

# Contents

<i>Preface</i>	vii
<i>Foreword</i>	xv
1. Production Function and Regression Methods Using R	1
1.1. R and Microeconomic Preliminaries . . . . .	2
1.1.1. Data on Metals Production Available in R . . . . .	3
1.1.2. Descriptive Statistics Using R . . . . .	4
1.1.3. Writing Skewness and Kurtosis Functions in R . . . . .	5
1.1.4. Units of Measurement and Numerical Reliability of Regressions . . . . .	6
1.1.5. Basic Graphics in R . . . . .	7
1.1.6. The Isoquant . . . . .	8
1.1.7. Total Productivity of an Input . . . . .	9
1.1.8. The Marginal Productivity (MP) of an Input . . . . .	9
1.1.9. Slope of the Isoquant and MRTS . . . . .	9
1.1.10. Scale Elasticity as the Returns to Scale Parameter . . . . .	11
1.1.11. Elasticity of Substitution . . . . .	12
1.1.12. Typical Steps in Empirical Work . . . . .	13
1.2. Preliminary Regression Theory: Results Using R . . . . .	13
1.2.1. Regression as an Object ‘reg1’ in R . . . . .	16
1.2.2. Accessing Objects Within an R Object by Using the Dollar Symbol . . . . .	17
1.3. Deeper Regression Theory: Diagonals of the Hat Matrix . . . . .	18
1.4. Discussion of Four Diagnostic Plots by R . . . . .	20
1.5. Testing Constant Returns and 3D Scatter Plots . . . . .	23
1.6. Homothetic Production and Cost Functions . . . . .	26

- 1.6.1. Euler Theorem and Duality Theorem . . . . . 29
- 1.6.2. Profit Maximizing Solutions . . . . . 30
- 1.6.3. Elasticity of Total Cost w.r.t. Output . . . . . 31
- 1.7. Miscellaneous Microeconomic Topics . . . . . 32
  - 1.7.1. Analytic Input Demand Function for the Cobb–Douglas Form . . . . . 32
  - 1.7.2. Separability in the Presence of Three or More Inputs . . . . . 32
  - 1.7.3. Two or More Outputs as Joint Outputs . . . . . 33
  - 1.7.4. Economies of Scope . . . . . 33
- 1.8. Nonhomogeneous Production Functions . . . . . 34
  - 1.8.1. Three-Input Production Function for Widgets . . . . . 34
  - 1.8.2. Isoquant Plotting for a Bell System Production Function . . . . . 42
- 1.9. Collinearity Problem, Singular Value Decomposition (SVD), and Ridge Regression . . . . . 45
  - 1.9.1. What is Collinearity? . . . . . 45
  - 1.9.2. Consequences of Near Collinearity . . . . . 48
  - 1.9.3. Regression Theory Using the Singular Value Decomposition . . . . . 51
- 1.10. Near Collinearity Solutions by Coefficient Shrinkage . . . . . 55
  - 1.10.1. Ridge Regression . . . . . 57
  - 1.10.2. Principal Components Regression . . . . . 61
- 1.11. Bell System Production Function in Anti-Trust Trial . . . . . 62
  - 1.11.1. Collinearity Diagnostics for Bell Data Trans-Log . . . . . 65
  - 1.11.2. Shrinkage Solution and Ridge Regression for Bell Data . . . . . 65
  - 1.11.3. Ridge Regression from Existing R Packages . . . . . 66
- 1.12. Comments on Wrong Signs, Collinearity, and Ridge Scaling . . . . . 69
  - 1.12.1. Concluding Comments on the 1982 Bell System Breakup . . . . . 75
- 1.13. Data Appendix . . . . . 75
  
- 2. Univariate Time Series Analysis with R . . . . . 77
  - 2.1. Econometric Univariate Time Series are Ubiquitous . . . . . 77
  - 2.2. Stochastic Difference Equations . . . . . 81

