

# Contents

CHAPTER 1	
Introduction	1
1.1 The Scope and Nature of Econometrics	1
1.2 The Organization of the Book	3
<b>PART I: FUNDAMENTAL METHODOLOGY</b>	<b>5</b>
CHAPTER 2	
Review of Ordinary Least Squares and Generalized Least Squares	7
2.1 Introduction	7
2.2 The Classical Linear Regression Model	7
2.3 Ordinary Least Squares and the Gauss–Markov Theorem	9
2.4 Large Sample Properties of Ordinary Least Squares Estimators	12
2.5 Generalized Least Squares and Aitken’s Theorem	16
2.6 Properties of the Ordinary Least Squares Estimators in the Context of the Generalized Least Squares Model	18
2.7 Summary and Guide to Further Readings	20
2.8 Exercises	21
2.9 References	25
CHAPTER 3	
Point Estimation and Tests of Hypotheses in Small Samples	26
3.1 Introduction	26
3.2 Maximum Likelihood Estimation	27
3.3 Small Sample Estimation Theory	31
3.3.1 Minimum Variance Unbiased Through Cramér–Rao Lower Bound Approach	32
3.3.2 Small Sample Efficiency of $\hat{\beta}$ and $\hat{\sigma}^2$	34
3.3.3 Minimum Variance Unbiased Through Complete-Sufficient Statistics Approach	35
	ix

3.4	Tests of Hypotheses in Small Samples	36
3.5	Confidence Intervals	41
3.6	Summary and Guide to Further Readings	42
3.7	Appendix: Proof of Cramér–Rao Theorem	43
3.8	Exercises	45
3.9	References	50

#### CHAPTER 4

### Large Sample Point Estimation and Tests of Hypotheses 52

4.1	Introduction	52
4.2	Asymptotic Distribution Theory	53
4.3	Asymptotic Efficiency of $\hat{\beta}$ and $\hat{\sigma}^2$ Under Normality	59
4.4	Nonnormal Disturbances	62
4.5	Summary and Guide to Further Readings	65
4.6	Exercises	66
4.7	References	69

#### CHAPTER 5

### Stochastic Regressors 70

5.1	Introduction	70
5.2	Multivariate Normal Linear Regression Model	71
5.3	Independent Stochastic Linear Regression Model	72
5.4	Summary and Guide to Further Readings	77
5.5	Exercises	78
5.6	References	79

#### CHAPTER 6

### Use of Prior Information 80

6.1	Introduction	80
6.2	Restricted Least Squares: Exact General Linear Restrictions	81
6.2.1	Dimension of Parameter Space	81
6.2.2	Correct Restrictions	82
6.2.3	Alternative Views of Restricted Least Squares	84
6.2.4	Incorrect Restrictions	85
6.3	Mixed Estimation: Stochastic Linear Restrictions	88
6.3.1	Nature of Stochastic Restrictions	88
6.3.2	Implications of Biased Restrictions	90
6.3.3	Feasible Mixed Estimation	91
6.3.4	Restricted Least Squares and Ordinary Least Squares as Limiting Cases of Mixed Estimation	92
6.3.5	A Reformulation of the Mixed Estimation Model	93
6.4	Mean Square Error Criteria	97
6.5	Inequality Restricted Least Squares	102
6.5.1	Derivation of Inequality Restricted Least Squares Estimator	102

6.5.2	Sampling Properties of Inequality Restricted Least Squares Estimator	105
6.5.3	Comparison of Restricted Least Squares and Mixed Estimation with Inequality Restricted Least Squares	106
6.6	Bayesian Procedures and Prior Information	108
6.6.1	Basic Concepts in Bayesian Analysis	108
6.6.2	Relationship Between Bayesian and Sampling Theory Approaches	110
6.7	Summary and Guide to Further Readings	111
6.8	Exercises	114
6.9	References	119
CHAPTER 7		
Preliminary Test and Stein-Rule Estimators		122
7.1	Introduction	122
7.2	Pretest Estimators	123
7.2.1	The Orthonormal Linear Statistical Model	123
7.2.2	The Pretest Estimator	124
7.2.3	Properties of the Pretest Estimator	125
7.2.4	The Choice of the Optimal Value of $\alpha$ for Pretesting	127
7.2.5	The Pretest Estimator in the General Linear Statistical Model	128
7.2.6	Some General Remarks About the Consequences and Scope of Preliminary Test Procedures	130
7.3	Stein-Rule Estimators for the Orthonormal Linear Regression Model	131
7.3.1	The James and Stein Estimator	131
7.3.2	The James–Stein Positive Rule Estimator	134
7.3.3	Sclove's Modified Positive-Part Rule	137
7.4	Stein-Rule Estimators for the General Linear Model	137
7.5	Summary and Guide to Further Readings	139
7.6	Exercises	140
7.7	References	143
PART II: VIOLATIONS OF BASIC ASSUMPTIONS		145
CHAPTER 8		
Feasible Generalized Least Squares Estimation		147
8.1	Introduction	147
8.2	Definition of Feasible Generalized Least Squares	148
8.3	Properties of Feasible Generalized Least Squares Estimators	150
8.3.1	Feasible Generalized Least Squares in the Absence of Normal Errors	150
8.3.2	Feasible Generalized Least Squares in the Presence of Normal Errors	151
8.4	An Example of Feasible Generalized Least Squares: Seemingly Unrelated Regressions	155
8.5	Seemingly Unrelated Regressions Estimation: Asymptotic Results	160
8.6	Seemingly Unrelated Regressions Estimation: Small Sample Results	162
8.7	Summary and Guide to Further Readings	166
8.8	Exercises	167
8.9	References	169

