 \end{bmatrix}.$$

Rules: Let A, B, C be matrices with appropriate dimensions.

- (1) $\text{vec}(A + B) = \text{vec}(A) + \text{vec}(B)$.
- (2) $\text{vec}(ABC) = (C' \otimes A)\text{vec}(B)$.
- (3) $\text{vec}(AB) = (I \otimes A)\text{vec}(B) = (B' \otimes I)\text{vec}(A)$.
- (4) $\text{vec}(ABC) = (I \otimes AB)\text{vec}(C) = (C' B' \otimes I)\text{vec}(A)$.
- (5) $\text{vec}(B')'\text{vec}(A) = \text{tr}(BA) = \text{tr}(AB) = \text{vec}(A')'\text{vec}(B)$.
- (6) $\begin{aligned} \text{tr}(ABC) &= \text{vec}(A')'(C' \otimes I)\text{vec}(B) \\ &= \text{vec}(A')'(I \otimes B)\text{vec}(C) \\ &= \text{vec}(B')'(A' \otimes I)\text{vec}(C) \\ &= \text{vec}(B')'(I \otimes C)\text{vec}(A) \\ &= \text{vec}(C')'(B' \otimes I)\text{vec}(A) \\ &= \text{vec}(C')'(I \otimes A)\text{vec}(B). \end{aligned}$

The vech operator is closely related to vec. It only stacks the elements on and below the main diagonal of a square matrix. For instance,

$$\text{vech} \begin{bmatrix} \alpha_{11} & \alpha_{12} & \alpha_{13} \\ \alpha_{21} & \alpha_{22} & \alpha_{23} \\ \alpha_{31} & \alpha_{32} & \alpha_{33} \end{bmatrix} = \begin{bmatrix} \alpha_{11} \\ \alpha_{21} \\ \alpha_{31} \\ \alpha_{22} \\ \alpha_{32} \\ \alpha_{33} \end{bmatrix}.$$

In general, if A is an $(m \times m)$ matrix, $\text{vech}(A)$ is an $m(m+1)/2$ -dimensional vector. The vech operator is usually applied to symmetric matrices to collect the separate elements only.

A.12.2 Elimination, Duplication, and Commutation Matrices

The vec and vech operators are related by the *elimination matrix*, \mathbf{L}_m , and the *duplication matrix*, \mathbf{D}_m . The former is an $(\frac{1}{2}m(m+1) \times m^2)$ matrix such that, for an $(m \times m)$ square matrix A ,

$$\text{vech}(A) = \mathbf{L}_m \text{vec}(A). \quad (\text{A.12.1})$$

Thus, e.g., for $m = 3$,

$$\mathbf{L}_3 = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix}.$$

The duplication matrix \mathbf{D}_m is $(m^2 \times \frac{1}{2}m(m+1))$ and is defined so that, for any symmetric $(m \times m)$ matrix A ,

$$\text{vec}(A) = \mathbf{D}_m \text{vech}(A). \quad (\text{A.12.2})$$

For instance, for $m = 3$,

$$\mathbf{D}_3 = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix}.$$

Because the rank of \mathbf{D}_m is easily seen to be $m(m + 1)/2$, the matrix $\mathbf{D}'_m \mathbf{D}_m$ is invertible. Thus, left-multiplication of (A.12.2) by $(\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m$ gives

$$(\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m \text{vec}(A) = \text{vech}(A). \tag{A.12.3}$$

Note, however, that $(\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m \neq \mathbf{L}_m$ in general because (A.12.3) holds for symmetric matrices A only while (A.12.1) holds for arbitrary square matrices A .

The *commutation matrix*, \mathbf{K}_{mn} , is another matrix that is occasionally useful in dealing with the vec operator. \mathbf{K}_{mn} is an $(mn \times mn)$ matrix defined such that, for any $(m \times n)$ matrix A ,

$$\text{vec}(A') = \mathbf{K}_{mn} \text{vec}(A)$$

or, equivalently,

$$\text{vec}(A) = \mathbf{K}_{nm} \text{vec}(A').$$

For example,

$$\mathbf{K}_{32} = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix}$$

because for

$$A = \begin{bmatrix} \alpha_{11} & \alpha_{12} \\ \alpha_{21} & \alpha_{22} \\ \alpha_{31} & \alpha_{32} \end{bmatrix},$$

$$\text{vec}(A') = \begin{bmatrix} \alpha_{11} \\ \alpha_{12} \\ \alpha_{21} \\ \alpha_{22} \\ \alpha_{31} \\ \alpha_{32} \end{bmatrix} = \mathbf{K}_{32} \begin{bmatrix} \alpha_{11} \\ \alpha_{21} \\ \alpha_{31} \\ \alpha_{12} \\ \alpha_{22} \\ \alpha_{32} \end{bmatrix} = \mathbf{K}_{32} \text{vec}(A).$$

Rules:

- (7) $\mathbf{L}_m \mathbf{D}_m = I_{m(m+1)/2}$.
 (8) $\mathbf{K}_{mm} \mathbf{D}_m = \mathbf{D}_m$.
 (9) $\mathbf{K}_{m1} = \mathbf{K}_{1m} = I_m$.
 (10) $\mathbf{K}'_{mn} = \mathbf{K}_{mn}^{-1} = \mathbf{K}_{nm}$.
 (11) $\text{tr } \mathbf{K}_{mm} = m$.
 (12) $\det(\mathbf{K}_{mn}) = (-1)^{mn(m-1)(n-1)/4}$.
 (13) $\text{tr}(\mathbf{D}'_m \mathbf{D}_m) = m^2$, $\text{tr}(\mathbf{D}'_m \mathbf{D}_m)^{-1} = m(m+3)/4$.
 (14) $\det(\mathbf{D}'_m \mathbf{D}_m) = 2^{m(m-1)/2}$.
 (15) $\text{tr}(\mathbf{D}_m \mathbf{D}'_m) = m^2$.
 (16) $|\mathbf{D}'_m (A \otimes A) \mathbf{D}_m| = 2^{m(m-1)/2} |A|^{m+1}$, where A is an $(m \times m)$ matrix.
 (17) $(\mathbf{D}'_m (A \otimes A) \mathbf{D}_m)^{-1} = (\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m (A^{-1} \otimes A^{-1}) \mathbf{D}_m (\mathbf{D}'_m \mathbf{D}_m)^{-1}$, if A is a nonsingular $(m \times m)$ matrix.
 (18) $\mathbf{L}_m \mathbf{L}'_m = I_{m(m+1)/2}$.
 (19) $\mathbf{L}_m \mathbf{L}'_m$ and $\mathbf{L}_m \mathbf{K}_{mm} \mathbf{L}'_m$ are idempotent.

Let A and B be lower triangular $(m \times m)$ matrices. Then we have the following rules:

- (20) $\mathbf{L}_m (A \otimes B) \mathbf{L}'_m$ is lower triangular.
 (21) $\mathbf{L}'_m \mathbf{L}_m (A' \otimes B) \mathbf{L}'_m = (A' \otimes B) \mathbf{L}'_m$.
 (22) $[\mathbf{L}_m (A' \otimes B) \mathbf{L}'_m]^s = \mathbf{L}_m ((A')^s \otimes B^s) \mathbf{L}'_m$ for $s = 0, 1, \dots$ and for $s = \dots, -2, -1$, if A^{-1} and B^{-1} exist.

Let G be $(m \times n)$, F $(p \times q)$, and \mathbf{b} $(p \times 1)$. Then the following results hold:

- (23) $\mathbf{K}_{pm}(G \otimes F) = (F \otimes G) \mathbf{K}_{qn}$.
 (24) $\mathbf{K}_{pm}(G \otimes F) \mathbf{K}_{nq} = F \otimes G$.
 (25) $\mathbf{K}_{pm}(G \otimes \mathbf{b}) = \mathbf{b} \otimes G$.
 (26) $\mathbf{K}_{pm}(\mathbf{b} \otimes G) = G \otimes \mathbf{b}$.
 (27) $\text{vec}(G \otimes F) = (I_n \otimes \mathbf{K}_{qm} \otimes I_p)(\text{vec}(G) \otimes \text{vec}(F))$.
 (28) $(\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m \mathbf{K}_{mm} = (\mathbf{D}'_m \mathbf{D}_m)^{-1} \mathbf{D}'_m$.

A.13 Vector and Matrix Differentiation

In the following, it will be assumed that all derivatives exist and are continuous. Let $f(\beta)$ be a scalar function that depends on the $(n \times 1)$ vector $\beta = (\beta_1, \dots, \beta_n)'$.

$$\frac{\partial f}{\partial \beta} := \begin{bmatrix} \frac{\partial f}{\partial \beta_1} \\ \vdots \\ \frac{\partial f}{\partial \beta_n} \end{bmatrix}, \quad \frac{\partial f}{\partial \beta'} := \left[\frac{\partial f}{\partial \beta_1}, \dots, \frac{\partial f}{\partial \beta_n} \right]$$

are $(n \times 1)$ and $(1 \times n)$ vectors of first order partial derivatives, respectively, and

$$\frac{\partial^2 f}{\partial \beta \partial \beta'} := \left[\frac{\partial^2 f}{\partial \beta_i \partial \beta_j} \right] = \begin{bmatrix} \frac{\partial^2 f}{\partial \beta_1 \partial \beta_1} & \cdots & \frac{\partial^2 f}{\partial \beta_1 \partial \beta_n} \\ \vdots & & \vdots \\ \frac{\partial^2 f}{\partial \beta_n \partial \beta_1} & \cdots & \frac{\partial^2 f}{\partial \beta_n \partial \beta_n} \end{bmatrix}$$

is the $(n \times n)$ *Hessian matrix* of second order partial derivatives. If $f(A)$ is a scalar function of an $(m \times n)$ matrix $A = (a_{ij})$, then

$$\frac{\partial f}{\partial A} := \left[\frac{\partial f}{\partial a_{ij}} \right]$$

is an $(m \times n)$ matrix of partial derivatives. If the $(m \times n)$ matrix $A = (a_{ij})$ depends on the scalar β , then

$$\frac{\partial A}{\partial \beta} := \left[\frac{\partial a_{ij}}{\partial \beta} \right]$$

is an $(m \times n)$ matrix. If $y(\beta) = (y_1(\beta), \dots, y_m(\beta))'$ is an $(m \times 1)$ vector that depends on the $(n \times 1)$ vector β , then

$$\frac{\partial y}{\partial \beta'} := \begin{bmatrix} \frac{\partial y_1}{\partial \beta_1} & \cdots & \frac{\partial y_1}{\partial \beta_n} \\ \vdots & & \vdots \\ \frac{\partial y_m}{\partial \beta_1} & \cdots & \frac{\partial y_m}{\partial \beta_n} \end{bmatrix}$$

is an $(m \times n)$ matrix and

$$\frac{\partial y'}{\partial \beta} := \left(\frac{\partial y}{\partial \beta'} \right)'.$$

For example, if $\beta = (\beta_1, \beta_2)'$ and $f(\beta) = \beta_1^2 - 2\beta_1\beta_2$, then

$$\frac{\partial f}{\partial \beta} = \begin{bmatrix} \frac{\partial f}{\partial \beta_1} \\ \frac{\partial f}{\partial \beta_2} \end{bmatrix} = \begin{bmatrix} 2\beta_1 - 2\beta_2 \\ -2\beta_1 \end{bmatrix}.$$

If

$$y(\beta) = \begin{bmatrix} \beta_1^3 + \beta_2 \\ e^{\beta_1} \end{bmatrix}, \quad \text{then} \quad \frac{\partial y}{\partial \beta'} = \begin{bmatrix} 3\beta_1^2 & 1 \\ e^{\beta_1} & 0 \end{bmatrix}.$$

The following two propositions are useful for deriving rules for vector and matrix differentiation.

Proposition A.1 (*Chain Rule for Vector Differentiation*)

Let α and β be $(m \times 1)$ and $(n \times 1)$ vectors, respectively, and suppose $h(\alpha)$ is $(p \times 1)$ and $g(\beta)$ is $(m \times 1)$. Then, with $\alpha = g(\beta)$,

$$\frac{\partial h(g(\beta))}{\partial \beta'} = \frac{\partial h(\alpha)}{\partial \alpha'} \frac{\partial g(\beta)}{\partial \beta'} \quad (p \times n).$$

■

Proposition A.2 (*Product Rules for Vector Differentiation*)

(a) Suppose β is $(m \times 1)$, $a(\beta) = (a_1(\beta), \dots, a_n(\beta))'$ is $(n \times 1)$, $c(\beta) = (c_1(\beta), \dots, c_p(\beta))'$ is $(p \times 1)$ and $A = (a_{ij})$ is $(n \times p)$ and does not depend on β . Then

$$\frac{\partial [a(\beta)'Ac(\beta)]}{\partial \beta'} = c(\beta)'A' \frac{\partial a(\beta)}{\partial \beta'} + a(\beta)'A \frac{\partial c(\beta)}{\partial \beta'}.$$

(b) If β is a (1×1) scalar, $A(\beta)$ is $(m \times n)$ and $B(\beta)$ is $(n \times p)$, then

$$\frac{\partial AB}{\partial \beta} = \frac{\partial A}{\partial \beta}B + A \frac{\partial B}{\partial \beta}.$$

(c) If β is an $(m \times 1)$ vector, $A(\beta)$ is $(n \times p)$ and $B(\beta)$ is $(p \times q)$, then

$$\frac{\partial \text{vec}(AB)}{\partial \beta'} = (I_q \otimes A) \frac{\partial \text{vec}(B)}{\partial \beta'} + (B' \otimes I_n) \frac{\partial \text{vec}(A)}{\partial \beta'}.$$

■

Proof:

(a)

$$\begin{aligned} \frac{\partial (a'Ac)}{\partial \beta'} &= \frac{\partial \left(\sum_{i,j} a_i a_{ij} c_j \right)}{\partial \beta'} \\ &= \sum_{i,j} \left[\frac{\partial a_i}{\partial \beta'} a_{ij} c_j + a_i a_{ij} \frac{\partial c_j}{\partial \beta'} \right] \\ &= c' A' \frac{\partial a}{\partial \beta'} + a' A \frac{\partial c}{\partial \beta'}. \end{aligned}$$

(b)

$$AB = \left[\sum_j a_{ij} b_{jk} \right] \text{ and}$$

$$\frac{\partial \left(\sum_j a_{ij} b_{jk} \right)}{\partial \beta} = \sum_j \left[\frac{\partial a_{ij}}{\partial \beta} b_{jk} + a_{ij} \frac{\partial b_{jk}}{\partial \beta} \right].$$

(c) Follows from (b) by stacking the columns of AB and writing the resulting columns $\partial \text{vec}(AB)/\partial \beta_i$ for $i = 1, \dots, m$ in one matrix. ■

The following rules are now easy to verify.

Rules:

(1) Let A be an $(m \times n)$ matrix and β be an $(n \times 1)$ vector. Then

$$\frac{\partial A\beta}{\partial \beta'} = A \quad \text{and} \quad \frac{\partial \beta' A'}{\partial \beta} = A'.$$

Proof: This result is a special case of Proposition A.2(a). ■

(2) Let A be $(m \times m)$ and β be $(m \times 1)$. Then

$$\frac{\partial \beta' A \beta}{\partial \beta} = (A + A')\beta \quad \text{and} \quad \frac{\partial \beta' A \beta}{\partial \beta'} = \beta'(A + A).$$

Proof: See Proposition A.2(a). ■

(3) If A is $(m \times m)$ and β is $(m \times 1)$, then

$$\frac{\partial^2 \beta' A \beta}{\partial \beta \partial \beta'} = A + A'.$$

Proof: Follows from (1) and (2). ■

(4) If A is a symmetric $(m \times m)$ matrix and β an $(m \times 1)$ vector then

$$\frac{\partial^2 \beta' A \beta}{\partial \beta \partial \beta'} = 2A.$$

Proof: See (3). ■

(5) Let Ω be a symmetric $(n \times n)$ matrix and $c(\beta)$ an $(n \times 1)$ vector that depends on the $(m \times 1)$ vector β . Then

$$\frac{\partial c(\beta)' \Omega c(\beta)}{\partial \beta'} = 2c(\beta)' \Omega \frac{\partial c(\beta)}{\partial \beta'}$$

and

$$\frac{\partial^2 c(\beta)' \Omega c(\beta)}{\partial \beta \partial \beta'} = 2 \left[\frac{\partial c(\beta)'}{\partial \beta} \Omega \frac{\partial c(\beta)}{\partial \beta'} + [c(\beta)' \Omega \otimes I_m] \frac{\partial \text{vec}(\partial c(\beta)' / \partial \beta)}{\partial \beta'} \right].$$

In particular, if y is an $(n \times 1)$ vector and X an $(n \times m)$ matrix,

$$\frac{\partial(y - X\beta)' \Omega(y - X\beta)}{\partial\beta'} = -2(y - X\beta)' \Omega X$$

and

$$\frac{\partial^2(y - X\beta)' \Omega(y - X\beta)}{\partial\beta\partial\beta'} = 2X' \Omega X.$$

Proof: Follows from Proposition A.2(a). ■

- (6) Suppose β is $(m \times 1)$, $B(\beta)$ is $(n \times p)$, A is $(k \times n)$, and C is $(p \times q)$ and the latter two matrices do not depend on β . Then

$$\frac{\partial \text{vec}(ABC)}{\partial\beta'} = (C' \otimes A) \frac{\partial \text{vec}(B)}{\partial\beta'}.$$

Proof: Follows from Rule (2), Section A.12, and Proposition A.1. ■

- (7) Suppose β is $(m \times 1)$, $A(\beta)$ is $(n \times p)$, $D(\beta)$ is $(q \times r)$, and C is $(p \times q)$ and does not depend on β . Then

$$\frac{\partial \text{vec}(ACD)}{\partial\beta'} = (I_r \otimes AC) \frac{\partial \text{vec}(D)}{\partial\beta'} + (D' C' \otimes I_n) \frac{\partial \text{vec}(A)}{\partial\beta'}.$$

Proof: Follows from Proposition A.2(c) by setting $B = CD$ and noting that $\partial \text{vec}(CD)/\partial\beta' = (I_r \otimes C) \partial \text{vec}(D)/\partial\beta'$. ■

- (8) If β is $(m \times 1)$ and $A(\beta)$ is $(n \times n)$, then, for any positive integer h ,

$$\frac{\partial \text{vec}(A^h)}{\partial\beta'} = \left[\sum_{i=0}^{h-1} (A')^{h-1-i} \otimes A^i \right] \frac{\partial \text{vec}(A)}{\partial\beta'}.$$

Proof: Follows inductively from Proposition A.2(c). The result is evident for $h = 1$. Assuming it holds for $h - 1$ gives

$$\begin{aligned} \frac{\partial \text{vec}(AA^{h-1})}{\partial\beta'} &= (I_n \otimes A) \left[\sum_{i=0}^{h-2} (A')^{h-2-i} \otimes A^i \right] \frac{\partial \text{vec}(A)}{\partial\beta'} \\ &\quad + ((A')^{h-1} \otimes I_n) \frac{\partial \text{vec}(A)}{\partial\beta'}. \end{aligned}$$
■

- (9) If A is a nonsingular $(m \times m)$ matrix, then

$$\frac{\partial \text{vec}(A^{-1})}{\partial \text{vec}(A)'} = -(A^{-1})' \otimes A^{-1}.$$

Proof: Using Proposition A.2(c),

$$0 = \frac{\partial \text{vec}(I_m)}{\partial \text{vec}(A)'} = \frac{\partial \text{vec}(A^{-1}A)}{\partial \text{vec}(A)'} = (I_m \otimes A^{-1}) \frac{\partial \text{vec}(A)}{\partial \text{vec}(A)'} + (A' \otimes I_m) \frac{\partial \text{vec}(A^{-1})}{\partial \text{vec}(A)'}$$

■

(10) Let A be a symmetric positive definite $(m \times m)$ matrix and let P be a lower triangular $(m \times m)$ matrix with positive elements on the main diagonal such that $A = PP'$. Moreover, let \mathbf{L}_m be an $(\frac{1}{2}m(m+1) \times m^2)$ elimination matrix such that $\mathbf{L}_m \text{vec}(A) = \text{vech}(A)$ consists of the elements on and below the main diagonal of A only. Then

$$\begin{aligned} \frac{\partial \text{vech}(P)}{\partial \text{vech}(A)'} &= \{\mathbf{L}_m[(I_m \otimes P)\mathbf{K}_{mm} + (P \otimes I_m)]\mathbf{L}_m'\}^{-1} \\ &= \{\mathbf{L}_m(I_m^2 + \mathbf{K}_{mm})(P \otimes I_m)\mathbf{L}_m'\}^{-1}, \end{aligned}$$

where \mathbf{K}_{mm} is an $(m^2 \times m^2)$ commutation matrix such that $\mathbf{K}_{mm} \text{vec}(P) = \text{vec}(P')$.

Proof: See Lütkepohl (1989a).

■

(11) If $A = (a_{ij})$ is an $(m \times m)$ matrix, then

$$\frac{\partial \text{tr}(A)}{\partial A} = I_m.$$

Proof: $\text{tr}(A) = a_{11} + \dots + a_{mm}$. Hence,

$$\frac{\partial \text{tr}(A)}{\partial a_{ij}} = \begin{cases} 0 & \text{if } i \neq j, \\ 1 & \text{if } i = j. \end{cases}$$

■

(12) If $A = (a_{ij})$ is $(m \times n)$ and $B = (b_{ij})$ is $(n \times m)$, then

$$\frac{\partial \text{tr}(AB)}{\partial A} = B'.$$

Proof: Follows because $\text{tr}(AB) = \sum_{j=1}^n a_{1j}b_{j1} + \dots + \sum_{j=1}^n a_{mj}b_{jm}$.

■

(13) Suppose A is an $(m \times n)$ matrix and B, C are $(m \times m)$ and $(n \times m)$, respectively. Then

$$\frac{\partial \text{tr}(BAC)}{\partial A} = B'C'.$$

Proof: Follows from Rule (12) because $\text{tr}(BAC) = \text{tr}(ACB)$.

■

(14) Let A, B, C, D be $(m \times n)$, $(n \times n)$, $(m \times n)$, and $(n \times m)$ matrices, respectively. Then

$$\frac{\partial \text{tr}(DABA'C)}{\partial A} = CDAB + D'C'AB'.$$

Proof: See Murata (1982, Appendix, Theorem 6a). ■

(15) Let A, B , and C be $(m \times m)$ matrices and suppose A is nonsingular. Then

$$\frac{\partial \operatorname{tr}(BA^{-1}C)}{\partial A} = -(A^{-1}CBA^{-1})'.$$

Proof: By Rule (6) of Section A.12,

$$\operatorname{tr}(BA^{-1}C) = \operatorname{vec}(B')'(C' \otimes I_m) \operatorname{vec}(A^{-1}).$$

Hence, using (9),

$$\begin{aligned} \frac{\partial \operatorname{tr}(BA^{-1}C)}{\partial \operatorname{vec}(A)'} &= -\operatorname{vec}(B')'(C' \otimes I_m)((A^{-1})' \otimes A^{-1}) \\ &= -[(A^{-1}C \otimes A^{-1'}) \operatorname{vec}(B')] \\ &= -[\operatorname{vec}(A^{-1'}B'C'A^{-1'})]' \end{aligned}$$

by Rule (2) of Section A.12. ■

(16) Let $A = (a_{ij})$ be an $(m \times m)$ matrix. Then

$$\frac{\partial |A|}{\partial A} = (A^{adj})',$$

where A^{adj} is the adjoint of A .

Proof: Developing by the i -th row of A gives

$$|A| = a_{i1}A_{i1} + \cdots + a_{im}A_{im},$$

where A_{ij} is the cofactor of a_{ij} . Hence,

$$\frac{\partial |A|}{\partial a_{ij}} = A_{ij}$$

because A_{ij} does not contain a_{ij} . ■

(17) If A is a nonsingular $(m \times m)$ matrix with $|A| > 0$, then

$$\frac{\partial \ln |A|}{\partial A} = (A')^{-1}.$$

Proof: Using Proposition A.1 (chain rule),

$$\frac{\partial \ln |A|}{\partial A} = \frac{\partial \ln |A|}{\partial |A|} \cdot \frac{\partial |A|}{\partial A} = \frac{1}{|A|} (A^{adj})' = (A')^{-1}. \quad \blacksquare$$

Proposition A.3 (*Taylor’s Theorem*)

Let $f(\beta)$ be a scalar valued function of the $(m \times 1)$ vector β . Suppose $f(\beta)$ is at least twice continuously differentiable on an open set \mathbb{S} that contains β_0, β , and the entire line segment between β_0 and β . Then there exists a point $\tilde{\beta}$ on the line segment such that

$$f(\beta) = f(\beta_0) + \frac{\partial f(\beta_0)}{\partial \beta'}(\beta - \beta_0) + \frac{1}{2}(\beta - \beta_0)' \frac{\partial^2 f(\tilde{\beta})}{\partial \beta \partial \beta'}(\beta - \beta_0), \quad (\text{A.13.1})$$

where $\partial f(\beta_0)/\partial \beta' := (\partial f/\partial \beta'|_{\beta_0})$. ■

The expansion of f given in (A.13.1) is a *second order Taylor expansion* at or around β_0 .

