Classical Least Squares Theory

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Lecture Outline

1. The Method of Ordinary Least Squares (OLS)
   - Simple Linear Regression
   - Multiple Linear Regression
   - Geometric Interpretations
   - Measures of Goodness of Fit
   - Example: Analysis of Suicide Rate

2. Statistical Properties of the OLS Estimator
   - Classical Conditions
   - Without the Normality Condition
   - With the Normality Condition

3. Hypothesis Testing
   - Tests for Linear Hypotheses
   - Power of the Tests
   - Alternative Interpretation of the $F$ Test
   - Confidence Regions
   - Example: Analysis of Suicide Rate
Multicollinearity
- Near Multicollinearity
- Regression with Dummy Variables
- Example: Analysis of Suicide Rate

Limitation of the Classical Conditions

The Method of Generalized Least Squares (GLS)
- The GLS Estimator
- Stochastic Properties of the GLS Estimator
- The Feasible GLS Estimator
- Heteroskedasticity
- Serial Correlation
- Application: Linear Probability Model
- Application: Seemingly Unrelated Regressions
Simple Linear Regression

Given the variable of interest $y$, we are interested in finding a function of another variable $x$ that can characterize the systematic behavior of $y$.

- $y$: Dependent variable or regressand
- $x$: Explanatory variable or regressor
- Specifying a linear function of $x$: $\alpha + \beta x$ with unknown parameters $\alpha$ and $\beta$
- The non-systematic part is the error: $y - (\alpha + \beta x)$

Together we write:

$$y = \alpha + \beta x + e(\alpha, \beta).$$
For the specification $\alpha + \beta x$, the objective is to find the “best” fit of the data $(y_t, x_t)$, $t = 1, \ldots, T$.

1. **Minimizing a least-squares (LS) criterion function** wrt $\alpha$ and $\beta$:

$$Q_T(\alpha, \beta) := \frac{1}{T} \sum_{t=1}^{T} (y_t - \alpha - \beta x_t)^2.$$  

2. **Minimizing a least-absolute-deviation (LAD) criterion** wrt $\alpha$ and $\beta$:

$$\frac{1}{T} \sum_{t=1}^{T} |y_t - \alpha - \beta x_t|.$$  

3. **Minimizing asymmetrically weighted absolute deviations**:

$$\frac{1}{T} \left( \theta \sum_{t: y_t > \alpha - \beta x_t} |y_t - \alpha - \beta x_t| + (1 - \theta) \sum_{t: y_t < \alpha - \beta x_t} |y_t - \alpha - \beta x_t| \right),$$  

with $0 < \theta < 1$.  

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with $0 < \theta < 1$. 
The OLS Estimators

The first order conditions (FOCs) of LS minimization are:

\[
\frac{\partial Q(\alpha, \beta)}{\partial \alpha} = -2 \frac{1}{T} \sum_{t=1}^{T} (y_t - \alpha - \beta x_t) = 0,
\]

\[
\frac{\partial Q(\alpha, \beta)}{\partial \beta} = -2 \frac{1}{T} \sum_{t=1}^{T} (y_t - \alpha - \beta x_t) x_t = 0.
\]

The solutions are known as the ordinary least squares (OLS) estimators:

\[
\hat{\beta}_T = \frac{\sum_{t=1}^{T} (y_t - \bar{y})(x_t - \bar{x})}{\sum_{t=1}^{T} (x_t - \bar{x})^2},
\]

\[
\hat{\alpha}_T = \bar{y} - \hat{\beta}_T \bar{x}.
\]
The estimated regression line is \( \hat{y} = \hat{\alpha} + \hat{\beta}x \), which is the linear model evaluated at \( \hat{\alpha} \) and \( \hat{\beta} \), and \( \hat{e} = y - \hat{y} \) is the error evaluated at \( \hat{\alpha} \) and \( \hat{\beta} \) and also known as residual.

- The \( t \)-th fitted value of the regression line is \( \hat{y}_t = \hat{\alpha} + \hat{\beta}x_t \).
- The \( t \)-th residual is \( \hat{e}_t = y_t - \hat{y}_t = e_t(\hat{\alpha}, \hat{\beta}) \).

\( \hat{\beta} \) characterizes the the predicted change of \( y \), given a change of one unit of \( x \), whereas \( \hat{\alpha} \) is the predicted \( y \) without \( x \).

No linear model of the form \( a + bx \) can provide a better fit of the data in terms of sum of squared errors.

For the OLS method here, we make no assumption on the data, except that \( x_t \) can not be a constant.
Substituting $\hat{\alpha}_T$ and $\hat{\beta}_T$ into the FOCs:

$$\sum_{t=1}^{T} (y_t - \alpha - \beta x_t) = 0, \quad \sum_{t=1}^{T} (y_t - \alpha - \beta x_t)x_t = 0,$$

we have the following algebraic results:

- $\sum_{t=1}^{T} \hat{e}_t = 0.$
- $\sum_{t=1}^{T} \hat{e}_tx_t = 0.$
- $\sum_{t=1}^{T} y_t = \sum_{t=1}^{T} \hat{y}_t$ so that $\bar{y} = \tilde{y}.$
- $\bar{y} = \hat{\alpha}_T + \hat{\beta}_T\bar{x}$; that is, the estimated regression line must pass through the point $(\bar{x}, \bar{y}).$
Example: Analysis of Suicide Rate

- Suppose we want to know how the suicide rate \((s)\) in Taiwan can be explained by unemployment rate \((u)\), GDP growth rate \((g)\), or time \((t)\). The suicide rate is \(1/100000\).

- Data (1981–2010): \(\bar{s} = 11.7\) with s.d. 3.93; \(\bar{g} = 5.94\) with s.d. 3.15; \(\bar{u} = 2.97\) with s.d. 1.33.

- Estimation results:

\[
\begin{align*}
\hat{s}_t &= 14.53 - 0.48 \, g_t, \quad \bar{R}^2 = 0.12; \\
\hat{s}_t &= 15.70 - 0.69 \, g_{t-1}, \quad \bar{R}^2 = 0.25; \\
\hat{s}_t &= 4.47 + 2.43 \, u_t, \quad \bar{R}^2 = 0.67; \\
\hat{s}_t &= 4.66 + 2.48 \, u_{t-1}, \quad \bar{R}^2 = 0.66; \\
\hat{s}_t &= 7.25 + 0.29 \, t, \quad \bar{R}^2 = 0.39.
\end{align*}
\]
(a) Suicide & GDP growth rates  (b) Suicide and unemploy. rates
Multiple Linear Regression

With $k$ regressors $x_1, \ldots, x_k$ ($x_1$ is usually the constant one):

$$y = \beta_1 x_1 + \cdots + \beta_k x_k + e(\beta_1, \ldots, \beta_k).$$

With data $(y_t, x_{t1}, \ldots, x_{tk})$, $t = 1, \ldots, T$, we can write

$$y = X\beta + e(\beta),$$

where $\beta = (\beta_1 \beta_2 \cdots \beta_k)'$,

$$y = \begin{bmatrix} y_1 \\ y_2 \\ \vdots \\ y_T \end{bmatrix}, \quad X = \begin{bmatrix} x_{11} & x_{12} & \cdots & x_{1k} \\ x_{21} & x_{22} & \cdots & x_{2k} \\ \vdots & \vdots & \ddots & \vdots \\ x_{T1} & x_{T2} & \cdots & x_{Tk} \end{bmatrix}, \quad e(\beta) = \begin{bmatrix} e_1(\beta) \\ e_2(\beta) \\ \vdots \\ e_T(\beta) \end{bmatrix}. $$
Least-squares criterion function:

\[ Q_T(\beta) := \frac{1}{T} e(\beta)' e(\beta) = \frac{1}{T} (y - X\beta)'(y - X\beta). \]  

(2)

The FOCs of minimizing \( Q_T(\beta) \) are \(-2X'(y - X\beta)/T = 0\), leading to the normal equations:

\[ X'X\beta = X'y. \]

Identification Requirement [ID-1]: \( X \) is of full column rank \( k \).

- Any column of \( X \) is not a linear combination of other columns.
- Intuition: \( X \) does not contain redundant information.
- When \( X \) is not of full column rank, we say there exists exact multicollinearity among regressors.
Given [ID-1], $XX'$ is positive definite and hence invertible. The unique solution to the normal equations is known as the OLS estimator of $\beta$:

$$\hat{\beta}_T = (XX')^{-1}X'y.$$  \hspace{1cm} (3)

Under [ID-1], we have the second order condition:

$$\nabla^2_\beta Q_T(\beta) = 2(XX')/T$$ is p.d.

The result below holds whenever the identification requirement is satisfied, and it does not depend on the statistical properties of $y$ and $X$.

**Theorem 3.1**

Given specification (1), suppose [ID-1] holds. Then, the OLS estimator

$$\hat{\beta}_T = (XX')^{-1}X'y$$ uniquely minimizes the criterion function (2).
The magnitude of $\hat{\beta}_T$ is affected by the measurement units of the dependent and explanatory variables; see homework. Thus, a larger coefficient does not imply that the associated regressor is more important.

Given $\hat{\beta}_T$, the vector of the OLS fitted values is $\hat{y} = X\hat{\beta}_T$, and the vector of the OLS residuals is $\hat{e} = y - \hat{y} = e(\hat{\beta}_T)$.

Plugging $\hat{\beta}_T$ into the FOCs $X'(y - X\beta) = 0$, we have:

- $X'\hat{e} = 0$.
- When $X$ contains a vector of ones, $\sum_{t=1}^{T} \hat{e}_t = 0$.
- $\hat{y}'\hat{e} = \hat{\beta}_T X'\hat{e} = 0$.

These are all algebraic results under the OLS method.
Recall that $P = X(X'X)^{-1}X'$ is the orthogonal projection matrix that projects vectors onto $\text{span}(X)$, and $I_T - P$ is the orthogonal projection matrix that projects vectors onto $\text{span}(X)^\perp$, the orthogonal complement of $\text{span}(X)$. Thus, $PX = X$ and $(I_T - P)X = 0$.

- The vector of fitted values, $\hat{y} = X\hat{\beta}_T = X(X'X)^{-1}X'y = Py$, is the orthogonal projection of $y$ onto $\text{span}(X)$.

- The residual vector, $\hat{e} = y - \hat{y} = (I_T - P)y$, is the orthogonal projection of $y$ onto $\text{span}(X)^\perp$.

- $\hat{e}$ is orthogonal to $X$, i.e., $X'\hat{e} = 0$, and it is also orthogonal to $\hat{y}$ because $\hat{y}$ is in $\text{span}(X)$, i.e., $\hat{y}'\hat{e} = 0$. 


\[ \hat{e} = (I - P)y \]

\[ P y = x_1 \hat{\beta}_1 + x_2 \hat{\beta}_2 \]

**Figure:** The orthogonal projection of \( y \) onto \( \text{span}(x_1, x_2) \).
Theorem 3.3 (Frisch-Waugh-Lovell)

Given $y = X_1\beta_1 + X_2\beta_2 + e$, the OLS estimators of $\beta_1$ and $\beta_2$ are

$$\hat{\beta}_{1,T} = [X_1'(I - P_2)X_1]^{-1}X_1'(I - P_2)y,$$

$$\hat{\beta}_{2,T} = [X_2'(I - P_1)X_2]^{-1}X_2'(I - P_1)y,$$

where $P_1 = X_1(X_1'X_1)^{-1}X_1'$ and $P_2 = X_2(X_2'X_2)^{-1}X_2'$.

