



Modelling Breaks and Clusters in the Steady States of Macroeconomic Variables

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ANU Working Papers in Economics and Econometrics
603

February 2013 JEL:

ISBN: 0 86831 603 2

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Abstract

Macroeconomists working with multivariate models typically face uncertainty over which (if any) of their variables have long run steady states which are subject to breaks. Furthermore, the nature of the break process is often unknown. In this paper, we draw on methods from the Bayesian clustering literature to develop an econometric methodology which: i) finds groups of variables which have the same number of breaks; and ii) determines the nature of the break process within each group. We present an application involving a five-variate steady-state VAR.

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[†]Gary Koop thanks the ESRC for support under grant RES-062-23-2646. He is a Fellow at the Rimini Centre for Economic Analysis.

1 Introduction

Macroeconomists working with multivariate models such as VARs face a myriad of modelling choices. Traditionally, such choices have involved restrictions on parameters. For instance, cointegration, lag length selection or the economic theory used by DSGE modelers all involve restrictions on the coefficients of a VAR (or similar multivariate time series model). However, the increasing realization of the importance of parameter change has led macroeconomists to work with more parameter-rich models which allow for such change. Examples include time-varying parameter (TVP) VAR models (see, among many others, Cogley and Sargent, 2001, 2005 or Primiceri, 2005), multivariate Markov switching models such as Sims and Zha (2006) or structural break VAR models such as Jochmann, Koop and Strachan (2010).

Often the researcher is unsure of the nature of parameter change (e.g. is it associated with VAR coefficients or the error covariance matrix? is it associated with time such as in a structural break model or does change occur over the business cycle?, etc.). Multivariate time series models such as VARs are parameter-rich even with constant parameters. Allowing for parameter change in VARs increases the number of parameters to be estimated. This raises worries about over-fitting and over-parameterization. The presence of model uncertainty relating to time-variation in parameters greatly exacerbates these worries.

The present paper is motivated by these considerations. Faced with uncertainty over the nature of parameter change, we want an econometric method which will discover its nature in a data-based fashion. And faced with over-fitting, we want to do this in as parsimonious manner as possible. In many cases, this latter goal can be achieved by focussing on economically important parameters. For instance, a VAR may have hundreds of parameters (or even more, see Banbura, Giannone and Reichlin, 2010). These parameters control the dynamics (short-run and long-run) of the variables in the model as well as the economic relationships of interest to the macroeconomists (e.g. impulse responses are functions of VAR coefficients and the error covariance matrix). But VAR coefficients are hard to directly interpret and allowing for parameter change in all of them can lead to a very parameter-rich model. When considering ways of allowing for parameter change, the researcher may wish to focus on some economically meaningful function of the parameters (e.g. allowing for only the monetary transmission mechanism to change). And it is typically most important to model parameter change in the eco-

conomic feature under study. For instance, in a study of the monetary policy transmission mechanism it is very important to correctly model parameter change in this relationship, but it may be less important to correctly model parameter change in other parts of the model.

In this paper, we develop an econometric methodology which is more parsimonious than other approaches (such as TVP-VARs) and uncovers parameter change of an unknown sort in features of economic importance. We focus on the long run steady states of VAR dependent variables (although the general ideas can be adapted to any feature of interest). These are features that have a straightforward economic interpretation and theoretical macroeconomic models such as DSGE models typically have strong implications for long run steady states. We extend the steady state VAR of Villani (2009) to allow for the steady states to change over time. Of course, it would be straightforward to adapt any of the existing modelling approaches described above (e.g. Markov switching or structural break models) so as to apply only to the steady states. However, such an approach would assume all of the steady states change in a particular way (e.g. a structural break model would imply they all change at the break time). The econometric methodology developed in this paper (drawing on ideas from the Bayesian clustering literature, see Tadesse, Sha and Vannucci, 2005) is more sophisticated than this. It determines (in an automatic, data-based fashion) which variables exhibit breaks in their steady states (i.e. some variables can exhibit breaks and others not) and the nature of the break process (e.g. it can estimate structural breaks which occur at a point in time or parameter change over the business cycle or anything else).