<b>CHAPTER 9</b>	
<b>Heteroscedasticity</b>	<b>170</b>
9.1 Introduction	170
9.2 Estimation Under Various Forms of Heteroscedasticity	174
9.2.1 Grouped Heteroscedasticity	174
9.2.2 Heteroscedasticity as a Function of Exogenous Variables	176
9.2.2a Variance as a Linear Function of Exogenous Variables: $\sigma_i^2 = \mathbf{z}_i' \boldsymbol{\alpha}$	177
9.2.2b Standard Deviation as a Linear Function of Exogenous Variables: $\sigma_i = \mathbf{z}_i' \boldsymbol{\alpha}$	180
9.2.2c Multiplicative Heteroscedasticity: $\sigma_i^2 = \exp(\mathbf{z}_i' \boldsymbol{\alpha})$	183
9.2.2d Heteroscedasticity of Known but General Functional Form: Maximum Likelihood Estimation	186
9.3 Tests for Heteroscedasticity	187
9.3.1 Likelihood Ratio Test for Grouped Heteroscedasticity	188
9.3.2 Tests for Heteroscedasticity Which Are Specific Functions of Exogenous Variables	189
9.3.2a Tests of Variance as a Linear Function of Exogenous Variables: $\sigma_i^2 = \mathbf{z}_i' \boldsymbol{\alpha}$	189
9.3.2b Tests of Standard Deviation as a Linear Function of Exogenous Variables: $\sigma_i = \mathbf{z}_i' \boldsymbol{\alpha}$	190
9.3.2c Tests for Multiplicative Heteroscedasticity: $\sigma_i^2 = \exp(\mathbf{z}_i' \boldsymbol{\alpha})$	191
9.3.2d Tests Involving Heteroscedasticity of Known but General Form: Maximum Likelihood Methods	192
9.3.3 Nonspecific Tests for Heteroscedasticity	193
9.3.3a Goldfeld–Quandt Test	193
9.3.3b Peak Test	194
9.3.3c Breush–Pagan Test	195
9.3.3d White’s General Heteroscedasticity Test	196
9.4 Chow Test Under Heteroscedasticity	197
9.4.1 Jayatissa’s Test	199
9.5 Summary and Guide to Further Readings	201
9.6 Exercises	202
9.7 References	204
<b>CHAPTER 10</b>	
<b>Autocorrelation</b>	<b>205</b>
10.1 Introduction	205
10.2 Autoregressive Error Structure AR(1)	206
10.3 Maximum Likelihood Estimation of AR(1)	208
10.3.1 Maximum Likelihood Search	208
10.3.2 Cochrane–Orcutt Iterative Procedure	209
10.3.3 Hildreth–Lu Search Procedure	210
10.4 Two-Step Methods	211
10.5 Small Sample Estimation in the AR(1) Model	213
10.6 Other Correlated Error Structures	215
10.7 Feasible Generalized Least Squares for AR(2), MA(1), and ARMA( $p, q$ )	217
10.7.1 Estimation for AR(2) Process	217
10.7.2 Estimation for MA(1) Process	219
10.7.3 Estimation for General ARMA( $p, q$ ) Process	221