A.14 Optimization of Vector Functions

Suppose $f(\beta)$ is a real valued (scalar) differentiable function of the $(m \times 1)$ vector β . A necessary condition for a local optimum (minimum or maximum) at $\tilde{\beta}$ is that

$$\frac{\partial f}{\partial \beta} = 0 \quad \text{for } \beta = \tilde{\beta}, \quad \text{that is,} \quad \frac{\partial f(\tilde{\beta})}{\partial \beta} := \left[\frac{\partial f}{\partial \beta} \Big|_{\tilde{\beta}} \right] = 0.$$

In other words, $f(\cdot)$ has a *stationary point* at $\tilde{\beta}$. If this condition is satisfied and the *Hessian matrix* of second order partial derivatives

$$\frac{\partial^2 f}{\partial \beta \partial \beta'}$$

is negative (positive) definite for $\beta = \tilde{\beta}$, then $\tilde{\beta}$ is a local maximum (minimum).

If a set of constraints is given in the form

$$\varphi(\beta) = (\varphi_1(\beta), \dots, \varphi_n(\beta))' = 0,$$

that is, $\varphi(\beta)$ is an $(n \times 1)$ vector, then a local optimum, subject to these constraints, is obtained at a stationary point of the *Lagrange function*

$$\mathcal{L}(\beta, \lambda) = f(\beta) - \lambda' \varphi(\beta),$$

where λ is an $(n \times 1)$ vector of *Lagrange multipliers*. In other words, a necessary condition for a constrained local optimum is that

$$\frac{\partial \mathcal{L}}{\partial \beta} = 0 \quad \text{and} \quad \frac{\partial \mathcal{L}}{\partial \lambda} = 0$$

hold simultaneously.

The following results are useful in some optimization problems.

Proposition A.4 (*Maximum of $\text{tr}(B'\Omega B)$*)

Let Ω be a positive semidefinite symmetric $(K \times K)$ matrix with eigenvalues $\lambda_1 \geq \lambda_2 \geq \dots \geq \lambda_K$ and corresponding orthonormal $(K \times 1)$ eigenvectors v_1, v_2, \dots, v_K . Moreover, let B be a $(K \times r)$ matrix with $B'B = I_r$. Then the maximum of $\text{tr}(B'\Omega B)$ with respect to B is obtained for

$$B = \widehat{B} = [v_1, \dots, v_r]$$

and

$$\max_B \text{tr}(B'\Omega B) = \lambda_1 + \dots + \lambda_r.$$

■

Proof: The proposition follows from Theorem 6, p. 205, of Magnus & Neudecker (1988) by induction. For $r = 1$, our result is just a special case of that theorem. For $r > 1$, assuming that the proposition holds for $r - 1$ and denoting the columns of B by b_1, \dots, b_r ,

$$\begin{aligned} \text{tr}(B'\Omega B) &= \text{tr} \begin{bmatrix} b'_1 \\ \vdots \\ b'_r \end{bmatrix} \Omega [b_1, \dots, b_r] = \text{tr} \begin{bmatrix} b'_1 \Omega b_1 & & * \\ & \ddots & \\ * & & b'_r \Omega b_r \end{bmatrix} \\ &= b'_1 \Omega b_1 + \dots + b'_{r-1} \Omega b_{r-1} + b'_r \Omega b_r \\ &= \lambda_1 + \dots + \lambda_{r-1} + b'_r \Omega b_r \end{aligned}$$

and $\max b'_r \Omega b_r = v' \Omega v_r = \lambda_r$, under the conditions of the proposition, by the aforementioned theorem from Magnus & Neudecker (1988). ■

The next proposition may be regarded as a corollary of Proposition A.4.

Proposition A.5 (*Minimum of $\text{tr}(Y - BCX)' \Sigma_u^{-1} (Y - BCX)$*)

Let Y, X, Σ_u, B , and C be matrices of dimensions $(K \times T), (Kp \times T), (K \times K), (K \times r)$, and $(r \times Kp)$, respectively, with Σ_u positive definite, $\text{rk}(B) = \text{rk}(C) = r$, $\text{rk}(X) = Kp$, and $\text{rk}(Y) = K$. Then a minimum of

$$\text{tr}[(Y - BCX)' \Sigma_u^{-1} (Y - BCX)] \tag{A.14.1}$$

with respect to B and C is obtained for

$$B = \widehat{B} = \Sigma_u^{1/2} \widehat{V} \quad \text{and} \quad C = \widehat{C} = \widehat{V}' \Sigma_u^{-1/2} Y X' (X X')^{-1}, \tag{A.14.2}$$

where $\widehat{V} = [\widehat{v}_1, \dots, \widehat{v}_r]$ is the $(K \times r)$ matrix of the orthonormal eigenvectors corresponding to the r largest eigenvalues of

$$\frac{1}{T} \Sigma_u^{-1/2} Y X' (X X')^{-1} X Y' \Sigma_u^{-1/2}$$

in nonincreasing order. ■

Proof: We first assume $\Sigma_u = I_K$.

$$\begin{aligned} & \text{tr}[(Y - BCX)'(Y - BCX)] \\ &= \text{tr}[(Y - BCX)(Y - BCX)'] \\ &= [\text{vec}(Y) - \text{vec}(BCX)]'[\text{vec}(Y) - \text{vec}(BCX)] \\ &= [\text{vec}(Y) - (X' \otimes B)\text{vec}(C)]' [\text{vec}(Y) - (X' \otimes B)\text{vec}(C)]. \end{aligned} \tag{A.14.3}$$

A derivation similar to that in Section 3.2.1 shows that this sum of squares is minimized with respect to $\text{vec}(C)$ when this vector is chosen to be

$$\begin{aligned} \text{vec}(\widehat{C}) &= [(X \otimes B')(X' \otimes B)]^{-1} (X \otimes B')\text{vec}(Y) \\ &= (XX' \otimes B'B)^{-1} \text{vec}(B'YX') \\ &= \text{vec}[(B'B)^{-1}B'YX'(XX')^{-1}]. \end{aligned}$$

Because we may normalize the columns of B , we choose $B'B = I_r$ without loss of generality. Hence,

$$\widehat{C} = B'YX'(XX')^{-1}. \tag{A.14.4}$$

Substituting for C in (A.14.3) gives

$$\begin{aligned} & \text{tr}[(Y - BB'YX'(XX')^{-1}X)(Y - BB'YX'(XX')^{-1}X)'] \\ &= \text{tr}(YY') - \text{tr}(BB'YX'(XX')^{-1}XY') - \text{tr}(YX'(XX')^{-1}XY'BB') \\ &\quad + \text{tr}(BB'YX'(XX')^{-1}XX'(XX')^{-1}XY'BB') \\ &= \text{tr}(YY') - \text{tr}(B'YX'(XX')^{-1}XY'B), \end{aligned}$$

where again $B'B = I_r$ has been used. This expression is minimized with respect to B , where

$$\frac{1}{T} \text{tr} B'YX'(XX')^{-1}XY'B$$

assumes its maximum. By Proposition A.4, the maximum is attained if B consists of the eigenvectors corresponding to the r largest eigenvalues of

$$\frac{1}{T} YX'(XX')^{-1}XY'$$

which proves the proposition for $\Sigma_u = I_K$.

If $\Sigma_u \neq I_K$,

$$\text{tr}[(Y - BCX)' \Sigma_u^{-1} (Y - BCX)] = \text{tr}[(Y^\# - B^\#CX)'(Y^\# - B^\#CX)]$$

has to be minimized with respect to $B^\#$ and C . Here $Y^\# = \Sigma_u^{-1/2}Y$ and $B^\# = \Sigma_u^{-1/2}B$. From the above derivation the solution is $\widehat{B}^\# = \widehat{V}$ and

$$\widehat{C} = \widehat{B}^{\#'} Y^\# X'(XX')^{-1} = \widehat{V}' \Sigma_u^{-1/2} Y X'(XX')^{-1},$$

where the columns of \widehat{V} are the eigenvectors corresponding to the r largest eigenvalues of

$$\frac{1}{T} Y^\# X' (X X')^{-1} X Y^\#{}' = \frac{1}{T} \Sigma_u^{-1/2} Y X' (X X')^{-1} X Y' \Sigma_u^{-1/2}.$$

Hence, $\widehat{B} = \Sigma_u^{1/2} \widehat{B}^\# = \Sigma_u^{1/2} \widehat{V}$. ■

A result similar to that in Proposition A.4 also holds for the maximum and minimum of a determinant. The following proposition is a slight modification of Theorem 15 of Magnus & Neudecker (1988, Chapter 11).

Proposition A.6 (*Maximum and Minimum of $|C\Omega C'|$*)

Let Ω be a positive definite symmetric ($K \times K$) matrix with eigenvalues $\lambda_1 \geq \lambda_2 \geq \dots \geq \lambda_K$ and corresponding orthonormal ($K \times 1$) eigenvectors v_1, \dots, v_K . Furthermore, let C be an ($r \times K$) matrix with $CC' = I_r$. Then

$$\max_C |C\Omega C'| = \lambda_1 \cdots \lambda_r$$

and the maximum is attained for

$$C = \widehat{C} = [v_1, \dots, v_r]'.$$

Moreover,

$$\min_C |C\Omega C'| = \lambda_K \lambda_{K-1} \cdots \lambda_{K-r+1}$$

and the minimum is attained for

$$C = \widehat{C} = [v_K, \dots, v_{K-r+1}]'.$$

■

An important implication of this proposition is used in Chapter 7 and is stated next.

Proposition A.7 (*Minimum of $|T^{-1}(Y - BCX)(Y - BCX)'|$*)

Let Y and X be ($K \times T$) matrices of rank K and let B and C be of rank r and dimensions ($K \times r$) and ($r \times K$), respectively. Furthermore, let $\lambda_1 \geq \dots \geq \lambda_K$ be the eigenvalues of

$$(X X')^{-1/2} X Y' (Y Y') Y X' (X X')^{-1/2}$$

and the corresponding orthonormal eigenvectors are v_1, \dots, v_K . Here

$$(X X')^{-1/2}$$

is some matrix satisfying

$$(X X')^{-1/2} (X X') (X X')^{-1/2} = I_K.$$

Then

$$\min_{B,C} |T^{-1}(Y - BCX)(Y - BCX)'| = |T^{-1}YY'| (1 - \lambda_1) \cdots (1 - \lambda_r)$$

and the minimum is attained for

$$C = \widehat{C} = [v_1, \dots, v_r]'(XX')^{-1/2}$$

and

$$B = \widehat{B} = YX'\widehat{C}'(\widehat{C}XX'\widehat{C}')^{-1}.$$

■

A proof of this proposition can be found in Tso (1981). It should be noted that the minimizing matrices \widehat{B} and \widehat{C} are not unique. Any nonsingular $(r \times r)$ matrix F leads to another set of minimizing matrices $F\widehat{C}, \widehat{B}F^{-1}$.

A.15 Problems

The following problems refer to the matrices

$$A = \begin{bmatrix} 5 & 2 \\ -1 & 1 \end{bmatrix}, \quad B = \begin{bmatrix} 6 & 0 & 0 \\ -6 & 1 & 0 \end{bmatrix}, \quad C = \begin{bmatrix} 1 & 4 & 0 \\ 2 & 2 & 2 \\ 1 & 2 & 0 \end{bmatrix},$$

$$D = \begin{bmatrix} 5 & 2 \\ 2 & 1 \end{bmatrix}, \quad H(\beta) = \begin{bmatrix} 4\beta_1 & 2\beta_1 + \beta_2 \\ 1 + \beta_2 & 3 \end{bmatrix}.$$

Problem A.1

Determine $A + D, A - 2D, A', AB, BC, B'A, B'A', A \otimes D, B \otimes D, D \otimes B, B' \otimes D', B + BC, \text{tr } A, \text{tr } D, \det A, |D|, |C|, \text{vec}(B), \text{vec}(B'), \text{vech}(C), \mathbf{K}_{33}, A^{-1}, D^{-1}, (A \otimes D)^{-1}, \text{rk}(C), \text{rk}(B), \det(A \otimes D), \text{tr}(A \otimes D), C^{-1}$ (use the rules for the partitioned inverse).

Problem A.2

Determine the eigenvalues of $A, D,$ and $A \otimes D$.

Problem A.3

Find an upper triangular matrix Q such that $D = QQ'$ and find an orthogonal matrix P such that $D = PAP'$, where Λ is a diagonal matrix with the eigenvalues of D on the main diagonal. Compute D^5 .

Problem A.4

Is $F = I_2 - BB'$ idempotent? Is BB' positive definite?

Problem A.5

Determine the following derivatives.

$$\frac{\partial \det(H)}{\partial \beta}, \quad \frac{\partial^2 \det(H)}{\partial \beta \partial \beta'}, \quad \frac{\partial \operatorname{tr}(H)}{\partial \beta},$$

$$\frac{\partial \operatorname{vec}(H)}{\partial \beta'}, \quad \frac{\partial \operatorname{vec}(H^2)}{\partial \beta'}, \quad \frac{\partial H(\beta)\beta}{\partial \beta'},$$

where $\beta = (\beta_1, \beta_2)'$.

Problem A.6

Determine the stationary points of $|H|$ with respect to β . Are they local extrema?

Problem A.7

Give a second order Taylor expansion of $\det(H)$ around $\beta = (0, 0)'$.

B

Multivariate Normal and Related Distributions

B.1 Multivariate Normal Distributions

A K -dimensional vector of continuous random variables $y = (y_1, \dots, y_K)'$ has a *multivariate normal distribution* with mean vector $\mu = (\mu_1, \dots, \mu_K)'$ and covariance matrix Σ , briefly

$$y \sim \mathcal{N}(\mu, \Sigma),$$

if its distribution has the probability density function (p.d.f.)

$$f(y) = \frac{1}{(2\pi)^{K/2}} |\Sigma|^{-1/2} \exp \left[-\frac{1}{2} (y - \mu)' \Sigma^{-1} (y - \mu) \right]. \quad (\text{B.1.1})$$

Alternatively, $y \sim \mathcal{N}(\mu, \Sigma)$, if for any K -vector c for which $c' \Sigma c \neq 0$ the linear combination $c'y$ has a univariate normal distribution, that is, $c'y \sim \mathcal{N}(c'\mu, c'\Sigma c)$ (see Rao (1973, Chapter 8)). This definition of a multivariate normal distribution is useful because it carries over to the case where Σ is positive semidefinite and singular, while the multivariate density in (B.1.1) is only meaningful, if Σ is positive definite and, hence, nonsingular. It must be emphasized, however, that the two definitions are equivalent, if Σ is positive definite rather than just positive semidefinite. Another possibility to define a multivariate normal distribution with singular covariance matrix may be found in Anderson (1984).

The following results regarding the multivariate normal and related distributions are useful. Many of them are stated in Judge et al. (1985, Appendix A). Proofs can be found in Rao (1973, Chapter 8) and Hogg & Craig (1978, Chapter 12).

Proposition B.1 (*Marginal and Conditional Distributions of a Multivariate Normal*)

Let y_1 and y_2 be two random vectors such that

$$\begin{bmatrix} y_1 \\ y_2 \end{bmatrix} \sim \mathcal{N}\left(\begin{bmatrix} \mu_1 \\ \mu_2 \end{bmatrix}, \begin{bmatrix} \Sigma_{11} & \Sigma_{12} \\ \Sigma_{21} & \Sigma_{22} \end{bmatrix}\right),$$

where the partitioning of the mean vector and covariance matrix corresponds to that of the vector $(y'_1, y'_2)'$. Then,

$$y_1 \sim \mathcal{N}(\mu_1, \Sigma_{11})$$

and the conditional distribution of y_1 given $y_2 = c$ is also multivariate normal,

$$(y_1|y_2 = c) \sim \mathcal{N}(\mu_1 + \Sigma_{12}\Sigma_{22}^{-1}(c - \mu_2), \Sigma_{11} - \Sigma_{12}\Sigma_{22}^{-1}\Sigma_{21}).$$

If Σ_{22} is singular, the inverse can be replaced by a generalized inverse. Moreover, y_1 and y_2 are independent if and only if $\Sigma_{12} = \Sigma'_{21} = 0$. ■

Proposition B.2 (*Linear Transformation of a Multivariate Normal Random Vector*)

Suppose $y \sim \mathcal{N}(\mu, \Sigma)$ is $(K \times 1)$, A is an $(M \times K)$ matrix and c an $(M \times 1)$ vector. Then

$$x = Ay + c \sim \mathcal{N}(A\mu + c, A\Sigma A').$$

■

B.2 Related Distributions

Suppose $y \sim \mathcal{N}(0, I_K)$. The distribution of $z = y'y$ is a (central) *chi-square distribution* with K degrees of freedom,

$$z \sim \chi^2(K).$$

Proposition B.3 (*Distributions of Quadratic Forms*)

- (1) Suppose $y \sim \mathcal{N}(0, I_K)$ and A is a symmetric idempotent $(K \times K)$ matrix with $\text{rk}(A) = n$. Then $y'Ay \sim \chi^2(n)$.
- (2) If $y \sim \mathcal{N}(0, \Sigma)$, where Σ is a positive definite $(K \times K)$ matrix, then $y'\Sigma^{-1}y \sim \chi^2(K)$.
- (3) Let $y \sim \mathcal{N}(0, QA)$, where Q is a symmetric idempotent $(K \times K)$ matrix with $\text{rk}(Q) = n$ and A is a positive definite $(K \times K)$ matrix. Then $y'A^{-1}y \sim \chi^2(n)$.
- (4) Suppose $y \sim \mathcal{N}(0, \Sigma)$, where Σ is a nonsingular $(K \times K)$ covariance matrix. Furthermore, let A be a $(K \times K)$ matrix with $\text{rk}(A) = n$. Then

$$y'Ay \sim \chi^2(n) \quad \Rightarrow \quad A\Sigma A = A$$

and

$$A\Sigma A = A \quad \Rightarrow \quad y'Ay \sim \chi^2(n).$$

■

Proposition B.4 (*Independence of a Normal Vector and a Quadratic Form*)
 Suppose $y \sim \mathcal{N}(\mu, \sigma^2 I_K)$, A is a symmetric, idempotent ($K \times K$) matrix, B is an ($M \times K$) matrix and $BA = 0$. Then By is stochastically independent of the random variable $y' Ay$. ■

Proposition B.5 (*Independence of Quadratic Forms*)
 Suppose $y \sim \mathcal{N}(\mu, \sigma^2 I_K)$ and A and B are symmetric, idempotent ($K \times K$) matrices with $AB = 0$, then $y' Ay$ and $y' By$ are stochastically independent. ■

If $z \sim \mathcal{N}(0, 1)$ and $u \sim \chi^2(m)$ are stochastically independent, then

$$T = \frac{z}{\sqrt{u/m}}$$

has a *t-distribution* with m degrees of freedom, $T \sim t(m)$. If $u \sim \chi^2(m)$ and $v \sim \chi^2(n)$ are independent, then

$$\frac{u/m}{v/n} \sim F(m, n),$$

that is, the ratio of two independent χ^2 random variables, each divided by its degrees of freedom, has an *F-distribution* with m and n degrees of freedom. The numbers m and n indicate the numerator and denominator degrees of freedom, respectively.

Proposition B.6 (*Distributions of Ratios of Quadratic Forms*)

(1) Suppose $x \sim \mathcal{N}(0, I_m)$ and $y \sim \mathcal{N}(0, I_n)$ are independent. Then

$$\frac{x'x/m}{y'y/n} \sim F(m, n).$$

(2) If $y \sim \mathcal{N}(0, I_K)$ and A and B are symmetric, idempotent ($K \times K$) matrices with $\text{rk}(A) = m$, $\text{rk}(B) = n$ and $AB = 0$, then

$$\frac{y' Ay/m}{y' By/n} \sim F(m, n).$$

(3) $z \sim F(m, n) \Rightarrow \frac{1}{z} \sim F(n, m)$. ■

If $y \sim \mathcal{N}(\mu, I_K)$, then $y'y$ has a *noncentral χ^2 -distribution* with K degrees of freedom and *noncentrality parameter* (or simply *noncentrality*) $\tau = \mu' \mu$. Briefly,

$$y'y \sim \chi^2(K; \tau).$$

The noncentrality parameter is sometimes defined differently in the literature. For instance, $\lambda = \frac{1}{2}\mu'\mu$ is sometimes called noncentrality parameter. Let $w \sim \chi^2(m; \tau)$ and $v \sim \chi^2(n)$ be independent random variables, then

$$\frac{w/m}{v/n} \sim F(m, n; \tau),$$

that is, the ratio has a *noncentral F-distribution* with m and n degrees of freedom and noncentrality parameter τ .

Proposition B.7 (*Quadratic Form with Noncentral χ^2 -Distribution*)

If $y \sim \mathcal{N}(\mu, \Sigma)$ with positive definite ($K \times K$) covariance matrix Σ , then $y'\Sigma^{-1}y \sim \chi^2(K; \mu'\Sigma^{-1}\mu)$. ■

C

Stochastic Convergence and Asymptotic Distributions

It is often difficult to derive the exact distributions of estimators and test statistics. In that case, their asymptotic or limiting properties, when the sample size gets large, are of interest. The limiting properties are then regarded as approximations to the properties for the sample size available. In order to study the limiting properties, some concepts of convergence of sequences of random variables and vectors are useful. They are discussed in Sections C.1 and C.2. Infinite sums of random variables are treated in Section C.3. Laws of large numbers and central limit theorems are given in Section C.4. Asymptotic properties of estimators are considered in Section C.5. Maximum likelihood estimators and their asymptotic properties are discussed in Section C.6 and some common testing principles are treated in Section C.7. Finally, asymptotic properties of nonstationary processes with unit roots are dealt with in Section C.8.

This appendix contains a brief summary of results used in the text. Many of these results can be found in Judge et al. (1985, Section 5.8). A more complete discussion and proofs are provided in Fuller (1976), Roussas (1973), Serfling (1980), Davidson (1994, 2000) and other more advanced books on statistics. Further references will be given in the following.

C.1 Concepts of Stochastic Convergence

Let x_1, x_2, \dots or $\{x_T\}$, $T = 1, 2, \dots$, be a sequence of scalar random variables which are all defined on a common probability space $(\Omega, \mathcal{F}, \Pr)$. The sequence $\{x_T\}$ *converges in probability* to the random variable x (which is also defined on $(\Omega, \mathcal{F}, \Pr)$) if for every $\epsilon > 0$,

$$\lim_{T \rightarrow \infty} \Pr(|x_T - x| > \epsilon) = 0$$

or, equivalently,

$$\lim_{T \rightarrow \infty} \Pr(|x_T - x| < \epsilon) = 1.$$

This type of stochastic convergence is abbreviated as

$$\text{plim } x_T = x \quad \text{or} \quad x_T \xrightarrow{p} x.$$

The limit x may be a fixed, nonstochastic real number which is then regarded as a degenerate random variable that takes on one particular value with probability one.

The sequence $\{x_T\}$ *converges almost surely* (a.s.) or *with probability one* to the random variable x if for every $\epsilon > 0$,

$$\Pr \left(\lim_{T \rightarrow \infty} |x_T - x| < \epsilon \right) = 1.$$

This type of stochastic convergence is often written as $x_T \xrightarrow{a.s.} x$ and is sometimes called *strong convergence*.

The sequence $\{x_T\}$ *converges in quadratic mean* or *mean square error* to x , briefly $x_T \xrightarrow{q.m.} x$, if

$$\lim_{T \rightarrow \infty} E(x_T - x)^2 = 0.$$

This type of convergence requires that the mean and variance of the x_T 's and x exist.

Finally, denoting the distribution functions of x_T and x by F_T and F , respectively, the sequence $\{x_T\}$ is said to *converge in distribution* or *weakly* or *in law* to x , if for all real numbers c for which F is continuous,

$$\lim_{T \rightarrow \infty} F_T(c) = F(c).$$

This type of convergence is abbreviated as $x_T \xrightarrow{d} x$. It must be emphasized that we do not require the convergence of the sequence of p.d.f.s of the x_T 's to the p.d.f. of x . In fact, we do not even require that the distributions of the x_T 's have p.d.f.s. Even if they do have p.d.f.s, convergence in distribution does not imply their convergence to the p.d.f. of x .

All these concepts of stochastic convergence can be extended to sequences of random vectors (multivariate random variables). Suppose $\{x_T = (x_{1T}, \dots, x_{KT})'\}$, $T = 1, 2, \dots$, is a sequence of K -dimensional random vectors and $x = (x_1, \dots, x_K)'$ is a K -dimensional random vector. Then the following definitions are used:

$$\text{plim } x_T = x \quad \text{or} \quad x_T \xrightarrow{p} x \quad \text{if} \quad \text{plim } x_{kT} = x_k \quad \text{for } k = 1, \dots, K.$$

$$x_T \xrightarrow{a.s.} x \quad \text{if} \quad x_{kT} \xrightarrow{a.s.} x_k \quad \text{for } k = 1, \dots, K.$$

$$x_T \xrightarrow{q.m.} x \quad \text{if} \quad \lim E[(x_T - x)'(x_T - x)] = 0.$$

$$x_T \xrightarrow{d} x \quad \text{if} \quad \lim F_T(c) = F(c) \quad \text{for all continuity points of } F.$$

Here F_T and F are the joint distribution functions of x_T and x , respectively. Almost sure convergence and convergence in probability can be defined for matrices in the same way in terms of convergence of the individual elements. Convergence in quadratic mean and in distribution is easily extended to sequences of random matrices by vectorizing them. In the following proposition, the relationships between the different modes of convergence are given.