- This result shows that $\hat{\beta}_{1,T}$ can be computed from regressing $(I - P_2)y$ on $(I - P_2)X_1$, where $(I - P_2)y$ and $(I - P_2)X_1$ are the residual vectors of $y$ on $X_2$ and $X_1$ on $X_2$, respectively.
- Similarly, regressing $(I - P_1)y$ on $(I - P_1)X_2$ yields $\hat{\beta}_{2,T}$.
- The OLS estimator of regressing $y$ on $X_1$ is not the same as $\hat{\beta}_{1,T}$, unless $X_1$ and $X_2$ are orthogonal to each other.
**Proof:** Writing $y = X_1 \hat{\beta}_{1,T} + X_2 \hat{\beta}_{2,T} + (I - P)y$, where $P = X(X'X)^{-1}X'$ with $X = [X_1 \ X_2]$, we have

$$X_1'(I - P_2)y$$

$$= X_1'(I - P_2)X_1\hat{\beta}_{1,T} + X_1'(I - P_2)X_2\hat{\beta}_{2,T} + X_1'(I - P_2)(I - P)y$$

$$= X_1'(I - P_2)X_1\hat{\beta}_{1,T} + X_1'(I - P_2)(I - P)y.$$ 

We know $\text{span}(X_2) \subseteq \text{span}(X)$, so that $\text{span}(X)^\perp \subseteq \text{span}(X_2)^\perp$. Hence, $(I - P_2)(I - P) = I - P$, and

$$X_1'(I - P_2)y = X_1'(I - P_2)X_1\hat{\beta}_{1,T} + X_1'(I - P)y$$

$$= X_1'(I - P_2)X_1\hat{\beta}_{1,T},$$

from which we obtain the expression for $\hat{\beta}_{1,T}$. 
Frisch-Waugh-Lovell Theorem

Observe that $(I - P_1)y = (I - P_1)X_2\hat{\beta}_2, T + (I - P_1)(I - P)y$.

1. $(I - P_1)(I - P) = I - P$, so that the residual vector of regressing $(I - P_1)y$ on $(I - P_1)X_2$ is identical to the residual vector of regressing $y$ on $X = [X_1 \ X_2]$:

$(I - P_1)y = (I - P_1)X_2\hat{\beta}_2, T + (I - P)y$.

2. $P_1 = P_1P$, so that the orthogonal projection of $y$ directly on span($X_1$) (i.e., $P_1y$) is equivalent to iterated projections of $y$ on span($X$) and then on span($X_1$) (i.e., $P_1Py$). Hence,

$(I - P_1)X_2\hat{\beta}_2, T = (I - P_1)Py = (P - P_1)y$. 
Figure: An illustration of the Frisch-Waugh-Lovell Theorem.
Measures of Goodness of Fit

Given \( \hat{y}'\hat{e} = 0 \), we have \( y'y = \hat{y}'\hat{y} + \hat{e}'\hat{e} \), where \( y'y \) is known as TSS (total sum of squares), \( \hat{y}'\hat{y} \) is RSS (regression sum of squares), and \( \hat{e}'\hat{e} \) is ESS (error sum of squares).

The non-centered coefficient of determination (or non-centered \( R^2 \)),

\[ R^2 = \frac{RSS}{TSS} = 1 - \frac{ESS}{TSS}, \tag{4} \]

measures the proportion of the total variation of \( y_t \) that can be explained by the model.

- It is invariant wrt measurement units of the dependent variable but not invariant wrt constant addition.
- It is a relative measure such that \( 0 \leq R^2 \leq 1 \).
- It is nondecreasing in the number of regressors. (Why?)
Centered $R^2$

- When the specification contains a constant term,

$$\sum_{t=1}^{T} (y_t - \bar{y})^2 = \sum_{t=1}^{T} (\hat{y}_t - \bar{y})^2 + \sum_{t=1}^{T} \hat{e}_t^2,$$

i.e., centered TSS = centered RSS + ESS.

- The centered coefficient of determination (or centered $R^2$),

$$R^2 = \frac{\sum_{t=1}^{T} (\hat{y}_t - \bar{y})^2}{\sum_{t=1}^{T} (y_t - \bar{y})^2} = \frac{\text{Centered RSS}}{\text{Centered TSS}} = 1 - \frac{\text{ESS}}{\text{Centered TSS}},$$

measures the proportion of the total variation of $y_t$ that can be explained by the model, excluding the effect of the constant term.

- It is invariant wrt constant addition.
- $0 \leq R^2 \leq 1$, and it is non-decreasing in the number of regressors.
- It may be negative when the model does not contain a constant term.
Centered $R^2$: Alternative Interpretation

- When the specification contains a constant term,
  \[
  \sum_{t=1}^{T} (y_t - \bar{y})(\hat{y}_t - \bar{y}) = \sum_{t=1}^{T} (\hat{y}_t - \bar{y} + \hat{e}_t)(\hat{y}_t - \bar{y}) = \sum_{t=1}^{T} (\hat{y}_t - \bar{y})^2,
  \]
  because $\sum_{t=1}^{T} \hat{y}_t \hat{e}_t = \sum_{t=1}^{T} \hat{e}_t = 0$.

- Centered $R^2$ can also be expressed as
  \[
  R^2 = \frac{\sum_{t=1}^{T} (\hat{y}_t - \bar{y})^2}{\sum_{t=1}^{T} (y_t - \bar{y})^2} = \frac{[\sum_{t=1}^{T} (y_t - \bar{y})(\hat{y}_t - \bar{y})]^2}{[\sum_{t=1}^{T} (y_t - \bar{y})^2][\sum_{t=1}^{T} (\hat{y}_t - \bar{y})^2]},
  \]
  which is the the squared sample correlation coefficient of $y_t$ and $\hat{y}_t$, also known as the squared multiple correlation coefficient.

- Models for different dep. variables are not comparable in terms of $R^2$. 

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Adjusted $R^2$

- Adjusted $R^2$ is the centered $R^2$ adjusted for the degrees of freedom:

$$\overline{R}^2 = 1 - \frac{\hat{e}'\hat{e}/(T - k)}{(y'y - T\bar{y}^2)/(T - 1)}.$$

- $\overline{R}^2$ adds a penalty term to $R^2$:

$$\overline{R}^2 = 1 - \frac{T - 1}{T - k}(1 - R^2) = R^2 - \frac{k - 1}{T - k}(1 - R^2),$$

where the penalty term depends on the trade-off between model complexity and model explanatory ability.

- $\overline{R}^2$ may be negative and need not be non-decreasing in $k$. 
Example: Analysis of Suicide Rate

Q: How the suicide rate \( (s) \) can be explained by unemployment rate \( (u) \), GDP growth rate \( (g) \), and time \( (t) \) during 1981–2010?

Estimation results with \( g_t \) and \( u_t \):

\[
\hat{s}_t = 14.53 - 0.48 g_t, \quad \bar{R}^2 = 0.12;
\]
\[
\hat{s}_t = 4.47 + 2.43 u_t, \quad \bar{R}^2 = 0.67;
\]
\[
\hat{s}_t = 4.06 + 2.49 u_t + 0.05 g_t, \quad \bar{R}^2 = 0.66.
\]

Estimation results with \( g_{t-1} \) and \( u_{t-1} \):

\[
\hat{s}_t = 15.70 - 0.69 g_{t-1}, \quad \bar{R}^2 = 0.25;
\]
\[
\hat{s}_t = 4.66 + 2.48 u_{t-1}, \quad \bar{R}^2 = 0.66;
\]
\[
\hat{s}_t = 4.51 + 2.50 u_{t-1} + 0.02 g_{t-1}, \quad \bar{R}^2 = 0.65.
\]
Estimation results with $t$ but without $g$:

\[
\hat{s}_t = 4.47 + 2.43 u_t, \quad \bar{R}^2 = 0.67;
\]
\[
\hat{s}_t = 4.47 + 2.46 u_t - 0.01 t, \quad \bar{R}^2 = 0.66;
\]
\[
\hat{s}_t = 4.66 + 2.48 u_{t-1}, \quad \bar{R}^2 = 0.66;
\]
\[
\hat{s}_t = 4.66 + 2.44 u_{t-1} + 0.01 t, \quad \bar{R}^2 = 0.65.
\]

Estimation results with $t$ and $g$:

\[
\hat{s}_t = 4.04 + 2.49 u_t + 0.05 g_t, \quad \bar{R}^2 = 0.66;
\]
\[
\hat{s}_t = 4.04 + 2.50 u_t + 0.05 g_t - 0.003 t, \quad \bar{R}^2 = 0.65;
\]
\[
\hat{s}_t = 4.51 + 2.50 u_{t-1} + 0.02 g_{t-1}, \quad \bar{R}^2 = 0.65;
\]
\[
\hat{s}_t = 4.47 + 2.46 u_{t-1} + 0.02 g_{t-1} + 0.01 t, \quad \bar{R}^2 = 0.64.
\]
Estimation results with $t$ and $t^2$:

\[
\hat{s}_t = 7.25 + 0.29 t, \quad \bar{R}^2 = 0.39;
\]
\[
\hat{s}_t = 13.36 - 0.86 t + 0.04 t^2, \quad \bar{R}^2 = 0.81;
\]
\[
\hat{s}_t = 10.86 + 1.10 u_t - 0.75 t + 0.03 t^2, \quad \bar{R}^2 = 0.84;
\]
\[
\hat{s}_t = 14.16 - 0.10 g_t - 0.87 t + 0.04 t^2, \quad \bar{R}^2 = 0.81;
\]
\[
\hat{s}_t = 11.13 + 1.07 u_t - 0.03 g_t - 0.76 t + 0.03 t^2, \quad \bar{R}^2 = 0.84;
\]
\[
\hat{s}_t = 10.93 + 1.15 u_{t-1} - 0.76 t + 0.03 t^2, \quad \bar{R}^2 = 0.85;
\]
\[
\hat{s}_t = 12.95 + 0.06 g_{t-1} - 0.87 t + 0.04 t^2, \quad \bar{R}^2 = 0.80;
\]
\[
\hat{s}_t = 9.54 + 1.29 u_{t-1} + 0.16 g_{t-1} - 0.78 t + 0.03 t^2, \quad \bar{R}^2 = 0.85.
\]

As far as $\bar{R}^2$ is concerned, a specification with $t$, $t^2$, and $u$ seems to provide good fit of data and reasonable interpretation.

Q: Is there any other way to determine if a specification is “good”? 

Classical Conditions

To derive the statistical properties of the OLS estimator, we assume:

[A1] \( X \) is non-stochastic.

[A2] \( y \) is a random vector such that
   (i) \( \mathbb{E}(y) = X\beta_0 \) for some \( \beta_0 \);
   (ii) \( \text{var}(y) = \sigma_o^2 I_T \) for some \( \sigma_o^2 > 0 \).

[A3] \( y \) is a random vector s.t. \( y \sim \mathcal{N}(X\beta_0, \sigma_o^2 I_T) \) for some \( \beta_0 \) and \( \sigma_o^2 > 0 \).

- The specification (1) with [A1] and [A2] is known as the classical linear model, whereas (1) with [A1] and [A3] is the classical normal linear model.

- When \( \text{var}(y) = \sigma_o^2 I_T \), the elements of \( y \) are homoskedastic and (serially) uncorrelated.
Without Normality

The OLS estimator of the parameter $\sigma_o^2$ is

$$\hat{\sigma}_T^2 = \frac{1}{T-k} \sum_{t=1}^{T} \hat{e}_t^2.$$ 

**Theorem 3.4**

Consider the linear specification (1).

(a) Given [A1] and [A2](i), $\hat{\beta}_T$ is unbiased for $\beta_o$.

(b) Given [A1] and [A2], $\hat{\sigma}_T^2$ is unbiased for $\sigma_o^2$.