The paper is organized as follows. The next section of this paper describes the modelling framework and provides a general outline of the Markov chain Monte Carlo (MCMC) algorithm used to estimate the model. Full technical details on prior, posterior and MCMC algorithm are provided in the Technical Appendix. The third section of the paper illustrates the usefulness of our methods in an empirical application relating to one presented in Del Negro and Schorfheide (2008). We use a five-variate VAR and find that breaks exist in the steady states of some of the series but not others.

2 Modelling Framework

Bayesian VAR analysis traditionally works with a VAR of the form:

$$A^\dagger(L) y_t = \mu^\dagger + \varepsilon_t$$

where y_t is an $n \times 1$ vector of dependent variables for $t = 1, \dots, T$, ε_t is $N(0, \Sigma)$ and $A^\dagger(L) = I - A_1^\dagger L - \dots - A_p^\dagger L^p$ is a polynomial in the lag operator. Conventional Bayesian VAR approaches such as the Minnesota prior (see Doan, Litterman and Sims, 1984) place a prior on the parameters in $A^\dagger(L)$ and μ^\dagger . This parameterization can be hard to directly interpret (e.g. μ^\dagger is not the unconditional mean of the series). In contrast to this, the steady state VAR (see Villani, 2009) can be written as

$$A(L)(y_t - \mu) = \varepsilon_t. \tag{1}$$

This specification for the VAR has the advantage that μ is the unconditional mean of y_t and, thus, can be interpreted as the steady state of y_t . As argued in Villani (2009), the steady state is often something that researchers have strong prior beliefs about (unlike A_1, \dots, A_p). Thus, it may be preferable to focus prior elicitation efforts on μ . The parameters in $A(L)$, controlling the short run dynamics for deviations from steady states, may be of less interest to the macroeconomist. For instance, DSGE modelers often have strong prior information about steady states and elicit their priors in terms of such structural parameters (see, among many others, Smets and Wouters, 2007 and Del Negro and Schorfheide, 2008). A drawback of the steady state VAR relative to the traditional VAR is that MCMC methods must be used. However, the gain in interpretability and the ability to elicit priors directly off of parameters with an economic interpretation are large benefits which may outweigh this drawback.

In empirical macroeconomic work, it is likely that the steady states of some variables remain constant over time, while others change at a particular point in time (i.e. structural breaks might occur), while others might change in some other fashion (e.g. they may differ between expansions and recessions). However, the researcher is typically unsure about which of these possibilities holds for which variable. Unless n is small, the number of modelling choices can be daunting. In this paper, we draw on ideas from the Bayesian clustering literature (see, e.g., Tadesse, Sha and Vannucci, 2005) to propose a modelling framework which allows us to group the dependent variables into clusters which have the same structure. For instance, one cluster might have constant steady states, another cluster might include dependent

variables whose long run steady states exhibit a break, etc. This grouping is done in an automatic data-based manner.

Since the contributions of this paper relate to μ , we will draw out the basic intuition of our methodology ignoring the role of $A(L)$ and the error covariance matrix. Of course, in our empirical application $A(L)$ will be included as well as a time-varying error covariance matrix. Complete details of the full model are given in the Technical Appendix.

Accordingly, let us begin with a simple model:

$$y_t = \mu_1 + \varepsilon_t \quad (2)$$

where ε_t is $N(0, \Sigma_1)$. In the spirit of Tadesse, Sha and Vannucci (2005), we begin by extending this to a mixture of Normals specification where

$$p(y_t|q, \mu, \Sigma) = \sum_{j=1}^G q_j \phi(y_t|\mu_j, \Sigma_j), \quad (3)$$

where $\phi(y_t|\mu_j, \Sigma_j)$ is the p.d.f. of the Normal distribution with mean μ_j and variance Σ_j , $q = (q_1, \dots, q_G)'$, $\mu = (\mu'_1, \dots, \mu'_G)'$ and $\Sigma = (\Sigma_1, \dots, \Sigma_G)$. Or, equivalently, we can introduce the discrete random variables: $\lambda_t \in \{1, \dots, G\}$ such that:

$$y_t|\lambda_t = j \sim N(\mu_j, \Sigma_j) \quad (4)$$

where $p(\lambda_t = j) = q_j$. For future reference, let $\lambda = (\lambda_1, \dots, \lambda_T)'$ and $y = (y'_1, \dots, y'_T)'$.

