

# Preface

Since the seminal papers of Kalman (1960, 1961) and the early development in the field of engineering, state-space models have become an increasingly important tool for research in finance and economics in recent years. This book is a collection of contributed papers that reflect this new phase of theoretical developments of state-space models and their applications in economics and finance. We hope that the breadth of research shared in this volume will serve as an inspiration and a valuable reference for future users of state-space models in these two areas.

A generic state-space model consists of two equations. One describes how observable economic variables relate to potentially unobservable *state variables*, and the other describes how state variables evolve over time. Both state and observable variables can be either discrete- or continuous-time stochastic processes.

This book is divided into four parts. In Parts I and II, we mainly consider discrete-time state-space models. Let  $Y_t$  be an  $n \times 1$  observable variable and  $X_t$  be a  $k \times 1$  state variable. Then, a state-space model can be written as follows:

$$Y_t = f(X_t, \theta, \varepsilon_t) \quad (1)$$

$$X_{t+1} = g(X_t, \theta, \eta_{t+1}) \quad (2)$$

where  $\theta$  is an  $m \times 1$  vector of model parameters, and  $\varepsilon_t$  and  $\eta_t$  are independent and identically distributed random shocks (or noises).  $f(\cdot)$  and  $g(\cdot)$  are  $n \times 1$  and  $k \times 1$  (non)linear functions, respectively. Because of its flexibility, many discrete-time models in economics and finance can be represented in this state-space form. These models include autoregressive moving average (ARMA) models, regression models with time-varying coefficients, dynamic factor models (DFM), models with stochastic volatility (SV), regime-switching models, and hidden Markov models (HMM). In these models, the parameter  $\theta$  is typically unknown. Therefore, one central question in many applications is to estimate  $\theta$  and to conduct statistical inferences of the model (e.g., hypothesis testing). Researchers are also highly interested in obtaining unbiased and efficient estimates of the underlying state variables  $X_t$ .

In Parts III and IV, we include models where the state variable,  $X(t)$ , can be a continuous-time finite-state Markov chain as that in hidden Markov or

regime-switching models of Chaps. 8–11.  $X(t)$  can also be a general continuous-time Markov process described by a stochastic differential equation as those in Chaps. 12–15. The Markov processes include a geometric Brownian motion (GBM) and a jump-diffusion process with regime switching among others. The observation process,  $Y(t)$ , can be a continuous-path process (Chaps. 10 and 11), an equally spaced time series (Chap. 14), or an irregularly spaced point process (Chaps. 8, 13, and 15). These models have found many applications in finance such as pricing of credit risk, optimal trading rules and hedging, optimal annuity purchasing or dividend policies, optimal learning in financial markets, and modeling (ultra) high-frequency data.

Below, we provide a more detailed description of each part.

*Part I* includes three chapters on *Particle Filtering and Parameter Learning in Nonlinear State-Space Models*. The introduction of particle filters has had a major impact on the development of nonlinear and non-Gaussian state-space models. This technique has expanded the range of practical applicability of state-space models to cases with high-dimension state space.

In Chap. 1, Tze Leung Lai and Vibhav Bukkapatnam provide a review of the estimation of the latent state variables using particle filters with known or unknown model parameters. They also present a new adaptive particle filter that uses a computationally efficient Markov Chain Monte Carlo estimate of the posterior distribution of the state-space model parameters in conjunction with sequential state estimation. They describe several applications in finance and economics, including frailty models of portfolio default probabilities, SV models with contemporaneous price and volatility jumps, and hidden Markov models for high-frequency transaction data.

In Chap. 2, Maria Paula Rios and Hedibert Freitas Lopes explore kernel smoothing and conditional sufficient statistics extensions of the auxiliary particle filters (Pitt and Shepard 1999) and bootstrap filters (Gordon, Salmond and Smith 1993). Using simulated data from SV models with Markov switching, they show that the Liu-West particle filter degenerates and has the largest Monte Carlo error, while their auxiliary particle filter extended with sufficient statistics (APF + SS) has a much better performance. Their APF + SS filter takes advantage of recursive sufficient statistics that are sequentially tracked and whose behavior resembles that of a latent state with conditionally deterministic updates. They also assess the performance of the APF + SS filter in sequential estimation in examples with real data.