(c) Given [A1] and [A2], $\text{var}(\hat{\beta}_T) = \sigma_o^2(X'X)^{-1}$. 
Proof: By [A1], \( \mathbb{E}(\hat{\beta}_T) = \mathbb{E}[(X'X)^{-1}X'y] = (X'X)^{-1}X'\mathbb{E}(y) \). [A2](i) gives \( \mathbb{E}(y) = X\beta_o \), so that

\[
\mathbb{E}(\hat{\beta}_T) = (X'X)^{-1}X'X\beta_o = \beta_o,
\]
proving unbiasedness. Given \( \hat{e} = (I_T - P)y = (I_T - P)(y - X\beta_o) \),

\[
\mathbb{E}(\hat{e}'\hat{e}) = \mathbb{E}[\text{trace}((y - X\beta_o)'(I_T - P)(y - X\beta_o))] \\
= \mathbb{E}[\text{trace}((y - X\beta_o)(y - X\beta_o)'(I_T - P))] \\
= \text{trace}(\mathbb{E}[(y - X\beta_o)(y - X\beta_o)'](I_T - P)) \\
= \text{trace}(\sigma_o^2 I_T(I_T - P)) \\
= \sigma_o^2 \text{trace}(I_T - P).
\]

where the 4-th equality follows from [A2](ii) that \( \text{var}(y) = \sigma_o^2 I_T \).
Proof (cont’d): As \( \text{trace}(I_T - P) = \text{rank}(I_T - P) = T - k \), we have

\[
\mathbb{E}(\hat{e}'\hat{e}) = \sigma_o^2 (T - k) \text{ and }
\]

\[
\mathbb{E}(\hat{\sigma}_T^2) = \mathbb{E}(\hat{e}'\hat{e})/(T - k) = \sigma_o^2,
\]

proving (b). By [A1] and [A2](ii),

\[
\text{var}(\hat{\beta}_T) = \text{var}((X'X)^{-1}X'y) = (X'X)^{-1}X'[\text{var}(y)]X(X'X)^{-1} = \sigma_o^2(X'X)^{-1}X'I_TX(X'X)^{-1} = \sigma_o^2(X'X)^{-1}.
\]

This establishes the assertion of (c).
Theorem 3.4 establishes unbiasedness of the OLS estimators \( \hat{\beta}_T \) and \( \hat{\sigma}_T^2 \) but does not address the issue of efficiency.

By Theorem 3.4(c), the elements of \( \hat{\beta}_T \) can be more precisely estimated (i.e., with a smaller variance) when \( X \) has larger variation. To see this, consider the simple linear regression: \( y = \alpha + \beta x + e \), it can be verified that

\[
\text{var}(\hat{\beta}_T) = \sigma_o^2 \frac{1}{\sum_{t=1}^{T} (x_t - \bar{x})^2}.
\]

Thus, the larger the (squared) variation of \( x_t \) (i.e., \( \sum_{t=1}^{T} (x_t - \bar{x})^2 \)), the smaller is the variance of \( \hat{\beta}_T \).
The result below establishes efficiency of $\hat{\beta}_T$ among all unbiased estimators of $\beta_o$ that are linear in $y$.

**Theorem 3.5 (Gauss-Markov)**

Given linear specification (1), suppose that [A1] and [A2] hold. Then the OLS estimator $\hat{\beta}_T$ is the best linear unbiased estimator (BLUE) for $\beta_o$.

**Proof:** Consider an arbitrary linear estimator $\tilde{\beta}_T = Ay$, where $A$ is a non-stochastic matrix, say, $A = (X'X)^{-1}X' + C$. Then, $\tilde{\beta}_T = \hat{\beta}_T + Cy$, such that

$$\text{var}(\tilde{\beta}_T) = \text{var}(\hat{\beta}_T) + \text{var}(Cy) + 2 \text{cov}(\hat{\beta}_T, Cy).$$

By [A1] and [A2](i), $\text{IE}(\tilde{\beta}_T) = \beta_o + CX\beta_o$, which is unbiased iff $CX = 0$. 
Proof (cont’d): The condition $C\mathbf{X} = 0$ implies $\text{cov}(\hat{\beta}_T, C\mathbf{y}) = 0$. Thus,

$$\text{var}(\tilde{\beta}_T) = \text{var}(\hat{\beta}_T) + \text{var}(C\mathbf{y}) = \text{var}(\hat{\beta}_T) + \sigma_o^2 C C' .$$

This shows that $\text{var}(\tilde{\beta}_T) - \text{var}(\hat{\beta}_T)$ is a p.s.d. matrix $\sigma_o^2 C C'$, so that $\hat{\beta}_T$ is more efficient than any linear unbiased estimator $\tilde{\beta}_T$. 
Example: $\mathbb{E}(y) = X_1 b_1$ and $\text{var}(y) = \sigma_o^2 I_T$. Two specification:

$$y = X_1 \beta_1 + \epsilon.$$ 

with the OLS estimator $\hat{b}_{1,T}$, and

$$y = X \beta + \epsilon = X_1 \beta_1 + X_2 \beta_2 + \epsilon.$$ 

with the OLS estimator $\hat{\beta}_T = (\hat{\beta}'_1, \hat{\beta}'_2)'$. Clearly, $\hat{b}_{1,T}$ is the BLUE of $b_1$ with $\text{var}(\hat{b}_{1,T}) = \sigma_o^2 (X_1' X_1)^{-1}$. By the Frisch-Waugh-Lovell Theorem,

$$\mathbb{E}(\hat{\beta}_{1,T}) = \mathbb{E} \left( [X_1' (I_T - P_2) X_1]^{-1} X_1' (I_T - P_2) y \right) = b_1,$$

$$\mathbb{E}(\hat{\beta}_{2,T}) = \mathbb{E} \left( [X_2' (I_T - P_1) X_2]^{-1} X_2' (I_T - P_1) y \right) = 0.$$

That is, $\hat{\beta}_T$ is unbiased for $(b_1' \ 0')'$. 
Example (cont’d):

\[
\text{var}(\hat{\beta}_{1,T}) = \text{var}\left([X_1'(I_T - P_2)X_1]^{-1}X_1'(I_T - P_2)y\right)
\]
\[
= \sigma^2_o[X_1'(I_T - P_2)X_1]^{-1}.
\]

As \(X_1'X_1 - X_1'(I_T - P_2)X_1 = X_1'P_2X_1\) is p.s.d., it follows that

\[
[X_1'(I_T - P_2)X_1]^{-1} - (X_1'X_1)^{-1}
\]

is p.s.d. This shows that \(\hat{b}_{1,T}\) is more efficient than \(\hat{\beta}_{1,T}\), as it ought to be.
Under [A3] that \( y \sim \mathcal{N}(X\beta_o, \sigma_o^2 I_T) \), the log-likelihood function of \( y \) is

\[
\log L(\beta, \sigma^2) = -\frac{T}{2} \log(2\pi) - \frac{T}{2} \log \sigma^2 - \frac{1}{2\sigma^2} (y - X\beta)'(y - X\beta).
\]

The score vector is

\[
s(\beta, \sigma^2) = \begin{bmatrix}
\frac{1}{\sigma^2} X'(y - X\beta) \\
-\frac{T}{2\sigma^2} + \frac{1}{2\sigma^4} (y - X\beta)'(y - X\beta)
\end{bmatrix},
\]

Solutions to \( s(\beta, \sigma^2) = 0 \) are the (quasi) maximum likelihood estimators (MLEs). Clearly, the MLE of \( \beta \) is the OLS estimator, and the MLE of \( \sigma^2 \) is

\[
\tilde{\sigma}^2_T = \frac{(y - X\hat{\beta}_T)'(y - X\hat{\beta}_T)}{T} = \frac{\hat{e}'\hat{e}}{T} \neq \hat{\sigma}^2_T.
\]
With the normality condition on $y$, a lot more can be said about the OLS estimators.

**Theorem 3.7**

Given the linear specification (1), suppose that [A1] and [A3] hold.

(a) $\hat{\beta}_T \sim \mathcal{N}(\beta_o, \sigma_o^2 (X'X)^{-1})$.

(b) $(T - k)\hat{\sigma}_T^2/\sigma_o^2 \sim \chi^2(T - k)$.

(c) $\hat{\sigma}_T^2$ has mean $\sigma_o^2$ and variance $2\sigma_o^4/(T - k)$.

**Proof:** For (a), we note that $\hat{\beta}_T$ is a linear transformation of $y \sim \mathcal{N}(X\beta_o, \sigma_o^2 I_T)$ and hence also a normal random vector. As for (b), writing $\hat{e} = (I_T - P)(y - X\beta_o)$, we have

$$(T - k)\hat{\sigma}_T^2/\sigma_o^2 = \hat{e}'\hat{e}/\sigma_o^2 = y^*(I_T - P)y^*,$$

where $y^* = (y - X\beta_o)/\sigma_o \sim \mathcal{N}(0, I_T)$ by [A3].
Proof (cont’d): Let \( C \) orthogonally diagonalizes \( I_T - P \) such that \( C'(I_T - P)C = \Lambda \). Since \( \text{rank}(I_T - P) = T - k \), \( \Lambda \) contains \( T - k \) eigenvalues equal to one and \( k \) eigenvalues equal to zero. Then,

\[
y^*(I_T - P)y^* = y'^*C[C'(I_T - P)C]C'y^* = \eta' \begin{bmatrix} I_{T-k} & 0 \\ 0 & 0 \end{bmatrix} \eta.
\]

where \( \eta = C'y^* \). As \( \eta \sim N(0, I_T) \), \( \eta_i \) are independent, standard normal random variables. It follows that

\[
y^*(I_T - P)y^* = \sum_{i=1}^{T-k} \eta_i^2 \sim \chi^2(T - k),
\]

proving (b). (c) is a direct consequence of (b) and the facts that \( \chi^2(T - k) \) has mean \( T - k \) and variance \( 2(T - k) \).
Theorem 3.8

Given the linear specification (1), suppose that [A1] and [A3] hold. Then the OLS estimators $\hat{\beta}_T$ and $\hat{\sigma}^2_T$ are the best unbiased estimators (BUE) for $\beta_o$ and $\sigma^2_o$, respectively.

Proof: The Hessian matrix of the log-likelihood function is

$$H(\beta, \sigma^2) = \begin{bmatrix}
-\frac{1}{\sigma^2} X'X & -\frac{1}{\sigma^4} X'(y - X\beta) \\
-\frac{1}{\sigma^4} (y - X\beta)'X & \frac{T}{2\sigma^4} - \frac{1}{\sigma^6} (y - X\beta)'(y - X\beta)
\end{bmatrix}. $$

Under [A3], $\mathbb{E}[s(\beta_o, \sigma^2_o)] = 0$ and

$$\mathbb{E}[H(\beta_o, \sigma^2_o)] = \begin{bmatrix}
-\frac{1}{\sigma^2_o} X'X & 0 \\
0 & -\frac{T}{2\sigma^4_o}
\end{bmatrix}. $$
Proof (cont’d):

By the information matrix equality, $-\mathbb{E}[\mathbf{H}(\beta_o, \sigma_o^2)]$ is the information matrix. Then, its inverse,

$$
-\mathbb{E}[\mathbf{H}(\beta_o, \sigma_o^2)]^{-1} = \begin{bmatrix}
\sigma_o^2 (\mathbf{X}'\mathbf{X})^{-1} & 0 \\
0 & 2\sigma_o^4/T
\end{bmatrix},
$$

is the Cramér-Rao lower bound.

- $\text{var}(\hat{\beta}_T)$ achieves this lower bound (the upper-left block) so that $\hat{\beta}_T$ is the best unbiased estimator for $\beta_o$. This conclusion is much stronger than the Gauss-Markov Theorem.

- Although $\text{var}(\hat{\sigma}_T^2) = 2\sigma_o^4/(T - k)$ is greater than the lower bound (lower-right element), it can be shown that $\hat{\sigma}_T^2$ is still the best unbiased estimator for $\sigma_o^2$; see Rao (1973, p. 319) for a proof.
Tests for Linear Hypotheses

- Linear hypothesis: $R\beta_o = r$, where $R$ is $q \times k$ with full row rank $q$ and $q < k$, $r$ is a vector of hypothetical values.

- A natural way to construct a test statistic is to compare $R\hat{\beta}_T$ and $r$; we reject the null if their difference is too “large.”

- Given [A1] and [A3], Theorem 3.7(a) states:

  $$\hat{\beta}_T \sim \mathcal{N}(\beta_o, \sigma_o^2(X'X)^{-1}),$$

  so that

  $$R\hat{\beta}_T \sim \mathcal{N}(R\beta_o, \sigma_o^2[R(X'X)^{-1}R']).$$

  The comparison between $R\hat{\beta}_T$ and $r$ is based on this distribution.
Suppose first that \( q = 1 \). Then, \( R\hat{\beta}_T \) and \( R(X'X)^{-1}R' \) are scalars. Under the null hypothesis,

\[
\frac{R\hat{\beta}_T - r}{\sigma_o[R(X'X)^{-1}R']^{1/2}} = \frac{R(\hat{\beta}_T - \beta_o)}{\sigma_o[R(X'X)^{-1}R']^{1/2}} \sim \mathcal{N}(0, 1).
\]

An operational statistic is obtained by replacing \( \sigma_o \) with \( \hat{\sigma}_T \):

\[
\tau = \frac{R\hat{\beta}_T - r}{\hat{\sigma}_T[R(X'X)^{-1}R']^{1/2}}.
\]

**Theorem 3.9**

Given the linear specification (1), suppose that [A1] and [A3] hold. When \( R \) is \( 1 \times k \), \( \tau \sim t(T - k) \) under the null hypothesis.

