

Vector Error Correction Mechanism (VECM) Models

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Spurious Problem & Cointegrating Equation – Long-run Relationship

Spurious Problem

If y_t and x_t are nonstationary series

OLS estimated result of model

$$y_t = \alpha + \beta x_t + u_t$$

can lead to spurious problem.

Spurious regression has significant t-statistics,
but the results are without any theoretical
meaning.

R^2 is higher than Durbin-Watson.

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Cointegrating Equation – Long-run Relationship

Cointegrated Time-series

If y_t and x_t are nonstationary, but their linear combination $u_t = y_t - \alpha - \beta x_t$ is stationary.

Then, y_t and x_t are cointegrated time-series.

Cointegration Test

Statistical test that tests whether the series are cointegrated or not.

Engle-Granger – Univariate Cointegration Test

Why Multivariate Cointegration Test?

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Cointegrating Equation – Long-run Relationship

Cointegrating Equation

Long-run relationship of cointegrated time series can be stated as: $y_t = \alpha + \beta x_t$

Error Correction Mechanism (ECM)

ECM can be stated as:

$$\Delta y_t = \alpha_0 + \alpha_1 \Delta x_t + \delta \hat{u}_{t-1} + \varepsilon_t$$

δ determines speed of adjustment to equilibrium and is expected to be negative and $-1 < \delta < 0$

Multivariate Data Generating Process

From VARs unrestricted model:

$$\begin{pmatrix} y_t \\ x_t \end{pmatrix} = \begin{pmatrix} b_{10} \\ b_{20} \end{pmatrix} + \begin{pmatrix} b_{11} & b_{12} \\ b_{21} & b_{22} \end{pmatrix} \begin{pmatrix} y_{t-1} \\ x_{t-1} \end{pmatrix} + \begin{pmatrix} e_{1t} \\ e_{2t} \end{pmatrix},$$

$$\begin{pmatrix} e_{1t} \\ e_{2t} \end{pmatrix} \sim IID \left(\begin{pmatrix} 0 \\ 0 \end{pmatrix}, \begin{pmatrix} \sigma_{11} & \sigma_{12} \\ \sigma_{21} & \sigma_{22} \end{pmatrix} \right)$$

Model in matrix form:

$$Y_t = B_0 + B_1 Y_{t-1} + \epsilon_t$$

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Multivariate Data Generating Process

From: $Y_t = B_0 + B_1 Y_{t-1} + \epsilon_t$

Let eigenvalues and eigenvectors of B_1 be

$$\Lambda = \begin{bmatrix} \lambda_1 & 0 \\ 0 & \lambda_2 \end{bmatrix} \quad \text{and} \quad C = \begin{bmatrix} c_{11} & c_{12} \\ c_{21} & c_{22} \end{bmatrix}$$

Provided eigenvalues are distinct, the eigenvectors will be linear independent and C is nonsingular. Then,

$$C^{-1} B_1 C = \Lambda \quad \text{and} \quad B_1 = C \Lambda C^{-1}$$

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Example – Bivariate Case

Define new vector of variables (linear combination of x_t and y_t) S_t as

$$S_t = C^{-1}Y_t \quad \text{or} \quad X_t = CS_t$$

$$C^{-1}Y_t = C^{-1}B_0 + C^{-1}C\Lambda C^{-1}Y_{t-1} + C^{-1}\epsilon_t$$

Then, $S_t = B_0^* + \Lambda S_{t-1} + \eta_t$

where: $B_0^* = C^{-1}B_0$ and $\eta_t = C^{-1}\epsilon_t$

Thus, $s_{1t} = b_{10}^* + \lambda_1 s_{1t-1} + \eta_{1t}$

$$s_{2t} = b_{20}^* + \lambda_2 s_{2t-1} + \eta_{2t}$$

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Example – Bivariate Case

From

$$s_{1t} = b_{10}^* + \lambda_1 s_{1t-1} + \eta_{1t}$$
$$s_{2t} = b_{20}^* + \lambda_2 s_{2t-1} + \eta_{2t}$$

Case 1: $|\lambda_1| < 1$ and $|\lambda_2| < 1$

The two series y_t and x_t are stationary or $I(0)$.

Case 2: $\lambda_1 = 1$ and $|\lambda_2| < 1$

Series y_t is $I(0)$ and x_t is $I(1)$.

Case 3: $\lambda_1 = \lambda_2 = 1$

Series y_t and x_t are nonstationary.