This is a standard mixture of Normals representation which has been used in many papers. Mixtures of Normals are very flexible as discussed, e.g., in Geweke and Keane (2007) and Geweke and Amisano (2011). For our purposes, we stress that (4) allows for clustering over time and so would be able to pick up features like structural breaks or regime switching, where the steady states of all variables change. That is, it says each y_t for $t = 1, \dots, T$ can be drawn from one of G different distributions. For instance, if y_1, \dots, y_τ were drawn from one distribution and $y_{\tau+1}, \dots, y_T$ were drawn from a second, then we would have a structural break at time τ . But it is also possible that y_j is drawn from the first distribution where j denotes times when the economy is in recession (and other time periods are drawn from a second distribution). Then we have a model with properties similar to a Markov

switching model where properties differ over the business cycle. In general, any grouping is possible.

It is also worth noting that (4) allows for the error covariance matrix to differ across regimes. So formally, if we find evidence for $G > 1$ this implies either that the steady states are changing or that the error covariance matrix is changing. It is possible to restrict $\Sigma_1 = \dots = \Sigma_G$ if the researcher wishes to focus solely on steady-state changes in the context of a homoskedastic VAR. Alternatively, at the cost of adding extra blocks to the MCMC algorithm, the error covariance matrix could be modelled separately from the mixtures of Normal component of the model (e.g. as a multivariate stochastic volatility process).

Simple mixtures of Normals model such as (4) allow for all parameters to differ across elements in the mixture. For high-dimensional models such as VARs such flexibility can lead to an over-parameterized model. This flexibility can be unnecessary and lead to undesirable consequences. If the steady states in only one or two variables change and n is large, it is distinctly possible that the econometric model will indicate no change. That is, the model (4) offers the choice between “steady states of all variables are constant over time” and “all n steady states change”. Given these alternatives, and the reward for parsimony built into Bayesian model selection methods, it will only choose the latter if most of the steady states change or if the change in the steady state in one variable is huge. These considerations motivate the development of a model designed to pick up breaks which occur only in some subset of the variables. In practice, the researcher rarely knows which subsets of variables might have breaks in their steady states, so the model should be able to find these subsets in an automatic data-based fashion. The following extension of the standard mixture of Normals model can achieve these goals.

Let $\gamma = (\gamma_1, \dots, \gamma_n)'$ be a vector of dummy variables where $\gamma_j = 1$ implies that the j^{th} dependent variable follows a mixture of Normals representation such as that given in (4). If $\gamma_j = 0$ then the j^{th} dependent variable does not follow a mixture of Normals, but rather has a time-invariant steady state (and error covariance matrix) such as (2). In other words, γ serves to divide our dependent variables into two groups, where one group allows for up to G changes in steady states over time or across regimes and the other group has constant steady states.

Formally, let $y_{t(\gamma=1)}$ denote the vector containing the elements of y_t which have $\gamma_j = 1$ and $y_{t(\gamma=0)}$ the vector containing the remaining elements of

y_t . And adopt the same “subscript ($\gamma = 0/1$)” notational convention for the parameters in the model (e.g. $\mu_{(\gamma=0)}$ will be the unconditional mean for all variables which have a time-invariant steady state, $n_{(\gamma=0)}$ will be the number of such variables, etc.). This leads to the following distribution for y, λ which Tadesse, Sha and Vannucci (2005) use as their likelihood function:¹