**Note:** This \( t \) distribution result holds under the normality condition [A3].
Proof: We write the statistic $\tau$ as

$$
\tau = \frac{\mathbf{R}\hat{\beta}_T - \mathbf{r}}{\sigma_o[\mathbf{R}(\mathbf{X}'\mathbf{X})^{-1}\mathbf{R}']^{1/2}} \sqrt{\frac{(T - k)\hat{\sigma}^2_T}{\sigma^2_o} \frac{1}{T - k}},
$$

where the numerator is $\mathcal{N}(0, 1)$ and $(T - k)\hat{\sigma}^2_T/\sigma^2_o$ is $\chi^2(T - k)$ by Theorem 3.7(b). The assertion follows when the numerator and denominator are independent. This is indeed the case, because $\hat{\beta}_T$ and $\hat{e}$ are jointly normally distributed with

$$
\text{cov}(\hat{e}, \hat{\beta}_T) = \mathbb{E}[(\mathbf{I}_T - \mathbf{P})(\mathbf{y} - \mathbf{X}\beta_o)\mathbf{y}'\mathbf{X}(\mathbf{X}'\mathbf{X})^{-1}]
$$

$$
= (\mathbf{I}_T - \mathbf{P})\mathbb{E}[(\mathbf{y} - \mathbf{X}\beta_o)\mathbf{y}']\mathbf{X}(\mathbf{X}'\mathbf{X})^{-1}
$$

$$
= \sigma^2_o(\mathbf{I}_T - \mathbf{P})\mathbf{X}(\mathbf{X}'\mathbf{X})^{-1} = \mathbf{0}.
$$
Examples

To test $\beta_i = c$, let $R = [0 \cdots 0 1 0 \cdots 0]$ and $m^{ij}$ be the $(i,j)$th element of $M^{-1} = (X'X)^{-1}$. Then,

$$
\tau = \frac{\hat{\beta}_{i,T} - c}{\hat{\sigma}_T \sqrt{m^{ii}}} \sim t(T - k),
$$

where $m^{ii} = R(X'X)^{-1}R'$. $\tau$ is a $t$ statistic; for testing $\beta_i = 0$, $\tau$ is also referred to as the $t$ ratio.

It is straightforward to verify that to test $a\beta_i + b\beta_j = c$, with $a, b, c$ given constants, the corresponding test reads:

$$
\tau = \frac{a\hat{\beta}_{i,T} + b\hat{\beta}_{j,T} - c}{\hat{\sigma}_T \sqrt{[a^2 m^{ii} + b^2 m^{jj} + 2ab m^{ij}]}} \sim t(T - k).
$$
When $\mathbf{R}$ is a $q \times k$ matrix with full row rank, note that

$$(\mathbf{R}\hat{\beta}_T - r)'[\mathbf{R}(\mathbf{X}'\mathbf{X})^{-1}\mathbf{R}']^{-1}(\mathbf{R}\hat{\beta}_T - r)/\sigma_o^2 \sim \chi^2(q).$$

An operational statistic is

$$\varphi = \frac{(\mathbf{R}\hat{\beta}_T - r)'[\mathbf{R}(\mathbf{X}'\mathbf{X})^{-1}\mathbf{R}']^{-1}(\mathbf{R}\hat{\beta}_T - r)/(\sigma_o^2 q)}{(T - k)\hat{\sigma}_T^2/\sigma_o^2(T - k)}$$

$$= \frac{(\mathbf{R}\hat{\beta}_T - r)'[\mathbf{R}(\mathbf{X}'\mathbf{X})^{-1}\mathbf{R}']^{-1}(\mathbf{R}\hat{\beta}_T - r)}{\hat{\sigma}_T^2 q}.$$

When $q = 1$, $\varphi = \tau^2$.

**Theorem 3.10**

Given the linear specification (1), suppose that [A1] and [A3] hold. When $\mathbf{R}$ is $q \times k$ with full row rank, $\varphi \sim F(q, T - k)$ under the null hypothesis.
Example: \( H_0 : \beta_1 = b_1 \) and \( \beta_2 = b_2 \). The \( F \) statistic,

\[
\varphi = \frac{1}{2\hat{\sigma}^2_T} \left( \begin{array}{c}
\hat{\beta}_{1,T} - b_1 \\
\hat{\beta}_{2,T} - b_2
\end{array} \right)'
\left[
\begin{array}{cc}
m^{11} & m^{12} \\
m^{21} & m^{22}
\end{array}
\right]^{-1}
\left( \begin{array}{c}
\hat{\beta}_{1,T} - b_1 \\
\hat{\beta}_{2,T} - b_2
\end{array} \right),
\]
is distributed as \( F(2, T - k) \).

Example: \( H_0 : \beta_2 = 0, \) and \( \beta_3 = 0, \cdots \) and \( \beta_k = 0, \)

\[
\varphi = \frac{1}{(k - 1)\hat{\sigma}^2_T} \left( \begin{array}{c}
\hat{\beta}_{2,T} \\
\hat{\beta}_{3,T} \\
\vdots \\
\hat{\beta}_{k,T}
\end{array} \right)'
\left[
\begin{array}{cccc}
m^{22} & m^{23} & \cdots & m^{2k} \\
m^{32} & m^{33} & \cdots & m^{3k} \\
\vdots & \vdots & \ddots & \vdots \\
m^{k2} & m^{k3} & \cdots & m^{kk}
\end{array}
\right]^{-1}
\left( \begin{array}{c}
\hat{\beta}_{2,T} \\
\hat{\beta}_{3,T} \\
\vdots \\
\hat{\beta}_{k,T}
\end{array} \right),
\]
is distributed as \( F(k - 1, T - k) \) and known as regression \( F \) test.
To examine the power of the $F$ test, we evaluate the distribution of $\varphi$ under the alternative hypothesis: $R\beta_o = r + \delta$, with $R$ is a $q \times k$ matrix with rank $q < k$ and $\delta \neq 0$.

**Theorem 3.11**

Given the linear specification (1), suppose that [A1] and [A3] hold. When $R\beta_o = r + \delta$,

$$\varphi \sim F(q, T - k; \delta' D^{-1} \delta, 0),$$

where $D = \sigma_o^2[R(X'X)^{-1}R']$, and $\delta' D^{-1} \delta$ is the non-centrality parameter of the numerator of $\varphi$. 
Proof: When \( R\beta_\circ = r + \delta \),

\[
[R(X'X)^{-1}R']^{-1/2}(R\hat{\beta}_T - r)/\sigma_\circ = D^{-1/2}[R(\hat{\beta}_T - \beta_\circ) + \delta],
\]

which is distributed as \( N(0, I_q) + D^{-1/2}\delta \). Then,

\[
(R\hat{\beta}_T - r)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta}_T - r)/\sigma_\circ^2 \sim \chi^2(q; \delta'D^{-1}\delta),
\]

a non-central \( \chi^2 \) distribution with the non-centrality parameter \( \delta'D^{-1}\delta \). It is also readily seen that \( (T - k)\hat{\sigma}_T^2/\sigma_\circ^2 \) is still distributed as \( \chi^2(T - k) \). Similar to the argument before, these two terms are independent, so that \( \varphi \) has a non-central \( F \) distribution.
Test power is determined by the non-centrality parameter $\delta' D^{-1} \delta$, where $\delta$ signifies the deviation from the null. When $R\beta_o$ deviates farther from the hypothetical value $r$ (i.e., $\delta$ is “large”), the non-centrality parameter $\delta' D^{-1} \delta$ increases, and so does the power.

Example: The null distribution is $F(2, 20)$, and its critical value at 5% level is 3.49. Then for $F(2, 20; \nu_1, 0)$ with the non-centrality parameter $\nu_1 = 1, 3, 5$, the probabilities that $\varphi$ exceeds 3.49 are approximately 12.1%, 28.2%, and 44.3%, respectively.

Example: The null distribution is $F(5, 60)$, and its critical value at 5% level is 2.37. Then for $F(5, 60; \nu_1, 0)$ with $\nu_1 = 1, 3, 5$, the probabilities that $\varphi$ exceeds 2.37 are approximately 9.4%, 20.5%, and 33.2%, respectively.
Alternative Interpretation

- **Constrained OLS**: Finding the saddle point of the Lagrangian:

  \[
  \min_{\beta, \lambda} \frac{1}{T} (y - X\beta)'(y - X\beta) + (R\beta - r)'\lambda,
  \]

  where \( \lambda \) is the \( q \times 1 \) vector of Lagrangian multipliers, we have

  \[
  \ddot{\lambda}_T = 2[R(X'X/T)^{-1}R']^{-1}(R\hat{\beta}_T - r),
  \]

  \[
  \ddot{\beta}_T = \hat{\beta}_T - (X'X/T)^{-1}R'\ddot{\lambda}_T/2.
  \]

- The constrained OLS residuals are

  \[
  \ddot{e} = y - X\hat{\beta}_T + X(\hat{\beta}_T - \ddot{\beta}_T) = \ddot{e} + X(\hat{\beta}_T - \ddot{\beta}_T),
  \]

  with \( \hat{\beta}_T - \ddot{\beta}_T = (X'X)^{-1}R'[R(X'X)^{-1}R']^{-1}(R\hat{\beta}_T - r) \).
The sum of squared, constrained OLS residuals are:

\[ \bar{\epsilon}'\bar{\epsilon} = \hat{\epsilon}'\hat{\epsilon} + (\hat{\beta}_T - \bar{\beta}_T)'X'X(\hat{\beta}_T - \bar{\beta}_T) \]

\[ = \hat{\epsilon}'\hat{\epsilon} + (R\hat{\beta}_T - r)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta}_T - r), \]

where the 2nd term on the RHS is the numerator of the \( F \) statistic.

Letting \( ESS_c = \bar{\epsilon}'\bar{\epsilon} \) and \( ESS_u = \hat{\epsilon}'\hat{\epsilon} \) we have

\[ \varphi = \frac{\bar{\epsilon}'\bar{\epsilon} - \hat{\epsilon}'\hat{\epsilon}}{q\hat{\sigma}_T^2} = \frac{(ESS_c - ESS_u)/q}{ESS_u/(T-k)}, \]

suggesting that \( F \) test in effect compares the constrained and unconstrained models based on their lack-of-fitness.

The regression \( F \) test is thus \( \varphi = \frac{(R_u^2 - R_c^2)/q}{(1 - R_u^2)/(T-k)} \) which compares model fitness of the full model and the model with only a constant term.
The sum of squared, constrained OLS residuals are:

\[ \hat{\epsilon}' \hat{\epsilon} = \hat{\epsilon}' \hat{\epsilon} + (\hat{\beta}_T - \bar{\beta}_T)'X'X(\hat{\beta}_T - \bar{\beta}_T) \]

\[ = \hat{\epsilon}' \hat{\epsilon} + (R\hat{\beta}_T - r)'[R(X'X)^{-1}R']^{-1}(R\hat{\beta}_T - r), \]

where the 2nd term on the RHS is the numerator of the \( F \) statistic.

Letting \( \text{ESS}_c = \hat{\epsilon}' \hat{\epsilon} \) and \( \text{ESS}_u = \hat{\epsilon}' \hat{\epsilon} \) we have

\[ \varphi = \frac{\hat{\epsilon}' \hat{\epsilon} - \hat{\epsilon}' \hat{\epsilon}}{q \hat{\sigma}_T^2} = \frac{(\text{ESS}_c - \text{ESS}_u)/q}{\text{ESS}_u/(T - k)}, \]

suggesting that \( F \) test in effect compares the constrained and unconstrained models based on their lack-of-fit.