2.3.	Second-Order Stochastic Difference Equation and Business Cycles . . . . .	85
2.3.1.	Complex Number Solution of the Stochastic AR(2) Difference Equation . . . . .	87
2.3.2.	General Solution to ARMA ( $p, p - 1$ ) Stochastic Difference Equations . . . . .	89
2.4.	Properties of ARIMA Models . . . . .	91
2.4.1.	Identification of the Lag Order . . . . .	93
2.4.2.	ARIMA Estimation . . . . .	100
2.4.3.	ARIMA Diagnostic Checking . . . . .	101
2.5.	Stochastic Process and Stationarity . . . . .	108
2.5.1.	Stochastic Process and Underlying Probability Space . . . . .	108
2.5.2.	Autocovariance of a Stochastic Process and Ergodicity . . . . .	110
2.5.3.	Stationary Process . . . . .	112
2.5.4.	Detrending and Differencing to Achieve Stationarity . . . . .	117
2.6.	Mean Reversion . . . . .	129
2.7.	Autocovariance Generating Functions (AGF) and the Power Spectrum . . . . .	132
2.7.1.	How to Get the Power Spectrum from the AGF? .	133
2.8.	Explicit Modeling of Variance (ARCH, GARCH Models) .	136
2.9.	Tests of Independence, Neglected Nonlinearity, Turning Points . . . . .	139
2.10.	Long Memory Models and Fractional Differencing . . . . .	143
2.11.	Forecasting . . . . .	147
2.12.	Concluding Remarks and Examples . . . . .	150
3.	Bivariate Time Series Analysis Including Stochastic Diffusion and Cointegration . . . . .	153
3.1.	Autoregressive Distributed Lag (ARDL) Models . . . . .	153
3.2.	Economic Interpretations of ARDL(1,1) Model . . . . .	161
3.2.1.	Description of M1 to M11 Model Specifications . .	162
3.2.2.	ARDL(0, $q$ ) as M12 Model, Impact and Long-Run Multipliers . . . . .	166
3.2.3.	Adaptive Expectations Model to Test Rational Expectations Hypothesis . . . . .	167

- 3.2.4. Statistical Inference and Estimation with Lagged-Dependent Variables . . . . . 168
- 3.2.5. Identification Problems Involving Expectational Variables (I. Fisher Example) . . . . . 168
- 3.2.6. Impulse Response, Mean Lag and Insights from a Polynomials in L . . . . . 169
- 3.2.7. Choice Between M1 to M11 Models Using R . . . . . 170
- 3.3. Stochastic Diffusion Models for Asset Prices . . . . . 176
- 3.4. Spurious Regression ( $R^2 >$  Durbin Watson) and Cointegration . . . . . 183
  - 3.4.1. Definition of a Process Integrated of Order  $d, I(d)$  183
  - 3.4.2. Cointegration Definition and Discussion . . . . . 184
  - 3.4.3. Error Correction Models of Cointegration . . . . . 185
  - 3.4.4. Economic Equilibria and Error Reductions through Learning . . . . . 186
  - 3.4.5. Signs and Significance of Coefficients on Past Errors while Agents Learn . . . . . 187
- 3.5. Granger Causality Testing . . . . . 189
  
- 4. Utility Theory and Empirical Implications 191
  - 4.1. Utility Theory . . . . . 191
    - 4.1.1. Expected Utility Theory (EUT) . . . . . 192
    - 4.1.2. Arrow–Pratt Coefficient of Absolute Risk Aversion (CARA) . . . . . 197
    - 4.1.3. Risk Premium Needed to Encourage Risky Investments . . . . . 199
    - 4.1.4. Taylor Series Links EUT, Moments of  $f(x)$  and Derivatives of  $U(x)$  . . . . . 200
  - 4.2. Non-Expected Utility Theory . . . . . 202
    - 4.2.1. Lorenz Curve Scaling over the Unit Square . . . . . 203
    - 4.2.2. Mapping From EUT to Non-EUT within the Unit Square to Get Decision Weights . . . . . 206
  - 4.3. Incorporating Utility Theory into Risk Measurement and Stochastic Dominance . . . . . 210
    - 4.3.1. Class D1 of Utility Functions and Investors . . . . . 210
    - 4.3.2. Class D2 of Utility Functions and Investors . . . . . 210
    - 4.3.3. Explicit Utility Functions and Arrow–Pratt Measures of Risk Aversion . . . . . 211