Proposition C.1 (*Convergence Properties of Sequences of Random Variables*)

Suppose $\{x_T\}$ is a sequence of K -dimensional random variables. Then the following relations hold:

- (1) $x_T \xrightarrow{a.s.} x \Rightarrow x_T \xrightarrow{p} x \Rightarrow x_T \xrightarrow{d} x$.
- (2) $x_T \xrightarrow{q.m.} x \Rightarrow x_T \xrightarrow{p} x \Rightarrow x_T \xrightarrow{d} x$.
- (3) If x is a fixed, nonstochastic vector, then

$$x_T \xrightarrow{q.m.} x \Leftrightarrow [\lim E(x_T) = x \text{ and } \lim E\{(x_T - Ex_T)'(x_T - Ex_T)\} = 0].$$

- (4) If x is a fixed, nonstochastic random vector, then

$$x_T \xrightarrow{p} x \Leftrightarrow x_T \xrightarrow{d} x.$$

- (5) (Slutsky's Theorem) If $g : \mathbb{R}^K \rightarrow \mathbb{R}^m$ is a continuous function, then

$$x_T \xrightarrow{p} x \Rightarrow g(x_T) \xrightarrow{p} g(x) \quad [\text{plim } g(x_T) = g(\text{plim } x_T)],$$

$$x_T \xrightarrow{d} x \Rightarrow g(x_T) \xrightarrow{d} g(x),$$

and

$$x_T \xrightarrow{a.s.} x \Rightarrow g(x_T) \xrightarrow{a.s.} g(x).$$



Proposition C.2 (*Properties of Convergence in Probability and in Distribution*)

Suppose $\{x_T\}$ and $\{y_T\}$ are sequences of $(K \times 1)$ random vectors, $\{A_T\}$ is a sequence of $(K \times K)$ random matrices, x is a $(K \times 1)$ random vector, c is a fixed $(K \times 1)$ vector, and A is a fixed $(K \times K)$ matrix.

- (1) If $\text{plim } x_T$, $\text{plim } y_T$, and $\text{plim } A_T$ exist, then
 - (a) $\text{plim } (x_T \pm y_T) = \text{plim } x_T \pm \text{plim } y_T$;
 - (b) $\text{plim } (c'x_T) = c'(\text{plim } x_T)$;
 - (c) $\text{plim } x_T'y_T = (\text{plim } x_T)'(\text{plim } y_T)$;
 - (d) $\text{plim } A_Tx_T = \text{plim } (A_T)\text{plim } (x_T)$.
- (2) If $x_T \xrightarrow{d} x$ and $\text{plim } (x_T - y_T) = 0$, then $y_T \xrightarrow{d} x$.
- (3) If $x_T \xrightarrow{d} x$ and $\text{plim } y_T = c$, then

- (a) $x_T \pm y_T \xrightarrow{d} x \pm c$;
 (b) $y'_T x_T \xrightarrow{d} c'x$.
 (4) If $x_T \xrightarrow{d} x$ and $\text{plim } A_T = A$, then $A_T x_T \xrightarrow{d} Ax$.
 (5) If $x_T \xrightarrow{d} x$ and $\text{plim } A_T = 0$, then $\text{plim } A_T x_T = 0$.

■

Proposition C.3 (*Limits of Sequences of t and F Random Variables*)

- (1) $t(T) \xrightarrow{d}_{T \rightarrow \infty} \mathcal{N}(0, 1)$
 (that is, a sequence of random variables with t -distributions with T degrees of freedom converges to a standard normal distribution as the degrees of freedom go to infinity).
 (2) $JF(J, T) \xrightarrow{d}_{T \rightarrow \infty} \chi^2(J)$.

■

C.2 Order in Probability

Let $\{a_T\}$ be a sequence of real numbers and $\{b_T\}$ a sequence of positive real numbers. Then a_T is said to be *of smaller order than* b_T ($a_T = o(b_T)$) if $\lim_{T \rightarrow \infty} a_T/b_T = 0$ and a_T is said to be *at most of order* b_T ($a_T = O(b_T)$) if there exists a number c such that for all T , $|a_T|/b_T \leq c$.

Proposition C.4 (*Order of Convergence Results*)

For sequences of real numbers $\{a_T\}$, $\{b_T\}$ and sequences of positive real numbers $\{c_T\}$, $\{d_T\}$, the following results hold:

- (1) $a_T = o(c_T), b_T = o(d_T) \Rightarrow a_T b_T = o(c_T d_T), a_T + b_T = o(\max[c_T, d_T])$
 and $|a_T|^s = o(c_T^s)$ for $s > 0$.
 (2) $a_T = O(c_T), b_T = O(d_T) \Rightarrow a_T b_T = O(c_T d_T), a_T + b_T = O(\max[c_T, d_T])$
 and $|a_T|^s = O(c_T^s)$ for $s > 0$.
 (3) $a_T = o(c_T), b_T = O(d_T) \Rightarrow a_T b_T = o(c_T d_T)$.

■

Let $\{A_T = (a_{ij,T})\}$ be a sequence of random $(m \times n)$ matrices and $\{b_T\}$ a sequence of positive real numbers. Then A_T is said to be *of smaller order in probability than* b_T ($A_T = o_p(b_T)$) if $\text{plim}_{T \rightarrow \infty} A_T/b_T = 0$ and A_T is said to be *at most of order in probability* b_T or *bounded in probability by* b_T ($A_T = O_p(b_T)$) if, for every $\epsilon > 0$, there exists a number c_ϵ such that for all T , $\Pr\{|a_{ij,T}| \geq c_\epsilon b_T\} \leq \epsilon$ for $i = 1, \dots, m, j = 1, \dots, n$. The following results hold for sequences of random matrices.

Proposition C.5 (*Order in Probability Results*)

For sequences of random matrices of suitable fixed dimensions $\{A_T\}$, $\{B_T\}$ and sequences of positive real numbers $\{c_T\}$, $\{d_T\}$ the following results hold:

- (1) $A_T = o_p(c_T), B_T = o_p(d_T) \Rightarrow A_T B_T = o_p(c_T d_T)$ and $A_T + B_T = o_p(\max[c_T, d_T])$.
- (2) $A_T = O_p(c_T), B_T = O_p(d_T) \Rightarrow A_T B_T = O_p(c_T d_T)$ and $A_T + B_T = O_p(\max[c_T, d_T])$.
- (3) $A_T = o_p(c_T), B_T = O_p(d_T) \Rightarrow A_T B_T = o_p(c_T d_T)$.

■

For the next result see, e.g., Fuller (1976, p. 192).

Proposition C.6 (*Taylor’s Theorem for Functions of Random Vectors*)

Let $y_T = (y_{1T}, \dots, y_{KT})' = a + O_p(r_T)$ be a K -dimensional random vector sequence, where $r_T = o(1)$, and let $g : \mathbb{R}^K \rightarrow \mathbb{R}$ be a function with continuous partial derivatives of order two at $a = (a_1, \dots, a_K)'$. Then

$$g(y_T) = g(a) + \frac{\partial g(a)}{\partial y'}(y_T - a) + O_p(r_T^2).$$

If g has continuous partial derivatives of order three,

$$g(y_T) = g(a) + \frac{\partial g(a)}{\partial y'}(y_T - a) + \frac{1}{2}(y_T - a)' \frac{\partial^2 g(a)}{\partial y \partial y'}(y_T - a) + O_p(r_T^3).$$

■

C.3 Infinite Sums of Random Variables

The MA representation of a VAR process is often an infinite sum of random vectors. As in the study of infinite sums of real numbers, we must specify what we mean by such an infinite sum. The concept of absolute convergence is basic in the following. A doubly infinite sequence of real numbers $\{a_i\}$, $i = 0, \pm 1, \pm 2, \dots$, is *absolutely summable* if

$$\lim_{n \rightarrow \infty} \sum_{i=-n}^n |a_i|$$

exists and is finite. The limit is usually denoted by

$$\sum_{i=-\infty}^{\infty} |a_i|.$$

The following theorem provides a justification for working with infinite sums of random variables. A proof may be found in Fuller (1976, pp. 29-31).

Proposition C.7 (*Existence of Infinite Sums of Random Variables*)

Suppose $\{a_i\}$ is an absolutely summable sequence of real numbers and $\{z_t\}$, $t = 0, \pm 1, \pm 2, \dots$, is a sequence of random variables satisfying

$$E(z_t^2) \leq c, \quad t = 0, \pm 1, \pm 2, \dots,$$

for some finite constant c . Then there exists a sequence of random variables $\{y_t\}$, $t = 0, \pm 1, \pm 2, \dots$, such that

$$\sum_{i=-n}^n a_i z_{t-i} \xrightarrow[n \rightarrow \infty]{q.m.} y_t$$

and, thus,

$$\text{plim}_{n \rightarrow \infty} \sum_{i=-n}^n a_i z_{t-i} = y_t.$$

The random variables y_t are uniquely determined except on a set of probability zero. If, in addition, the z_t are independent random variables, then

$$\sum_{i=-n}^n a_i z_{t-i} \xrightarrow{a.s.} y_t.$$

■

This theorem makes precise what we mean by a (univariate) infinite MA

$$y_t = \sum_{i=0}^{\infty} \Phi_i u_{t-i},$$

where u_t is univariate zero mean white noise with variance $\sigma_u^2 < \infty$. Defining $a_i = 0$ for $i < 0$ and $a_i = \Phi_i$ for $i \geq 0$ and assuming that $\{a_i\}$ is absolutely summable, the proposition guarantees that the process y_t is uniquely defined as a limit in mean square, except on a set of probability zero. The latter qualification may be ignored for practical purposes because we may always change a random variable on a set of probability zero without changing its probability characteristics. The requirement for the MA coefficients to be absolutely summable is satisfied if y_t is a stable AR process. For instance, if $y_t = \alpha y_{t-1} + u_t$ is an AR(1) process, $\Phi_i = \alpha^i$ which is an absolutely summable sequence for $|\alpha| < 1$. With respect to the moments of an infinite sum of random variables the following result holds:

Proposition C.8 (*Moments of Infinite Sums of Random Variables*)

Suppose z_t satisfies the conditions of Proposition C.7, $\{a_i\}$ and $\{b_i\}$ are absolutely summable sequences of real numbers,

$$y_t = \sum_{i=-\infty}^{\infty} a_i z_{t-i}, \quad \text{and} \quad x_t = \sum_{i=-\infty}^{\infty} b_i z_{t-i}.$$

Then

$$E(y_t) = \lim_{n \rightarrow \infty} \sum_{i=-n}^n a_i E(z_{t-i})$$

and

$$E(y_t x_t) = \lim_{n \rightarrow \infty} \sum_{i=-n}^n \sum_{j=-n}^n a_i b_j E(z_{t-i} z_{t-j})$$

and, in particular,

$$E(y_t^2) = \lim_{n \rightarrow \infty} \sum_{i=-n}^n \sum_{j=-n}^n a_i a_j E(z_{t-i} z_{t-j}).$$

■
■

Proof: Fuller (1976, pp. 32-33).

All these concepts and results may be extended to vector processes. A sequence of $(K \times K)$ matrices $\{A_i = (a_{mn,i})\}$, $i = 0, \pm 1, \pm 2, \dots$, is *absolutely summable* if each sequence $\{a_{mn,i}\}$, $m, n = 1, \dots, K$; $i = 0, \pm 1, \pm 2, \dots$, is absolutely summable. Equivalently, $\{A_i\}$ may be defined to be absolutely summable if the sequence $\{\|A_i\|\}$ is summable, where

$$\|A_i\| = [\text{tr}(A_i A_i')]^{1/2} = \left(\sum_m \sum_n a_{mn,i}^2 \right)^{1/2}$$

is the Euclidean norm of A_i . To see the equivalence of the two definitions, note that

$$|a_{mn,i}| \leq \|A_i\| \leq \sum_m \sum_n |a_{mn,i}|.$$

Hence,

$$\sum_{i=-\infty}^{\infty} |a_{mn,i}| \tag{C.3.1}$$

exists and is finite if

$$\sum_{i=-\infty}^{\infty} \|A_i\| \tag{C.3.2}$$

is finite. In turn, if (C.3.1) is finite for all m, n , then, for all h ,

$$\sum_{i=-h}^h \|A_i\| \leq \sum_{i=-h}^h \sum_m \sum_n |a_{mn,i}|$$

so that (C.3.2) is finite. Thus, the two definitions are indeed equivalent.

Proposition C.9 (*Existence of Infinite Sums of Random Vectors*)

Suppose $\{A_i\}$ is an absolutely summable sequence of real ($K \times K$) matrices and $\{z_t\}$ is a sequence of K -dimensional random variables satisfying

$$E(z'_t z_t) \leq c, \quad t = 0, \pm 1, \pm 2, \dots,$$

for some finite constant c . Then there exists a sequence of K -dimensional random variables $\{y_t\}$ such that

$$\sum_{i=-n}^n A_i z_{t-i} \xrightarrow[n \rightarrow \infty]{q.m.} y_t.$$

The sequence is uniquely determined except on a set of probability zero. ■

Proof: Analogous to Fuller (1976, pp. 29-31); replace the absolute value by $\|\cdot\|$. ■

This proposition ensures that the infinite MA representations of the VAR processes considered in this text are well-defined because it can be shown that the MA coefficient matrices of a stable VAR process form an absolutely summable sequence. With respect to moments of infinite sums, we have the following result.

Proposition C.10 (*Moments of Infinite Sums of Random Vectors*)

Suppose z_t satisfies the conditions of Proposition C.9, $\{A_i\}$ and $\{B_i\}$ are absolutely summable sequences of ($K \times K$) matrices,

$$y_t = \sum_{i=-\infty}^{\infty} A_i z_{t-i} \quad \text{and} \quad x_t = \sum_{i=-\infty}^{\infty} B_i z_{t-i}.$$

Then

$$E(y_t) = \lim_{n \rightarrow \infty} \sum_{i=-n}^n A_i E(z_{t-i})$$

and

$$E(y_t x'_t) = \lim_{n \rightarrow \infty} \sum_{i=-n}^n \sum_{j=-n}^n A_i E(z_{t-i} z'_{t-j}) B'_j,$$

where the limit of the sequence of matrices is the matrix of limits of the sequences of individual elements. ■

Proof: Along similar lines as the proof of Fuller (1976, Theorem 2.2.2, pp. 32-33). ■

While we have restricted the discussion to absolutely summable sequences of coefficients, it may be worth mentioning that infinite sums of random variables and vectors can be defined in more general terms.

C.4 Laws of Large Numbers and Central Limit Theorems

The derivation of asymptotic properties of estimators and test statistics is largely based on *laws of large numbers* (LLNs) and *central limit theorems* (CLTs) some examples of which are listed in the following. So-called *weak LLNs* specify conditions under which a sample mean converges in probability to the population mean and *strong LLNs* state the corresponding results for almost sure convergence.

In stating some of the results, martingale difference processes are useful tools. Suppose $\{x_t\}$ ($t = 1, 2, \dots$) is a sequence of zero mean random variables and let Ω_t be an information set available at time t which includes at least $\{x_1, \dots, x_t\}$ and possibly other random variables. The sequence $\{x_t\}$ is said to be a *martingale difference sequence with respect to the sequence Ω_t* if $E(x_t|\Omega_{t-1}) = 0$ for all $t = 2, 3, \dots$. It is simply referred to as *martingale difference sequence* if $E(x_t) = 0$ for $t = 1, 2, \dots$, and $E(x_t|x_{t-1}, \dots, x_1) = 0$ for $t = 2, 3, \dots$. More generally, a sequence $\{x_t\}$ of K -dimensional vector random variables satisfying $E(x_t) = 0$ for all t and $E(x_t|x_{t-1}, \dots, x_1) = 0$ for $t = 2, 3, \dots$, is a *vector martingale difference sequence*.

It is sometimes useful to allow the x_t 's to depend on the sample size. This way a different sequence for each sample size T is obtained. Denoting by $x_{T,t}$ the t -th element of the T -th sequence, not just a sequence but an *array* of random variables $\{x_{T,t}\}$ ($t = 1, 2, \dots, T; T = 1, 2, \dots$) is obtained. Such an array is called a *martingale difference array* if $E(x_{T,t}) = 0$ for all t and T and $E(x_{T,t}|x_{T,t-1}, \dots, x_{T,1}) = 0$ for all t and $T > 1$. This definition also applies for vector arrays.

The following inequality is a useful device for deriving asymptotic results. It is therefore presented here (see, e.g., Fuller (1976, Theorem 5.1.1)).

Proposition C.11 (*Chebyshev's Inequality*)

Given $r \in \mathbb{N}$, $r > 0$, let x be a random variable such that $E(|x|^r)$ exists. Then, for any $c \in \mathbb{R}$ and $\epsilon > 0$,

$$\Pr\{|x - c| \geq \epsilon\} \leq \frac{E(|x - c|^r)}{\epsilon^r}.$$

■

The next proposition collects some weak LLNs (see, e.g., Davidson (1994, Part IV)).

Proposition C.12 (*Weak Laws of Large Numbers*)

(1) (Khinchine's Theorem) (Rao (1973, p. 112))

Let $\{x_t\}$ be a sequence of i.i.d. random variables with $E(x_t) = \mu < \infty$. Then

$$\bar{x}_T := \frac{1}{T} \sum_{t=1}^T x_t \xrightarrow{P} \mu.$$

(2) Let $\{x_t\}$ be a sequence of independent random variables with $E(x_t) = \mu < \infty$ and $E|x_t|^{1+\epsilon} \leq c < \infty$ ($t = 1, 2, \dots$) for some $\epsilon > 0$ and a finite constant c . Then $\bar{x}_T \xrightarrow{P} \mu$.

(3) (Chebyshev's Theorem) (Rao (1973, p. 112))

Let $\{x_t\}$ be a sequence of uncorrelated random variables with $E(x_t) = \mu < \infty$ and $\lim_{T \rightarrow \infty} E(\bar{x}_T - \mu)^2 = 0$. Then $\bar{x}_T \xrightarrow{P} \mu$.

(4) (Corollary to Chebyshev's Theorem)

Let $\{x_t\}$ be a sequence of independent random variables with $E(x_t) = \mu < \infty$ and $\text{Var}(x_t) \leq c < \infty$ ($t = 1, 2, \dots$) for some finite constant c . Then $\bar{x}_T \xrightarrow{P} \mu$.

(5) (LLN for Martingale Differences)

Let $\{x_t\}$ be a strictly stationary martingale difference sequence with $E|x_t| < \infty$ ($t = 1, 2, \dots$). Then $\bar{x}_T \xrightarrow{P} 0$.

(6) (LLN for Martingale Difference Arrays)

Let $\{x_{T,t}\}$ be a martingale difference array with $E|x_{T,t}|^{1+\epsilon} \leq c < \infty$ for all t and T for some $\epsilon > 0$ and a finite constant c . Then $\bar{x}_T := T^{-1} \sum_{t=1}^T x_{T,t} \xrightarrow{P} 0$.

(7) (Stationary Processes) (Hamilton (1994, Proposition 7.5))

Let $\{x_t\}$ be a stationary stochastic process with $E(x_t) = \mu < \infty$ and $E[(x_t - \mu)(x_{t-j} - \mu)] = \gamma_j$ ($t = 1, 2, \dots$) such that $\sum_{j=0}^{\infty} |\gamma_j| < \infty$. Then $\bar{x}_T \xrightarrow{q.m.} \mu$ and, hence, $\bar{x}_T \xrightarrow{P} \mu$, and $\lim_{T \rightarrow \infty} TE(\bar{x}_T - \mu)^2 = \sum_{j=-\infty}^{\infty} \gamma_j$. ■

Notice that the i.i.d. assumption in Khinchine's theorem may be replaced by the requirement that moments exist of order larger than one. In fact, Chebyshev's theorem even requires the existence of second order moments. It is actually sufficient that the variances of the x_t are bounded. It may be worth noting that heterogenous variances are allowed for the weak LLN to hold, if the variances are bounded. The last result in the proposition shows that uncorrelated elements of the sequence under consideration are not required. Actually, a martingale difference sequence does not necessarily have independent elements so that for most of the above results independence of the sequence elements is not assumed.

Notice, that the proposition generalizes straightforwardly to sequences of random vectors because convergence in probability for a sequence of random vectors is defined in terms of convergence of the sequences of the individual

elements. The following CLTs are stated for vector sequences and, of course, hold for univariate sequences as special cases.

Proposition C.13 (*Central Limit Theorems*)

(1) (Lindeberg-Levy CLT)

Let $\{x_t\}$ be a sequence of K -dimensional i.i.d. random vectors with mean μ and covariance matrix Σ_x . Then

$$\sqrt{T}(\bar{x}_T - \mu) \xrightarrow{d} \mathcal{N}(0, \Sigma_x).$$

(2) (CLT for Martingale Difference Arrays) (see Hamilton (1994, Proposition 7.9))

Let $\{x_{T,t} = (x_{1T,t}, \dots, x_{KT,t})'\}$ be a K -dimensional martingale difference array with covariance matrices $E(x_{T,t}x'_{T,t}) = \Sigma_{Tt}$ such that $T^{-1} \sum_{t=1}^T \Sigma_{Tt} \rightarrow \Sigma$, where Σ is positive definite. Moreover, suppose that $T^{-1} \sum_{t=1}^T x_{T,t}x'_{T,t} \xrightarrow{p} \Sigma$ and $E(x_{iT,t}x_{jT,t}x_{kT,t}x_{lT,t}) < \infty$ for all t and T and all $1 \leq i, j, k, l \leq K$. Then

$$\sqrt{T}\bar{x}_T \xrightarrow{d} \mathcal{N}(0, \Sigma).$$

(3) (CLT for Stationary Processes)

Let $x_t = \mu + \sum_{j=0}^{\infty} \Phi_j u_{t-j}$ be a K -dimensional stationary stochastic process with $E(x_t) = \mu < \infty$, $\sum_{j=0}^{\infty} \|\Phi_j\| < \infty$ and $u_t \sim (0, \Sigma_u)$ i.i.d. white noise. Then

$$\sqrt{T}(\bar{x}_T - \mu) \xrightarrow{d} \mathcal{N}\left(0, \sum_{j=-\infty}^{\infty} \Gamma_x(j)\right),$$

where $\Gamma_x(j) := E[(x_t - \mu)(x_{t-j} - \mu)']$. ■

The results in Proposition C.13 are just examples of useful CLTs. A variety of similar results exists for different sets of conditions. More discussion of CLTs and proofs can be found in Davidson (1994, Part V). For the CLT for stationary processes see Anderson (1971, Chapters 7 and 8).

To derive the asymptotic distribution of a vector sequence it is actually sufficient to consider univariate series. This is a consequence of the following result.

Proposition C.14 (*Cramér-Wold Device*) (Rao (1973, p. 123))

Let x_T be a K -dimensional sequence of random vectors and x a K -dimensional random vector. If $c'x_T \xrightarrow{d} c'x$ for all $c \in \mathbb{R}^K$, then $x_T \xrightarrow{d} x$. ■

Therefore, to show asymptotic normality of a sequence, $\sqrt{T}(\hat{\beta}_T - \beta) \xrightarrow{d} \mathcal{N}(0, \Sigma)$, it suffices to show for all K -vectors c with $c' \Sigma c \neq 0$,

$$\frac{\sqrt{T}c'(\hat{\beta}_T - \beta)}{(c' \Sigma c)^{1/2}} \xrightarrow{d} \mathcal{N}(0, 1).$$

Hence, CLTs for univariate series can in fact be used to show multivariate results.

C.5 Standard Asymptotic Properties of Estimators and Test Statistics

Suppose we have a sequence of $(m \times n)$ estimators $\{\hat{B}_T\}$ for an $(m \times n)$ parameter matrix B , where T denotes the sample sizes (time series lengths) on which the estimators are based. For simplicity we will delete the subscript T in the following and we will mean the sequence of estimators when we use the term “estimator”.

The estimator \hat{B} is *consistent* if $\text{plim } \hat{B} = B$. In the related literature, this type of consistency is sometimes called *weak consistency*. However, in this text, we simply use the term consistency instead. The estimator is *strongly consistent* if $\hat{B} \xrightarrow{a.s.} B$, and the estimator is *mean square consistent* if $\hat{B} \xrightarrow{q.m.} B$. By Proposition C.1, both strong consistency and mean square consistency imply consistency.

Let $\hat{\beta}$ be an estimator (a sequence of estimators) of a $(K \times 1)$ vector β . The estimator is said to have an *asymptotic normal distribution* if $\sqrt{T}(\hat{\beta} - \beta)$ converges in distribution to a random vector with multivariate normal distribution $\mathcal{N}(0, \Sigma)$, that is,

$$\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} \mathcal{N}(0, \Sigma). \tag{C.5.1}$$

In that case, for large T , $\mathcal{N}(\beta, \Sigma/T)$ is usually used as an approximation to the distribution of $\hat{\beta}$. Equivalently, by the Cramér-Wold device (Proposition C.14), (C.5.1) may be defined by requiring that

$$\frac{\sqrt{T}c'(\hat{\beta} - \beta)}{(c' \Sigma c)^{1/2}} \xrightarrow{d} \mathcal{N}(0, 1),$$

for any $(K \times 1)$ vector c for which $c' \Sigma c \neq 0$. The following proposition provides some useful rules for determining the asymptotic distributions of estimators and test statistics.

Proposition C.15 (*Asymptotic Properties of Estimators*)

Suppose $\hat{\beta}$ is an estimator of the $(K \times 1)$ vector β with $\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} \mathcal{N}(0, \Sigma)$. Then the following rules hold:

- (1) If $\text{plim } \hat{A} = A$, then $\sqrt{T}\hat{A}(\hat{\beta} - \beta) \xrightarrow{d} \mathcal{N}(0, A\Sigma A')$ (see Schmidt (1976, p. 251)).
- (2) If $R \neq 0$ is an $(M \times K)$ matrix, then $\sqrt{T}(R\hat{\beta} - R\beta) \xrightarrow{d} \mathcal{N}(0, R\Sigma R')$.
- (3) (Delta method)
 If $g(\beta) = (g_1(\beta), \dots, g_m(\beta))'$ is a vector-valued continuously differentiable function with $\partial g/\partial\beta' \neq 0$ at β , then

$$\sqrt{T}[g(\hat{\beta}) - g(\beta)] \xrightarrow{d} \mathcal{N}\left(0, \frac{\partial g(\beta)}{\partial\beta'} \Sigma \frac{\partial g(\beta)'}{\partial\beta}\right).$$

If $\partial g/\partial\beta' = 0$ at β , $\sqrt{T}[g(\hat{\beta}) - g(\beta)] \xrightarrow{p} 0$. (See Serfling (1980, pp. 122-124)).