The regression \( F \) test is thus \( \varphi = \frac{(R_u^2 - R_c^2)/q}{(1 - R_u^2)/(T - k)} \) which compares model fitness of the full model and the model with only a constant term.
A confidence interval for $\beta_{i,o}$ is the interval $(\underline{g}_\alpha, \overline{g}_\alpha)$ such that

$$\mathbb{P}\{\underline{g}_\alpha \leq \beta_{i,o} \leq \overline{g}_\alpha\} = 1 - \alpha,$$

where $(1 - \alpha)$ is known as the confidence coefficient.

Letting $c_{\alpha/2}$ be the critical value of $t(T - k)$ with tail prob. $\alpha/2$,

$$\mathbb{P}\left\{ \left| (\hat{\beta}_{i,T} - \beta_{i,o}) / (\hat{\sigma}_T \sqrt{m^{ii}}) \right| \leq c_{\alpha/2} \right\}$$

$$\mathbb{P}\left\{ \hat{\beta}_{i,T} c_{\alpha/2} \hat{\sigma}_T \sqrt{m^{ii}} \leq \beta_{i,o} \leq \hat{\beta}_{i,T} + c_{\alpha/2} \hat{\sigma}_T \sqrt{m^{ii}} \right\} = 1 - \alpha.$$
• The confidence region for a vector of parameters can be constructed by resorting to $F$ statistic.

• For $(\beta_1, o = b_1, \beta_2, o = b_2)'$, suppose $T - k = 30$ and $\alpha = 0.05$. Then, $F_{0.05}(2, 30) = 3.32$, and

$$
\left\{ \frac{1}{2\hat{\sigma}_T^2} \left( \begin{array}{c}
\hat{\beta}_{1,T} - b_1 \\
\hat{\beta}_{2,T} - b_2
\end{array} \right) \right. \left[ \begin{array}{cc}
m_{11} & m_{12} \\
m_{21} & m_{22}
\end{array} \right]^{-1} \left( \begin{array}{c}
\hat{\beta}_{1,T} - b_1 \\
\hat{\beta}_{2,T} - b_2
\end{array} \right) \leq 3.32
$$

is $1 - \alpha$, which results in an ellipse with the center $(\hat{\beta}_{1,T}, \hat{\beta}_{2,T})$.

Note: It is possible that $(\beta_1, \beta_2)$ is outside the confidence box formed by individual confidence intervals but inside the joint confidence ellipse. That is, while a $t$ ratio may indicate statistic significance of a coefficient, the $F$ test may suggest the opposite based on the confidence region.
Example: Analysis of Suicide Rate

### Part I: Estimation results with $t$

<table>
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<th>const</th>
<th>$u_t$</th>
<th>$u_{t-1}$</th>
<th>$t$</th>
<th>$\bar{R}^2$</th>
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<td>(7.62**)</td>
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*Note:* The numbers in parentheses are $t$-ratios; ** and * stand for significance of a two-sided test at 1% and 5% levels.
### Part II: Estimation results with $t$ and $g$

<table>
<thead>
<tr>
<th>const</th>
<th>$u_t$</th>
<th>$u_{t-1}$</th>
<th>$g_t$</th>
<th>$g_{t-1}$</th>
<th>$t$</th>
<th>$\bar{R}^2$</th>
<th>Reg F</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.04</td>
<td>2.49</td>
<td>0.05</td>
<td></td>
<td></td>
<td></td>
<td>0.66</td>
<td>29.34**</td>
</tr>
<tr>
<td>(2.26*)</td>
<td>(6.80**)</td>
<td>0.29</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.04</td>
<td>2.50</td>
<td>0.05</td>
<td></td>
<td>-0.003</td>
<td>0.65</td>
<td>18.84**</td>
<td></td>
</tr>
<tr>
<td>(2.21*)</td>
<td>(4.62**)</td>
<td>0.28</td>
<td>-0.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.51</td>
<td>2.50</td>
<td>0.02</td>
<td></td>
<td></td>
<td></td>
<td>0.65</td>
<td>27.99**</td>
</tr>
<tr>
<td>(2.09*)</td>
<td>(5.73**)</td>
<td>0.08</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.47</td>
<td>2.46</td>
<td>0.02</td>
<td>0.01</td>
<td></td>
<td></td>
<td>0.64</td>
<td>17.98**</td>
</tr>
<tr>
<td>(2.00*)</td>
<td>(4.25**)</td>
<td>0.10</td>
<td>0.11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

$F$ tests for the joint significance of the coefficients of $g$ and $t$: 0.04 (Model 2) and 0.01 (Model 4).
Part III: Estimation results with \( t \) and \( t^2 \)

<table>
<thead>
<tr>
<th>const</th>
<th>( u_t )</th>
<th>( u_{t-1} )</th>
<th>( g_t )</th>
<th>( g_{t-1} )</th>
<th>( t )</th>
<th>( t^2 )</th>
<th>( \bar{R}^2 / F )</th>
</tr>
</thead>
<tbody>
<tr>
<td>13.36</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>−0.86</td>
<td>0.04</td>
<td>0.81</td>
</tr>
<tr>
<td>(13.30**)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(−5.74**)</td>
<td>(7.90**)</td>
<td>62.74**</td>
</tr>
<tr>
<td>10.86</td>
<td>1.10</td>
<td></td>
<td></td>
<td></td>
<td>−0.75</td>
<td>0.03</td>
<td>0.84</td>
</tr>
<tr>
<td>(8.21**)</td>
<td>(2.61**)</td>
<td></td>
<td></td>
<td></td>
<td>(−5.33**)</td>
<td>(5.70**)</td>
<td>53.06**</td>
</tr>
<tr>
<td>11.13</td>
<td>1.07</td>
<td>−0.03</td>
<td></td>
<td></td>
<td>−0.76</td>
<td>0.03</td>
<td>0.84</td>
</tr>
<tr>
<td>(6.27**)</td>
<td>(2.38*)</td>
<td>−0.24</td>
<td></td>
<td></td>
<td>(−5.21**)</td>
<td>(5.59**)</td>
<td>38.36**</td>
</tr>
<tr>
<td>10.93</td>
<td>1.15</td>
<td></td>
<td></td>
<td></td>
<td>−0.76</td>
<td>0.03</td>
<td>0.85</td>
</tr>
<tr>
<td>(8.83**)</td>
<td>(2.85**)</td>
<td></td>
<td></td>
<td></td>
<td>(−5.57**)</td>
<td>(6.05**)</td>
<td>55.53**</td>
</tr>
<tr>
<td>9.54</td>
<td>1.29</td>
<td>0.16</td>
<td></td>
<td>−0.78</td>
<td></td>
<td>0.03</td>
<td>0.85</td>
</tr>
<tr>
<td>(5.83**)</td>
<td>(3.11**)</td>
<td>1.28</td>
<td></td>
<td>(−5.74**)</td>
<td></td>
<td>(6.26**)</td>
<td>43.07**</td>
</tr>
</tbody>
</table>

\( F \) tests for the joint significance of the coefficients of \( g \) and \( t \): 13.72** (Model 3) and 16.69** (Model 5).
Selected estimation results:

\[ \hat{s}_t = 10.86 + 1.10 u_t - 0.75 t + 0.03 t^2, \quad \bar{R}^2 = 0.84; \]
\[ \hat{s}_t = 10.93 + 1.15 u_{t-1} - 0.76 t + 0.03 t^2, \quad \bar{R}^2 = 0.85. \]

- The marginal effect of \( u \) on \( s \): The second model predicts an increase of this year’s suicide rate by 1.15 (approx. 264 persons) when there is one percent increase of last year’s unemployment rate.
- The time effect is \(-0.76 + 0.06t\) and changes with \( t \): At 2010, this effect is approx 1.04 (approx. 239 persons).
- Since 1993 (about 12.6 years after 1980), there has been a natural increase of the suicide rate in Taiwan. Lowering unemployment rate would help cancel out the time effect to some extent.
- The prediction of the suicide rate in 2010 is 21.43 (vs. actual suicide rate 16.8); the difference, corresponding to approx. 1000 persons, seems too large.
Near Multicollinearity

It is more common to have near multicollinearity: $\mathbf{X} \mathbf{a} \approx \mathbf{0}$.

- Writing $\mathbf{X} = [\mathbf{x}_i \ \mathbf{X}_i]$, we have from the FWL Theorem that

$$\text{var}(\hat{\beta}_i, T) = \sigma_o^2 [\mathbf{x}_i'(\mathbf{I} - \mathbf{P}_i)\mathbf{x}_i]^{-1} = \frac{\sigma_o^2}{\sum_{t=1}^{T}(x_{ti} - \bar{x}_i)^2(1 - R^2(i))},$$

where $\mathbf{P}_i = \mathbf{X}_i(\mathbf{X}_i'\mathbf{X}_i)^{-1}\mathbf{X}_i'$, and $R^2(i)$ is the centered $R^2$ from regressing $\mathbf{x}_i$ on $\mathbf{X}_i$.

- Consequence of near multicollinearity:
  - $R^2(i)$ is high, so that $\text{var}(\hat{\beta}_i, T)$ tend to be large and that $\hat{\beta}_i, T$ are sensitive to data changes.
  - Large $\text{var}(\hat{\beta}_i, T)$ lead to small (insignificant) $t$ ratios. Yet, regression $F$ test may suggest that the model (as a whole) is useful.
How do we circumvent the problems from near multicollinearity?

- Try to break the approximate linear relation.
  - Adding more data if possible.
  - Dropping some regressors.

- Statistical approaches:
  - Ridge regression: For some $\lambda \neq 0$,
    \[
    \hat{b}_{\text{ridge}} = (X'X + \lambda I_k)^{-1}X'y.
    \]
  - Principal component regression:

- Note: Multicollinearity vs. “micronumerosity” (Goldberger)
**Example:** Let $y_t$ denote the wage of the $t$th individual and $x_t$ the working experience (in years). We consider the following specification:

$$y_t = \alpha_0 + \alpha_1 D_t + \beta_0 x_t + e_t,$$

where $D_t$ is a dummy variable such that $D_t = 1$ if $t$ is a male and $D_t = 0$ otherwise. This specification puts together two regressions: the regression for female ($D_t = 0$) has intercept $\alpha_0$, and the regression for male ($D_t = 1$) has intercept $\alpha_0 + \alpha_1$. These two regressions coincide if $\alpha_1 = 0$.

We may also consider the specification:

$$y_t = \alpha_0 + \alpha_1 D_t + \beta_0 x_t + \beta_1 (x_t D_t) + e_t.$$

Then, the slopes of the regressions for female and male are, respectively, $\beta_0$ and $\beta_0 + \beta_1$. These two regressions coincide if $\alpha_1 = 0$ and $\beta_1 = 0$. 

C.-M. Kuan (Finance & CRETA, NTU)
Example: Consider two dummy variables:

\[ D_{1,t} = 1 \text{ if high school is } t\text{'s highest degree and } D_{1,t}=0 \text{ otherwise;} \]
\[ D_{2,t} = 1 \text{ if college or graduate is } t\text{'s highest degree and } D_{2,t}=0 \text{ otherwise.} \]

The specification below in effect puts together 3 regressions:

\[ y_t = \alpha_0 + \alpha_1 D_{1,t} + \alpha_2 D_{2,t} + \beta x_t + \epsilon_t, \]

where below-high-school regression has intercepts \( \alpha_0 \), high-school regression has intercept \( \alpha_0 + \alpha_1 \), college regression has intercept \( \alpha_0 + \alpha_2 \).

Similar to the previous example, we may also consider a more general specification in which \( x \) interacts with \( D_1 \) and \( D_2 \).