10.8	Testing for AR(1) Error Process	222
10.8.1	The Durbin–Watson Test	222
10.8.2	The Inconclusive Region	225
10.8.2a	Approximate Methods	225
10.8.2b	Nonparametric Test	226
10.8.2c	Transformations of Ordinary Least Squares Residuals	228
10.8.2d	Imhof Technique	228
10.8.3	Power Comparisons of Various AR(1) Tests	229
10.9	Testing ARMA( $p, q$ ) Processes	229
10.10	Summary and Guide to Further Readings	231
10.11	Exercises	232
10.12	References	235
CHAPTER 11		
Lagged Dependent Variables and Autocorrelation		237
11.1	Introduction	237
11.2	Lagged Dependent Variable Model (Autoregressive Linear Model)	238
11.3	Lagged Dependent Variable Models with Autocorrelated Errors	242
11.3.1	Inconsistency of Ordinary Least Squares	242
11.3.2	Durbin $h$ -test	244
11.3.3	Estimation of the Lagged Dependent Variable Model with Autocorrelated Errors	245
11.4	Feasible Generalized Least Squares and Contemporaneous Correlation	249
11.5	Hatanaka's Estimator	251
11.6	Summary and Guide to Further Readings	253
11.7	Appendix: Instrumental Variables	254
11.7.1	Motivation	254
11.7.2	Theoretical Results	254
11.7.3	Criteria for Selection of $Z$	258
11.7.4	Lagged Variables as Instruments	259
11.7.5	Asymptotic Inefficiency of Instrumental Variable Estimators	260
11.7.6	Case of Surplus Instruments	261
11.8	Exercises	263
11.9	References	266
CHAPTER 12		
Unobservable Variables		268
12.1	Introduction	268
12.2	Maximum Likelihood Approach	271
12.3	Instrumental Variable Methods	273
12.3.1	Wald's Grouping Method	273
12.3.2	Durbin's Ranking Procedure	274
12.4	The Use of Incidental Equations	275
12.5	Summary and Guide to Further Readings	276
12.6	Exercises	277
12.7	References	279

<b>PART III: SPECIAL TOPICS</b>		<b>281</b>
<b>CHAPTER 13</b>		
<b>Multicollinearity</b>		<b>283</b>
13.1	Introduction	283
13.2	The Nature and Statistical Consequences of Multicollinearity	284
13.2.1	Exact Multicollinearity	285
13.2.2	Near Exact Multicollinearity	285
13.2.3	Principal Components	287
13.2.4	The Geometry of Principal Components	288
13.3	Detection of the Presence and Form of Multicollinearity	293
13.4	Improved Estimation in the Context of Multicollinearity	296
13.4.1	Principal Components Regression	298
13.4.2	Ridge Regression	300
13.5	Summary and Guide to Further Readings	303
13.6	Exercises	304
13.7	References	305
 <b>CHAPTER 14</b>		
<b>Varying Coefficient Models</b>		<b>307</b>
14.1	Introduction	307
14.2	Dummy Variables and Sets of Regression Equations	308
14.3	Switching Regression Models	312
14.3.1	Piecewise Regression Models: Known Join Point	312
14.3.2	Piecewise Regression Models: Unknown Join Point	313
14.4	Systematically Varying Parameter Models	314
14.5	Random Coefficient Models	316
14.5.1	The Hildreth–Houck Random Coefficient Model	316
14.5.2	The Swamy Random Coefficient Model	317
14.5.3	Models with Coefficients That Evolve Over Time	319
14.6	Summary and Guide to Further Readings	320
14.7	Exercises	321
14.8	References	321
 <b>CHAPTER 15</b>		
<b>Models That Combine Time-Series and Cross-Section Data</b>		<b>324</b>
15.1	Introduction	324
15.2	Models in Which All Variation Is Contained in the Error Term	325
15.3	Models Where All Structural Change Is Captured by the Intercept	328
15.3.1	Dummy Variable Models	328
15.3.1a	Dummy Variable Models Where the Intercept Varies Over Individuals	328
15.3.1b	Dummy Variable Models Where the Intercept Varies Over Individuals and Time	330
15.3.2	Error Components with Variation Only Over Individuals	332
15.3.2a	Generalized Least Squares Estimation	333
15.3.2b	Estimation of the Variance Components	333
15.3.3	Error Components Models with Variation Over Individuals and Time	334

15.4	Models Where All Coefficients Are Allowed to Vary	336
15.5	Summary and Guide to Further Readings	337
15.6	Exercises	338
15.7	References	338