- (4) If Σ is nonsingular, $T(\hat{\beta} - \beta)' \Sigma^{-1}(\hat{\beta} - \beta) \xrightarrow{d} \chi^2(K)$.
- (5) If Σ is nonsingular and $\text{plim } \hat{\Sigma} = \Sigma$, then $T(\hat{\beta} - \beta)' \hat{\Sigma}^{-1}(\hat{\beta} - \beta) \xrightarrow{d} \chi^2(K)$.
- (6) If $\Sigma = QA$, where Q is symmetric, idempotent of rank n and A is positive definite, then $T(\hat{\beta} - \beta)' A^{-1}(\hat{\beta} - \beta) \xrightarrow{d} \chi^2(n)$.



C.6 Maximum Likelihood Estimation

Suppose y_1, y_2, \dots is a sequence of K -dimensional random vectors, the first T of which have a joint probability density function $f_T(y_1, \dots, y_T; \delta_0)$, where δ_0 is an unknown $(M \times 1)$ vector of parameters that does not depend on T . It is assumed to be from a subset \mathbb{D} of the M -dimensional Euclidean space \mathbb{R}^M . Suppose further that $f_T(\cdot; \delta)$ has a known functional form and one wishes to estimate δ_0 .

For a fixed realization y_1, \dots, y_T , the function

$$l(\delta) = l(\delta|y_1, \dots, y_T) = f_T(y_1, \dots, y_T; \delta),$$

viewed as a function of δ , is the *likelihood function*. Its natural logarithm $\ln l(\delta|\cdot)$ is the *log-likelihood function*. A vector $\tilde{\delta}$, maximizing the likelihood function or log-likelihood function, is called a *maximum likelihood (ML) estimate*, that is, if

$$l(\tilde{\delta}) = \sup_{\delta \in \mathbb{D}} l(\delta),$$

then $\tilde{\delta}$ is an ML estimate. Here sup denotes the supremum, that is, the least upper bound, which may exist even if the maximum does not. In general, $\tilde{\delta}$ depends on y_1, \dots, y_T , that is, $\tilde{\delta} = \tilde{\delta}(y_1, \dots, y_T)$. Replacing the fixed values y_1, \dots, y_T by their corresponding random vectors, $\tilde{\delta}$ is an *ML estimator* of δ_0 if the functional dependence on y_1, \dots, y_T is such that $\tilde{\delta}$ is a random vector.

If $l(\delta)$ is a differentiable function of δ , the vector of first order partial derivatives of $\ln l(\delta)$, that is,

$$s(\delta) = \partial \ln l(\delta) / \partial \delta,$$

regarded as a random vector (a function of the random vectors y_1, \dots, y_T), is the *score vector*. It vanishes at $\delta = \tilde{\delta}$ if the maximum of $\ln l(\delta)$ is attained at an interior point of the parameter space \mathbb{D} . The *information matrix* for δ_0 is minus the expectation of the matrix of second order partial derivatives of $\ln l$, evaluated at the true parameter vector δ_0 ,

$$\mathcal{I}(\delta_0) = -E \left[\left. \frac{\partial^2 \ln l}{\partial \delta \partial \delta'} \right|_{\delta_0} \right].$$

The matrix

$$\mathcal{I}_a(\delta_0) = \lim_{T \rightarrow \infty} \mathcal{I}(\delta_0) / T,$$

if it exists, is the *asymptotic information matrix* for δ_0 . If it is nonsingular, its inverse is a lower bound for the covariance matrix of the asymptotic distribution of any consistent estimator with asymptotic normal distribution. In other words, if $\hat{\delta}$ is a consistent estimator of δ_0 with

$$\sqrt{T}(\hat{\delta} - \delta_0) \xrightarrow{d} \mathcal{N}(0, \Sigma_{\hat{\delta}}),$$

then $\mathcal{I}_a(\delta_0)^{-1} \leq \Sigma_{\hat{\delta}}$, that is, $\Sigma_{\hat{\delta}} - \mathcal{I}_a(\delta_0)^{-1}$ is positive semidefinite. Under quite general regularity conditions, an ML estimator $\tilde{\delta}$ for δ_0 is consistent and

$$\sqrt{T}(\tilde{\delta} - \delta_0) \xrightarrow{d} \mathcal{N}(0, \mathcal{I}_a(\delta_0)^{-1}).$$

Thus, in large samples, $\tilde{\delta}$ is approximately distributed as $\mathcal{N}(\delta_0, \mathcal{I}_a(\delta_0)^{-1} / T)$.

C.7 Likelihood Ratio, Lagrange Multiplier, and Wald Tests

Three principles for constructing tests of statistical hypotheses are employed frequently in the text. We consider testing of

$$H_0 : \varphi(\delta_0) = 0 \quad \text{against} \quad H_1 : \varphi(\delta_0) \neq 0, \quad (\text{C.7.1})$$

where δ_0 is the true $(M \times 1)$ parameter vector, as in the previous section, and $\varphi : \mathbb{R}^M \rightarrow \mathbb{R}^N$ is a continuously differentiable function so that $\varphi(\delta)$ is of dimension $(N \times 1)$. We assume that $[\partial \varphi / \partial \delta' |_{\delta_0}]$ has rank N . This condition implies that $N \leq M$ and the N restrictions for the parameter vector are

distinguishable in a neighborhood of δ_0 . Often the hypotheses can be written alternatively as

$$H_0 : \delta_0 = g(\gamma_0) \quad \text{against} \quad H_1 : \delta_0 \neq g(\gamma_0), \tag{C.7.2}$$

where γ_0 is an $(M - N)$ -dimensional vector and $g : \mathbb{R}^{M-N} \rightarrow \mathbb{R}^M$ is a continuously differentiable function in a neighborhood of γ_0 (see Gallant (1987, pp. 57-58)).

The *likelihood ratio (LR) test* of (C.7.1) or (C.7.2) is based on the statistic

$$\lambda_{LR} = 2[\ln l(\tilde{\delta}) - \ln l(\tilde{\delta}_r)],$$

where $\tilde{\delta}$ denotes the unconstrained ML estimator and $\tilde{\delta}_r$ is the restricted ML estimator of δ_0 , subject to the restrictions specified under H_0 , that is, $\tilde{\delta}_r$ is obtained by maximizing $\ln l$ over the parameter space restricted by the conditions stated in H_0 . Under suitable regularity conditions, we have

$$\lambda_{LR} \xrightarrow{d} \chi^2(N). \tag{C.7.3}$$

The *Lagrange multiplier (LM) statistic* for testing (C.7.1) or (C.7.2) is of the form

$$\lambda_{LM} = s(\tilde{\delta}_r)' \mathcal{I}(\tilde{\delta}_r)^{-1} s(\tilde{\delta}_r), \tag{C.7.4}$$

where $s(\delta)$ denotes the score vector and $\mathcal{I}(\delta)$ the information matrix, as before. In the LM statistic, both functions are evaluated at the restricted estimator of δ_0 . Under H_0 , λ_{LM} has an asymptotic $\chi^2(N)$ -distribution, if weak regularity conditions are satisfied. The name derives from the fact that it can be written as

$$\lambda_{LM} = \tilde{\lambda}' \left[\frac{\partial \varphi}{\partial \delta'} \Big|_{\tilde{\delta}_r} \right] \mathcal{I}(\tilde{\delta}_r)^{-1} \left[\frac{\partial \varphi'}{\partial \delta} \Big|_{\tilde{\delta}_r} \right] \tilde{\lambda}, \tag{C.7.5}$$

where $\tilde{\lambda}$ is the vector of Lagrange multipliers for which the Lagrange function has a stationary point corresponding to the constrained estimator (see Appendix A.14).

The equivalence of (C.7.4) and (C.7.5) can be seen by recalling that the constrained minimum of $-\ln l$ is attained at a stationary point of the Lagrange function

$$\mathcal{L}(\delta, \lambda) = -\ln l(\delta) + \lambda' \varphi(\delta).$$

In other words, $\tilde{\delta}_r$ satisfies

$$0 = \left[\frac{\partial \mathcal{L}}{\partial \delta'} \Big|_{\tilde{\delta}_r, \tilde{\lambda}} \right] = - \left[\frac{\partial \ln l}{\partial \delta'} \Big|_{\tilde{\delta}_r} \right] + \tilde{\lambda}' \left[\frac{\partial \varphi}{\partial \delta'} \Big|_{\tilde{\delta}_r} \right] = -s(\tilde{\delta}_r)' + \tilde{\lambda}' \left[\frac{\partial \varphi}{\partial \delta'} \Big|_{\tilde{\delta}_r} \right].$$

The LM statistic is often computed via an auxiliary regression. To see how this can be done, consider a normal regression model of the form

$$\mathbf{y} = X\boldsymbol{\beta} + Z\boldsymbol{\gamma} + \mathbf{u},$$

where \mathbf{y} and \mathbf{u} are $(T \times 1)$ vectors, X and Z are $(T \times M)$ and $(T \times N)$ regressor matrices, respectively, $\boldsymbol{\beta}$ and $\boldsymbol{\gamma}$ are $(M \times 1)$ and $(N \times 1)$ parameter vectors and $\mathbf{u} \sim \mathcal{N}(0, \sigma_u^2 I_T)$. Suppose we wish to test the pair of hypotheses

$$H_0 : \boldsymbol{\gamma} = 0 \quad \text{versus} \quad H_1 : \boldsymbol{\gamma} \neq 0.$$

In this case, the score vector is

$$s \begin{pmatrix} \boldsymbol{\beta} \\ \boldsymbol{\gamma} \end{pmatrix} = \frac{1}{\sigma_u^2} \begin{bmatrix} X' \\ Z' \end{bmatrix} (\mathbf{y} - X\boldsymbol{\beta} - Z\boldsymbol{\gamma}),$$

the inverse information matrix is

$$\sigma_u^2 \begin{bmatrix} X'X & X'Z \\ Z'X & Z'Z \end{bmatrix}^{-1},$$

and the restricted estimator is

$$\begin{bmatrix} \widehat{\boldsymbol{\beta}} \\ 0 \end{bmatrix} = \begin{bmatrix} (X'X)^{-1}X'\mathbf{y} \\ 0 \end{bmatrix}.$$

Notice that the first order conditions for computing this estimator imply

$$X'(y - X\widehat{\boldsymbol{\beta}}) = X'\widehat{\mathbf{u}} = 0.$$

Here $\widehat{\mathbf{u}} := y - X\widehat{\boldsymbol{\beta}}$ is the residual vector of the restricted estimation. Hence, the score vector evaluated at the restricted estimator is

$$s \begin{pmatrix} \widehat{\boldsymbol{\beta}} \\ 0 \end{pmatrix} = \frac{1}{\sigma_u^2} \begin{bmatrix} X'(y - X\widehat{\boldsymbol{\beta}}) \\ Z'(y - X\widehat{\boldsymbol{\beta}}) \end{bmatrix} = \frac{1}{\sigma_u^2} \begin{bmatrix} 0 \\ Z'\widehat{\mathbf{u}} \end{bmatrix}$$

and the LM statistic becomes

$$\begin{aligned} \lambda_{LM} &= [0 : \widehat{\mathbf{u}}'Z] \begin{bmatrix} X'X & X'Z \\ Z'X & Z'Z \end{bmatrix}^{-1} \begin{bmatrix} 0 \\ Z'\widehat{\mathbf{u}} \end{bmatrix} / \sigma_u^2 \\ &= \widehat{\mathbf{u}}'Z(Z'Z - Z'X(X'X)^{-1}X'Z)^{-1}Z'\widehat{\mathbf{u}} / \sigma_u^2, \end{aligned}$$

where the rules for the partitioned inverse have been used (see Appendix A.10).

The same statistic is obtained by using the usual χ^2 -statistic for testing $\boldsymbol{\gamma} = 0$ in the auxiliary regression model

$$\widehat{\mathbf{u}} = X\boldsymbol{\beta} + Z\boldsymbol{\gamma} + \mathbf{e},$$

where \mathbf{e} is an error vector. The LS estimator from this model is

$$\begin{bmatrix} \tilde{\boldsymbol{\beta}} \\ \tilde{\boldsymbol{\gamma}} \end{bmatrix} = \begin{bmatrix} X'X & X'Z \\ Z'X & Z'Z \end{bmatrix}^{-1} \begin{bmatrix} X'\hat{\mathbf{u}} \\ Z'\hat{\mathbf{u}} \end{bmatrix}.$$

Using $X'\hat{\mathbf{u}} = 0$ and the rules for the partitioned inverse gives

$$\begin{aligned} \tilde{\boldsymbol{\gamma}} &= (Z'Z - Z'X(X'X)^{-1}X'Z)^{-1}Z'\hat{\mathbf{u}} \\ &\sim \mathcal{N}(\boldsymbol{\gamma}, \sigma_u^2(Z'Z - Z'X(X'X)^{-1}X'Z)^{-1}). \end{aligned}$$

Hence, the χ^2 -statistic

$$\tilde{\boldsymbol{\gamma}}'(Z'Z - Z'X(X'X)^{-1}X'Z)\tilde{\boldsymbol{\gamma}}/\sigma_u^2$$

is easily seen to be identical to the previously obtained expression for λ_{LM} . Of course, algebraically the same result is obtained if σ_u^2 is replaced by an estimator. Using the usual modifications, the statistic has an F -distribution in this case. More precisely,

$$\frac{\tilde{\boldsymbol{\gamma}}'(Z'Z - Z'X(X'X)^{-1}X'Z)\tilde{\boldsymbol{\gamma}}}{N\hat{\sigma}_u^2} \sim F(N, T - M - N).$$

Although we have used a normal regression model with nonstochastic regressors in this illustration, a similar reasoning often applies for more general situations and it implies an auxiliary regression model from which the LM statistic can be obtained. The reason is that much of the derivation rests on the algebraic properties of the quantities involved. Therefore, similar arguments can be used, for example, if the regressors are stochastic or a GLS estimation is used. In Chapters 4 and 5, the LM statistics for residual autocorrelation in VAR models are, for instance, derived in this way.

The *Wald statistic* is based on an unconstrained estimator which is asymptotically normal,

$$\sqrt{T}(\tilde{\delta} - \delta_0) \xrightarrow{d} \mathcal{N}(0, \Sigma_{\tilde{\delta}}).$$

By Proposition C.15(3), it follows that

$$\sqrt{T}[\varphi(\tilde{\delta}) - \varphi(\delta_0)] \xrightarrow{d} \mathcal{N}\left(0, \begin{bmatrix} 0, & \left[\frac{\partial\varphi}{\partial\delta'}\Big|_{\delta_0}\right] \Sigma_{\tilde{\delta}} \left[\frac{\partial\varphi'}{\partial\delta}\Big|_{\delta_0}\right] \end{bmatrix}\right).$$

Thus, by Proposition C.15(5), if $H_0 : \varphi(\delta_0) = 0$ is true and the covariance matrix is invertible,

$$\lambda_W = T\varphi(\tilde{\delta})' \left(\begin{bmatrix} \frac{\partial\varphi}{\partial\delta'}\Big|_{\tilde{\delta}} \end{bmatrix} \tilde{\Sigma}_{\tilde{\delta}} \begin{bmatrix} \frac{\partial\varphi'}{\partial\delta}\Big|_{\tilde{\delta}} \end{bmatrix} \right)^{-1} \varphi(\tilde{\delta}) \xrightarrow{d} \chi^2(N), \tag{C.7.6}$$

where $\tilde{\Sigma}_{\tilde{\delta}}$ is a consistent estimator of $\Sigma_{\tilde{\delta}}$. The statistic λ_W is the Wald statistic. For further discussion of the three test statistics and proofs of their asymptotic distributions see also Hayashi (2000, Chapter 7).

In summary, we have three test statistics with equivalent asymptotic distributions under the null hypothesis. The LR statistic involves both the restricted and the unrestricted ML estimators, the LM statistic is based on the restricted estimator only, and the Wald statistic requires just the unrestricted estimator. The choice among the three statistics is often based on computational convenience. Wald tests have the disadvantage that they are not invariant under transformations of the restrictions. In other words, if the restrictions can be written in two equivalent ways (e.g., $\delta_i = 0$ and $\delta_i^2 = 0$) the corresponding Wald tests may have different small sample properties. Their small sample power may be low (see Gregory & Veall (1985), Breusch & Schmidt (1988)).

C.8 Unit Root Asymptotics

C.8.1 Univariate Processes

In deriving asymptotic results for processes with unit roots, it is helpful to consider also continuous stochastic processes. An important example is a *standard Brownian motion* or a *standard Wiener process* $\mathbf{W}(\cdot)$ which is a function defined on the unit interval $[0, 1]$ and it assigns a random variable $\mathbf{W}(t)$ to each $t \in [0, 1]$ such that the following conditions hold:

- (1) $\mathbf{W}(0) = 0$ with probability one.
- (2) $\mathbf{W}(t)$ is continuous in t with probability one.
- (3) For any partitioning of the unit interval, $0 \leq t_1 < t_2 < \dots < t_k \leq 1$, the vector

$$\begin{bmatrix} \mathbf{W}(t_2) - \mathbf{W}(t_1) \\ \vdots \\ \mathbf{W}(t_k) - \mathbf{W}(t_{k-1}) \end{bmatrix} \sim \mathcal{N} \left(\begin{bmatrix} 0 \\ \vdots \\ 0 \end{bmatrix}, \begin{bmatrix} t_2 - t_1 & & 0 \\ & \ddots & \vdots \\ 0 & \dots & t_k - t_{k-1} \end{bmatrix} \right),$$

that is, the differences have a multivariate normal distribution with independent components, means of zero, and variances $t_i - t_{i-1}$.

Wiener processes play an important role in the asymptotic theory for unit root processes. Nonstandard versions of the type $Z(t) = \sigma \mathbf{W}(t)$ are often encountered. Their increments are still independent but $Z(t) - Z(s) \sim \mathcal{N}(0, \sigma^2(t-s))$ for $s < t$. Notice also that $Z(t) \sim \mathcal{N}(0, \sigma^2 t)$.

In developing unit root asymptotics, we are often interested in quantities of the form

$$X_T(r) = \frac{1}{T} \sum_{t=1}^{[Tr]} w_t,$$

where w_t is a stationary stochastic process, $r \in [0, 1]$ denotes a fraction and $[Tr]$ signifies the largest integer less than or equal to Tr . If the $w_t = u_t$ are i.i.d. $(0, \sigma_u^2)$, we know from a central limit theorem (see Proposition C.13) that

$$\sqrt{T}X_T(r) = \frac{\sqrt{[Tr]}}{\sqrt{T}} \frac{1}{\sqrt{[Tr]}} \sum_{t=1}^{[Tr]} u_t \xrightarrow{d} \mathcal{N}(0, r\sigma_u^2),$$

for every $r \in [0, 1]$, because $\sqrt{[Tr]}/\sqrt{T} \rightarrow \sqrt{r}$. Moreover,

$$\sqrt{T}[X_T(r_2) - X_T(r_1)]/\sigma_u \xrightarrow{d} \mathcal{N}(0, r_2 - r_1),$$

for $r_1 < r_2$. For nonoverlapping partitions of the unit interval, the partial sums will be made up of independent terms and they are therefore independent. Hence, it is plausible to write

$$\sqrt{T}X_T(\cdot)/\sigma_u \xrightarrow{d} \mathbf{W}(\cdot). \tag{C.8.1}$$

This notation and result generalizes the previously defined concept of convergence in distribution because now convergence is stated for a sequence of continuous time stochastic processes. The result is often referred to as a *functional central limit theorem* (FCLT) or *invariance principle* or *Donsker’s theorem*.

Giving a precise definition of the related concept of convergence in distribution is simplified by considering convergence of probability measures. A sequence of probability measures \Pr_T is said to converge to the probability measure \Pr or \Pr_T *converges weakly* to \Pr , if $\Pr_T(\mathbb{A}) \rightarrow \Pr(\mathbb{A})$ for all measurable sets \mathbb{A} , with the exception of sets for which the boundary points have nonzero probability mass. Instead of considering the distribution functions, we may define convergence in distribution via weak convergence of the corresponding sequence of probability measures. Thus, constructing a probability space on a suitable space of functions defined on the unit interval, the convergence in (C.8.1) can be defined rigorously. Although this type of convergence is more properly called weak convergence, we will still use the symbol \xrightarrow{d} for signifying it. For more precise discussions see, for example, Davidson (1994, 2000) or Johansen (1995).

We may also generalize the concept of convergence in probability to the case of sequences of random functions. For a sequence $G_T(\cdot)$ and a random function $G(\cdot)$ we write $G_T \xrightarrow{p} G$ if

$$\sup_{t \in [0,1]} |G_T(t) - G(t)| \xrightarrow{p} 0.$$

Another useful tool in dealing with unit root process is the *continuous mapping theorem* which states that, given a sequence of stochastic functions $\{G_T(\cdot)\}$, a stochastic function $G(\cdot)$ and a continuous functional $g(\cdot)$ (a function defined on a space of functions), we have

$$G_T \xrightarrow{d} G \quad \Rightarrow \quad g(G_T) \xrightarrow{d} g(G).$$

Using the FCLT, this theorem implies, for instance, that

$$\int_0^1 \sqrt{T} X_T(r) dr \xrightarrow{d} \sigma_u \int_0^1 \mathbf{W}(r) dr$$

because the integral is a continuous functional.

These tools are useful in proving the following proposition from Hamilton (1994, Proposition 17.1) which summarizes a number of helpful results from the literature, many of which were derived, e.g., by Phillips (1987).

Proposition C.16 (*Properties of Random Walks and Related Quantities*)

Suppose $x_t = x_{t-1} + u_t$ is a random walk with i.i.d. white noise, $u_t \sim (0, \sigma_u^2)$, and $x_0 = 0$. Then the following results hold:

- (1) $T^{-1/2} \sum_{t=1}^T u_t \xrightarrow{d} \sigma_u \mathbf{W}(1) = \mathcal{N}(0, \sigma_u^2)$.
- (2) $T^{-1} \sum_{t=1}^T x_{t-1} u_t \xrightarrow{d} \frac{1}{2} \sigma_u^2 [\mathbf{W}(1)^2 - 1] = \frac{1}{2} \sigma_u^2 [\chi^2(1) - 1]$.
- (3) $T^{-3/2} \sum_{t=1}^T t u_t \xrightarrow{d} \sigma_u \mathbf{W}(1) - \sigma_u \int_0^1 \mathbf{W}(r) dr = \mathcal{N}(0, \sigma_u^2/3)$.
- (4) $T^{-3/2} \sum_{t=1}^T x_{t-1} \xrightarrow{d} \sigma_u \int_0^1 \mathbf{W}(r) dr = \mathcal{N}(0, \sigma_u^2/3)$.
- (5) $T^{-2} \sum_{t=1}^T x_{t-1}^2 \xrightarrow{d} \sigma_u^2 \int_0^1 \mathbf{W}(r)^2 dr$.
- (6) $T^{-5/2} \sum_{t=1}^T t x_{t-1} \xrightarrow{d} \sigma_u \int_0^1 r \mathbf{W}(r) dr$.
- (7) $T^{-3} \sum_{t=1}^T t x_{t-1}^2 \xrightarrow{d} \sigma_u^2 \int_0^1 r \mathbf{W}(r)^2 dr$.
- (8) $T^{-(n+1)} \sum_{t=1}^T t^n \rightarrow 1/(n+1)$ for $n = 0, 1, \dots$

■

From these results, the following asymptotic distributions of Dickey-Fuller (DF) statistics for unit roots can be derived. For details see, e.g., Hamilton (1994, Section 17.4). It is assumed that estimation is based on a sample y_1, \dots, y_T and a presample value y_0 is also available.

Proposition C.17 (*Asymptotic Distributions of Dickey-Fuller Test Statistics*)

- (1) Suppose $\hat{\rho} = \sum_{t=1}^T y_{t-1} y_t / \sum_{t=1}^T y_{t-1}^2$ is the LS estimator of the coefficient ρ of the AR(1) process $y_t = \rho y_{t-1} + u_t$, $t = 1, 2, \dots$, where $u_t \sim (0, \sigma_u^2)$ is i.i.d. white noise. Here y_0 is a fixed starting value or a stochastic variable with a given fixed distribution (which does not depend on the sample size). Then, if $\rho = 1$,

$$T(\hat{\rho} - 1) \xrightarrow{d} \frac{\frac{1}{2}[\mathbf{W}(1)^2 - 1]}{\int_0^1 \mathbf{W}(r)^2 dr}$$

and the t -statistic

$$t_{\hat{\rho}-1} = \frac{\hat{\rho} - 1}{\hat{\sigma}_{\hat{\rho}}} \xrightarrow{d} \frac{\frac{1}{2}[\mathbf{W}(1)^2 - 1]}{\left[\int_0^1 \mathbf{W}(r)^2 dr\right]^{1/2}},$$

where $\hat{\sigma}_{\hat{\rho}}^2 = T^{-1} \sum_{t=1}^T (y_t - \hat{\rho} y_{t-1})^2 / \sum_{t=1}^T y_{t-1}^2$ is the usual LS estimator of the variance of $\hat{\rho}$.