**Dummy variable trap:** To avoid exact multicollinearity, the number of dummy variables in a model (with the constant term) should be one less than the number of groups.
Example: Analysis of Suicide Rate

Let $D_t = 1$ for $t = T^* + 1, \ldots, T$ and $D_t = 0$ otherwise, where $T^*$ is the year of structure change. Consider the specification:

$$s_t = \alpha_0 + \delta D_t + \beta_0 u_{t-1} + \gamma u_{t-1} D_t + e_t.$$

The before-change regression has intercept $\alpha_0$ and slope $\beta_0$, and the after-change regression has intercept $\alpha_0 + \delta$ and slope $\beta_0 + \gamma$. Testing a structure change at $T^*$ amounts to testing $\delta = 0$ and $\gamma = 0$ (Chow test). Alternatively, we can estimate the specification:

$$s_t = \alpha_0(1 - D_t) + \alpha_1 D_t + \beta_0 u_{t-1}(1 - D_t) + \beta_1 u_{t-1} D_t + e_t.$$

We can also test a structure change at $T^*$ by testing $\alpha_0 = \alpha_1$ and $\beta_0 = \beta_1$. 
Part I: Estimation results with a known change: Without $t$

<table>
<thead>
<tr>
<th>$T^*$</th>
<th>const</th>
<th>$D_t$</th>
<th>$u_{t-1}$</th>
<th>$u_{t-1}D_t$</th>
<th>$\bar{R}^2$/Reg $F$</th>
<th>Chow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>6.97</td>
<td>−3.15</td>
<td>1.40</td>
<td>1.29</td>
<td>0.65</td>
<td>0.58</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(2.77*) (−1.07)</td>
<td>19.14**</td>
</tr>
<tr>
<td>1993</td>
<td>6.10</td>
<td>−1.74</td>
<td>1.74</td>
<td>0.83</td>
<td>0.64</td>
<td>0.21</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(2.51*) (−0.59)</td>
<td>18.40**</td>
</tr>
<tr>
<td>1994</td>
<td>5.60</td>
<td>−0.75</td>
<td>1.93</td>
<td>0.52</td>
<td>0.64</td>
<td>0.14</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(2.41*) (−0.25)</td>
<td>18.25**</td>
</tr>
<tr>
<td>1995</td>
<td>5.38</td>
<td>0.04</td>
<td>2.01</td>
<td>0.31</td>
<td>0.64</td>
<td>0.20</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(2.38*) (0.01)</td>
<td>18.36**</td>
</tr>
</tbody>
</table>

Chow test is the $F$ test of the coefficients of $D_t$ and $u_{t-1}D_t$ being zero.
Part II: Estimation results with a known change: With $t$

<table>
<thead>
<tr>
<th>$T^*$</th>
<th>$\text{const}$</th>
<th>$D_t$</th>
<th>$u_{t-1}$</th>
<th>$t$</th>
<th>$tD_t$</th>
<th>$\bar{R}^2$/Reg $F$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>12.51</td>
<td>$-15.61$</td>
<td>0.42</td>
<td>$-0.55$</td>
<td>1.23</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>(12.02**)</td>
<td>(−8.44**)</td>
<td>(1.19)</td>
<td>(−5.58**)</td>
<td>(8.78**)</td>
<td>74.05**</td>
</tr>
<tr>
<td>1993</td>
<td>12.49</td>
<td>$-15.48$</td>
<td>0.42</td>
<td>$-0.54$</td>
<td>1.22</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>(12.12**)</td>
<td>(−8.02**)</td>
<td>(1.18)</td>
<td>(−6.18**)</td>
<td>(8.92**)</td>
<td>74.09**</td>
</tr>
<tr>
<td>1994</td>
<td>12.36</td>
<td>$-15.26$</td>
<td>0.38</td>
<td>$-0.50$</td>
<td>1.19</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>(11.82**)</td>
<td>(−7.49**)</td>
<td>(1.05)</td>
<td>(−6.23**)</td>
<td>(8.65**)</td>
<td>70.87**</td>
</tr>
<tr>
<td>1995</td>
<td>12.13</td>
<td>$-14.83$</td>
<td>0.35</td>
<td>$-0.45$</td>
<td>1.13</td>
<td>0.90</td>
</tr>
<tr>
<td></td>
<td>(11.11**)</td>
<td>(−6.70**)</td>
<td>(0.91)</td>
<td>(−5.85**)</td>
<td>(8.04**)</td>
<td>63.90**</td>
</tr>
</tbody>
</table>

$F$ test of the coefficients of $D_t$ and $tD_t$ being zero: 39.75** ('92); 39.77** ('93); 37.68** ('94); 33.15** ('95)
Selected estimation results:

\[
\begin{align*}
1992 & : \hat{s}_t = 12.51 - 15.61 D_t + 0.42 u_{t-1} - 0.55 t + 1.23 t D_t; \\
1993 & : \hat{s}_t = 12.49 - 15.48 D_t + 0.42 u_{t-1} - 0.54 t + 1.22 t D_t; \\
1994 & : \hat{s}_t = 12.36 - 15.26 D_t + 0.38 u_{t-1} - 0.50 t + 1.19 t D_t.
\end{align*}
\]

- There appears to be a structural change over time. For \( T^* = 1993 \), the before-change slope is \(-0.54\) (a decrease over time), and the after-change slope is \(0.68\) (an increase over time).
- The marginal effect of \( u_{t-1} \) on \( s_t \) is not significant even at 10% level.
- These models predict the suicide rate in 2010 as 19.83, 19.8 and 19.75, whereas the prediction based on the quadratic trend model is 21.43. For the model with \( T^* = 1993 \), the difference between the predicted and actual suicide rates is 3.0 (approx. 690 persons).
Limitation of the Classical Conditions

- **[A1]** $X$ is non-stochastic: Economic variables cannot be regarded as non-stochastic; also, lagged dependent variables may be used as regressors.

- **[A2]**
  1. $\mathbb{E}(y) = X\beta_o$: $\mathbb{E}(y)$ may be a linear function with more regressors or a nonlinear function of regressors.
  2. $\text{var}(y) = \sigma_o^2 I_T$: The elements of $y$ may be correlated (serial correlation, spatial correlation) and/or may have unequal variances.

- **[A3]** Normality: $y$ may have a non-normal distribution.

- The OLS estimator loses the properties derived before when some of the classical conditions fail to hold.
When $\text{var}(y) \neq \sigma_o^2 I_T$

Given the linear specification $y = X\beta + e$, suppose, in addition to [A1] and [A2](i), $\text{var}(y) = \Sigma_o \neq \sigma_o^2 I_T$, where $\Sigma_o$ is p.d. That is, the elements of $y$ may be correlated and have unequal variances.

- The OLS estimator $\hat{\beta}_T$ remains unbiased with
  
  $$\text{var}(\hat{\beta}_T) = \text{var}((X'X)^{-1}X'y) = (X'X)^{-1}X'\Sigma_o X(X'X)^{-1}.$$  

- $\hat{\beta}_T$ is not the BLUE for $\beta_o$, and it is not the BUE for $\beta_o$ under normality.

- The estimator $\text{var}(\hat{\beta}_T) = \hat{\sigma}_T^2 (X'X)^{-1}$ is a biased estimator for $\text{var}(\hat{\beta}_T)$. Consequently, the $t$ and $F$ tests do not have $t$ and $F$ distributions, even when $y$ is normally distributed.
The GLS Estimator

Consider the specification: \( Gy = GX\beta + Ge \), where \( G \) is nonsingular and non-stochastic.

- \( \mathbb{E}(Gy) = GX\beta \) and \( \text{var}(Gy) = G\Sigma_o G' \).
- \( GX \) has full column rank so that the OLS estimator can be computed:

\[
b(G) = (X'G'GX)^{-1}X'G'Gy,
\]

which is still linear and unbiased. It would be the BLUE provided that \( G \) is chosen such that \( G\Sigma_o G' = \sigma_o^2 I_T \).

- Setting \( G = \Sigma_o^{-1/2} \), where \( \Sigma_o^{-1/2} = C\Lambda^{-1/2}C' \) and \( C \) orthogonally diagonalizes \( \Sigma_o \): \( C'\Sigma_o C = \Lambda \), we have \( \Sigma_o^{-1/2} \Sigma_o \Sigma_o^{-1/2'} = I_T \).
With \( y^* = \Sigma_o^{-1/2} y \) and \( X^* = \Sigma_o^{-1/2} X \), we have the GLS estimator:

\[
\hat{\beta}_{GLS} = (X^* X^*)^{-1} X^* y^* = (X' \Sigma_o^{-1} X)^{-1}(X' \Sigma_o^{-1} y).
\] (5)

The \( \hat{\beta}_{GLS} \) is a minimizer of weighted sum of squared errors:

\[
Q(\beta; \Sigma_o) = \frac{1}{T}(y^* - X^* \beta)'(y^* - X^* \beta) = \frac{1}{T}(y - X \beta)' \Sigma_o^{-1}(y - X \beta).
\]

The vector of GLS fitted values, \( \hat{y}_{GLS} = X(X' \Sigma_o^{-1} X)^{-1}(X' \Sigma_o^{-1} y) \), is an oblique projection of \( y \) onto \( \text{span}(X) \), because \( X(X' \Sigma_o^{-1} X)^{-1}X' \Sigma_o^{-1} \) is idempotent but asymmetric. The GLS residual vector is \( \hat{e}_{GLS} = y - \hat{y}_{GLS} \).

The sum of squared OLS residuals is less than the sum of squared GLS residuals. (Why?)
Theorem 4.1 (Aitken)

Given linear specification (1), suppose that [A1] and [A2](i) hold and that 
\( \text{var}(y) = \Sigma_o \) is positive definite. Then, \( \hat{\beta}_{GLS} \) is the BLUE for \( \beta_o \).

- Given [A3′] \( y \sim \mathcal{N}(X\beta_o, \Sigma_o) \),
  \[ \hat{\beta}_{GLS} \sim \mathcal{N}(\beta_o, (X'\Sigma_o^{-1}X)^{-1}) \].

- Under [A3′], the log likelihood function is
  \[ \log L(\beta; \Sigma_o) = -\frac{T}{2} \log(2\pi) - \frac{1}{2} \log(\det(\Sigma_o)) - \frac{1}{2} (y - X\beta)'\Sigma_o^{-1}(y - X\beta), \]
  with the FOC: \( X'\Sigma_o^{-1}(y - X\beta) = 0 \). Thus, the GLS estimator is also the MLE under normality.
Under normality, the information matrix is

\[ I = \begin{bmatrix} X' \Sigma_o^{-1} (y - X\beta) (y - X\beta)' \Sigma_o^{-1} X \end{bmatrix} \bigg|_{\beta = \beta_o} = X' \Sigma_o^{-1} X. \]

Thus, the GLS estimator is the BUE for \( \beta_o \), because its covariance matrix reaches the Crámer-Rao lower bound.

Under the null hypothesis \( R\beta_o = r \), we have

\[ (R\hat{\beta}_{GLS} - r)' [R(X' \Sigma_o^{-1} X)^{-1} R']^{-1} (R\hat{\beta}_{GLS} - r) \sim \chi^2(q). \]

A major difficulty: How should the GLS estimator be computed when \( \Sigma_o \) is unknown?
Under normality, the information matrix is

\[
\mathbb{E}[X'\Sigma_o^{-1}(y - X\beta)(y - X\beta)'\Sigma_o^{-1}X]\bigg|_{\beta=\beta_o} = X'\Sigma_o^{-1}X.
\]

Thus, the GLS estimator is the BUE for $\beta_o$, because its covariance matrix reaches the Crámer-Rao lower bound.

Under the null hypothesis $R\beta_o = r$, we have

\[
(R\hat{\beta}_{GLS} - r)'[R(X'\Sigma_o^{-1}X)^{-1}R']^{-1}(R\hat{\beta}_{GLS} - r) \sim \chi^2(q).
\]

A major difficulty: How should the GLS estimator be computed when $\Sigma_o$ is unknown?
The Feasible GLS Estimator

The Feasible GLS (FGLS) estimator is

$$\hat{\beta}_{\text{FGLS}} = \left( X' \hat{\Sigma}_T^{-1} X \right)^{-1} X' \hat{\Sigma}_T^{-1} y,$$

where $\hat{\Sigma}_T$ is an estimator of $\Sigma_o$.

