THE LONG-RUN ECONOMIC RELATIONSHIPS: 
AN OPTIMIZATION APPROACH TO FRACTIONAL 
INTEGRATED AND BILINEAR TIME SERIES

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Abstract. One objective of this paper is to estimate the parameters $p,d,q$ of an autoregressive fractionally integrated moving average ARFIMA($p,d,q$) stochastic model by minimizing the squares of the residuals using a Bayesian global optimization techniques. We consider bilinear model, too because it is the simple extension of linear model, defined by adding a bilinear term to traditional ARMA model. Therefore, the second objective of the paper is to estimate parameters of a bilinear time series.

Keywords: autoregressive, fractionally integrated, bilinear, global optimization.

1. Introduction. Existence of long-run relationships among relevant economic variables is very important for at least two major reasons. First, presence of a long-run relationship among the variables of a model excludes the possibility of spurious co-movement among the variables (Granger and Newbold, 1974). Second, for policy analysis it is highly desirable to know whether there exists some exploitable connection between the instrument and target variables.

The development of co-integration methods by Engle and Granger (1987) and Johansen (1988, 1991) has given economists opportunities to explore the existence of long-run relationships among economic variables. Since the advent of these techniques, an extensive literature has emerged which deals with applications of these methods in various fields of economics. These researchers have attempted to exploit the following property of two co-integrating series.
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Granger (1986) and Engle and Granger (1987) have shown that two co-integrating series tend to move in proximity of each other over the long-run. This implies that for two co-integrating series, the equilibrium error $Z_t$ is mean-reverting in spite of wandering behavior of the series $y_{1t}$ and $y_{2t}$.

Note that in the absence of the mean-reversion property, and even in cases where economic theory predicts existence of long-run equilibrium, a shock to the system can force two time series into disequilibrium permanently.

Co-integration methods, however, rest on binary choice of stationary or integrated of degree one time series in examining mean-reversion property of the residuals of the models. This approach excludes a class of long-memory stochastic processes with the fractional co-integrating property which also have mean-reverting characteristics. Due to this and other attractive properties of the ARFIMA models, empirical research using the models has flourished in recent years (Diebold and Rudebush, 1989, 1991; Cheung, 1993; Cheung and Lai, 1993; Koop et al., 1994).

The coefficient estimation of the ARFIMA models is an important part of the fractional co-integrated problems. In estimating the coefficients of the ARFIMA models, three approaches have been used: Maximum likelihood (ML) (Sowell, 1992); approximate ML (Li and McLeod, 1986; Fox and Taqque, 1986); and two-step procedures (Geweke and Porter-Hudak, 1983; Janacek, 1982). Geweke and Porter-Hudak's method, unlike the ML approach, is less computationally demanding but is considered inadequate for finite sample. In all the cases local optimization techniques were used.

Recent advances in global optimization techniques (Mockus, 1994) opens new possibilities. Theoretically we may apply the global optimization algorithms to the traditional ML problem. However, for parsimony in computation, local optimization is usually applied (Sowell, 1992). In this case the optimization results depend on the initial values. It means that one cannot be sure if a global maximum is found.

Theoretically, we may get much better approximation to the global optimum using the advanced techniques of global optimization (Horst and Pardalos, 1995; Mockus, 1994), Torn and Žilinskas, 1989; and Žilinskas and Zygliavski, 1992). However, due to problems associated with optimization of polynomial-time computable real functions (Ko, 1991), the global optimization is very hard in almost all the cases.
An approximate approach in estimating the parameters of the ARFIMA models is Least Squares (LS). We minimize the sum of square residuals instead of maximizing log-likelihood. This way is less attractive theoretically: we are not sure about the asymptotics, we do not estimate the covariances, etc.

Therefore, the consensus is that the maximal likelihood estimates are, theoretically, superior to the least square ones. This opinion is based on the assumption that we may get the exact likelihood maximum. Otherwise, the only remaining advantage of likelihood maximization is the covariances estimation. Therefore, if the covariances are not to be had by other means, then we have to use the likelihood maximization. Otherwise, it would be difficult to justify not applying the simple, more convenient squared residuals minimization method (instead of likelihood maximization)\(^1\)

One objective of this paper is to estimate the parameters \(p, d, q\) of an autoregressive fractionally integrated moving average ARFIMA\((p, d, q)\) stochastic model by minimizing the squares of the residuals using a Bayesian global optimization method (Mockus, 1994)\(^2\).

The linear time series models\(^3\) describe many economic processes well enough. However there could be cases when non-linearities cannot be ignored. We think that the bilinear time series may be a useful tool in describing the long-term behavior of the processes that generate international financial data.