- (2) Suppose $y_t = \mu + x_t$, $t = 1, 2, \dots$, with $x_t = \rho x_{t-1} + u_t$, where $u_t \sim (0, \sigma_u^2)$ is i.i.d. white noise and μ is a fixed mean term. Moreover, let $x_0 = 0$ and y_0 be a fixed starting value or a stochastic variable with a given fixed distribution. Furthermore, $\hat{\rho}$ is the LS estimator of ρ from a regression $y_t = \nu + \rho y_{t-1} + u_t$. Then, if $\rho = 1$,

$$T(\hat{\rho} - 1) \xrightarrow{d} \frac{\frac{1}{2}[\mathbf{W}(1)^2 - 1] - \mathbf{W}(1) \int_0^1 \mathbf{W}(r) dr}{\int_0^1 \mathbf{W}(r)^2 dr - \left[\int_0^1 \mathbf{W}(r) dr \right]^2}$$

and the t -statistic

$$t_{\hat{\rho}-1} = \frac{\hat{\rho} - 1}{\hat{\sigma}_{\hat{\rho}}} \xrightarrow{d} \frac{\frac{1}{2}[\mathbf{W}(1)^2 - 1] - \mathbf{W}(1) \int_0^1 \mathbf{W}(r) dr}{\left\{ \int_0^1 \mathbf{W}(r)^2 dr - \left[\int_0^1 \mathbf{W}(r) dr \right]^2 \right\}^{1/2}},$$

where $\hat{\sigma}_{\hat{\rho}}^2$ is the usual LS estimator of the variance of $\hat{\rho}$.

- (3) Suppose $y_t = \nu + y_{t-1} + u_t$, $t = 1, 2, \dots$, where $u_t \sim (0, \sigma_u^2)$ is i.i.d. white noise and $\nu \neq 0$ is a constant term. Moreover, let y_0 be a fixed starting value or a stochastic variable with a given fixed distribution. Furthermore, $\hat{\rho}$ is the LS estimator of ρ from a regression $y_t = \nu + \rho y_{t-1} + u_t$. Then, if $\rho = 1$,

$$T^{3/2}(\hat{\rho} - 1) \xrightarrow{d} \mathcal{N}(0, 12\sigma_u^2/\nu^2)$$

and the t -statistic

$$t_{\hat{\rho}-1} = \frac{\hat{\rho} - 1}{\hat{\sigma}_{\hat{\rho}}} \xrightarrow{d} \mathcal{N}(0, 1),$$

where $\hat{\sigma}_{\hat{\rho}}^2$ is the usual LS estimator of the variance of $\hat{\rho}$.

- (4) Suppose $y_t = \mu_0 + \mu_1 t + x_t$, $t = 1, 2, \dots$, with $x_t = \rho x_{t-1} + u_t$, where $u_t \sim (0, \sigma_u^2)$ is i.i.d. white noise and μ_0 and μ_1 are fixed intercept and trend slope terms. Moreover, let $x_0 = 0$ and y_0 be a fixed starting value or a stochastic variable with a given fixed distribution. Furthermore, $\hat{\rho}$ is the LS estimator of ρ from a regression $y_t = \nu_0 + \nu_1 t + \rho y_{t-1} + u_t$. Then, if $\rho = 1$,

$$T(\hat{\rho} - 1) \xrightarrow{d} a/b$$

and

$$t_{\hat{\rho}-1} = \frac{\hat{\rho} - 1}{\hat{\sigma}_{\hat{\rho}}} \xrightarrow{d} a/\sqrt{b},$$

where

$$\begin{aligned}
 a &= \int_0^1 \mathbf{W}(r) d\mathbf{W}(r) \\
 &+ 12 \left[\int_0^1 r \mathbf{W}(r) dr - \frac{1}{2} \int_0^1 \mathbf{W}(r) dr \right] \left[\int_0^1 \mathbf{W}(r) dr - \frac{1}{2} \mathbf{W}(1) \right] \\
 &- \mathbf{W}(1) \int_0^1 \mathbf{W}(r) dr
 \end{aligned}$$

and

$$\begin{aligned}
 b &= \int_0^1 \mathbf{W}(r)^2 dr - 12 \left(\int_0^1 r \mathbf{W}(r) dr \right)^2 \\
 &+ 12 \int_0^1 \mathbf{W}(r) dr \int_0^1 r \mathbf{W}(r) dr - 4 \left(\int_0^1 \mathbf{W}(r) dr \right)^2.
 \end{aligned}$$

Furthermore, $\hat{\sigma}_\rho^2$ is the usual LS estimator of the variance of $\hat{\rho}$. ■

Obviously, most of the asymptotic distributions obtained for $\hat{\rho}$ are non-standard if $\rho = 1$. In fact, even the convergence rate of the estimator is non-standard. It converges at a much faster rate to its true value of 1 than usual estimators based on stationary processes. More precisely, $\hat{\rho} - \rho = O_p(T^{-1})$ if $\rho = 1$ in Cases 1, 2, and 4 in the proposition, whereas in the stationary case of an AR(1) process $y_t = \rho y_{t-1} + u_t$, say, we have for the LS estimator of ρ , $\hat{\rho} - \rho = O_p(T^{-1/2})$. The latter rate also holds if y_t is stationary and has a nonzero mean term. In Case 3 of Proposition C.17, the convergence rate of $\hat{\rho}$ is even larger because in that case the estimator is dominated by the linear trend which is generated by the drift term.

It is important to note that the limiting distributions in Cases 1, 2, and 4 are free of unknown nuisance parameters. Therefore, it is easy to compute percentage points of the limiting distributions by simulation methods. To do that, it is strictly speaking not even necessary to know the exact form of the asymptotic distributions of the estimators. It is sufficient to know that well-defined asymptotic distributions are obtained which do not depend on unknown nuisance parameters. Of course, there are also situations when a more detailed knowledge of the asymptotic distributions and closed form expressions are helpful.

The results of Proposition C.16 can be generalized in different ways. First of all, the process x_t may have a more complicated dependence structure. In particular, the error process may be a stationary process. Consider, for instance, a process $x_t = x_{t-1} + w_t$, where $w_t = \sum_{j=0}^\infty \theta_j u_{t-j} = \theta(L)u_t$ is a stationary process with $\sum_{j=0}^\infty j|\theta_j| < \infty$ and $u_t \sim (0, \sigma_u^2)$ is white noise, then x_t can be rewritten as

$$x_t = x_0 + w_1 + \dots + w_t = x_0 + \theta(1)(u_1 + \dots + u_t) + \sum_{j=0}^\infty \theta_j^* u_{t-j} - w_0^*,$$

where $\theta(1) = \sum_{j=0}^{\infty} \theta_j$, $\theta_j^* = -\sum_{i=j+1}^{\infty} \theta_i$, $j = 0, 1, \dots$, and $w_0^* = \sum_{j=0}^{\infty} \theta_j^* u_{-j}$ contains initial values. Thus, x_t is the sum of a random walk, a stationary process and initial values. Note that the condition $\sum_{j=0}^{\infty} j|\theta_j| < \infty$ ensures that $\sum_{j=0}^{\infty} |\theta_j^*| < \infty$, so that $\sum_{j=0}^{\infty} \theta_j^* u_{t-j}$ is indeed well-defined according to Proposition C.7. Although the condition for the θ_j is stronger than absolute summability, it is satisfied for many processes of practical interest. For example, the MA representation of a stable AR or ARMA process satisfies the condition. The decomposition of x_t in a random walk, a stationary component, and initial values is known as the *Beveridge-Nelson decomposition*. It is a convenient tool in generalizing the results in Propositions C.16 and C.17.

In fact, if y_t is a finite order AR process, $y_t = \alpha_1 y_{t-1} + \dots + \alpha_p y_{t-p} + u_t$, where u_t is again white noise, y_t can be rewritten as

$$y_t = \rho y_{t-1} + \gamma_1 \Delta y_{t-1} + \dots + \gamma_{p-1} \Delta y_{t-p+1} + u_t$$

or, subtracting y_{t-1} on both sides,

$$\Delta y_t = (\rho - 1)y_{t-1} + \gamma_1 \Delta y_{t-1} + \dots + \gamma_{p-1} \Delta y_{t-p+1} + u_t.$$

Estimating ρ or $\rho - 1$ from these equations by LS, it turns out that the resulting estimators have the same asymptotic properties as in Proposition C.17 (see, e.g., Hamilton (1994)).

Another possible generalization of these results may be obtained by considering multivariate processes. We will tackle both generalizations at once in the following.

C.8.2 Multivariate Processes

For the present purposes, multivariate Brownian motions or Wiener processes are of central importance. The univariate definition can be generalized as follows. A K -dimensional *standard Brownian motion* or *standard Wiener process* $\mathbf{W}(\cdot)$ is a function defined on the unit interval $[0, 1]$ which assigns a K -dimensional random vector $\mathbf{W}(t)$ to each $t \in [0, 1]$ such that:

- (1) $\mathbf{W}(0) = 0$ with probability one.
- (2) A realization $\mathbf{W}(t)$ is a continuous function in t on the unit interval with probability one.
- (3) For any partitioning of the unit interval, $0 \leq t_1 < t_2 < \dots < t_k \leq 1$, the vector

$$\begin{bmatrix} \mathbf{W}(t_2) - \mathbf{W}(t_1) \\ \vdots \\ \mathbf{W}(t_k) - \mathbf{W}(t_{k-1}) \end{bmatrix} \sim \mathcal{N} \left(\begin{bmatrix} 0 \\ \vdots \\ 0 \end{bmatrix}, \begin{bmatrix} (t_2 - t_1)I_K & & 0 \\ & \ddots & \vdots \\ 0 & \dots & (t_k - t_{k-1})I_K \end{bmatrix} \right),$$

that is, the differences have multivariate normal distributions with independent components, means of zero, and variances of the form $t_i - t_{i-1}$, depending on their difference in time.

Again, for any nonsingular ($K \times K$) matrix P , a nonstandard version of a Wiener process $Z(t) := P\mathbf{W}(t)$ is obtained for which the increments are still independent but $Z(t) - Z(s) \sim \mathcal{N}(0, (t - s)PP')$ for $s < t$. Moreover, $Z(t) \sim \mathcal{N}(0, tPP')$.

For a sequence $G_T(\cdot)$ of multivariate random functions, we define convergence in probability to a random function G , $G_T \xrightarrow{P} G$, to hold if

$$\sup_{t \in [0,1]} \|G_T(t) - G(t)\| \xrightarrow[T \rightarrow \infty]{P} 0.$$

Also, the continuous mapping theorem remains valid in the multivariate case.

As in the univariate case, it is of interest to consider quantities of the form

$$X_T(r) = \frac{1}{T} \sum_{t=1}^{[Tr]} w_t,$$

where w_t is a stationary stochastic process, $r \in [0, 1]$ denotes a fraction and $[Tr]$ signifies the largest integer less than or equal to Tr . If $w_t = u_t \sim (0, \Sigma_u)$ is i.i.d. white noise, it follows from a multivariate version of a suitable CLT (see Proposition C.13) that

$$\sqrt{T}[X_T(r_2) - X_T(r_1)] \xrightarrow{d} \mathcal{N}(0, (r_2 - r_1)\Sigma_u)$$

for $r_1 < r_2$. Hence, using the same ideas as in the univariate case,

$$\sqrt{T}\Sigma_u^{-1/2}X_T(\cdot) \xrightarrow{d} \mathbf{W}(\cdot),$$

which is a multivariate version of the previously stated FCLT also referred to as *invariance principle* or *Donsker's theorem*.

If $x_t = x_{t-1} + w_t$, where

$$w_t = \Xi(L)u_t = \sum_{j=0}^{\infty} \Xi_j u_{t-j}, \quad \text{with} \quad \sum_{j=0}^{\infty} j \|\Xi_j\| < \infty,$$

and $u_t \sim (0, \Sigma_u = (\sigma_{ij}))$ is white noise, then a *multivariate Beveridge-Nelson decomposition* is available,

$$x_t = x_0 + w_1 + \dots + w_t = x_0 + \Xi(1) \sum_{s=1}^t u_s + \sum_{j=0}^{\infty} \Xi_j^* u_{t-j} - w_0^*,$$

where $\Xi(1) = \sum_{j=0}^{\infty} \Xi_j$, $\Xi_j^* = -\sum_{i=j+1}^{\infty} \Xi_i$, $j = 0, 1, \dots$, and $w_0^* = \sum_{j=0}^{\infty} \Xi_j^* u_{-j}$ contains initial values. Now x_t is a sum of a multivariate random walk, a stationary process, and initial values (see also Proposition 6.1). Using these concepts, the following generalized version of Proposition C.16 can be established. It also goes back to Phillips and others (see Phillips & Durlauf (1986), Park & Phillips (1988, 1989), Phillips & Solo (1992), Sims et al. (1990), Johansen (1995)) and may be found, e.g., in Hamilton (1994, Proposition 18.1).

Proposition C.18 (*Properties of Multivariate Unit Root Processes*)

Suppose $x_t = x_{t-1} + w_t$, $t = 1, 2, \dots$, is a K -dimensional generalized random walk with initial vector $x_0 = 0$ and stationary error term

$$w_t = \Xi(L)u_t = \sum_{j=0}^{\infty} \Xi_j u_{t-j}, \quad t \in \mathbb{Z},$$

where

$$\sum_{j=0}^{\infty} j \|\Xi_j\| < \infty,$$

and $u_t \sim (0, \Sigma_u = (\sigma_{ij}))$, $t \in \mathbb{Z}$, is i.i.d. white noise with finite fourth moments. Let P be a lower triangular matrix such that $\Sigma_u = PP'$,

$$\Gamma_w(h) := E(w_t w'_{t-h}) = \sum_{j=0}^{\infty} \Xi_{j+h} \Sigma_u \Xi'_j, \quad h = 0, 1, 2, \dots,$$

for an arbitrary positive integer n , $W_t := (w'_{t-1}, \dots, w'_{t-n})'$ is a Kn -dimensional vector with $\Sigma_W := E(W_t W'_t)$, and the $(K \times K)$ matrix $\Lambda := \Xi(1)P$. Then the following results hold:

- (1) $T^{-1/2} \sum_{t=1}^T w_t \xrightarrow{d} \Lambda \mathbf{W}(1)$.
- (2) $T^{-1/2} \sum_{t=1}^T W_t u_{it} \xrightarrow{d} \mathcal{N}(0, \sigma_{ii} \Sigma_W)$ for $i = 1, \dots, K$.
- (3) $T^{-1} \sum_{t=1}^T w_t w'_{t-h} \xrightarrow{p} \Gamma_w(h)$ for $h = 0, 1, 2, \dots$.
- (4) $T^{-1} \sum_{t=1}^T (x_{t-1} w'_{t-h} + w_{t-h} x'_{t-1}) \xrightarrow{d} \begin{cases} \Lambda \mathbf{W}(1) \mathbf{W}(1)' \Lambda' - \Gamma_w(0) & \text{for } h = 0, \\ \Lambda \mathbf{W}(1) \mathbf{W}(1)' \Lambda' - \Gamma_w(0) + \sum_{j=-h+1}^{h-1} \Gamma_w(j) & \text{for } h = 1, 2, \dots \end{cases}$
- (5) $T^{-1} \sum_{t=1}^T x_{t-1} w'_t \xrightarrow{d} \Lambda \left\{ \int_0^1 \mathbf{W}(r) d\mathbf{W}(r)' \right\} \Lambda' + \sum_{j=1}^{\infty} \Gamma_w(j)$.
- (6) $T^{-1} \sum_{t=1}^T x_{t-1} u'_t \xrightarrow{d} \Lambda \left\{ \int_0^1 \mathbf{W}(r) d\mathbf{W}(r)' \right\} P'$.
- (7) $T^{-3/2} \sum_{t=1}^T x_{t-1} \xrightarrow{d} \Lambda \int_0^1 \mathbf{W}(r) dr$.
- (8) $T^{-3/2} \sum_{t=1}^T t w_{t-h} \xrightarrow{d} \Lambda \left\{ \mathbf{W}(1) - \int_0^1 \mathbf{W}(r) dr \right\}$ for $h = 0, 1, 2, \dots$.
- (9) $T^{-2} \sum_{t=1}^T x_{t-1} x'_{t-1} \xrightarrow{d} \Lambda \left\{ \int_0^1 \mathbf{W}(r) \mathbf{W}(r)' dr \right\} \Lambda'$.
- (10) $T^{-5/2} \sum_{t=1}^T t x_{t-1} \xrightarrow{d} \Lambda \int_0^1 r \mathbf{W}(r) dr$.
- (11) $T^{-3} \sum_{t=1}^T t x_{t-1} x'_{t-1} \xrightarrow{d} \Lambda \left\{ \int_0^1 r \mathbf{W}(r) \mathbf{W}(r)' dr \right\} \Lambda'$.

■

These results are the basis for much of the asymptotic theory related to multivariate VAR processes with unit roots. Extensions exist for more general processes w_t and u_t .

D

Evaluating Properties of Estimators and Test Statistics by Simulation and Resampling Techniques

If asymptotic theory is difficult or only small samples are available, properties of estimators and test statistics are sometimes investigated by heavy use of the computer. The idea is to simulate the distribution (or some of its properties) of the random variables of interest by artificially sampling from some known distribution. Generally, if the random variable or vector of interest, say $q = q(z)$, is a function of a random vector z with a known distribution F_z , then samples z_1, \dots, z_n are drawn from F_z and the empirical distribution of q given by $q_n = q(z_n)$, $n = 1, \dots, N$, is determined. The characteristics of the actual distribution of q are then inferred from the empirical distribution.

Often the statistics of interest in this book are functions of multiple time series generated by VAR(p) processes. Therefore, we will briefly describe in the next section how to simulate such time series. Afterwards, some more details are given on simulation and resampling techniques for evaluating estimators and test statistics.

D.1 Simulating a Multiple Time Series with VAR Generation Process

To simulate a multiple time series of dimension K and length T , we first generate a series of (often independent) disturbance vectors $u_{-s}, \dots, u_0, u_1, \dots, u_T$. If a series of Gaussian disturbances is desired, i.e., $u_t \sim \mathcal{N}(0, \Sigma_u)$, we may choose K independent univariate standard normal variates v_1, \dots, v_K and multiply by a $(K \times K)$ matrix P for which $PP' = \Sigma_u$, that is,

$$u_t = P \begin{bmatrix} v_1 \\ \vdots \\ v_K \end{bmatrix}.$$

This process is repeated $T + s + 1$ times until we have the desired series of disturbances. Programs for generating (pseudo) standard normal variates are

available on most computers. Also facilities for generating random numbers from other distributions are usually available and may be used in a similar manner to obtain disturbances from other distributions of interest.

For a given set of parameters ν, A_1, \dots, A_p , where ν is $(K \times 1)$ and the A_i are $(K \times K)$, and a given set of starting values y_{-p+1}, \dots, y_0 , the u_t may be used to simulate a time series y_1, \dots, y_T with VAR(p) generation process recursively as

$$y_t = \nu + A_1 y_{t-1} + \dots + A_p y_{t-p} + u_t$$

starting with $t = 1, t = 2$, etc. until $t = T$. There are different ways to obtain the initial values. Assuming that the desired process is stable, they may be set to zero or to the process mean $\mu = (I_K - A_1 - \dots - A_p)^{-1}\nu$. Because the choice of initial values has some impact on the generated time series, a number of presample values $y_t, t = -s, \dots, 0$, is often generated and then discarded in the subsequent analysis.

A possible way to ensure the same correlation structure for the initial values and the rest of the time series is to determine the covariance matrix of p consecutive y_t vectors, say Σ_Y . Using the results of Chapter 2, Section 2.1, that matrix may be obtained from

$$\text{vec}(\Sigma_Y) = (I_{(Kp)^2} - \mathbf{A} \otimes \mathbf{A})^{-1} \text{vec}(\Sigma_U),$$

where

$$\mathbf{A} = \begin{bmatrix} A_1 & A_2 & \dots & A_{p-1} & A_p \\ I_K & 0 & \dots & 0 & 0 \\ 0 & I_K & & 0 & 0 \\ \vdots & & \ddots & \vdots & \vdots \\ 0 & 0 & \dots & I_K & 0 \end{bmatrix} \quad \text{and} \quad \Sigma_U = \begin{bmatrix} \Sigma_u & 0 & \dots & 0 \\ 0 & 0 & \dots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ 0 & 0 & \dots & 0 \end{bmatrix}.$$

$(Kp \times Kp)$ $(Kp \times Kp)$

Then a $(Kp \times Kp)$ matrix Q is chosen such that $QQ' = \Sigma_Y$ and p initial starting vectors are obtained as

$$\begin{bmatrix} y_0 \\ \vdots \\ y_{-p+1} \end{bmatrix} = Q \begin{bmatrix} v_1 \\ \vdots \\ v_{Kp} \end{bmatrix} + \begin{bmatrix} \mu \\ \vdots \\ \mu \end{bmatrix},$$

where the v_i are independent variates with mean zero and unit variance.

D.2 Evaluating Distributions of Functions of Multiple Time Series by Simulation

Suppose we are interested in the function $q_T = q(y_1, \dots, y_T)$ of some VAR(p) process y_t , where q_T is of dimension $(M \times 1)$. The quantity q_T may be some

estimator or test statistic. To investigate the distribution F_T of q_T , we generate a large number, say N , of independent multiple time series of length T and compute the corresponding values of q_T , say $q_T(n)$, $n = 1, \dots, N$. The properties of F_T are then estimated from the empirical distribution of the $q_T(n)$. For instance, the mean vector of q_T is estimated as

$$\frac{1}{N} \sum_{n=1}^N q_T(n).$$

Analogously, we may estimate the variances, standard deviations, quantiles or other characteristics of F_T .

D.3 Resampling Methods

If the distribution of the disturbances of a VAR model under consideration is unknown, so-called *bootstrap* or *resampling* methods may be applied to investigate the distributions of functions of stochastic processes or multiple time series. Suppose a time series y_1, \dots, y_T and the presample values required for estimation are available. Fitting a VAR(p) model to this time series, we get coefficient estimates $\hat{v}, \hat{A}_1, \dots, \hat{A}_p$, and a series of residuals $\hat{u}_1, \dots, \hat{u}_T$. An estimator of a quantity of interest, say $q = q(A_1, \dots, A_p)$, is then obtained as

$$\hat{q} = q(\hat{A}_1, \dots, \hat{A}_p). \quad (\text{D.3.1})$$

The properties of \hat{q} follow from those of $\hat{A}_1, \dots, \hat{A}_p$. To assess the sampling uncertainty of \hat{q} , confidence intervals are often established, based on the asymptotic distribution of \hat{q} . Alternatively, if q is a test statistic, its p -value may be of interest which can be approximated on the basis of the asymptotic distribution. Unfortunately, this distribution is often a rather poor approximation of the actual distribution for a given finite sample. In some of these cases, bootstrap methods provide a better small sample approximation. The theoretical justification for the bootstrap also rests on asymptotic theory, however. In particular, it can usually be justified if the quantity of interest has a normal limiting distribution (Horowitz (2001)).

A *residual based bootstrap* is often used in this context. Assuming that a sample y_1, \dots, y_T plus presample values as required are available, it proceeds as follows:

- (1) The parameters of the model under consideration are estimated. Let \hat{u}_t , $t = 1, \dots, T$, be the estimation residuals.
- (2) Centered residuals $\hat{u}_1 - \bar{u}, \dots, \hat{u}_T - \bar{u}$ are computed. Here $\bar{u} = T^{-1} \sum \hat{u}_t$ denotes the usual average. Bootstrap residuals u_1^*, \dots, u_T^* are then obtained by randomly drawing with replacement from the centered residuals.

(3) Bootstrap time series are computed recursively as

$$y_t^* = \widehat{\nu} + \widehat{A}_1 y_{t-1}^* + \cdots + \widehat{A}_p y_{t-p}^* + u_t^*, \quad t = 1, \dots, T,$$

where the same initial values may be used for each generated series, $(y_{-p+1}^*, \dots, y_0^*) = (y_{-p+1}, \dots, y_0)$.

- (4) Based on the bootstrap time series, the parameters A_1, \dots, A_p are reestimated.
- (5) Using the parameter estimates obtained in the previous stage, a bootstrap version of the statistic of interest, say \widehat{q}^* , is calculated.
- (6) These steps are repeated N times, where N is a large number.

There is now a range of other bootstrap methods which may have advantages in certain situations. For example, rather than using a residual-based bootstrap, a *block bootstrap* may be applied which is based on the original observations rather than the model residuals (see, e.g., Li & Maddala (1996) for details). It may be preferable if there is uncertainty regarding specific aspects of the model like, for instance, the VAR order. These methods are not discussed here because residual based bootstraps are still the most popular methods in the present context.

In the following, the symbol q denotes the quantity of interest for which a confidence interval is desired. Its estimator implied by the estimators of the model coefficients and the corresponding bootstrap estimator are denoted by \widehat{q} and \widehat{q}^* , respectively. The following bootstrap confidence intervals are examples that have been considered in the literature in the context of impulse response analysis (see, e.g., Benkwitz, Lütkepohl & Wolters (2001)):

- *Standard percentile interval*

Denoting by $s_{\gamma/2}^*$ and $s_{(1-\gamma/2)}^*$ the $\gamma/2$ - and $(1 - \gamma/2)$ -quantiles, respectively, of the N bootstrap versions of \widehat{q}^* , the interval

$$CIS = \left[s_{\gamma/2}^*, s_{(1-\gamma/2)}^* \right],$$

may be set up. It is the percentile confidence interval discussed, e.g., by Efron & Tibshirani (1993).