Further difficulties in FGLS estimation:

- The number of parameters in $\Sigma_o$ is $T(T + 1)/2$. Estimating $\Sigma_o$ without some prior restrictions on $\Sigma_o$ is practically infeasible.
- Even when an estimator $\hat{\Sigma}_T$ is available under certain assumptions, the finite-sample properties of the FGLS estimator are still difficult to derive.
The Feasible GLS (FGLS) estimator is

\[ \hat{\beta}_{\text{FGLS}} = \left( X' \hat{\Sigma}^{-1} X \right)^{-1} X' \hat{\Sigma}^{-1} y, \]

where \( \hat{\Sigma}_T \) is an estimator of \( \Sigma_o \).

Further difficulties in FGLS estimation:

- The number of parameters in \( \Sigma_o \) is \( T(T + 1)/2 \). Estimating \( \Sigma_o \) without some prior restrictions on \( \Sigma_o \) is practically infeasible.
- Even when an estimator \( \hat{\Sigma}_T \) is available under certain assumptions, the finite-sample properties of the FGLS estimator are still difficult to derive.
A simple form of $\Sigma_0$ is

$$\Sigma_0 = \begin{bmatrix} \sigma_1^2 I_{T_1} & 0 \\ 0 & \sigma_2^2 I_{T_2} \end{bmatrix},$$

with $T = T_1 + T_2$; this is known as groupwise heteroskedasticity.

- The null hypothesis of homoskedasticity: $\sigma_1^2 = \sigma_2^2 = \sigma_0^2$.
- Perform separate OLS regressions using the data in each group and obtain the variance estimates $\hat{\sigma}_1^2$ and $\hat{\sigma}_2^2$.
- Under [A1] and [A3'], the $F$ test is:

$$\varphi := \frac{\hat{\sigma}_1^2}{\hat{\sigma}_2^2} = \frac{(T_1 - k)\hat{\sigma}_1^2}{\sigma_0^2(T_1 - k)} \bigg/ \frac{(T_2 - k)\hat{\sigma}_2^2}{\sigma_0^2(T_2 - k)} \sim F(T_1 - k, T_2 - k).$$
More generally, for some constants $c_0, c_1 > 0$, $\sigma_t^2 = c_0 + c_1 x_{tj}^2$.

The **Goldfeld-Quandt test**:

1. Rearrange obs. according to the values of $x_j$ in a descending order.
2. Divide the rearranged data set into three groups with $T_1$, $T_m$, and $T_2$ observations, respectively.
3. Drop the $T_m$ observations in the middle group and perform separate OLS regressions using the data in the first and third groups.
4. The statistic is the ratio of the variance estimates:

$$\hat{\sigma}_{T_1}^2 / \hat{\sigma}_{T_2}^2 \sim F(T_1 - k, T_2 - k).$$

Some questions:

- Can we estimate the model with all observations and then compute $\hat{\sigma}_{T_1}^2$ and $\hat{\sigma}_{T_2}^2$ based on $T_1$ and $T_2$ residuals?
- If $\Sigma_\beta$ is not diagonal, does the $F$ test above still work?
More generally, for some constants \( c_0, c_1 > 0 \), \( \sigma_t^2 = c_0 + c_1 x_{tj}^2 \).

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\[
\frac{\hat{\sigma}^2_{T_1}}{\hat{\sigma}^2_{T_2}} \sim F(T_1 - k, T_2 - k).
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- If $\Sigma_o$ is not diagonal, does the $F$ test above still work?
Under groupwise heteroskedasticity,

\[
\Sigma_\sigma^{-1/2} = \begin{bmatrix}
\sigma_1^{-1}I_{T_1} & 0 \\
0 & \sigma_2^{-1}I_{T_2}
\end{bmatrix},
\]

so that the transformed specification is

\[
\begin{bmatrix}
y_1/\sigma_1 \\
y_2/\sigma_2
\end{bmatrix} = \begin{bmatrix}
X_1/\sigma_1 \\
X_2/\sigma_2
\end{bmatrix} \beta + \begin{bmatrix}
e_1/\sigma_1 \\
e_2/\sigma_2
\end{bmatrix}.
\]

Clearly, \(\text{var}(\Sigma_\sigma^{-1/2} y) = I_T\). The GLS estimator is:

\[
\hat{\beta}_{\text{GLS}} = \left[ \frac{X'_1 X_1}{\sigma_1^2} + \frac{X'_2 X_2}{\sigma_2^2} \right]^{-1} \left[ \frac{X'_1 y_1}{\sigma_1^2} + \frac{X'_2 y_2}{\sigma_2^2} \right].
\]
With $\hat{\sigma}^2_{T_1}$ and $\hat{\sigma}^2_{T_2}$ from separate regressions, an estimator of $\Sigma_o$ is

$$
\hat{\Sigma} = \begin{bmatrix}
\hat{\sigma}^2_{T_1} & 0 \\
0 & \hat{\sigma}^2_{T_2}
\end{bmatrix}.
$$

The FGLS estimator is:

$$
\hat{\beta}_{\text{FGLS}} = \left[ \frac{X_1'X_1}{\hat{\sigma}^2_1} + \frac{X_2'X_2}{\hat{\sigma}^2_2} \right]^{-1} \left[ \frac{X_1'y_1}{\hat{\sigma}^2_1} + \frac{X_2'y_2}{\hat{\sigma}^2_2} \right].
$$

Note: If $\sigma^2_t = c x^2_{tj}$, a transformed specification is

$$
y_t / x_{tj} = \beta_j + \beta_1 \frac{1}{x_{tj}} + \cdots + \beta_{j-1} \frac{x_{t,j-1}}{x_{tj}} + \beta_{j+1} \frac{x_{t,j+1}}{x_{tj}} + \cdots + \beta_k \frac{x_{tk}}{x_{tj}} + \frac{e_t}{x_{tj}},
$$

where $\text{var}(y_t / x_{tj}) = c := \sigma^2_o$. Here, the GLS estimator is readily computed as the OLS estimator for the transformed specification.
Discussion and Remarks

- How do we determine the “groups” for groupwise heteroskedasticity?
- What if the diagonal elements of $\Sigma_o$ take multiple values (so that there are more than 2 groups)?
- A general form of heteroskedasticity: $\sigma^2_t = h(\alpha_0 + z_t'\alpha_1)$, with $h$ unknown, $z_t$ a $p \times 1$ vector and $p$ a fixed number less than $T$.
- When the $F$ test rejects the null of homoskedasticity, groupwise heteroskedasticity need not be a correct description of $\Sigma_o$.
- When the form of heteroskedasticity is incorrectly specified, the resulting FGLS estimator may be less efficient than the OLS estimator.
- The finite-sample properties of FGLS estimators and hence the exact tests are typically unknown.
Serial Correlation

- When time series data $y_t$ are correlated over time, they are said to exhibit **serial correlation**. For cross-section data, the correlations of $y_t$ are known as **spatial correlation**.

- A general form of $\Sigma_o$ is that its diagonal elements (variances of $y_t$) are a constant $\sigma_o^2$, and the off-diagonal elements ($\text{cov}(y_t, y_{t-i})$) are non-zero.

- In the time series context, $\text{cov}(y_t, y_{t-i})$ are known as the **autocovariances** of $y_t$, and the **autocorrelations** of $y_t$ are

  $$\text{corr}(y_t, y_{t-i}) = \frac{\text{cov}(y_t, y_{t-i})}{\sqrt{\text{var}(y_t)} \sqrt{\text{var}(y_{t-i})}} = \frac{\text{cov}(y_t, y_{t-i})}{\sigma_o^2}.$$
A time series $y_t$ is said to be weakly (covariance) stationary if its mean, variance, and autocovariances are all independent of $t$.

- i.i.d. random variables
- **White noise**: A time series with zero mean, a constant variance, and zero autocovariances.

**Disturbance**: $\epsilon := y - X\beta_o$ so that $\text{var}(y) = \text{var}(\epsilon) = \mathbb{E}(\epsilon\epsilon')$.

Suppose that $\epsilon_t$ follows a weakly stationary AR(1) (autoregressive of order 1) process:

$$\epsilon_t = \psi_1 \epsilon_{t-1} + u_t, \quad |\psi_1| < 1,$$

where $\{u_t\}$ is a white noise with $\mathbb{E}(u_t) = 0$, $\mathbb{E}(u_t^2) = \sigma_u^2$, and $\mathbb{E}(u_t u_\tau) = 0$ for $t \neq \tau$. 
By recursive substitution,
\[ \epsilon_t = \sum_{i=0}^{\infty} \psi_1^i u_{t-i}, \]
a weighted sum of current and previous “innovations” (shocks). This is a stationary process because:

- \( \mathbb{E}(\epsilon_t) = 0, \) \( \text{var}(\epsilon_t) = \sum_{i=0}^{\infty} \psi_1^2 \sigma_u^2 = \sigma_u^2/(1 - \psi_1^2), \) and
  \[ \text{cov}(\epsilon_t, \epsilon_{t-1}) = \psi_1 \mathbb{E}(\epsilon_{t-1}^2) = \psi_1 \sigma_u^2/(1 - \psi_1^2), \]
  so that \( \text{corr}(\epsilon_t, \epsilon_{t-1}) = \psi_1. \)

- \( \text{cov}(\epsilon_t, \epsilon_{t-2}) = \psi_1 \text{cov}(\epsilon_{t-1}, \epsilon_{t-2}) \) so that \( \text{corr}(\epsilon_t, \epsilon_{t-2}) = \psi_1^2. \) Thus,
  \[ \text{corr}(\epsilon_t, \epsilon_{t-i}) = \psi_1 \text{corr}(\epsilon_{t-1}, \epsilon_{t-i}) = \psi_1^i, \]
  which depend only on \( i, \) but not on \( t. \)
The variance-covariance matrix \( \text{var}(y) \) is thus

\[
\Sigma_o = \sigma_o^2 \begin{bmatrix}
1 & \psi_1 & \psi_1^2 & \cdots & \psi_1^{T-1} \\
\psi_1 & 1 & \psi_1 & \cdots & \psi_1^{T-2} \\
\psi_1^2 & \psi_1 & 1 & \cdots & \psi_1^{T-3} \\
\vdots & \vdots & \vdots & \ddots & \vdots \\
\psi_1^{T-1} & \psi_1^{T-2} & \psi_1^{T-3} & \cdots & 1
\end{bmatrix},
\]

with \( \sigma_o^2 = \sigma_u^2/(1 - \psi_1^2) \). Note that all off-diagonal elements of this matrix are non-zero, but there are only two unknown parameters.
A transformation matrix for GLS estimation is the following $\Sigma_o^{-1/2}$:

\[
\frac{1}{\sigma_o} \begin{bmatrix}
1 & 0 & 0 & \cdots & 0 & 0 \\
-\frac{\psi_1}{\sqrt{1-\psi_1^2}} & 1 & 0 & \cdots & 0 & 0 \\
0 & -\frac{\psi_1}{\sqrt{1-\psi_1^2}} & 1 & \cdots & 0 & 0 \\
\vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
0 & 0 & 0 & \cdots & \frac{1}{\sqrt{1-\psi_1^2}} & 0 \\
0 & 0 & 0 & \cdots & -\frac{\psi_1}{\sqrt{1-\psi_1^2}} & \frac{1}{\sqrt{1-\psi_1^2}}
\end{bmatrix}.
\]

Any matrix that is a constant proportion to $\Sigma_o^{-1/2}$ can also serve as a legitimate transformation matrix for GLS estimation.
The Cochrane-Orcutt Transformation is based on:

\[ V_o^{-1/2} = \sigma_o \sqrt{1 - \psi_1^2} \Sigma_o^{-1/2} = \begin{bmatrix}
\sqrt{1 - \psi_1^2} & 0 & 0 & \ldots & 0 & 0 \\
-\psi_1 & 1 & 0 & \ldots & 0 & 0 \\
0 & -\psi_1 & 1 & \ldots & 0 & 0 \\
\vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
0 & 0 & 0 & \ldots & 1 & 0 \\
0 & 0 & 0 & \ldots & -\psi_1 & 1 
\end{bmatrix}, \]

which depends only on the single parameter \( \psi_1 \). The resulting transformed data are: \( y^* = V_o^{-1/2} y \) and \( X^* = V_o^{-1/2} X \) with

\[ y_1^* = (1 - \psi_1^2)^{1/2} y_1, \quad x_1^* = (1 - \psi_1^2)^{1/2} x_1, \]

\[ y_t^* = y_t - \psi_1 y_{t-1}, \quad x_t^* = x_t - \psi_1 x_{t-1}, \quad t = 2, \ldots, T, \]

where \( x_t \) is the \( t \)th column of \( X' \).
Model Extensions

- Extension to AR($p$) process:

\[ \epsilon_t = \psi_1 \epsilon_{t-1} + \cdots + \psi_p \epsilon_{t-p} + u_t, \]

where \( \psi_1, \ldots, \psi_p \) must be restricted to ensure weak stationarity.