## CHAPTER 16

The Analysis of Models with Qualitative or Censored Dependent Variables		339
16.1	Introduction	339
16.2	A Framework for Studying Models with Binary Dependent Variables	340
16.3	Feasible Generalized Least Squares Estimation of Probit and Logit Models When Repeated Observations Are Available	344
16.3.1	Feasible Generalized Least Squares Estimation of the Probit Model	345
16.3.2	Feasible Generalized Least Squares Estimation of the Logit Model	346
16.3.3	An Interpretive Note	348
16.4	Maximum Likelihood Estimation of Logit and Probit Models	348
16.5	General Choice Models	352
16.6	Analysis of Models with Censored Dependent Variables	358
16.6.1	Heckman's Analysis of Censored Samples	358
16.6.2	Maximum Likelihood Estimation of Models with Censored Samples	360
16.6.3	An Interpretive Note	364
16.7	Summary and Guide to Further Readings	364
16.8	Exercises	367
16.9	References	367

## CHAPTER 17

Distributed Lags		371
17.1	Introduction	371
17.2	Finite Distributed Lags	373
17.2.1	The Arithmetic Lag	373
17.2.2	Lag Operators and Restrictions on Polynomial Distributed Lags	375
17.2.3	The Almon Polynomial Distributed Lag	377
17.2.4	Summary and Guide to Further Readings on Finite Lags	380
17.3	Geometric Lag Structures	381
17.3.1	Model Formulation	381
17.3.1a	Partial Adjustment Models	382
17.3.1b	Adaptive Expectations Models	384
17.3.2	Estimation of the Geometric Lag	384
17.3.2a	Estimation of the Autoregressive Form of the Geometric Lag	384
17.3.2b	Estimation of the Direct Form of the Geometric Lag	386
17.3.3	Summary and Guide to Further Readings on Geometric Lags	390
17.4	Other Infinite Lag Structures	390
17.4.1	The Pascal Lag	391
17.4.2	The Rational Distributed Lag	391
17.4.3	The Gamma Distributed Lag	392
17.4.4	The Exponential Lag	392
17.5	Exercises	392
17.6	References	397

<b>CHAPTER 18</b>	
<b>Uncertainty in Model Specification and Selection</b>	<b>400</b>
18.1 Introduction	400
18.2 Classical Specification Analysis	401
18.2.1 Effects of Omitting Relevant Variables or Including Irrelevant Variables	401
18.2.2 Other Forms of Misspecification in Regression Variables	405
18.3 Specification Error Tests	407
18.3.1 Traditional Tests for Relevant Variables	408
18.3.2 Tests for Omitted Variables and Incorrect Functional Form When the Alternatives Are Nonspecific	409
18.3.3 Hausman's Test	412
18.4 Choice Between Competing Nonnested Models	414
18.4.1 Mechanical Nesting	415
18.4.2 Residual Variance (Adjusted $R^2$ ) Criterion	416
18.4.3 The Cox Generalized Likelihood Ratio Procedure: Peseran's Results	418
18.4.4 Other Work on Discriminating Between Alternative Models	422
18.5 Choice of Functional Form: Box-Cox Transformation	423
18.5.1 Motivation	423
18.5.2 Maximum Likelihood Estimation	426
18.5.3 Overstatement of Significance by the Ordinary Least Squares Covariance Matrix	430
18.6 Summary and Guide to Further Readings	431
18.7 Exercises	432
18.8 References	435
<b>PART IV: SIMULTANEOUS EQUATIONS MODELS</b>	
	<b>437</b>
<b>CHAPTER 19</b>	
<b>Introduction to Simultaneous Equations Models</b>	<b>439</b>
19.1 Introduction	439
19.2 The Simultaneous Equations Problem	439
19.3 Notation and Assumptions	443
19.4 Ordinary Least Squares Estimation of the Reduced Form	445
19.5 Summary and Guide to Further Readings	448
19.6 Exercises	449
19.7 References	449
<b>CHAPTER 20</b>	
<b>Identification</b>	<b>451</b>
20.1 Introduction	451
20.2 The Identification Problem	451
20.3 Admissible Transformations	455
20.4 Identification Using Linear Homogeneous Restrictions	457
20.5 Identification Using Covariance Restrictions	463
20.6 Ordinary Least Squares and Simple Recursive Systems	467
20.7 Summary and Guide to Further Readings	468
20.8 Exercises	469
20.9 References	470