- *Hall's percentile interval*

Hall (1992) uses the result that asymptotically the distribution of $\sqrt{T}(\widehat{q} - q)$ corresponds to that of $\sqrt{T}(\widehat{q}^* - \widehat{q})$, to derive the interval

$$CI_H = \left[\widehat{q} - t_{(1-\gamma/2)}^*, \widehat{q} - t_{\gamma/2}^* \right].$$

Here $t_{\gamma/2}^*$ and $t_{(1-\gamma/2)}^*$ are the $\gamma/2$ - and $(1 - \gamma/2)$ -quantiles, respectively, of $(\widehat{q}^* - \widehat{q})$ and the interval is obtained by pretending that these are the quantiles of $(\widehat{q} - q)$.

- *Hall's studentized interval*

A studentized statistic $(\widehat{q} - q)/(\widehat{\text{Var}}(\widehat{q}))^{1/2}$ often results in more precise

confidence intervals at least in theory. Using bootstrap quantiles $t_{\gamma/2}^{**}$ and $t_{(1-\gamma/2)}^{**}$ from the distribution of $(\hat{q}^* - \hat{q})/(\widehat{\text{Var}}(\hat{q}^*))^{1/2}$, an interval

$$CI_{SH} = \left[\hat{q} - t_{(1-\gamma/2)}^{**} \sqrt{\widehat{\text{Var}}(\hat{q})}, \hat{q} - t_{\gamma/2}^{**} \sqrt{\widehat{\text{Var}}(\hat{q})} \right]$$

can be constructed by using these quantities in conjunction with $(\hat{q} - q)/(\widehat{\text{Var}}(\hat{q}))^{1/2}$. Here the variance $\text{Var}(\hat{q})$ may be estimated from the bootstrap estimates of q ,

$$\widehat{\text{Var}}(\hat{q}) = \frac{1}{N-1} \sum_{i=1}^N (\hat{q}^{*,i} - \bar{q}^*)^2,$$

where N is the number of bootstrap replications and $\hat{q}^{*,i}$ denotes the value of the statistic of interest obtained in the i -th bootstrap replication. Moreover, the variances $\widehat{\text{Var}}(\hat{q}^*)$ may be estimated by a bootstrap within each bootstrap replication. In other words,

$$\widehat{\text{Var}}(\hat{q}^*) = \frac{1}{N^*-1} \sum_{i=1}^{N^*} (\hat{q}^{**,i} - \bar{q}^{**})^2,$$

where $\hat{q}^{**,i}$ is obtained by a double bootstrap, that is, pseudo-data are generated according to a process obtained on the basis of the bootstrap systems parameters and N^* is the number of bootstrap replications within each bootstrap replication.

A number of refinements and modifications of these intervals exist (see Hall (1992)).

The bootstrap confidence intervals have the property that they attain the nominal confidence content at least asymptotically under general conditions. Roughly speaking, if $\sqrt{T}(\hat{q} - q)$ converges as $T \rightarrow \infty$, $\sqrt{T}(\hat{q}^* - \hat{q})$ converges to the same limit distribution under suitable conditions (e.g., Hall (1992)). Therefore CI_H has the correct size asymptotically, that is, $\Pr(q \in CI_H) \rightarrow 1 - \gamma$ as $T \rightarrow \infty$, under general conditions, and, hence, Hall's percentile method is asymptotically precise. The same holds for the CI_{SH} interval. On the other hand, to obtain such a result for the standard percentile interval CI_S , the limiting distribution of $\sqrt{T}(\hat{q} - q)$ has to be symmetric about zero. For example, this result holds if it is zero mean normal. Roughly speaking, CI_S works with an implicit asymptotic unbiasedness assumption for \hat{q} . If the distribution of \hat{q} is not centered at q , CI_S will generally not have the desired confidence content even asymptotically (see also Efron & Tibshirani (1993) and Benkwitz et al. (2000) for a more detailed discussion of this point).

If \hat{q} is a statistic for which a p -value is desired, the following method may be used. Recall that the p -value of a test is the probability of obtaining a value of the test statistic greater than the observed one, if the null hypothesis holds.

Hence, the p -value may be estimated by the proportion of bootstrap values \hat{q}^* exceeding the value of the test statistic \hat{q} . Again, under general assumptions, this estimator is consistent.

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Index of Notation

Most of the notation is clearly defined in the text where it is used. The following list is meant to provide some general guidelines. Occasionally, in the text a symbol has a meaning which differs from the one specified in this list when confusion is unlikely. For instance, A usually stands for a VAR coefficient matrix whereas in the Appendix it is often a general matrix.

General Symbols

| | |
|----------------------|--|
| $=$ | equals |
| $:=$ | equals by definition |
| \Rightarrow | implies |
| \Leftrightarrow | is equivalent to |
| \sim | is distributed as |
| \in | element of |
| \subset | subset of |
| \cup | union |
| \cap | intersection |
| \sum | summation sign |
| \prod | product sign |
| \rightarrow | converges to, approaches |
| \xrightarrow{p} | converges in probability to |
| $\xrightarrow{a.s.}$ | converges almost surely to |
| $\xrightarrow{q.m.}$ | converges in quadratic mean to |
| \xrightarrow{d} | converges in distribution to |
| i.i.d. | independently, identically distributed |
| lim | limit |
| plim | probability limit |
| max | maximum |
| min | minimum |
| sup | supremum, least upper bound |
| ln | natural logarithm |
| exp | exponential function |
| $ z $ | absolute value or modulus of z |
| K | dimension of a stochastic process or time series |
| T | sample size, time series length |
| \mathbb{R} | real numbers |
| \mathbb{R}^m | m -dimensional Euclidean space |
| \mathbb{C} | complex numbers |
| \mathbb{Z} | integers |
| \mathbb{N} | positive integers |
| $\mathbb{I}(\cdot)$ | indicator function |
| L | lag operator |
| Δ | differencing operator |
| E | expectation |
| Var | variance |
| Cov | covariance, covariance matrix |
| MSE | mean squared error (matrix) |
| Pr | probability |

| | |
|----------------|-------------------------------------|
| $l(\cdot)$ | likelihood function |
| $\ln l$ | log-likelihood function |
| $l_0(\cdot)$ | approximate likelihood function |
| $\ln l_0$ | approximate log-likelihood function |
| λ_{LM} | Lagrange multiplier statistic |
| λ_{LR} | likelihood ratio statistic |
| λ_W | Wald statistic |
| Q_h | portmanteau statistic |
| \tilde{Q}_h | modified portmanteau statistic |
| d.f. | degrees of freedom |
| AIC | Akaike information criterion |
| FPE | final prediction error (criterion) |
| HQ | Hannan-Quinn (criterion) |
| SC | Schwarz criterion |

Distributions and Stochastic Processes

| | |
|---|---|
| $\mathcal{N}(\mu, \Sigma)$ | (multivariate) normal distribution with mean (vector) μ and variance (covariance matrix) Σ |
| $\chi^2(m)$ | χ^2 -distribution with m degrees of freedom |
| $F(m, n)$ | F -distribution with m numerator and n denominator degrees of freedom |
| $t(m)$ | t -distribution with m degrees of freedom |
| AR | autoregressive (process) |
| AR(p) | autoregressive process of order p |
| ARCH | autoregressive conditional heteroskedasticity |
| ARMA | autoregressive moving average (process) |
| ARMA(p, q) | autoregressive moving average process of order (p, q) |
| ARMA _E | echelon form VARMA model |
| ARMA _E (p_1, \dots, p_K) | echelon form VARMA model with Kronecker indices (p_1, \dots, p_K) |
| EC-ARMA _{RE} | error correction echelon form VARMA model |
| GARCH | generalized autoregressive conditional heteroskedasticity |
| MA | moving average (process) |
| MA(q) | moving average process of order q |
| MGARCH | multivariate generalized autoregressive conditional heteroskedasticity |
| PAR | periodic (vector) autoregression |
| VAR | vector autoregressive (process) |
| VAR(p) | vector autoregressive process of order p |
| VARMA | vector autoregressive moving average (process) |
| VARMA(p, q) | vector autoregressive moving average process of order (p, q) |
| VECM | vector error correction model |

Vector and Matrix Operations

| | |
|---|---|
| M' | transpose of M |
| M^{adj} | adjoint of M |
| M^{-1} | inverse of M |
| M^+ | Moore-Penrose generalized inverse of M |
| M_{\perp} | orthogonal complement of M |
| $M^{1/2}$ | square root of M |
| M^k | k -th power of M |
| MN | matrix product of M and N |
| $+$ | plus |
| $-$ | minus |
| \otimes | Kronecker product |
| $\det(M)$, $\det M$ | determinant of M |
| $ M $ | determinant of M |
| $\ M\ $ | Euclidean norm of M |
| $\text{rk}(M)$, $\text{rk } M$ | rank of M |
| $\text{tr}(M)$, $\text{tr } M$ | trace of M |
| vec | column stacking operator |
| vech | column stacking operator for symmetric matrices (stacks the elements on and below the main diagonal only) |
| $\frac{\partial \varphi}{\partial \beta'}$ | vector or matrix of first order partial derivatives of φ with respect to β |
| $\frac{\partial^2 \varphi}{\partial \beta \partial \beta'}$ | Hessian matrix of φ , matrix of second order partial derivatives of φ with respect to β |

General Matrices

| | |
|------------------------|---|
| \mathbf{D}_m | $(m^2 \times \frac{1}{2}m(m+1))$ duplication matrix |
| I_m | $(m \times m)$ unit or identity matrix |
| $\mathcal{I}(\cdot)$ | information matrix |
| $\mathcal{I}_a(\cdot)$ | asymptotic information matrix |
| J | $:= [I_K : 0 : \cdots : 0]$ |
| \mathbf{K}_{mn} | $(mn \times mn)$ commutation matrix |
| \mathbf{L}_m | $(\frac{1}{2}m(m+1) \times m^2)$ elimination matrix |
| 0 | zero or null matrix or vector |

Vectors and Matrices Related to Stochastic Processes and Multiple Time Series

u_t K -dimensional white noise process

u_{kt} k -th element of u_t

$$u^{(k)} := \begin{bmatrix} u_{k1} \\ \vdots \\ u_{kT} \end{bmatrix}$$

$$U := [u_1, \dots, u_T]$$

$$\mathbf{u} := \text{vec}(U)$$

$$U_t := \begin{bmatrix} u_t \\ 0 \\ \vdots \\ 0 \end{bmatrix} \quad \text{or} \quad \begin{bmatrix} u_t \\ 0 \\ \vdots \\ u_t \\ 0 \\ \vdots \\ 0 \end{bmatrix}$$

y_t K -dimensional stochastic process

y_{kt} k -th element of y_t

$$y^{(k)} := \begin{bmatrix} y_{k1} \\ \vdots \\ y_{kT} \end{bmatrix}$$

$$\bar{y} := \sum_{t=1}^T y_t / T, \text{ sample mean (vector)}$$

$y_t(h)$ h -step forecast of y_{t+h} at origin t

$$Y := [y_1, \dots, y_T]$$

$$\mathbf{y} := \text{vec}(Y)$$

$$Y_t := \begin{bmatrix} y_t \\ \vdots \\ y_{t-p+1} \end{bmatrix} \quad \text{or} \quad \begin{bmatrix} y_t \\ \vdots \\ y_{t-p+1} \\ u_t \\ \vdots \\ u_{t-q+1} \end{bmatrix} \quad \text{or} \quad \begin{bmatrix} y_t \\ \vdots \\ y_{t-p+1} \\ x_t \\ \vdots \\ x_{t-s+1} \end{bmatrix}$$

$$Z_t := \begin{bmatrix} 1 \\ y_t \\ \vdots \\ y_{t-p+1} \end{bmatrix}$$

Matrices and Vectors Related to VAR and VARMA Representations and VECMs (Parts I, II, III, IV) A_i VAR coefficient matrix

$$A := [A_1, \dots, A_p]$$

$$\alpha := \text{vec}(A)$$

$$\mathbf{A} := \begin{bmatrix} A_1 & \dots & A_{p-1} & A_p \\ I_K & & 0 & 0 \\ & \ddots & \vdots & \vdots \\ 0 & \dots & I_K & 0 \end{bmatrix} \quad \text{or} \quad \begin{bmatrix} \mathbf{A}_{11} & \mathbf{A}_{12} \\ \mathbf{A}_{21} & \mathbf{A}_{22} \end{bmatrix}$$

$$\mathbf{A}_{11} := \begin{bmatrix} A_1 & \dots & A_{p-1} & A_p \\ I_K & & 0 & 0 \\ & \ddots & \vdots & \vdots \\ 0 & \dots & I_K & 0 \end{bmatrix} \quad (Kp \times Kp)$$

$$\mathbf{A}_{12} := \begin{bmatrix} M_1 & \dots & M_{q-1} & M_q \\ 0 & \dots & 0 & 0 \\ \vdots & & \vdots & \vdots \\ 0 & \dots & 0 & 0 \end{bmatrix} \quad (Kp \times Kq)$$

$$\mathbf{A}_{21} := 0 \quad (Kq \times Kp)$$

$$\mathbf{A}_{22} := \begin{bmatrix} 0 & 0 \\ I_{K(q-1)} & 0 \end{bmatrix} \quad (Kq \times Kq)$$

 M_i MA coefficient matrix

$$\mathbf{m} := \text{vec}[M_1, \dots, M_q]$$

$$\mathbf{M} := \begin{bmatrix} \mathbf{M}_{11} & \mathbf{M}_{12} \\ \mathbf{M}_{21} & \mathbf{M}_{22} \end{bmatrix} \quad (K(p+q) \times K(p+q))$$

$$\mathbf{M}_{11} := \begin{bmatrix} -M_1 & \dots & -M_{q-1} & -M_q \\ I_K & & 0 & 0 \\ & \ddots & \vdots & \vdots \\ 0 & \dots & I_K & 0 \end{bmatrix} \quad (Kq \times Kq)$$

$$\mathbf{M}_{12} := \begin{bmatrix} -A_1 & \dots & -A_{p-1} & -A_p \\ 0 & \dots & 0 & 0 \\ \vdots & & \vdots & \vdots \\ 0 & \dots & 0 & 0 \end{bmatrix} \quad (Kq \times Kp)$$

$$\mathbf{M}_{21} := 0 \quad (Kp \times Kq)$$

$$\mathbf{M}_{22} := \begin{bmatrix} 0 & 0 \\ I_{K(p-1)} & 0 \end{bmatrix} \quad (Kp \times Kp)$$

- Φ_i coefficient matrix of canonical MA representation
- Π_i coefficient matrix of pure VAR representation
- α loading matrix of VECM
- β cointegration matrix
- $\mathbf{\Pi} := \alpha\beta'$
- Γ_i short-run coefficient matrix of VECM

Impulse Responses and Related Quantities

- Φ_i matrix of forecast error impulse responses
- $\Psi_m := \sum_{i=0}^m \Phi_i$, matrix of accumulated forecast error impulse responses
- $\Psi_\infty := \sum_{i=0}^\infty \Phi_i$, matrix of total or long-run forecast error impulse responses
- Θ_i matrix of orthogonalized impulse responses
- $\Xi_m := \sum_{i=0}^m \Theta_i$, matrix of accumulated orthogonalized impulse responses
- $\Xi_\infty := \sum_{i=0}^\infty \Theta_i$, matrix of total or long-run orthogonalized impulse responses
- $\omega_{jk,h}$ proportion of h -step forecast error variance of variable j , accounted for by innovations in variable k
- Ξ matrix of long-run effects
- Ξ_j^* matrix of transitory effects

Moment Matrices

Γ := $\text{plim } ZZ'/T$

$\Gamma_y(h)$:= $\text{Cov}(y_t, y_{t-h})$ for a stationary process y_t

$R_y(h)$ correlation matrix corresponding to $\Gamma_y(h)$

Σ_u := $E(u_t u_t')$ = $\text{Cov}(u_t)$, white noise covariance matrix

Σ_y := $E[(y_t - \mu)(y_t - \mu)'] = \text{Cov}(y_t)$, covariance matrix of a stationary process y_t

P lower triangular Choleski decomposition of Σ_u

$\Sigma_{\hat{\alpha}}$ covariance matrix of the asymptotic distribution of $\sqrt{T}(\hat{\alpha} - \alpha)$

$\Omega(h)$ correction term for MSE matrix of h -step forecast

$\Sigma_y(h)$ MSE or forecast error covariance matrix of h -step forecast of y_t

$\Sigma_{\hat{y}}(h)$ approximate MSE matrix of h -step forecast of estimated process y_t

Author Index

- Abraham, B., 609
Ahn, S.K., 157, 165, 170, 222, 271, 272,
280, 290, 292–294, 297, 316, 323
Akaike, H., 146, 147, 507
Alavi, A.S., 507
Amisano, G., 358, 374
Anděl, J., 604, 625
Andersen, A.P., 624, 625
Anderson, B.D.O., 612, 628, 630, 637
Anderson, T.W., 104, 186, 222, 397,
619, 645, 677, 691
Andrews, D.W.K., 318
Ansley, C.F., 618
Aoki, M., 507, 612, 616
- Baba, Y., 564
Bai, J., 609
Baillie, R.T., 406, 562
Banerjee, A., 301, 343
Baringhaus, L., 177
Barone, P., 30
Bartel, H., 515, 523
Basu, A.K., 95, 316
Bauer, D., 636, 637
Bauwens, L., 559, 568, 571, 577
Benkwitz, A., 112, 113, 129, 710, 711
Bera, A.K., 175, 177, 559
Berk, K.N., 532
Bernanke, B., 357
Bewley, R., 343
Bhansali, R.J., 532
Bierens, H.J., 343, 398
Black, F., 568
Blanchard, O., 357, 367, 376, 385
- Boes, D.C., IX
Bollerslev, T., 559, 560, 562, 564, 565
Bosschaerts, P., 300
Boswijk, H.P., 307, 342, 604
Box, G.E.P., 171, 400, 401, 493, 495,
507, 609
Brailsford, T.J., 212
Braun, P.A., 568
Breitung, J., 343, 357, 364, 366, 372,
386
Brelsford, W.M., 604
Breusch, T.S., 173, 301, 698
Brockwell, P.J., 86, 434
Brooks, C., 573, 583
Brüggemann, R., 211, 212, 297, 345,
346, 348, 357, 364, 366, 372, 375,
386
Bucy, R.S., 625
Burda, M.M., 106–108
Burke, S., 573, 583
- Caines, P.E., 637
Calzolari, G., 578
Candelon, B., 184
Caner, M., 342
Caporale, G.M., 301
Cheung, Y.W., 579
Chitturi, R.V., 157
Choi, I., 343
Chou, R.Y., 559
Chow, G.C., 410, 411, 413, 623
Christiano, L.J., 362
Cipra, T., 604
Claessen, H., 515, 518, 526, 529

- Cleveland, W.P., 604
 Comte, F., 569, 579
 Cooley, T.F., 623
 Cooper, D.M., 507
 Craig, A.T., IX, 677
 Crowder, M.J., 637
- Davidson, J., 246, 400, 681, 689, 691, 699
 Davies, N., 171
 Davis, R.A., 86, 434
 Deistler, M., 397, 400, 422, 455, 467, 476, 477, 479, 499, 500, 502, 504, 505, 612, 616
 Dellaportas, P., 567, 584
 Demiroglu, U., 181, 348
 DeMoor, B., 479
 Dempster, A.P., 635
 Dent, W., 104
 Diebold, F.X., 562
 Doan, T., 225, 311, 623
 Dolado, J.J., 301, 318–320, 343
 Doornik, J.A., 173, 181, 307, 341, 576
 Dufour, J.M., 49, 50, 94, 161
 Dunsmuir, W.T.M., 479
 Durlauf, S.N., 290, 302, 323, 704
- Edgerton, D., 173
 Efron, B., 710, 711
 Eichenbaum, M., 362
 Engle, R.F., 245, 246, 316, 343, 388, 559, 560, 562, 564–566, 568, 577, 579, 581–583, 620, 621, 635
 Ericsson, N.R., 388
 Evans, C., 362
- Fiorentini, G., 578
 Fisher, L.A., 372
 Forni, M., 621
 Franses, P.H., 604
 Friedmann, R., 411
 Fuller, W.A., VIII, 35, 73, 84, 159, 546, 681, 685, 687–689
- Gabr, M.M., 625
 Galbraith, J.W., 301, 343
 Galí, J., 364, 376
 Gallant, A.R., 398, 580, 695
 Gasser, T., 177
- Geweke, J., 51, 104, 388, 620
 Ghysels, E., 583, 604
 Giannini, C., 358, 374, 375
 Gladyshev, E.G., 604
 Glostén, L., 568
 Godfrey, L.G., 173
 Gonzalo, J., 300, 343, 357, 370, 372
 Granger, C.W.J., 33, 41, 51, 245, 246, 343, 507, 562, 579, 624, 625
 Graybill, F.A., IX, 645
 Gregory, A.W., 698
 Griffiths, W.E., 229, 398, 400, 470–472, 677, 681
 Grupe, M.R., 604
 Guo, L., 523
- Hafner, C.M., 568, 582
 Haggan, V., 625
 Haldrup, N., 604
 Hall, P., 710, 711
 Hallin, M., 621
 Hamilton, J.D., VIII, 637, 690, 691, 700, 703, 704
 Hannan, E.J., 25, 141, 149, 150, 159, 397, 400, 422, 455, 476, 477, 479, 495, 498–500, 502, 504, 505, 523, 612
 Hansen, B.E., 301, 302
 Hansen, G., 297
 Hansen, H., 181, 351
 Hansen, P.R., 349
 Hanssens, D.M., 401
 Harbo, I., 401
 Harvey, A.C., 397, 583, 612, 618, 619
 Hassler, U., 343
 Hasza, D.P., 95
 Haug, A.A., 343, 401
 Haugh, L.D., 401
 Hausman, J.A., 398
 Hayashi, F., 398, 697
 Hendry, D.F., 212, 246, 301, 341, 343, 388, 576
 Henze, N., 177
 Herwartz, H., 568, 571, 582, 584, 604
 Higgins, M.L., 559
 Hildreth, C., 623
 Hill, R.C., 229, 398, 400, 470–472, 677, 681
 Hillmer, S.C., 463, 466

- Ho, M.S., 343
 Hogg, R.V., IX, 677
 Hong, Y., 579
 Horowitz, J.L., 709
 Hosking, J.R.M., 157, 171, 508, 510
 Houck, J.P., 623
 Hsiao, C., 212
 Huang, D.W., 523
 Hubrich, K., 336, 341, 343
 Huh, H., 372
 Hui, Y.V., 604
 Hylleberg, S., 411

 Inder, B., 301, 312

 Jacobson, T., 357
 Jagannathan, R., 568
 Jakeman, A.J., 401
 Jarque, C.M., 175, 177
 Jazwinski, A.H., 612
 Jeantreau, T., 570
 Jenkins, G.M., 400, 493, 495, 507
 Johansen, S., 251, 280, 283, 290, 294,
 296, 300, 302, 329–332, 334–336,
 340, 341, 351, 400, 401, 699, 704
 Jones, R.H., 604, 618
 Judge, G.G., 229, 398, 400, 470–472,
 677, 681
 Juselius, K., 302

 Kalman, R.E., 625
 Kapetanios, G., 479
 Kauppi, H., 318
 Kavalieris, L., 400, 476, 477, 498, 504
 Kilian, L., 126, 181, 348
 Kim, J.R., 297
 King, R.G., 357, 370, 371, 377
 Kitagawa, G., 618
 Kleibergen, F., 312
 Kohn, R., 463, 479, 508, 618
 Koop, G., 312, 383, 581
 Koreisha, S.G., 479
 Kraft, D.F., 562, 564
 Krätzig, M., IX
 Krolzig, H.M., 212
 Kroner, K.F., 559, 564–566, 577, 583

 Laird, N.M., 635
 Laurent, S., 559, 568, 571, 577

 Lee, K.C., 383
 Lee, T.C., 229, 398, 400, 470–472, 677,
 681
 Lee, T.H., 343
 Lewis, R., 532, 536
 Li, H., 710
 Li, W.K., 157, 510, 583, 604
 Lieberman, O., 569, 579
 Lilien, D.M., 583
 Lin, W.L., 567, 582
 Ling, S., 570
 Lippi, M., 621
 Litterman, R.B., 225, 311, 315, 623
 Liu, J., 625
 Liu, L.M., 401
 Ljung, G.M., 171
 Lomnicki, Z.A., 175
 Lucas, A., 342
 Lucas, R.E., 394
 Lumsdaine, R.L., 609
 Lundbergh, S., 577
 Lütkepohl, H., 49, 63, 106–108, 110,
 112, 113, 116, 129, 138, 156, 178,
 184, 186, 188, 189, 211, 212, 229,
 263, 297, 302, 303, 309, 318, 320,
 327, 334, 336, 337, 339–341, 343,
 345, 346, 348, 357, 364, 366, 372,
 386, 398, 400, 435, 438, 440, 441,
 470–472, 515, 518, 523–526, 529,
 534–536, 541, 543, 546, 549–552,
 561, 568, 571, 582, 595, 602, 605,
 645, 669, 677, 681, 710, 711
 Luukkonen, R., 525

 MacDonald, G.M., 177
 MacKinnon, J.G., 401
 Maddala, G.S., 710
 Magnus, J.R., 645, 651, 672, 674
 Mann, H.B., 73
 Mardia, K.V., 177
 McAleer, M., 570
 McLeod, A.I., 157, 510
 McMurtrie, R., 401
 Meese, R., 104
 Meinhold, R.J., 611, 630
 Michelis, L., 401
 Mittnik, S., 297, 431
 Mood, A.M., IX
 Moore, J.B., 612, 628, 630, 637