In Chap. 3, Alexandre J. Chorin, Matthias Morzfeld, and Xuemin Tu review the implicit particle filter. The key idea is to concentrate the particles on the high-probability regions of the target probability density function (pdf) so that the number of particles required for a good approximation of the pdf remains manageable even if the state space has high dimensions. They explain how this idea is implemented, discuss special cases of practical importance, and show the relations of the implicit particle filter with other data assimilation methods. They further illustrate the method with examples such as SV, stochastic Lorenz attractor, stochastic

Kuramoto–Sivashinsky equation, and data assimilations.

*Part II* includes four chapters on the application of *Linear State-Space Models in Macroeconomics and Finance*.

In Chap. 4, Yulei Luo, Jun Nie, and Eric Young explicitly solve a linear-quadratic macroeconomic model under model uncertainty (due to concerns of model misspecification) and state uncertainty (due to limited information constraint). They show that the model can be mapped to a state-space representation that can be used to quantify the key parameters of model uncertainty. They demonstrate through examples how this framework can be used to study a range of interesting questions in macroeconomics and international finance such as explaining current account dynamics and resolving the international consumption puzzle.

In Chap. 5, Pym Manopimoke estimates a state-space model of the inflation dynamics in Hong Kong. The model allows her to decompose Hong Kong inflation into a stochastic trend and a stationary cycle component that can be driven by both domestic and foreign economic variables such as output gaps. This empirical model is consistent with economic theories of inflation and output, offering new insight into the determination of trend and cyclical inflation in Hong Kong. This is an example of the power of state-space models in empirical macroeconomic research.

In recent years, vector autoregression models (VARs) have become a primary tool for investigating dynamic relationship between multiple economic variables. One challenge, however, is that such relationships are often evolving over time as a result of shifts in government policies or structural changes in the economy. In Chap. 6, Taeyoung Doh and Michael Connolly show that the state-space representation is a useful tool to estimate VARs with time-varying coefficients and/or SV. They show that these models can better capture the changing relationships between important macroeconomic variables.

Chapter 7 is an application to finance. Jun Ma and Mark Wohar use a state-space model to address one important issue regarding sources of stock market volatility. They argue that the existing empirical studies have focused on point estimation and lack robust statistical inference. The authors show that the small signal-to-noise ratio has made the market data contain too little useful information for researchers to reach robust conclusions about the relative importance of different sources of stock market volatility.

*Part III* includes five chapters on *Hidden Markov Models (HMM)*, *Regime Switching*, and *Mathematical Finance*.

Chapters 8 and 9 are on hidden Markov models and their applications to finance. In Chap. 8, Robert Elliott and Tak Kuen Siu discuss an intensity-based model of portfolio credit risk using a collection of hidden Markov-modulated single jump processes. The model is a dynamic version of a frailty model casted in state-space form, able to describe dependent default risks among firms that are exposed to a common hidden dynamic frailty factor. The authors develop filtering equations and filter-based estimates of the model in recursive forms. They also obtain the joint default probability of reference entities in a credit portfolio as well as the

variance dynamics for both observations and hidden states. In Chap. 9, Xiaojing Xi and Rogemar Mamon develop a weak hidden Markov model (WHMM) for the term structure of interest rates where the means and volatilities of bond yields are governed by a second-order Markov chain in discrete time. The authors use the multivariate filtering technique in conjunction with the EM algorithm to estimate the model parameters. They assess the goodness of fit of the model based on out-of-sample forecasts and apply AIC to determine the optimal number of regimes in their model. They apply the model to a data set of daily Treasury yields in the USA. The empirical results show that their WHMM outperforms the standard HMM in terms of out-of-sample forecasts.

Chapters 10 and 11 are applications of regime-switching models to insurance risk and optimal trading rule. Models with regime switching usually don't have analytical solutions to the associated stochastic control problems. In Chap. 10, Zhuo Jin and George Yin discuss numerical methods for solving stochastic optimization problems involving regime-switching models. They propose a numerical solution to the system of HJB equations based on Markov chain approximation. They show how these regime-switching models can be applied to analyze optimal annuity purchasing and optimal dividend payment strategy problems. In Chap. 11, Eunju Sohn and Qing Zhang study an optimal trading rule problem where the underlying asset price is governed by a mean-reverting process with regime switching. The investor's objective is to buy and sell the asset so as to maximize the overall return. The authors consider the case in which the jump rates of the Markov chain can go to infinite. They study the asymptotic properties of the limit value functions and establish a limiting problem which is easier to solve. They show that the solution to the limiting problem can be used to construct a trading rule that is nearly optimal.