We consider bilinear model (16) because it seems to be the simplest extension of linear model, defined by adding term (17) to traditional ARMA model.

Therefore, the second objective of the paper is to estimate parameters of a bilinear time series.

In the way of an example, we will test whether ARFIMA and bilinear models describe the rial-to-dollar black market monthly exchange rate 1965–1988, see Fig. 1.

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\(^1\) If we do not need covariance estimates, we may regard it as a nuisance parameter that we ignore defining the residuals. If we do not need the expectation estimates, we may ignore those, too. Otherwise, we may include the expectations while defining the residuals.

\(^2\) The estimation of covariance matrix \(\Sigma\) is not the main objective in this investigation.

\(^3\) For example, ARFIMA \((p,d,q)\).
2. Linear models

2.1. Definitions. We define ARIMA\((p, d, q)\) process as a time series

\[
A(L)(1 - L)^d z_t = B(L)\epsilon_t. \tag{1}
\]

Here

\[
A(L)w_t = w_t - \sum_{i=1}^{p} a_i w_{t-i}, \tag{2}
\]

and

\[
B(L)\epsilon_t = \epsilon_t - \sum_{i=1}^{q} b_i \epsilon_{t-i}, \tag{3}
\]

where \(\epsilon_t = \text{Gaussian } (0, \sigma^2)\).

We define the transformation \((1 - L)^d\) as follows:

\[
w_t = (1 - L)^d z_t = z_t - \sum_{i=1}^{\infty} d_i z_{t-i}. \tag{4}
\]

Here

\[
d_i = \frac{\Gamma(i - d)}{\Gamma(i + 1)\Gamma(-d)}, \tag{5}
\]
where \( d \) is a fractional integration parameter.

We assume, that

\[
\begin{align*}
&z_{t-i} = 0, \quad w_{t-i} = 0, \quad \epsilon_{t-i} = 0, \quad \text{if} \quad t \leq i.
\end{align*}
\]

We truncate sequence (4)

\[
d_i = 0, \quad \text{if} \quad i > R
\]

Here \( R \) is the truncation parameter\(^4\)

2.2. **Likelihood maximization.** We define the log-likelihood function of ARIMA\((p, d, q)\) process as follows:

\[
\log L(z; \mu, \Sigma) = -\frac{1}{2} \log |\Sigma| - \frac{1}{2} (z - \mu)^T \Sigma^{-1} (z - \mu).
\]

Here \( \Sigma \) is the covariance matrix and \( \mu \) is expectation vector of \( z \).

McLeod and Hipel (1978) used direct maximization of (8) to estimate the parameters of a fractional Gaussian model. To simplify the calculations, Hosking (1984) used the approximate optimization techniques, maximizing the log-likelihood function (8).

2.3. **Residuals minimization.** One of the advantages of residual minimization, as compared with log-likelihood maximization, is that we may see directly how the objective depends on the unknown parameters. We define residuals by recurrent expressions:

\[
\begin{align*}
\epsilon_1 &= w_1 \\
\epsilon_2 &= w_2 - a_1 w_1 + b_1 \epsilon_1 \\
\epsilon_3 &= w_3 - a_1 w_2 - a_p w_{t-p} + b_1 \epsilon_2 + b_q \epsilon_{t-q}.
\end{align*}
\]

We minimize the sum

\[
f_m(z) = \sum_{t=1}^{T} \epsilon_t^2.
\]

\(^4\) A number of non-zero components.
Here the objective \( f_m(x) \) depends on \( m = p + q + 1 \) unknown parameters that we represent as the \( m \)-dimensional vector \( x = (x_k, k = 1, \ldots, m) = (a_i, i = 1, \ldots, p, b_j, j = 1, \ldots, q, d) \).

We see from (10), (4), and (2) that residuals \( \varepsilon_t \) are linear functions of parameters \( a_t \). It means that the minimum conditions

\[
\frac{\partial f_m(x)}{\partial a_i} = 0, \ i = 1, \ldots, p \tag{12}
\]

are given by a system of linear equations that defines the estimates of parameters \( a_i = a_i(b_i, i = 1, \ldots, q, d) \) as a function of parameters \( b_i, i = 1, \ldots, q, d \). It reduces the number of parameters of nonlinear optimization to \( n = q + 1 \).

The system

\[
\frac{\partial f_m(x)}{\partial b_i} = 0, \ i = 1, \ldots, q \tag{13}
\]

may have a multiple solution, because the residuals \( \varepsilon_t \) depends on \( b_i \) as polynomials of degree \( T - 1 \).