- Morrison, D.F., 619
 Mosconi, R., 335
 Murata, Y., 410, 411, 670
 Muth, J.F., 393
- Nankervis, J.C., 82
 Nelson, D.B., 559, 568
 Nerlove, M., 562
 Neudecker, H., 645, 651, 672, 674
 Neumann, M., 112, 113, 129, 711
 Newbold, P., 33, 171, 507
 Ng, L.K., 579
 Ng, S., 357, 370, 372
 Ng, V.G., 581, 582
 Nicholls, D.F., 82, 623, 635, 637
 Nielsen, B., 335, 341, 401
 Nijman, T.E., 618
- Osborn, D.R., 604
 Ouliaris, S., 343
 Ozaki, T., 625
- Paap, R., 312
 Pagan, A.R., 364, 366, 559, 623, 635, 637
 Pagano, M., 604
 Palm, F., 494, 496
 Pantelidis, T., 579
 Park, J.Y., 251, 280, 290, 302, 704
 Paulsen, J., 82, 86, 144, 149, 150, 326
 Penm, J.H.W., 207, 212
 Persand, G., 583
 Pesaran, M.H., 383, 394, 581
 Phillips, P.C.B., 251, 280, 290, 297, 300–302, 318, 323, 343, 548, 700, 704
 Pierse, R.G., 383, 618
 Pittis, N., 301, 579
 Plosser, C.I., 357, 370, 371, 377
 Politis, D.N., 567, 584
 Pope, A.L., 82, 623
 Poskitt, D.S., 327, 400, 401, 477, 495, 498, 499, 505–508, 510, 515, 517, 518, 522–525, 534, 535, 541, 543
 Pötscher, B.M., 467
 Potter, S.M., 581
 Prescott, E., 623
 Priestley, M.B., 625
 Proietti, T., 619
- Pukkila, T.M., 479
- Quah, D., 357, 367, 376, 385
 Quenouille, M.H., 507
 Quinn, B.G., 149, 150, 153
- Rahbek, A., 401
 Rao, C.R., 173, 677, 690, 691
 Reichlin, L., 621
 Reimers, H.E., 302, 316, 320
 Reinsel, G.C., 86, 222, 271, 272, 280, 290, 292–294, 297, 316, 323, 522, 525, 532, 536
 Renault, E., 49, 50, 583
 Richard, J.F., 388
 Rissanen, J., 495
 Robins, R.P., 579, 583
 Rohatgi, V.K., IX
 Rombouts, J.V.K., 559, 568, 571, 577
 Rossi, P.E., 580
 Rothenberg, T.J., 360, 375
 Roussas, G.G., 681
 Roy, R., 161
 Rubin, D.B., 635
 Runkle, D., 126, 568
- Saikkonen, P., 254, 292, 294, 334, 336, 337, 339–341, 343, 345, 346, 348, 525, 546, 549–553, 609
- Salmon, M., 246
 Samaranyake, V.A., 95
 Sargent, T.J., 394, 620
 Savin, N.E., 82
 Schmidt, P., 407, 693, 698
 Schneider, W., 178, 628, 635, 637
 Schwarz, G., 150
 Searle, S.R., 645
 Sen Roy, S., 95, 316
 Sentana, E., 578
 Serfling, R.J., 681, 693
 Shapiro, M., 357
 Shibata, R., 151
 Shin, Y., 343, 383
 Shukur, G., 173
 Sims, C.A., 66, 116, 225, 289, 311, 320, 357, 383, 620, 623, 704
 Singpurwalla, N.D., 611, 630
 Smith, J.P., 604
 Snell, A., 343
 Solo, V., 548, 633, 704

- Sørensen, B.E., 343
 Srba, F., 246
 Stensholt, B.K., 625
 Stock, J.H., 289, 300–302, 320, 343, 357,
 370, 371, 377, 609, 621, 704
 Strachan, R.W., 312
 Subba Rao, T., 625
 Sunier, A.M., 568
 Swamy, P.A.V.B., 623
- Tauchen, G., 580
 Tavlas, G.S., 623
 Tay, A.S., 41
 Taylor, S.J., 560
 Teräsvirta, T., 577, 625
 Terrell, R.D., 207, 212
 Theil, H., 59
 Tiao, G.C., 463, 466, 507, 604, 609
 Tibshirani, R.J., 710, 711
 Tjøstheim, D., 82, 86, 144, 150, 625
 Toda, H.Y., 318
 Todd, P.H.J., 618
 Tong, H., 625
 Tremayne, A.R., 401, 508, 510
 Trenkler, C., 334, 339, 340, 609
 Triggs, C.M., 171
 Tsay, R.S., 326, 401, 507, 609
 Tse, Y.K., 568, 577
 Tso, M.K.S., 222, 675
 Tsui, A.K.C., 568, 577
- Uhlig, H., 383
 Ungern-Sternberg, T. von, 246
- van der Weide, R., 568
 van Dijk, H.K., 312
- van Overschee, P., 479
 Veall, M.R., 698
 Velu, R.P., 222
 Villani, M., 312
 Vlaar, P.J.G., 376, 377
 Vredin, A., 357
 Vrontos, I.D., 567, 584
- Wagner, M., 636, 637
 Wald, A., 73
 Wallis, K.F., 41, 494
 Warne, A., 357
 Watanabe, N., 637
 Watson, M.W., 289, 300, 301, 320, 343,
 357, 370, 371, 377, 620, 621, 635,
 704
 Weber, C.E., 385
 Wei, W.W.S., 616
 White, H., 177, 398
 Wichern, D.W., 222
 Wickens, M.R., 301
 Wold, H., 25
 Wolters, J., 710
 Wong, H., 583
 Wood, E.F., 507
 Wooldridge, J.M., 562, 564, 565
- Yamamoto, T., 318, 406
 Yang, M., 343
 Yap, S.F., 522, 525
 Yeo, S., 246
 Yoo, B.S., 316
 Young, P.C., 401
- Zellner, A., 71, 494, 496
 Zha, T., 116, 383

Subject Index

- Accumulated forecast error impulse responses, 55, 108
- Accumulated impulse responses, 55, 108
- Accumulated orthogonalized impulse responses, 108
- Adjoint of a matrix, 649
- Aggregation
 - of MA processes, 435–436
 - of VARMA processes, 440–441
 - contemporaneous —, 434–435, 440
 - temporal —, 434–435, 440–441, 616–618
- AIC, 147, 208
- Akaike information criterion, *see* AIC
- Analysis
 - Bayesian —, 222–229, 309–315
 - causality —, 261–262, 316–321, 441–444
 - impulse response —, 205–206, 262–264, 321–322, 444, 490
 - multiplier —, 392, 406–408
- ARCH model, 557–584
 - generalized —, 559
 - interpretation of —, 579–582
 - multivariate —, 563–564
 - univariate —, 559–562
- ARCH process, 557–584
 - forecasting of —, 561–562
 - generalized —, 559
- ARCH-in-mean, 583
- ARCH-LM test, 576–577
- ARCH-M, 583
- ARCH-portmanteau test, 576–577
- ARMA_{RE} form
 - of VARMA process, 518–519
 - estimation of —, 521–522
- Asymmetric GARCH model, 568
- Asymptotic distribution
 - of EGLS estimator, 197
 - of GLS estimator, 197
 - of LM statistic, 510
 - of LR statistic, 140
 - of LS estimator, 73, 532
 - of ML estimator, 93, 200, 296, 479–487, 636–637
 - of Wald statistic, 102, 321
 - of Yule-Walker estimator, 86
 - of autocorrelations, 159
 - of autocovariances, 159
 - of forecast error variance decomposition, 110–112, 541–543
 - of impulse responses, 110–112, 205–206, 321–322, 541–543
 - of kurtosis, 175, 178
 - of lag augmented Wald statistic, 318
 - of multivariate LS estimator, 73, 532
 - of residual autocorrelations, 166, 213
 - of residual autocovariances, 165, 213
 - of skewness, 175, 178
- Asymptotic properties
 - of LM statistic, 138–143
 - of LR statistic, 508–510

- of LS estimator, 72–77, 531–536
- of ML estimator, 90–93, 200, 296, 479–487, 636–637
- of Wald statistic, 102, 321
- of Yule-Walker estimator, 86
- of estimated forecasts, 93–102, 405–406, 536–538
- of impulse responses, 110–112, 321, 490
- of lag augmented Wald statistic, 318
- of sample mean, 84
- of white noise covariance matrix estimator, 75–76, 200, 296, 479–481
- Asymptotically stationary process, 241
- Autocorrelation function
 - of VAR process, 30–31
 - of VARMA process, 430
 - of residuals, 161–169, 212–214
 asymptotic distribution of —, 157–171
 estimation of —, 157–171
- Autocorrelation matrix
 - of VARMA process, 430
 - of residuals, 161–169, 212–214
 estimation of —, 157–171
- Autocovariance function
 - of MA process, 422
 - of VAR process, 21, 26–30
 - of VARMA process, 429–432
 - of residuals, 161–169, 212–214
 asymptotic distribution of —, 157–171
 estimation of —, 157–169
- Autoregressive conditional heteroskedasticity, 559
- Autoregressive process, 4
- Autoregressive representation of VARMA process
 - infinite order —, 425
 - pure —, 425
- Bayesian estimation
 - of Gaussian VAR process, 222–229
 - of integrated systems, 309–315
 - with normal priors, 222–225, 309–312
 basics of —, 222
- BEKK model, 565–567
- Beveridge-Nelson decomposition, 242, 703
 - multivariate —, 252, 704
- Bilinear state space model, 624
- Bilinear time series model, 624
- Block bootstrap, 710
- Bootstrap, 709–712
 - Hall's percentile interval, 710
 - Hall's studentized interval, 710
 - confidence interval, 710
 - standard percentile interval, 710
 - block —, 710
 - residual based —, 709
- Bootstrap confidence interval
 - Hall's percentile —, 710
 - Hall's studentized —, 710
 - standard percentile —, 710
- Bottom-up specification of subset VAR model, 210–211
- Bounded in probability, 684
- Box-Jenkins methodology, 493, 495
- Breusch-Godfrey test for autocorrelation, 171–174
- Brownian bridge, 338
- Brownian motion, 698
 - multivariate —, 703
- Causality, 41–51, 102–108, 261–262, 316–321, 441–444
 - in r -th moment, 579
 - in variance, 579–580
 Granger —, 41–51
 instantaneous —, 41–51
 multi-step —, 41–51
 Wold —, 359
- CCC GARCH model, 568
- Central limit theorem, 689–692
 - for martingale difference arrays, 691
 - for stationary processes, 691
 Donsker's —, 699
 functional —, 699
 invariance principle, 699
 Lindeberg-Levy —, 691
- Chain rule for vector differentiation, 665
- Characteristic
 - determinant, 652

- value of a matrix, 652
- vector of a matrix, 652
- polynomial
 - of a matrix, 652
- Chebyshev's inequality, 689
- Chebyshev's theorem, 690
- Checking the adequacy
 - of VAR models, 157–189
 - of VARMA models, 508–510
 - of cointegrated systems, 344–351
 - of dynamic SEMs, 400–401
 - of subset VAR models, 212–217
- Checking the whiteness
 - of VAR residuals, 157–174
 - of VARMA residuals, 510
- Chi-square distribution, 678
 - noncentral —, 679
- Choleski decomposition, 362
 - of a positive definite matrix, 659
- Chow forecast test, 183
- Chow test, 182
- Closed-loop control strategy, 388
- CLT, 689
- Cofactor of an element of a square matrix, 648
- Cointegrated process, 244–256
 - of order (d, b) , 245
- Cointegrated system, 244–256
 - Granger representation theorem for —, 251
 - vector error correction model of —, 244–256
- Cointegrated VAR process, 256
 - checking the adequacy of —, 344–351
 - estimation of —, 269–309
 - forecasting of —, 258–261, 315–316
 - GLS estimation of —, 291–294
 - Granger-causality in —, 261, 316
 - impulse response analysis of —, 262–264, 321–322
 - least squares estimation of —, 286–291
 - LS estimation of —, 286–291
 - ML estimation of —, 294–300
 - structural analysis of —, 261–264, 316–322
 - two-stage estimation of —, 301–302
- Cointegrated VARMA process, 515–521
 - ARMA_{RE} form of —, 518–519
 - EC-ARMA_{RE} form of —, 519–521
 - error correction echelon form of —, 519–521
 - estimation of —, 521–522
 - reverse echelon form of —, 518–519
 - specification of cointegrating rank of —, 525–526
- Cointegrating
 - matrix, 256
 - vector, 245
- Cointegrating rank, *see* cointegration rank
- Cointegration matrix, 248
- Cointegration rank, 248
 - of VAR process, 248
 - of VARMA process, 525–526
 - LR test for —, 327–335, 551–552
 - maximum eigenvalue test for —, 329
 - testing for —, 327–343, 551–552
 - trace test for —, 329
- Column vector, 645
- Common trend, 245
- Commutation matrix, 663
- Complex matrix, 657
- Complex number
 - modulus of —, 652
- Conditional forecast, 402
- Conditional likelihood function, 464
- Conditional model, 387
- Conditional moment profiles, 580–582
- Confidence interval
 - for forecast error variance components, 114
 - for impulse responses, 112
 - Hall's percentile —, 710
 - Hall's studentized —, 710
 - standard percentile —, 710
- Consistency
 - super —, 288, 301
- Consistent estimation
 - of Kronecker indices, 501
 - of VAR order, 148–150, 326
 - of white noise covariance matrix, 76
- Constant conditional correlation
 - GARCH model, 568
- Constrained VAR models
 - linear constraints, 194–221
 - nonlinear constraints, 221–222

- Contemporaneous aggregation of VARMA process, 440
- Continuous mapping theorem, 699
- Convergence
 - almost surely, 682
 - in distribution, 682
 - in law, 682
 - in mean square error, 682
 - in probability, 681
 - in quadratic mean, 682
 - with probability one, 682
 - strong —, 682
 - weak —, 682
- Cramér-Wold device, 691
- Data generation process, 4
- DCC GARCH model, 568
- Decomposition of matrices, 656–659
 - Choleski —, 659
 - Jordan —, 656–657
- Definite
 - matrix, 655–656
 - quadratic form, 655–656
- Degree
 - McMillan —, 453
- Degrees of freedom, 678
- Determinant of a matrix, 647
- Deterministic trend, 238
- DGP, 4
- Diagnostic checking
 - of VAR models, 157–189
 - of VARMA models, 508–510
 - of cointegrated systems, 344–351
 - of dynamic SEMs, 400–401
 - of restricted VAR models, 212–214
- Diagonal matrix, 646
- Diagonalization of a matrix, 657–658
- Dickey-Fuller test, 700
- Difference operator, 242
- Differencing, 242
- Differentiation of vectors and matrices, 664–671
- Direction matrix, 471
- Discrete stochastic process, 3
- Distributed lag model, 387, 391–392
 - rational —, 391–392
- Distribution
 - multivariate normal, 677–678
 - normal, 677–678
 - of quadratic form, 678
 - chi-square —, 678
 - F —, 679
 - noncentral F —, 680
 - noncentral chi-square —, 679
 - posterior —, 222
 - prior —, 222
- Distribution function, 3
 - joint —, 3
- Donsker's theorem, 699, 704
- Drift of a random walk, 238
- Dummy variable, 585
 - seasonal —, 585
- Duplication matrix, 662
- Dynamic
 - MIMIC model, 621
 - factor analytic model, 620
 - multipliers, 392
- Dynamic conditional correlation GARCH model, 568
- Dynamic SEM
 - checking the adequacy of —, 400–401
 - estimation of —, 394–400
 - final equations of —, 392
 - final form of —, 391
 - forecasting of —, 401–406
 - conditional —, 402
 - unconditional —, 402
 - multipliers of —, 406–408
 - optimal control of —, 408–411
 - rational expectations in —, 392–394
 - reduced form of —, 390
 - specification of —, 400–401
 - structural form of —, 390
- EC-ARMA_{RE} form
 - of VARMA process, 519–521
 - estimation of —, 522
 - specification of —, 523–526
- Echelon form
 - VARMA representation, 452–453
 - of a VARMA process, 452–453
 - specification of —, 498–507
- Effect of linear transformations
 - on MA process, 435
 - on VARMA orders, 436
 - on forecast efficiency, 439
- Efficiency
 - of estimators, 198–200

- of forecasts, 439
 - EGARCH model, 568
 - EGLS estimation
 - of parameters arranged equation-wise, 200–201
 - asymptotic properties of —, 197–200
 - implied restricted —, 197
 - restricted —, 197–201
 - Eigenvalue of a matrix, 652
 - Eigenvector of a matrix, 652
 - Elimination matrix, 662
 - EM algorithm, 635
 - Empirical distribution, 707
 - generation of —, 707
 - Endogenous variable, 387–390, 613
 - Equilibrium, 244–245
 - Equilibrium relation, 245
 - Error correction echelon form, 519–521
 - estimation of —, 522
 - specification of —, 523–526
 - Error correction model, 246
 - Error process
 - of the measurement equation of a state space model, 613
 - of the transition equation of a state space model, 613
 - Estimated generalized least squares estimation, *see* EGLS estimation
 - Estimation
 - of AB-model, 372–375
 - of ARMA_{RE} form, 521–522
 - of Blanchard-Quah model, 376
 - of SVAR, 372–376
 - of SVAR with long-run restrictions, 376
 - of SVECM, 376–377
 - of VAR models, 69–93, 531–536
 - of VARMA models, 447–487
 - of autocorrelations, 157–169
 - of autocovariances, 157–169
 - of cointegrated VARMA process, 521–522
 - of cointegrated systems, 269–309
 - of dynamic SEMs, 394–400
 - of error correction echelon form, 522
 - of integrated VAR processes, 309–315
 - of multivariate GARCH model, 569–571
 - of periodic models, 594–598
 - of process mean, 83–85
 - of reverse echelon form, 521–522
 - of state space models, 631–637
 - of time varying coefficient models, 589–591
 - of white noise covariance matrix, 75–77, 197–198
 - with linear restrictions, 195–204
 - with nonlinear restrictions, 222
 - with unknown process mean, 85
 - Bayesian —, 222–229
 - EGLS —, 197
 - generalized least squares —, 291–294
 - GLS —, 195
 - least squares —, 286–291
 - LS —, 69–82, 197
 - maximum likelihood —, 87–93, 200, 294–300, 589–591
 - multivariate least squares —, 69–82, 531–536
 - preliminary —, 474–477
 - restricted
 - EGLS —, 195–200
 - GLS —, 195–200
 - restricted —, 195–204, 222
 - two-stage —, 301–302
 - Yule-Walker —, 85–86
- Exact likelihood function, 458–461
- Exogenous variable, 387–390
 - strictly —, 389
 - strongly —, 388
 - super —, 388
 - systems with —, 388–390
 - weakly —, 388
- Expectation
 - rational —, 392
- F*-distribution, 679
 - noncentral, 680
- Factor analytic model
 - dynamic —, 620
- Factor GARCH model, 567
- Factor loadings, 620
- FCLT, 699
- Filter
 - Kalman —, 625–631

- Filtering, 625
- Final equations form
 - VARMA representation, 452
 - of a dynamic simultaneous equations model, 392
 specification of —, 494–498
- Final form of a dynamic simultaneous equations system, 391
- Final prediction error criterion, *see* FPE criterion
- Finite order MA process, 420–423
- Forecast
 - interval, 39–41
 - of VAR process, 93–102, 536–540
 - of VARMA process, 432–434, 487–490
 - region, 39–41
 conditional —, 402
 estimated —, 93–102, 487–490, 536–540
 loss function for —, 32–33
 minimum MSE —, 35–39
 point —, 33–39
 unconditional —, 402
- Forecast error, 93–95
- Forecast error impulse responses, 51–56
- Forecast error variance component, 108
- Forecast error variance decomposition, 63–66, 540–545
 - of VAR process, 63–66
 - of cointegrated system, 264
 asymptotic distribution of —, 108–118, 205–206, 541–543
 structural —, 381–382
- Forecast interval, 98
- Forecast MSE matrix, 434
 - approximate —, 96–98, 489–490, 536
- Forecast region, 98
- Forecasting
 - of ARCH process, 561–562
 - of GARCH model, 561–562
 - of VAR process, 31–41
 - of VARMA process, 432–434
 - of cointegrated system, 258–261, 315–316
 - of dynamic SEM, 401–406
 - of estimated VAR process, 93–102, 204–205
 - of estimated VARMA process, 487–490
 - of infinite order VAR process, 536–540
 - of integrated system, 258–261, 315–316
 - of restricted VAR process, 204–205
- FPE criterion, 146
- Fully modified VAR estimation, 318
- Functional central limit theorem, 699
 - multivariate —, 704
- GARCH model, 557–584
 - asymmetric —, 568
 - CCC —, 568
 - constant conditional correlation —, 568
 - dynamic conditional correlation —, 568
 - exponential —, 568
 - factor —, 567
 - generalized orthogonal —, 568
 - interpretation of —, 579–582
 - multivariate —, 562–584
 - univariate —, 559–562
- GARCH process, 557–584
 - forecasting of —, 561–562
- Gaussian likelihood function
 - of MA process, 458–463
 - of VAR process, 87–89
 - of VARMA process, 463–467
 - of cointegrated process, 294
 - of state space model, 631–633
- Gaussian process
 - VAR, 16
 - VARMA, 423
 - white noise, 75
- Generalized autoregressive conditional heteroskedasticity, 559
- Generalized impulse responses, 580–582
- Generalized inverse of a matrix, 650
- Generalized orthogonal GARCH model, 568
- Generating process of a time series, 4
- Generation process of a time series, 4
- Global identification, 633–634
- Globally identified model, 633–634
- GLS estimation, 195–200
 - of cointegrated system, 291–294

- asymptotic properties of —, 197
- Gradient
 - algorithm, 469
 - of log-likelihood function, 635
 - of vector function, 469
- Granger representation theorem, 251
- Granger-causality
 - in VAR models, 41–51, 102–104
 - in VARMA models, 441–444
 - in cointegrated system, 261–262
 - in cointegrated systems, 316–321
 - characterization of —, 316
 - lag augmentation test for —, 318
 - lag augmented Wald test for —, 318
 - test for —, 102–104, 316–321
 - Wald test for —, 102–104, 316–321
- Hall's percentile confidence interval, 710
- Hall's studentized confidence interval, 710
- Hannan-Kavalieris procedure, 503–505
- Hannan-Quinn criterion, *see* HQ criterion
- Hessian matrix, 665
- HQ criterion, 150, 208
- Idempotent matrix, 653
- Identification
 - of VARMA model, 447–458
 - of VARX model, 400
 - of dynamic simultaneous equations system, 400
 - of state space model, 633–634
 - global —, 634
 - local —, 634
- Identification problem, 447–458
- Identified model
 - globally —, 634
 - locally —, 634
 - state space, 633–634
 - VARMA, 447–458
- Identity matrix, 646
- Impact multiplier, 61
- Impulse response analysis, 377–382
 - of VAR model, 51–63
 - of VARMA model, 444, 490
 - of cointegrated system, 262–264, 321–322
- Impulse responses, 51–63, 377–382
 - of VARMA model, 444, 490
 - of cointegrated system, 262–264, 321–322
 - accumulated —, 55
 - asymptotic distribution of —, 108–118, 205–206, 541–543
 - estimation of —, 108, 205–206
 - forecast error —, 51–56
 - generalized —, 580–582
 - orthogonalized —, 56–62, 359
 - structural —, 359, 377–382
 - total —, 56
- Indefinite
 - matrix, 656
 - quadratic form, 656
- Index model, 222
- Infinite order MA representation
 - of a VARMA process, 423
 - of a time varying coefficient process, 587
- Infinite order VAR representation
 - of a VARMA process, 425
 - of an MA process, 420
- Information matrix
 - of VAR process, 90
 - of VARMA process, 472–474
 - of state space model, 635
 - of time varying coefficient VAR model, 591
- Initial
 - input, 613
 - state, 613
- Innovations
 - structural —, 359
- Input
 - matrix of a state space model, 613
 - variables, 388
 - observable —, 388, 613
 - unobservable —, 388
- Inputs of a state space model, 613
- Instantaneous causality
 - in VAR models, 41–51
 - tests for —, 104–108
- Instrument
 - variable, 388, 613
 - observable —, 388, 613
- Integrated
 - of order d , 242
 - process, 237–244

- time series, 237–244
- variable, 237–244
- Integration
 - order of —, 242
- Interim multipliers, 56, 392
- Interpretation
 - of ARCH model, 579–582
 - of GARCH model, 579–582
 - of VARMA model, 441–444
 - classical versus Bayesian —, 228–229
- Interval forecast, 39–41, 98
- Intervention
 - in intercept model, 604–606
 - testing for —, 605–606
- Intervention model, 586
 - estimation of —, 604–608
 - specification of —, 604–608
- Invariance principle, 699
 - multivariate —, 704
- Inverse of a matrix, 649
- Invertible
 - MA operator, 422
 - MA process, 420–422
 - VARMA process, 425
 - matrix, 649
- IS-LM model, 366
- Iterative optimization algorithm
 - EM algorithm, 635
 - Newton algorithm, 471
 - scoring algorithm, 472, 634–636
- Jarque-Bera test, 175
- Jordan canonical form, 657
- Kalman filter, 625–631
 - correction step, 627
 - forecasting step, 627
 - gain, 627
 - initialization, 627
 - prediction step, 627
 - recursions, 626–630
 - smoothing step, 630
- Kalman gain, 627
- Kalman smoothing matrix, 630
- Khinchine's theorem, 690
- Kronecker indices, 453
 - of VARMA process, 453
 - of cointegrated VARMA process, 518
 - of echelon form, 453
 - of reverse echelon form, 518
- determination of —, 498–507
- estimation of —, 498–507
- specification of —, 498–507
- Kronecker product, 660
- Kurtosis
 - asymptotic distribution of —, 175, 178
 - measure of multivariate —, 174–180
- Lagrange function, 671, 695
- Lagrange multiplier statistic, 508–510, 600–601
 - asymptotic distribution of —, 510, 601
- Lagrange multiplier test, 508–510, 600–601, 694–698
- Lagrange multipliers, 671
- Law of large numbers, 689–692
 - for martingale difference arrays, 690
 - for martingale difference sequence, 690
 - for stationary processes, 690
 - strong —, 689
 - weak —, 689
- Least squares estimation
 - of VAR process, 69–82, 531–536
 - of cointegrated VAR process, 286–291
 - with mean-adjusted data, 82–85
 - asymptotic properties of —, 72–77, 197–200, 532–533
 - multivariate —, 69–82, 531–536
 - restricted —, 197–200
 - small sample properties of —, 80–82
- Least squares estimator of white noise
 - covariance matrix, 75–77, 535–536
 - asymptotic properties of —, 75, 535–536
- Left-coprime operator, 452
- Leptokurtosis, 560
- Leverage effect, 568
- Likelihood function, 693
 - of MA process, 458–463
 - of VAR process, 87–89
 - of VARMA process, 463–467
 - of cointegrated process, 294