CHAPTER 21	
Limited Information Estimation	472
21.1 Introduction	472
21.2 Indirect Least Squares	473
21.3 Two-Stage Least Squares	475
21.4 Two-Stage Least Squares as Aitken and Instrumental Variable Estimators	478
21.5 Asymptotic Properties of Two-Stage Least Squares Estimators	482
21.6 $k$ -Class Estimators	486
21.7 Limited Information Maximum Likelihood	487
21.8 Summary and Guide to Further Readings	490
21.9 Exercises	492
21.10 References	495
CHAPTER 22	
Full Information Estimation	499
22.1 Introduction	499
22.2 Three-Stage Least Squares	500
22.3 Asymptotic Distribution of Three-Stage Least Squares Estimators and Relative Efficiency	501
22.4 Use of Linear Hypotheses in Simultaneous Equations	503
22.4.1 Restricted Three-Stage Least Squares Estimation	503
22.4.2 Tests of Linear Hypotheses Using Three-Stage Least Squares Estimates	505
22.5 Full Information Maximum Likelihood	505
22.6 Summary and Guide to Further Readings	506
22.7 Exercises	508
22.8 References	510
CHAPTER 23	
Reduced Form Estimation and Prediction in Simultaneous Equations Models	512
23.1 Introduction	512
23.2 Restricted Reduced Form	513
23.3 Forecasting in Simultaneous Equations Models with Usual Error Assumptions	518
23.4 Forecasting with an Autocorrelated Error Structure	524
23.5 Summary and Guide to Further Readings	526
23.6 Exercises	528
23.7 References	528
CHAPTER 24	
Properties of Dynamic Simultaneous Equations Models	530
24.1 Introduction	530
24.2 Final Form and Dynamic Multipliers	531
24.3 Efficient Estimation and Asymptotic Distribution of Dynamic Multipliers	539
24.4 Stability and Standard Error of Dominant Characteristic Root	543
24.5 Standard Errors of Dynamic Simulation Forecasts	545

24.6	Optimal Control in Dynamic Simultaneous Equations Models	547
24.7	Summary and Guide to Further Readings	549
24.8	Exercises	551
24.9	References	551

## PART V: FRONTIERS 553

CHAPTER 25		
Special Topics in Simultaneous Equations		555
25.1	Introduction	555
25.2	A Simultaneous Equations Tobit Model	555
25.2.1	Exercises	562
25.2.2	References	562
25.3	A Simultaneous Equations Generalized Probit Model	562
25.3.1	Exercise	566
25.3.2	References	566
25.4	Disequilibrium Econometric Models	567
25.4.1	References	575
25.5	Vector Autoregressive Error Processes in Simultaneous Equations Models	576
25.5.1	Covariance Structure of the Vector Autoregressive Error Structure	578
25.5.2	Two-Step Estimation of Simultaneous Equations with Vector Autoregressive Error Structure and No Lagged Dependent Variables	582
25.5.3	Tests of Hypotheses $R = 0$ and $R = \text{diag}(r_{11}, \dots, r_{gg})$ when No Lagged Dependent Variables Are Present	583
25.5.4	Two-Step Estimation of a Simultaneous Equations Model with Vector Autoregressive Error Structure and Lagged Dependent Variables	585
25.5.4a	A Wallis-Like Two-Step Estimator	586
25.5.4b	Hatanaka's Residual Adjusted Two-Step Estimator for Simultaneous Equations with Vector Autoregressive Error Processes	587
25.5.5	Final Comments	588
25.5.6	References	589
25.6	Rational Expectations	590
25.6.1	Rationality and Model Specification	590
25.6.2	Estimation	593
25.6.3	Applications	594
25.6.4	Exercises	595
25.6.5	References	596
25.7	Updating	597
25.7.1	Mixed Estimation and Kalman Filtering	597
25.7.2	Implications for Experimental Design	599
25.7.3	Conclusions	600
25.7.4	Exercises	601
25.7.5	References	601

## APPENDIX

Estimation and Inference in Nonlinear Statistical Models		603
A.1	Nonlinear Optimization	603
A.1.1	Method of Steepest Ascent	605
A.1.2	The Method of Newton	606

A.1.3	Method of Quadratic Hill Climbing	606
A.1.4	Numerical Differentiation	608
A.2	Maximum Likelihood Estimation	610
A.2.1	Use of the Method of Newton	610
A.2.2	Method of Scoring	611
A.2.3	The Method of Berndt, Hall, Hall, and Hausman	612
A.2.4	Asymptotic Tests Based on the Maximum Likelihood Method	612
A.2.4a	The Wald Test	612
A.2.4b	The Lagrange-Multiplier Test	613
A.2.4c	The Likelihood Ratio Test Statistic	613
A.2.4d	Concluding Remarks	614
A.3	Nonlinear Regression	614
A.4	Summary and Guide to Further Readings	615
A.5	References	616
Index		619