4.3.4.	Class D3 of Utility Functions and Investors . . . .	212
4.3.5.	Class D4 of Utility Functions and Investors . . . .	212
4.3.6.	First-Order Stochastic Dominance (1SD) . . . . .	214
4.3.7.	Second-Order Stochastic Dominance (2SD) . . . .	216
4.3.8.	Third-Order Stochastic Dominance (3SD) . . . . .	217
4.3.9.	Fourth-Order Stochastic Dominance (4SD) . . . .	218
4.3.10.	Empirical Checking of Stochastic Dominance Using Matrix Multiplications and Incorporation of 4DPs of Non-EUT . . . . .	218
5.	Vector Models for Multivariate Problems	227
5.1.	Introduction and VAR Models . . . . .	227
5.1.1.	Some R Packages for Vector Modeling . . . . .	228
5.1.2.	Vector Autoregression or VAR Models . . . . .	228
5.1.3.	Data Collection Tips Using R . . . . .	229
5.1.4.	VAR Estimation of Sims' Model . . . . .	237
5.1.5.	Granger-Causality Analysis in VAR Models . . . .	240
5.1.6.	Forecasting Out-of-Sample in VAR Models . . . .	242
5.1.7.	Impulse Response Analysis in VAR Models . . . .	243
5.2.	Multivariate Regressions: Canonical Correlations . . . . .	248
5.2.1.	Why Canonical Correlation is Not Popular So Far	251
5.3.	VAR Estimation and Cointegration Testing Using Canonical Correlations . . . . .	257
5.4.	Final Remarks: Multivariate Statistics Using R . . . . .	259
6.	Simultaneous Equation Models	261
6.1.	Introduction . . . . .	261
6.1.1.	Simultaneous Equation Notation System with Stars and Subscripts . . . . .	263
6.1.2.	Simultaneous Equations Bias and the Reduced Form . . . . .	266
6.1.3.	Successively Weaker Assumptions Regarding the Nature of the $Z_j$ Matrix of Regressors . . . .	269
6.1.4.	Reduced Form Estimation and Other Alternatives to OLS . . . . .	269
6.1.5.	Assumptions of Simultaneous Equations Models .	271

6.2.	Instrumental Variables and Generalized Least Squares . . .	272
6.2.1.	The Instrumental Variables (IV) and Generalized IV (GIV) Estimator . . . . .	273
6.2.2.	Choice Between OLS and IV by Using Wu–Hausman Specification Test . . . . .	275
6.3.	Limited Information and Two-Stage Least Squares . . . . .	277
6.3.1.	Two-Stage Least Squares . . . . .	277
6.3.2.	The $k$ -class Estimator . . . . .	278
6.3.3.	Limited Information Maximum Likelihood (LIML) Estimator . . . . .	280
6.4.	Identification of Simultaneous Equation Models . . . . .	282
6.4.1.	Identification is Uniquely Going from the Reduced Form to the Structure . . . . .	285
6.5.	Full Information and Three-Stage Least Squares (3SLS) . . . . .	288
6.5.1.	Full Information Maximum Likelihood . . . . .	293
6.6.	Potential of Simultaneous Equations Beyond Econometrics . . . . .	294
7.	Limited Dependent Variable (GLM) Models . . . . .	295
7.1.	Problems with Dummy Dependent Variables . . . . .	295
7.1.1.	Proof of the Claim that $\text{Var}(\varepsilon_i) = P_i(1 - P_i)$ . . . . .	300
7.1.2.	The General Linear Model from Biostatistics . . . . .	304
7.1.3.	Marginal Effects (Partial Derivatives) in Logit-Type GLM Models . . . . .	308
7.1.4.	Further Generalizations of Logit and Probit Models . . . . .	309
7.1.5.	Ordered Response . . . . .	312
7.2.	Quasi-Likelihood Function for Binary Choice Models . . . . .	314
7.2.1.	The ML Estimator in Binary Choice Models . . . . .	315
7.2.2.	Tobit Model for Censored Dependent Variables . . . . .	317
7.3.	Heckman Two-Step Estimator for Self-Selection Bias . . . . .	322
7.4.	Time Duration Length (Survival) Models . . . . .	326
7.4.1.	Probability Distributions and Implied Hazard Functions . . . . .	330
7.4.2.	Parametric Survival (Hazard) Models . . . . .	331
7.4.3.	Semiparametric Including Cox Proportional Hazard Models . . . . .	333

8.	Dynamic Optimization and Empirical Analysis of Consumer Behavior	343
8.1.	Introduction	343
8.2.	Dynamic Optimization	344
8.3.	Hall's Random Walk Model	346
8.3.1.	Data from the Internet and an Implementation	349
8.3.2.	OLS Estimation of the Random Walk Model	350
8.3.3.	Direct Estimation of Hall's NLHS Specification	352
8.3.4.	Strong Assumptions and Granger-Causality Tests	356
8.4.	Nonparametric Kernel Estimation	358
8.4.1.	Kernel Estimation of Amorphous Partially	360
8.5.	Wiener-Hopf-Whittle Model if Consumption Precedes Income	364
8.5.1.	Determination of Target Consumption	365
8.5.2.	Implications for Various Puzzles of Consumer Theory	368
8.6.	Final Remarks on Consumer Theory	369
8.7.	Appendix: Additional R Code	370
9.	Single, Double and Maximum Entropy Bootstrap and Inference	377
9.1.	The Motivation and Background Behind Bootstrapping	377
9.1.1.	Pivotal Quantity and $p$ -Value	378
9.1.2.	Uncertainty Regarding Proper Density for Regression Errors Illustrated	380
9.1.3.	The Delta Method for Standard Error of Functions	382
9.2.	Description of Parametric iid Bootstrap	383
9.2.1.	Simulated Sampling Distribution for Statistical Inference Using OLS Residuals	383
9.2.2.	Steps in a Parametric Approximation	386
9.2.3.	Percentile Confidence Intervals	387
9.2.4.	Reflected Percentile Confidence Interval for Bias Correction	388
9.2.5.	Significance Tests as Duals to Confidence Intervals	388
9.3.	Description of Nonparametric iid Bootstrap	391
9.3.1.	Map Data from Time-Domain to (Numerical Magnitudes) Values-Domain	391