- of state space model, 631–633
- of time varying coefficient VAR model, 589
- conditional —, 464
- Likelihood ratio statistic
 - asymptotic distribution of —, 140
 - definition of —, 138
- Likelihood ratio test, 694–698
 - for cointegration rank, 327–343, 551–552
 - of linear restrictions, 138–143
 - of periodicity, 598
 - of varying coefficients, 595–598
 - of zero restrictions, 138–143
- Lindeberg-Levy central limit theorem, 691
- Linear constraints
 - for VAR coefficients, 194–195
- Linear system, 387
- Linear transformation
 - of MA process, 435–436
 - of VARMA process, 436–440
 - of multivariate normal distribution, 678
- Linearly dependent vectors, 652
- Linearly independent vectors, 652
- Litterman prior
 - for nonstationary process, 310–315
 - for stationary process, 225–227
- LLN, 689
- LM test, 695
 - for autocorrelation, 171–174
- Loading matrix, 248
- Locally identified model, 634
- Log-likelihood function, 693
- Lomnicki-Jarque-Bera test, 175
- Long-run
 - effect, 392
 - multiplier, 392
- Loss function, 32–33
 - quadratic —, 409
- LR test, 695
- LS estimation, *see* least squares estimation
- MA operator, 422
- MA process
 - autocovariances of —, 422
 - finite order —, 420–423
 - invertible —, 420–422
 - likelihood function of —, 458–463
- MA representation
 - of a VARMA process, 423
 - canonical —, 426
 - forecast error —, 426
 - prediction error —, 426
- MA representation of VAR process, 18–24
- Martingale difference array, 689
 - law of large numbers for —, 690
- Martingale difference sequence, 689
 - law of large numbers for —, 690
 - vector —, 689
- Matrix, 645
 - addition, 646
 - differentiation, 664–671
 - multiplication, 646
 - multiplication by a scalar, 646
 - operations, 646–647
 - rules, 645–675
 - subtraction, 646
- operator
 - left-coprime —, 452
 - unimodular —, 452
- adjoint of —, 649
- characteristic determinant of —, 652
- characteristic polynomial of —, 652
- characteristic root of —, 652
- characteristic value of —, 652
- characteristic vector of —, 652
- Choleski decomposition of —, 659
- cofactor of an element of —, 648
- column dimension of —, 645
- commutation —, 663
- conformable —, 647
- decomposition of —, 656–659
- determinant of —, 647
- diagonal —, 646
- diagonalization of —, 657–658
- duplication —, 662
- eigenvalue of —, 652
- eigenvector of —, 652
- element of —, 645
- elimination —, 662
- full rank —, 652
- generalized inverse of —, 650
- Hessian —, 665
- idempotent —, 653

- identity —, 646
- indefinite —, 656
- information —, 694
- inverse of —, 649
- invertible —, 649
- Jordan canonical form of —, 657
- lower triangular —, 646
- minor of an element of —, 648
- Moore-Penrose inverse of —, 650
- negative definite —, 656
- negative semidefinite —, 656
- nilpotent —, 653
- nonsingular —, 649
- null —, 646
- orthogonal —, 654
- orthogonal complement of —, 654
- partitioned —, 659
- positive definite —, 655
- positive semidefinite —, 655
- rank of —, 652
- regular —, 649
- row dimension of —, 645
- square —, 645
- square root of —, 658
- symmetric —, 646
- trace of —, 653
- transpose of —, 646
- triangular —, 646
- typical element of —, 645
- unit —, 646
- upper triangular —, 646
- zero —, 646
- Maximum eigenvalue test for cointegration rank, 329
- Maximum likelihood estimation, *see* ML estimation
- McMillan degree
 - of VARMA process, 453
 - of echelon form, 453
- Mean squared error matrix, *see* MSE matrix
- Mean vector of a VAR process, 82
- Mean-adjusted
 - VAR process, 82
 - process, 82
- Measurement
 - equation of state space model, 611, 613
 - errors, 613
 - matrix, 613
- MGARCH, 562–584
- MIMIC models, 621
- Minimization
 - algorithms, 469–472
 - iterative —, 469–472
 - numerical —, 469–472
- Minimum MSE forecast, 35–39
- Minor of an element of a square matrix, 648
- ML estimates
 - computation of —, 89–90, 467–477, 631–637
- ML estimation, 693
 - of AB-model, 372–375
 - of Blanchard-Quah model, 376
 - of SVAR, 372–376
 - of SVECM, 376–377
 - of VAR process, 87–93
 - of VAR process with time varying coefficients, 589–591
 - of VARMA process, 458–487
 - of cointegrated system, 294–300
 - of periodic VAR process, 594–598
 - of restricted VAR process, 200
 - of state space model, 631–637
 - quasi —, 140
- Model checking
 - of VAR models, 157–189
 - of VARMA models, 508–510
 - of cointegrated systems, 344–351
 - of dynamic SEMs, 400–401
 - of restricted VAR models, 212–217
 - of state space models, 639
 - of subset VAR models, 212–217
- Model selection
 - of VAR models, 135–157
 - of VARMA models, 493–508
 - of cointegrated processes, 325–344
 - of subset VAR models, 206–212
- Model specification
 - of VAR models, 135–157
 - of VARMA models, 493–508
 - of cointegrated processes, 325–344
 - of dynamic SEMs, 400–401
 - of periodic VAR models, 594–604
 - of subset VAR models, 206–212
- Model specification criteria
 - AIC, 147, 208

- FPE, 146
- HQ, 150, 208
- SC, 150, 208
- Modified portmanteau statistic, 174, 214
 - approximate distribution of —, 174, 214
- Modified portmanteau test, 174, 214, 510
- Modulus of a complex number, 652
- Moore-Penrose (generalized) inverse, 650
- Moving average process, *see* MA process
- Moving average representation of VAR process, 18–24
- MSE matrix, 434
 - approximate —, 96–98, 489–490, 536
- MSE of forecast, 96–98, 434, 489–490, 536
- Multi-step causality
 - in VAR models, 41–51
 - tests for —, 105–108
- Multiplicative operator, 221–222
- Multiplier
 - analysis, 392, 406–408
 - dynamic —, 392
 - impact —, 61
 - interim —, 392
 - long-run —, 392
 - total —, 392
- Multivariate ARCH model, 563–564
 - interpretation of —, 579–582
- Multivariate Beveridge-Nelson decomposition, 252
- Multivariate GARCH model, 562–584
 - BEKK, 565–567
 - estimation of —, 569–571
 - interpretation of —, 579–582
- Multivariate least squares estimation, 69–86
 - of VAR process, 69–82
 - of infinite order VAR process, 531–536
- Multivariate normal distribution, 677–678
 - linear transformation of —, 678
- Multivariate stochastic process
 - discrete —, 3
- Negative definite
 - matrix, 656
 - quadratic form, 656
- Negative semidefinite matrix, 656
- Newton algorithm, 471
- Newton-Raphson algorithm, 471
- Nilpotent matrix, 653
- Noncentral F -distribution, 680
- Noncentral chi-square distribution, 679
- Noncentrality parameter, 679
- Nonlinear
 - parameter restrictions, 221–222
 - state space model, 623–625
- Nonnormality
 - tests for —, 174–180
- Nonsingular matrix, 649
- Nonstationary
 - VAR process, 242, 256, 585–586
 - process, 237, 585–586, 614, 621–623
 - time series, 237
- Normal distribution
 - multivariate, 677–678
- Normal equations
 - for VAR coefficient estimates, 71
 - for VAR process with time varying coefficients, 589
 - for VARMA estimation, 467–469
- Normal prior, 222–225
 - p.d.f., 222
- Normal prior for Gaussian VAR process, 222–225, 309
- Observable
 - input, 388
 - output, 388
 - variables, 388
- Observation
 - equation of state space model, 611, 613
 - error, 611, 613
 - noise, 613
- Open-loop strategy, 411
- Operator
 - left-coprime —, 452
 - MA —, 422
 - unimodular —, 452
- Optimal control, 408–411
 - closed-loop —, 411

- open-loop —, 411
- problem of —, 410
- Optimization
 - algorithms, 469–472
 - of vector functions, 671–675
- Order determination
 - for VAR process, 135–157
 - for cointegrated process, 325–327
 - criteria for —, 146–157
 - tests for —, 136–145
- Order estimation
 - for cointegrated processes, 325–327
 - of VAR process, 146–157
 - consistent —, 148–150
 - criteria for —, 146–157
- Order in probability, 684–685
- Order of
 - MA process, 420
 - VAR process, 136
 - VARMA process, 423
- Orthogonal
 - matrix, 654
 - vectors, 654
- Orthogonal complement of a matrix, 654
- Orthogonalized impulse responses, 56–62
 - accumulated —, 108
- Orthonormal vectors, 654
- Outlier, 609
- Output
 - of a state space system, 613
 - observable —, 388
- Partial model, 387
- Partitioned matrix, 659
 - rules for —, 659–660
- Period of a stochastic process, 591
- Periodic VAR process
 - definition of, 591–594
 - estimation of, 594–598
 - specification of, 594–604
- Permanent shock, 369
- Point forecast, 33–39
- Policy
 - simulation, 406
 - variable, 613
- Portmanteau statistic, 169–171, 214, 510
 - approximate distribution of —, 169, 214, 510
 - modified —, 171, 214, 510
- Portmanteau test, 169–171, 214, 510
 - modified —, 171, 214, 510
- Positive definite
 - matrix, 655
 - quadratic form, 655
- Positive semidefinite matrix, 655
- Poskitt's procedure, 505–507
- Posterior
 - density, 222
 - mean, 222
 - p.d.f., 222
- Postmultiplication, 647
- Predetermined variable, 388
- Prediction tests for structural change
 - based on one forecast, 184–186
 - based on several forecasts, 186–188
 - for cointegrated systems, 349–351
 - of VAR processes, 184–189
 - of VARMA processes, 510
- Preliminary estimation of VARMA process, 474–477
- Preliminary estimator of VARMA process, 475–477
- Premultiplication, 647
- Probability space, 2
- Process
 - cointegrated —, 244–256
 - invertible MA —, 420–422
 - invertible VARMA —, 425
 - periodic —, 586
 - stable VARMA —, 423
 - VAR —, 5
 - VARMA —, 423–426
- Product rule for vector differentiation, 665
- Pure MA representation of a VARMA process, 423
- Pure VAR representation of a VARMA process, 425
- Quadratic form, 655
 - distribution of —, 678
 - indefinite —, 656
 - independence of —, 679
 - negative definite —, 656
 - negative semidefinite —, 656

- positive definite —, 655
- positive semidefinite —, 655
- Quasi ML estimator, 140
- Random coefficient VARX model, 621–623
- Random variable, 2
- Random vector, 3
- Random walk, 237
- Random walk with drift, 238
- Rank of a matrix, 652
- Rank of cointegration
 - LR test for —, 327–343, 551–552
 - testing for —, 327–343, 551–552
- Rational
 - distributed lag model, 391–392
 - expectations, 392
 - transfer function, 392
 - transfer function model, 392
- Real matrices, 645
- Recursions
 - Kalman filter —, 626–630
- Recursive computation
 - of derivatives, 467–468
 - of residuals, 478
- Reduced form of a dynamic SEM, 390
- Regular matrix, 649
- Resampling, 709–712
- Resampling technique, 709–712
- Residual autocorrelation
 - of VAR process, 161–169, 212–213
 - of VARMA process, 510
 - asymptotic properties of —, 166, 212–213
 - estimation of —, 161–169, 212–213
- Residual autocovariance
 - of VAR process, 161–169, 212–213
 - of VARMA process, 510
 - asymptotic properties of —, 165, 212–213
 - estimation of —, 161–169, 212–213
- Residual based bootstrap, 709
- Residuals of VAR process
 - checking the whiteness of —, 157–174, 214
- Residuals of VARMA process
 - checking the whiteness of —, 510
 - estimation of —, 475
- Restricted estimation of VAR models, 195–204
 - asymptotic properties of —, 197–201
 - EGLS, 197–200
 - GLS, 195–197
 - LS, 197
 - ML, 200
- Restrictions for VAR coefficients
 - for individual equations, 200–201
 - linear —, 194–195
 - nonlinear —, 221–222
 - tests of —, 104–108, 138–143
 - Wald test of —, 104–108
 - zero —, 206–212
- Restrictions for VARMA coefficients
 - Granger-causality —, 441–444
 - identifying —, 452–454
 - linear —, 464
 - LM test of —, 508–510
 - tests of —, 508–510
- Restrictions on white noise covariance, 202–204
- Reverse echelon form, 518–519
 - estimation of —, 521–522
- Row vector, 645
- Sample
 - autocorrelations, 159
 - autocovariances, 157
 - mean, 83–85
- SC, 150, 208
- Schwarz criterion, *see* SC
- Score vector, 694
- Scoring algorithm, 374, 472, 634–636
- Seasonal
 - dummies, 585
 - model, 585
 - operator, 221
 - process, 585
 - time series, 585
- Second order Taylor expansion, 671
- SEM, 387
- Sequential elimination of regressors
 - specification of subset VAR model, 211
- Shock
 - permanent —, 369
 - transitory —, 369
- Simulation techniques

- evaluating properties of estimators by —, 707–709
 - evaluating properties of test statistics by —, 707–709
- Simultaneous equations model, *see* SEM
- Skewness
 - asymptotic distribution of —, 175, 178
 - measure of multivariate —, 174–180
- Slutsky's theorem, 683
- Small sample properties
 - of LS estimator, 80–82
 - of VAR order selection criteria, 151–157
 - of estimated forecasts, 100–102
 - of estimators, 707–709
 - of test statistics, 707–709
 - investigation of —, 80, 707–709
- Smoothing, 630
- Smoothing matrix
 - Kalman —, 630
- Smoothing step, 630
- Specification of
 - EC-ARMA_{RE} form, 523–526
 - VAR models, 135–157
 - VARMA models, 493–508
 - cointegrated systems, 325–344
 - dynamic SEMs, 400–401
 - echelon form, 498–507
 - error correction echelon form, 523–526
 - final equations form, 494–498
 - subset VAR models, 206–212
- Specification of cointegrating rank
 - of EC-ARMA_{RE} form, 525–526
 - of VAR process, 327–343
 - of error correction echelon form, 525–526
- Square root of a matrix, 658
- Stability condition, 15, 16
- Stability of a VARMA process, 423
- Stable
 - VAR process, 13–18
 - VARMA process, 423
- Standard percentile confidence interval, 710
- Standard VARMA representation, 448
- Standard white noise, 73
- State space model
 - estimation of —, 631–637
 - global identification of —, 634
 - identification of —, 633–634
 - local identification of —, 634
 - log-likelihood function of —, 631–633
 - ML estimation of —, 631–637
 - nonlinear —, 623–625
- State space representation
 - of VAR process, 614–616
 - of VARMA process, 616
 - of VARX process, 616
 - of VARX process with systematically varying coefficients, 621
 - of factor analytic model, 619–621
 - of random coefficient VARX model, 621–623
- State vector, 611, 613
- Stationarity
 - asymptotic —, 241
 - strict —, 24
- Stationarity condition for VAR process, 25
- Stationary point of a function, 671
- Stationary stochastic process, 24–26
 - strictly —, 24
- Stationary VAR process, 24–26
- Step direction, 469
- Stochastic convergence, 681–684
 - almost surely, 682
 - in distribution, 682
 - in law, 682
 - in mean square error, 682
 - in probability, 681
 - in quadratic mean, 682
 - with probability one, 682
 - strong —, 682
 - weak —, 682
- Stochastic process
 - cointegrated —, 244–256
 - discrete —, 3
 - MA, 420–423
 - multivariate —, 3
 - nonstationary —, 237, 585–586, 614, 621–623
 - periodic —, 591–594
 - VAR, 13–18
 - VARMA, 423–426

- VARX, 387, 616, 621–623
- Stochastic trend, 238
- Stochastic volatility model, 583
- Strictly exogenous variable, 389
- Strictly stationary stochastic process, 24
- Strong law of large numbers, 689
- Strongly exogenous variable, 388
- Structural analysis
 - of VARMA models, 441–444
 - of cointegrated system, 261–264
 - of cointegrated systems, 316–322
 - of dynamic SEMs, 406–408
 - of subset VAR models, 205–206, 221
- Structural change, 182
 - Chow test for —, 182–184, 348–349
 - prediction test for —, 349–351
 - testing for —, 182–189, 348–351, 510, 598–601, 608
- Structural form
 - of a VAR process, 358
 - of a dynamic SEM, 390
- Structural impulse responses, 359, 377–382
- Structural innovation, 359
 - permanent —, 369
 - transitory —, 369
- Structural models
 - VAR, 357–386
 - VECM, 357–386
- Structural time series model, 618–619
- Structural VAR, 358–368
 - with Blanchard-Quah restrictions, 367–368
 - with long-run restrictions, 367–368
 - AB-model, 364–367
 - A-model, 358–362
 - B-model, 362–364
- Structural vector autoregression, *see* structural VAR
- Structural vector error correction model, 368–372
- Submatrix, 659
- Subset model
 - bottom-up procedure for —, 344
 - full search procedure for —, 344
 - sequential elimination of regressors, 344
 - top-down procedure for —, 344
- Subset VAR model, 206–221
 - checking of —, 212–217
 - specification of —, 206–212
 - bottom-up strategy, 211
 - sequential elimination of regressors, 211
 - top-down strategy, 208–210
 - structural analysis of —, 221
- Super-exogenous variable, 388
- Superconsistent estimator, 288, 301
- SVAR, 357–368
 - with Blanchard-Quah restrictions, 367–368
 - with long-run restrictions, 367–368
 - AB-model, 364–367
 - A-model, 358–362
 - B-model, 362–364
 - Blanchard-Quah —, 367–368
 - concentrated likelihood function, 373
 - estimation of —, 372–376
 - ML estimation of —, 372–376
- SVECM, 368–372
 - estimation of —, 376–377
 - ML estimation of —, 376–377
- Symmetric matrix, 646
- System equation, 611
- System matrix, 613
- System with exogenous variables, 388–412
- Systematic sampling, 616–618
- Systematically varying coefficients
 - of VAR models, 585–589
 - of VARX models, 621
- Taylor expansion, 671
 - second order —, 671
- Taylor's theorem, 670, 685
- Temporal aggregation, 434–435, 440–441, 616–618
- Testing for
 - Granger-causality, 102–104, 316–321
 - causal relations, 102–108, 316–321
 - instantaneous causality, 104–108
 - multi-step causality, 105–108
 - nonnormality, 174–180
 - periodicity, 598–604

- rank of cointegration, 327–343, 551–552
- structural change, 181–189, 348–351, 510, 598–601, 608
- whiteness of residuals, 169–174, 214, 510
- nonnormality
 - of VAR process, 177–180
 - of white noise process, 174–177
- residual autocorrelation
 - of VAR process, 169–174
 - of VARMA process, 510
 - of subset VAR model, 214
 - of white noise process, 157–161
- structural change
 - based on one forecast period, 182–186
 - based on several forecast periods, 186–188
- Tests of parameter restrictions
 - linear restrictions, 102, 138–143
 - nonlinear restrictions, 508–510
- Threshold models, 625
- Time invariant
 - autocovariances, 597
 - coefficients, 596
- Time series
 - nonstationary—, 237
 - seasonal —, 585
- Time varying
 - coefficients, 585–591
 - randomly —, 621–623
 - systematically —, 585–591
- Top-down strategy for subset VAR specification, 208–210
- Total forecast error impulse responses, 56
- Total impact matrix, 367
- Total impulse responses, 56
- Total multiplier, 392
- Trace of a matrix, 653
- Trace test for cointegration rank, 329
- Transfer function, 392
- Transfer function model, 387, 392
 - rational —, 392
- Transformation
 - of MA process, 435–436
 - of VARMA process, 436–440
 - linear —, 435–440
- Transition equation
 - errors, 613
 - noise, 613
 - of a state space model, 611
- Transition matrix, 613
- Transitory shock, 369
- Transpose of a matrix, 646
- Trend
 - deterministic —, 238
 - stochastic —, 238
- Triangular matrix
 - lower —, 646
 - upper —, 646
- Triangular representation of cointegrated system, 251
- Two-stage estimation
 - of cointegrated system, 301–302
 - asymptotic properties of —, 301
- Unconditional forecast, 402
- Unimodular operator, 452
- Univariate ARCH model, 559–562
- Univariate GARCH model, 559–562
- Unmodelled variable, 387–390
- VAR estimation
 - fully modified —, 318
- VAR order estimator
 - consistent —, 148
 - small sample properties of —, 151–157
 - strongly consistent —, 148
- VAR order selection
 - AIC criterion for —, 147
 - comparison of criteria for —, 150–157
 - consistent —, 148–150
 - criteria for —, 146–157
 - FPE criterion for —, 146
 - HQ criterion for —, 150
 - SC criterion for —, 150
 - sequence of tests for —, 136–145
 - testing scheme for —, 143–144
- VAR process, 5
 - with linear parameter restrictions, 194–221
 - with nonlinear parameter restrictions, 221–222
 - with parameter constraints, 193–231

- with time varying coefficients, 586–591
- autocorrelations of —, 30–31
- autocovariances of —, 21, 26–30
- checking the adequacy of —, 157–189
- estimation of —, 69–93, 531–536
- forecast error variance decomposition of —, 63–66
- forecasting of —, 31–41, 93–102, 536–540
- impulse response analysis of —, 108–129, 540–545
- infinite order —, 531–552
- LS estimation of —, 69–86, 531–536
- MA representation of —, 18–24
- mean-adjusted —, 82
- nonstationary —, 256, 586–594
- order determination of —, 135–157
- order estimation of —, 146–157
- specification of —, 135–157
- stable —, 13–18
- state space representation of —, 614–616
- stationarity condition for —, 25
- structural —, 358–368
- subset —, 206–221
- unstable —, 256
- Yule-Walker estimation of —, 85–86
- VAR representation of a VARMA process
 - infinite order —, 425
 - pure —, 425
- VARMA process
 - for integrated variables, 515–521
 - in standard form, 448
 - representation in standard form, 448
- aggregation of —, 440–441
- ARMA_{RE} form of —, 518–519
- autocorrelations of —, 430
- autocovariances of —, 429–432
- checking the adequacy of —, 508–510
- definition of —, 423–426
- EC-ARMA_{RE} form of —, 519–521
- echelon form of —, 452–453
- error correction echelon form of —, 519–521
- estimation of —, 447–487, 521–522
- final equations form of —, 452
- forecasting of —, 432–434, 487–490
- Granger-causality in —, 441–444
- identifiability of —, 447–458
- identification of —, 447–458
- impulse response analysis of —, 444, 490
- interpretation of —, 441–444
- invertible —, 425
- linear transformation of —, 435–440
- MA representation of —, 423
- ML estimation of —, 458–487
- nonuniqueness of —, 447–452
- preliminary estimation of —, 474–477
- reverse echelon form of —, 518–519
- specification of —, 493–508
- stable —, 423
- standard form —, 448
- state space representation of —, 616
- transformation of —, 434–441
- VAR representation of —, 425
- VAR(1) representation of —, 426–429
- VARX model, 387, 616, 621
 - random coefficient —, 621–623
- Vec operator, 661
- Vech operator, 662
- VECM, 244–256
- Vector autoregressive moving average process, *see* VARMA process
- Vector autoregressive process, *see* VAR process
- Vector differentiation, 664–671
- Vector error correction model, 244–256
- Wald statistic, 102, 321, 598
 - asymptotic distribution of —, 102, 321, 598
- Wald test, 694–698
 - for Granger-causality, 102, 316–321
 - for instantaneous causality, 104–108
 - for multi-step causality, 105–108
 - of linear constraints, 102, 316–321
 - of zero constraints, 104–108, 598–600
- Weak law of large numbers, 689
- Weakly exogenous variable, 388
- White noise
 - Gaussian —, 75
 - standard —, 73

- testing for —, 157–161, 169–174, 214, 510
- White noise assumption
 - checking of —, 157–161
 - testing of —, 169–174, 214, 510
- White noise covariance matrix estimator
 - asymptotic properties of —, 75–76, 200, 296, 479–481
- Whiteness of residuals
 - checking the —, 157–174, 214, 510
 - testing for —, 169–174, 214, 510
- Wiener process, 698
 - multivariate —, 703
 - standard —, 698
- Wold causal ordering, 61, 359
- Wold's decomposition theorem, 25
- Yule-Walker estimation of VAR process, 85–86
- Zero mean VARMA process, 429