In Chap. 12, Mingming Wang and Allanus Tsoi discuss Constant Proportion Portfolio Insurance (CPPI) problem with jump diffusion. They also consider the associated problem of hedging using both the PDE/PIDE and martingale approaches. In particular, they consider the mean-variance hedging problem when the contingent claim is a function of the CPPI portfolio value.

*Part IV* includes three chapters on *Nonlinear State-Space Models for High-Frequency Financial Data*.

In Chap. 13, combining classical Kyle and Glosten–Milgrom models, Yoonjung Lee proposes a new state-space modeling framework under asymmetric information. The model is able to describe the interactions among some important variables in financial markets such as the price impact of a trade, the duration between trades, and the degree of information asymmetry. In the model, a private signal is partially revealed through trades, while new public information arrives continuously at the market. In order to set a competitive price that rationally incorporates these two sources of information, the market maker utilizes Bayesian learning. The author derives the corresponding nonlinear filtering equation using anticipative Girsanov transformation. She further proves the existence and uniqueness of the ask and bid prices using an SPDE approach. The pricing rule depends on the actual sequence of order arrivals, not just the total number of buy/sell orders. The price impact of a

trade tends to decrease when the duration between trades gets longer. The speed at which the information gets incorporated into the price depends on the quality of the private signal and the trading rate of informed traders.

Chapter 14 is concerned with volatility estimation and prediction. A popular approach is to use the high-frequency data to estimate volatilities and then fit a low-frequency AR volatility model for forecasting. While the empirical performance of this approach is good, there is a lack of theoretical foundation. In this chapter, Yazhen Wang and Xin Zhang show that, for rather general underlying price and volatility processes, the realized volatility estimators approximately follow a heterogeneous autoregressive model, hence providing theoretical justifications of the popular approach. An important feature of the model is that the two- or multi-scaled realized volatility estimators employed are based on a state-space model, where the prices from high-frequency transactions may include market microstructure noise.

Chapter 15 is concerned with estimating models for ultra-high frequency data. The class of models has a random-arrival-time state-space form that explicitly accommodates market microstructure noises in asset price. Although the model is able to capture stylized facts of tick data, the nonlinear state-space model structure makes parameter estimation a challenge. Cai Zhu and James Huang apply particle Markov Chain Monte Carlo (PMCMC) method to estimate a couple models when the underlying intrinsic value processes follow a GBM or a jump-diffusion process. They show that the PMCMC method is able to yield reasonable estimates of the model parameters and further discuss numeric methods that are able to enhance the efficiency of the algorithm.

We would like to express our gratitude to all the contributors of the book chapters for their efforts in making their research accessible to a wide range readers. We hope the book can lead to more interdisciplinary research among economists, mathematicians, and statisticians. We also would like to thank Yaozhong Hu of University of Kansas, Neng Wang of Columbia University, and Zhenxiao Wu of National University of Singapore for their generous help during the preparation of this book.

We want to thank Brian Foster, a former Springer editor, for his enthusiasm and help in the early stage of this book project. We also want to thank Hannah Bracken, Marc Strauss, Nicolas Philipson, and William Curtis of Springer New York. Their continuing support and commitment throughout the project are highly appreciated. We owe a special thanks to Hannah Bracken for her superb editorial assistance.

Yong Zeng's research is supported by National Science Foundation under the grants of TG-DMS100019 and DMS-1228244 and a grant from the University of Missouri Research Board in 2011. He gratefully acknowledges those grant supports. Finally, we would like to thank our families for their continuous support, which makes the completion of this project possible.

Kansas City, MO  
Lawrence, KS

Yong Zeng  
Shu Wu



<http://www.springer.com/978-1-4614-7788-4>

State-Space Models

Applications in Economics and Finance

Zeng, Y.; Wu, S. (Eds.)

2013, XXI, 347 p., Hardcover

ISBN: 978-1-4614-7788-4