The equation

\[
\frac{\partial f_m(x)}{\partial d} = 0 \tag{14}
\]

also may have multiple solutions, because the residuals depend on \( d \) as a polynomial of degree \( R \), where \( R \) is a truncation parameter.

It means that, in general, the objective \( f_m(x) \) is a multi modal function of parameters \( d \) and \( b_i, i = 1, \ldots, q \). \(^5\) Therefore, we have to consider the methods of global optimization (see, for example Mockus, 1994).

We denote

\[
f(x) = f_m(x), \ x_i = a_i(b_i, i = 1, \ldots, q, d), \ i = 1, \ldots, p. \tag{15}
\]

It means that we define by condition (12) those \( x \)-components that represent the parameters \( a_t, i = 1, \ldots, p \).

We see that the variance \( \sigma^2 \) is not in residuals expressions (15) and (10). If required, we have to estimate the variance by some other well known techniques.

3. Bilinear models. It is well known that for the adequate description of some phenomena, one needs nonlinear time series. A large number of empirical

\(^5\) The same reasoning applies to log-likelihood function, too.
works have tested for the nonlinearity of macroeconomics and financial time series (Brock and Potter, 1993). The simple case of the nonlinear models is bilinear time series (Subba Rao and Gabr, 1984; Liu, 1989).

An example of bilinear time series follows:

\[ A(L)z_t = B(L)\varepsilon_t + C(L)z_t\varepsilon_t, \]  

where

\[ C(L)z_t\varepsilon_t = \sum_{i=1}^{s} \sum_{j=1}^{r} c_{ij}z_{t-i}\varepsilon_{t-j}. \]

A bilinear extension of linear ARIMA model (1) follows

\[ A(L)(1-L)^d z_t = B(L)\varepsilon_t + C(L)z_t\varepsilon_t. \]  

We expect that this model may represent both the persistence and nonlinearity well enough.

Consider an example of bilinear time series (16) with \( p = 2, \ q = 1, \ s = 2, \ r = 1: \)

\[ z_t = a_1z_{t-1}a_2z_{t-2} + \varepsilon_t + c_{1,1}z_{t-1}\varepsilon_{t-1} + c_{2,1}z_{t-2}\varepsilon_{t-1}, \quad t = 1, \ldots, T. \]  

We consider a simple case when \( T = 12, \varepsilon_t \) are Gaussian 0,1, and \( a_1 = 0.8, \ a_2 = -0.4, \ c_{1,1} = 0.6, \ c_{2,1} = 0.7. \) The mean square deviation \( f(x) = \sum_{t=1}^{12} \varepsilon_t. \)

Fig. 2 shows how \( f(x) \) depends on \( c_{2,1}. \) In Fig. 2 \( d(x^4) \) denotes a mean square deviation \( f(x), \) and \( x^4 \) denotes variable parameter \( c_{2,1}. \)

4. Optimization and fractional co-integration. Define two \( I(d) \) series \( y_{1t} \) and \( y_{2t} \) as \( y_t = (y_{1t}, y_{2t}). \) We say that series \( y_{1t} \) and \( y_{2t} \) are co-integrated of order \( (d, b) \) if there exists a vector \( \alpha \) such that

\[ z_t = \alpha y_t \]  

is \( I(d-b) \) with \( b > 0. \)

Considering the fractional co-integration problem, we may estimate unknown parameters \( d \) and \( b \) at different fixed values of the vector \( \alpha \) by the residual minimization techniques. Then we may pick up such \( \alpha \) that maximizes the difference \( b. \) That is one way to apply optimization in the fractional co-integration problems. We expect to investigate different ways.
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Fig. 2. Bilinear time series, residuals minimization.

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ILGALAIKIAI EKONOMINIAI SANTYKIAI:
OPTIMIZAVIMO POŽIŪRIS TRUPMENINIAI INTEGRUOTOSE
IR DVITIESINĖSE LAIKO EILUTĖSE

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Nagrinėjami trupmeniniai ko-integruoti uždavini, kurie svarbūs tiriant ilgalaikius ryšius tarp susijusių ekonominių kintamųjų. Numatoma panaudoti naujus globalinio optimizavimo metodus įvertinti tiesinių ARIMA modelių parametrus.

Nagrinėjami taip pat ir tai kurie netiesiniai modeliai, konkrečiai bi-tiesiniai modeliai. Šių modelių pavyzdziai parodoma, kad vidutinis kvadratinis nukrypimas gali turėti daug minimumų.

Kaip pirmas pavyzdyrs nagrinėjama Irano rialo ir JAV dolerio kurso laiko eilutė nuo 1965 iki 1988 metų.