- 9.4. Double Bootstrap Illustrated with a Nonlinear Model . . . 398
  - 9.4.1. A Digression on the Size of Resamples . . . . . 399
  - 9.4.2. Double Bootstrap Theory Involving Roots  
and Uniform Density . . . . . 399
  - 9.4.3. GNR Implementation of Nonlinear Regression  
for Metals Data . . . . . 401
- 9.5. Maximum Entropy Density Bootstrap  
for Time-Series Data . . . . . 407
  - 9.5.1. Wiener, Kolmogorov, Khintchine (WKK)  
Ensemble of Time Series . . . . . 408
  - 9.5.2. Avoiding Unrealistic Properties of iid Bootstrap . 409
  - 9.5.3. Maximum Entropy Density is Uniform When  
Limits are Known . . . . . 410
  - 9.5.4. Quantiles of the Patchwork of the ME Density . . 412
  - 9.5.5. Numerical Illustration of “Meboot” Package in R 413
  - 9.5.6. Simple and Size-Corrected Confidence Bounds . . 418
- 10. Generalized Least Squares, VARMA, and Estimating  
Functions . . . . . 419
  - 10.1. Feasible Generalized Least Squares (GLS) to Adjust for  
Autocorrelated Errors and/or Heteroscedasticity . . . . . 419
    - 10.1.1. Consequences of Ignoring Nonspherical  
Errors  $\Omega \neq I_T$  . . . . . 419
    - 10.1.2. Derivation of the GLS and Efficiency Comparison 420
    - 10.1.3. Computation of the GLS and Feasible GLS . . . . 422
    - 10.1.4. Improved OLS Inference for Nonspherical Errors . 424
    - 10.1.5. Efficient Estimation of  $\beta$  Coefficients . . . . . 425
    - 10.1.6. An Illustration Using Fisher’s  
Model for Interest Rates . . . . . 426
  - 10.2. Vector ARMA Estimation for Rational  
Expectations Models . . . . . 429
    - 10.2.1. Greater Realism of VARMA( $p, q$ ) Models . . . . . 431
    - 10.2.2. Expectational Variables from Conditional  
Forecasts in a General Model . . . . . 432
    - 10.2.3. A Rational Expectation Model Using VARMA . . 433
    - 10.2.4. Further Forecasts, Transfer Function Gains,  
and Response Analysis . . . . . 438

10.3. Optimal Estimating Function (OptEF) and Generalized Method of Moments (GMM) . . . . .	443
10.3.1. Derivation of Optimal Estimating Functions for Regressions . . . . .	443
10.3.2. Finite Sample Optimality of OptEF . . . . .	445
10.3.3. Introduction to the GMM . . . . .	445
10.3.4. Cases Where OptEF Viewpoint Dominates GMM	447
10.3.5. Advantages and Disadvantages of GMM and OptEF . . . . .	449
10.4. Godambe Pivot Functions (GPFs) and Statistical Inference . . . . .	450
10.4.1. Application of the Frisch–Waugh Theorem to Constructing CI95 . . . . .	452
10.4.2. Steps in Application of GPF to Feasible GLS Estimation . . . . .	453
11. Box–Cox, Loess and Projection Pursuit Regression	459
11.1. Further R Tools for Studying Nonlinear Relations . . . . .	459
11.2. Box–Cox Transformation . . . . .	459
11.2.1. Logarithmic and Square Root Transformations . .	459
11.3. Scatterplot Smoothing and Loess Regressions . . . . .	463
11.3.1. Improved Fit (Forecasts) by Loess Smoothing . .	465
11.4. Projection Pursuit Methods . . . . .	466
11.5. Remarks on Nonlinear Econometrics . . . . .	477
Appendix	479
References	485
Index	505