- MA(1) (moving average of order 1) process:

\[ \epsilon_t = u_t - \pi_1 u_{t-1}, \quad |\pi_1| < 1, \]

where \( \{u_t\} \) is a white noise.

- MA($q$) Process: \( \epsilon_t = u_t - \pi_1 u_{t-1} - \cdots - \pi_q u_{t-q} \).
Tests for AR(1) Disturbances

Under AR(1), the null hypothesis is $\psi_1 = 0$. A natural estimator of $\psi_1$ is the OLS estimator of regressing $\hat{e}_t$ on $\hat{e}_{t-1}$:

$$\hat{\psi}_T = \frac{\sum_{t=2}^{T} \hat{e}_t \hat{e}_{t-1}}{\sum_{t=2}^{T} \hat{e}_{t-1}^2}.$$  

- The Durbin-Watson statistic is

$$d = \frac{\sum_{t=2}^{T} (\hat{e}_t - \hat{e}_{t-1})^2}{\sum_{t=1}^{T} \hat{e}_t^2}.$$  

- When the sample size $T$ is large, it can be seen that

$$d = 2 - 2\hat{\psi}_T \frac{\sum_{t=2}^{T} \hat{e}_{t-1}^2}{\sum_{t=1}^{T} \hat{e}_t^2} - \frac{\hat{e}_1^2 + \hat{e}_T^2}{\sum_{t=1}^{T} \hat{e}_t^2} \approx 2(1 - \hat{\psi}_T).$$
For $0 < \hat{\psi}_T \leq 1$ ($-1 \leq \hat{\psi}_T < 0$), $0 \leq d < 2$ ($2 < d \leq 4$), there may be positive (negative) serial correlation. Hence, $d$ essentially checks whether $\hat{\psi}_T$ is “close” to zero (i.e., $d$ is “close” to 2).

Difficulty: The exact null distribution of $d$ holds only under the classical conditions [A1] and [A3] and depends on the data matrix $X$. Thus, the critical values for $d$ can not be tabulated, and this test is not pivotal.

The null distribution of $d$ lies between a lower bound ($d_L$) and an upper bound ($d_U$):

$$d_{L,\alpha}^* < d_{\alpha}^* < d_{U,\alpha}^*.$$ 

The distributions of $d_L$ and $d_U$ are not data dependent, so that their critical values $d_{L,\alpha}^*$ and $d_{U,\alpha}^*$ can be tabulated.
• Durbin-Watson test:

  (1) Reject the null if \( d < d^{*}_{L,\alpha} \) \((d > 4 - d^{*}_{L,\alpha})\).

  (2) Do not reject the null if \( d > d^{*}_{U,\alpha} \) \((d < 4 - d^{*}_{U,\alpha})\).

  (3) Test is inconclusive if
      \[ d^{*}_{L,\alpha} < d < d^{*}_{U,\alpha} \] \((4 - d^{*}_{L,\alpha}) > d > 4 - d^{*}_{U,\alpha})\).

• For the specification \( y_t = \beta_1 + \beta_2 x_{t2} + \cdots + \beta_k x_{tk} + \gamma y_{t-1} + e_t \),

  Durbin’s \( h \) statistic is

  \[
  h = \hat{\gamma}_T \sqrt{\frac{T}{1 - T \widehat{\text{var}}(\hat{\gamma}_T)}} \approx \mathcal{N}(0, 1),
  \]

  where \( \hat{\gamma}_T \) is the OLS estimate of \( \gamma \) with \( \widehat{\text{var}}(\hat{\gamma}_T) \) the OLS estimate of \( \text{var}(\hat{\gamma}_T) \).

  Note: \( \widehat{\text{var}}(\hat{\gamma}_T) \) cannot be greater \( 1/T \). (Why?)
FGLS Estimation

- **Notations:** Write $\Sigma(\sigma^2, \psi)$ and $V(\psi)$, so that $\Sigma_o = \Sigma(\sigma_o^2, \psi_1)$ and $V_o = V(\psi_1)$. Based on $V(\psi)^{-1/2}$, we have

  \[
  y_1(\psi) = (1 - \psi^2)^{1/2}y_1, \quad x_1(\psi) = (1 - \psi^2)^{1/2}x_1,
  \]

  \[
  y_t(\psi) = y_t - \psi y_{t-1}, \quad x_t(\psi) = x_t - \psi x_{t-1}, \quad t = 2, \ldots, T.
  \]

- **Iterative FGLS Estimation:**
  
  1. Perform OLS estimation and compute $\hat{\psi}_T$ using the OLS residuals $\hat{e}_t$.
  2. Perform the Cochrane-Orcutt transformation based on $\hat{\psi}_T$ and compute the resulting FGLS estimate $\hat{\beta}_{FGLS}$ by regressing $y_t(\hat{\psi}_T)$ on $x_t(\hat{\psi}_T)$.
  3. Compute a new $\hat{\psi}_T$ with $\hat{e}_t$ replaced by $\hat{e}_{t,FGLS} = y_t - x'_t \hat{\beta}_{FGLS}$.
  4. Repeat steps (2) and (3) until $\hat{\psi}_T$ converges numerically.

Steps (1) and (2) suffice for FGLS estimation; more iterations may improve the performance in finite samples.
Instead of estimating $\hat{\psi}_T$ based on OLS residuals, the Hildreth-Lu procedure adopts grid search to find a suitable $\psi \in (-1, 1)$.

- For a $\psi$ in $(-1, 1)$, conduct the Cochrane-Orcutt transformation and compute the resulting FGLS estimate (by regressing $y_t(\psi)$ on $x_t(\psi)$) and the ESS based on the FGLS residuals.
- Try every $\psi$ on the grid; a $\psi$ is chosen if the corresponding ESS is the smallest.
- The results depend on the grid.

Note: This method is computationally intensive and difficult to apply when $\epsilon_t$ follow an AR($p$) process with $p > 2$. 
Consider binary $y$ with $y = 1$ or $0$.

- Under [A1] and [A2](i), $\mathbb{E}(y_t) = \mathbb{P}(y_t = 1) = x_t' \beta_o$; this is known as the linear probability model.

- Problems with the linear probability model:
  - Under [A1] and [A2](i), there is heteroskedasticity:
    \[
    \text{var}(y_t) = x_t' \beta_o (1 - x_t' \beta_o),
    \]

    and hence the OLS estimator is not the BLUE for $\beta_o$.
  - The OLS fitted values $x_t' \hat{\beta}_T$ need not be bounded between 0 and 1.
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    \]
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  - The OLS fitted values $x_t' \hat{\beta}_T$ need not be bounded between 0 and 1.
An FGLS estimator may be obtained using

\[ \hat{\Sigma}_{-1/2} = \text{diag} \left[ [x_1' \hat{\beta}_T (1 - x_1' \hat{\beta}_T)]^{-1/2}, \ldots, [x_T' \hat{\beta}_T (1 - x_T' \hat{\beta}_T)]^{-1/2} \right]. \]

Problems with FGLS estimation:

- \( \hat{\Sigma}_{-1/2} \) can not be computed if \( x_t' \hat{\beta}_T \) is not bounded between 0 and 1.
- Even when \( \hat{\Sigma}_{-1/2} \) is available, there is no guarantee that the FGLS fitted values are bounded between 0 and 1.
- The finite-sample properties of the FGLS estimator are unknown.

A key issue: A linear model here fails to take into account data characteristics.
Application: Seemingly Unrelated Regressions

To study the joint behavior of several dependent variables, consider a system of $N$ equations, each with $k_i$ explanatory variables and $T$ obs:

$$y_i = X_i\beta_i + e_i, \quad i = 1, 2, \ldots, N.$$

Stacking these equations yields Seemingly unrelated regressions (SUR):

$$
\begin{bmatrix}
y_1 \\
y_2 \\
\vdots \\
y_N
\end{bmatrix}
= 
\begin{bmatrix}
x_1 & 0 & \cdots & 0 \\
0 & x_2 & \cdots & 0 \\
\vdots & \vdots & \ddots & \vdots \\
0 & 0 & \cdots & x_N
\end{bmatrix}
\begin{bmatrix}
\beta_1 \\
\beta_2 \\
\vdots \\
\beta_N
\end{bmatrix}
+ 
\begin{bmatrix}
e_1 \\
e_2 \\
\vdots \\
e_N
\end{bmatrix}.
$$

where $y$ is $TN \times 1$, $X$ is $TN \times \sum_{i=1}^{N} k_i$, and $\beta$ is $\sum_{i=1}^{N} k_i \times 1$. 
Suppose \( y_{it} \) and \( y_{jt} \) are contemporaneously correlated, but \( y_{it} \) and \( y_{j\tau} \) are serially uncorrelated, i.e., \( \text{cov}(y_i, y_j) = \sigma_{ij} I_T \).

For this system, \( \Sigma_o = S_o \otimes I_T \) with

\[
S_o = \begin{bmatrix}
\sigma_1^2 & \sigma_{12} & \cdots & \sigma_{1N} \\
\sigma_{21} & \sigma_2^2 & \cdots & \sigma_{2N} \\
\vdots & \vdots & \ddots & \vdots \\
\sigma_{N1} & \sigma_{N2} & \cdots & \sigma_N^2 \\
\end{bmatrix};
\]

that is, the SUR system has both serial and spatial correlations.

As \( \Sigma_o^{-1} = S_o^{-1} \otimes I_T \), then

\[
\hat{\beta}_{GLS} = \left[X'(S_o^{-1} \otimes I_T)X\right]^{-1}X'(S_o^{-1} \otimes I_T)y,
\]

and its covariance matrix is \( [X'(S_o^{-1} \otimes I_T)X]^{-1} \).
Remarks:

- When $\sigma_{ij} = 0$ for $i \neq j$, $S_o$ is diagonal, and so is $\Sigma_o$. Then, the GLS estimator for each $\beta_i$ reduces to the corresponding OLS estimator, so that joint estimation of $N$ equations is not necessary.
- If all equations in the system have the same regressors, i.e., $X_i = X_0$ (say) and $X = I_N \otimes X_0$, the GLS estimator is also the same as the OLS estimator.
- More generally, there would not be much efficiency gain for GLS estimation if $y_i$ and $y_j$ are less correlated and/or $X_i$ and $X_j$ are highly correlated.

The FGLS estimator can be computed as

$$\hat{\beta}_{FGLS} = [X'(\hat{S}_{TN}^{-1} \otimes I_T)X]^{-1}X'(\hat{S}_{TN}^{-1} \otimes I_T)y.$$
\( \hat{S}_{TN} \) is an \( N \times N \) matrix:

\[
\hat{S}_{TN} = \frac{1}{T} \begin{bmatrix}
\hat{e}'_1 \\
\hat{e}'_2 \\
\vdots \\
\hat{e}'_N
\end{bmatrix} \begin{bmatrix}
\hat{e}_1 \\
\hat{e}_2 \\
\vdots \\
\hat{e}_N
\end{bmatrix},
\]

where \( \hat{e}_i \) is the OLS residual vector of the \( i \)th equation.

The estimator \( \hat{S}_{TN} \) is valid provided that \( \text{var}(y_i) = \sigma_i^2 I_T \) and \( \text{cov}(y_i, y_j) = \sigma_{ij} I_T \). Without these assumptions, FGLS estimation would be more complicated.

Again, the finite-sample properties of the FGLS estimator are unknown.