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Multivariate Cointegration Test

VAR(I) with two variables

$$Y_t = B_0 + B_1 Y_{t-1} + \epsilon_t$$

Assume that the two series are both $I(1)$, the model can be written in form of ΔY_t

$$\Delta Y_t = B_0 + \Pi Y_{t-1} + \epsilon_t, \quad \Pi = B_1 - I$$

where: $\Pi = \begin{pmatrix} b_{11} - 1 & b_{12} \\ b_{21} & b_{22} - 1 \end{pmatrix}$

Decompose of B_1 :

$$\Pi = B_1 - I = C \Lambda C^{-1} - I = C \begin{bmatrix} \lambda_1 - 1 & 0 \\ 0 & \lambda_2 - 1 \end{bmatrix} C^{-1}$$

Then, if $Trace(\Pi) = 0$, it implies $\lambda_1 = \lambda_2 = 1$.
There is no cointegration.

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Multivariate Cointegration Test VECM

From Error Correction Mechanism (ECM)

$$\Delta y_t = \alpha_0 + \alpha_1 \Delta x_t + \delta \hat{u}_{t-1} + \varepsilon_t \quad \text{and} \quad \hat{u}_{t-1} = y_{t-1} - \hat{\beta} x_{t-1}$$

In term of multivariate, the model can be written as VECM

$$\Delta Y_t = A_0 + \Pi Y_{t-1} + A_1 \Delta Y_{t-1} + \epsilon_t$$

where:

$$\Pi = \begin{pmatrix} \delta_1 & -\beta\delta_1 \\ \delta_2 & -\beta\delta_2 \end{pmatrix} = \begin{pmatrix} \delta_1 \\ \delta_2 \end{pmatrix} (1 \quad -\beta)$$

Then, VECM becomes: Cointegrating Equation

$$\Delta y_t = \alpha_{10} + \delta_1 (y_{t-1} - \beta x_{t-1}) + \alpha_{11} \Delta x_{t-1} + \alpha_{12} \Delta y_{t-1} + e_{1t},$$

$$\Delta x_t = \alpha_{20} + \delta_2 (y_{t-1} - \beta x_{t-1}) + \alpha_{21} \Delta x_{t-1} + \alpha_{22} \Delta y_{t-1} + e_{2t}$$

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Multivariate Cointegration Test

Cointegration in VECM(I) depend on the rank of Π .

Cointegration in VECM(p) models for m variables. $\Delta Y_t = A_0 + \Pi Y_{t-1} + A_1 \Delta Y_{t-1} + \dots + A_{p-1} \Delta Y_{t-p+1} + \epsilon_t$,

$$t = p + 1, \dots, n$$

Cointegration depend on the rank of Π (r).

If $r=m$, all variables are stationary

If $1 \leq r \leq m-1$, there exists cointegration relations.

Multivariate Cointegration Test

VECM can be estimated by ML.

The maximal value of the log-likelihood, for given rank r of the matrix Π , is equal to

$$\log(L_{\max}(r)) = c - \frac{n-p}{2} \sum_{j=1}^r \log(1 - \hat{\lambda}_j)$$

Eigenvalues test is to check how many of the canonical correlations differ significant from zero. $r = (\text{number of significant } \hat{\lambda}_j)$

Johansen trace test is LR-test.

$$LR(r) = 2(\log(L_{\max}(m)) - \log(L_{\max}(r))) = -(n-p) \sum_{j=r+1}^m \log(1 - \hat{\lambda}_j)$$

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Multivariate Cointegration Test

Test for number of cointegration relations

1. Test $H_0: r=0$ against $H_1: r \geq 1$
2. Test $H_0: r=1$ against $H_1: r \geq 2$
3. Iteratively test $H_0: \text{rank}(\Pi)=r$ against $H_1: \text{rank}(\Pi) \geq r+1$.

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Multivariate Cointegration Test

Trends in Johansen VECM Framework

$$\Delta Y_t = \alpha(\beta Y_{t-1} + \mu + \rho t) + \sum_{i=1}^{p-1} A_i \Delta Y_{t-i} + \nu + \tau t + e_t$$

Place restrictions on the trend terms:

1. Linear trend
2. Restricted trend, $\tau=0$
3. Unrestricted Constant, $\tau=0$ and $\rho=0$
4. Restricted constant, $\tau=0$, $\rho=0$, and $\nu=0$
5. No trend, $\tau=0$, $\rho=0$, $\nu=0$, and $\mu=0$