$$\begin{aligned}
p(y, \lambda | \gamma, q, \mu, \Sigma) &= 2\pi^{-n_{(\gamma=0)} \frac{T}{2}} \left| \Sigma_{(\gamma=0)} \right|^{-\frac{T}{2}} \\
&\times \exp \left\{ -\frac{1}{2} \sum_{t=1}^T (y_{t(\gamma=0)} - \mu_{(\gamma=0)})' \Sigma_{(\gamma=0)}^{-1} (y_{t(\gamma=0)} - \mu_{(\gamma=0)}) \right\} \\
&\times \prod_{j=1}^G 2\pi^{-n_{(\gamma=1)} \frac{T_j}{2}} \left| \Sigma_{j,(\gamma=1)} \right|^{-\frac{T_j}{2}} q_j^{T_j} \\
&\times \exp \left\{ -\frac{1}{2} \sum_{t \in C_j} (y_{t(\gamma=1)} - \mu_{j,(\gamma=1)})' \Sigma_{j(\gamma=1)}^{-1} (y_{t(\gamma=1)} - \mu_{j,(\gamma=1)}) \right\}
\end{aligned} \tag{5}$$

where T_j is the number of observations in the j^{th} element in the Normal mixture given in (4) and $t \in C_j$ denotes observations belonging to cluster j (i.e. C_j is the set of observations for which $\lambda_t = j$). Note that λ enters this likelihood function since it determines T_j .

It is worth noting that (5) assumes that, conditional on γ , the dependent variables are broken into two groups: those which exhibit breaks/parameter change and those which do not. These structure of the error covariance matrices means that, these two groups are (conditionally) uncorrelated with one another. However, unconditionally (i.e. with γ integrated out) they are correlated with one another.

To carry out posterior simulation in the steady state VAR version of this model, we require a prior to combine with the likelihood function (5) and an MCMC algorithm for drawing the parameters $\gamma, q, \mu, \Sigma, \lambda$ and A_1, \dots, A_p . Note that the relationship $p(\lambda_t = j) = q_j$ given after (4) provides us with a hierarchical prior for λ . For γ we assume a Bernoulli prior which implies, a priori, each variable is equally likely to exhibit no breaks as exhibit breaks. Complete details of these priors and priors for other parameters are given in the Technical Appendix. The appendix also includes MCMC diagnostics indicating convergence of the algorithm.

¹In the terminology of, e.g., Fruhwirth-Schnatter and Wagner (2008) this is the complete data likelihood, as opposed to the integrated likelihood which would be $p(y|\gamma, q, \mu, \Sigma)$.

The basic idea of our MCMC algorithm can be described very simply: it combines the algorithm of Tadesse, Sha and Vannucci (2005) with a Bayesian VAR algorithm. Complete details are given in the Technical Appendix. There are many approaches to selecting, G , the number of elements in the Normal mixture. For instance, marginal likelihoods or cross-validation have been used. Tadesse, Sha and Vannucci (2005) use a reversible-jump MCMC algorithm. In this paper, we choose G using the Bayesian information criterion (BIC) defined as $\text{BIC} = -2 \ln \hat{L} + m \ln T$, where \hat{L} is the maximized likelihood value and m is the number of parameters in the model. For $G = 1$, \hat{L} is obtained as follows: first the likelihood function is evaluated (when $G = 1$, there are no latent variables so the likelihood value can be easily obtained) at each posterior draw, and \hat{L} is set to be the maximum value. For $G > 1$ cases, \hat{L} is approximated by the average of the complete data likelihood values evaluated at each posterior draw.

3 Empirical Illustration with a Five-variate VAR

3.1 Data

The data set is similar to that used in Del Negro and Schorfheide (2008) and runs from 1954Q3 through 2012Q3. It consists of five commonly-used US macroeconomic variables: real GDP per capita (Y_t), hours worked per capita (L_t), labor income share (lsh_t), the GDP deflator (P_t) and interest rates (the Fed Funds rate, R_t). All data was obtained from the FRED database of the Federal Reserve Bank of St. Louis. The variables are constructed and transformed as in Del Negro and Schorfheide (2008), pages 1196 and 1199, and we reproduce their definitions and transformations in the following table:

Output growth	$400(\ln Y_t - \ln Y_{t-1})$
Hours	$100 \ln L_t$
Labor share	$100 \ln lsh_t$
Inflation	$400(\ln P_t - \ln P_{t-1})$
Interest rates	R_t

Table 1: BIC's.

	$G = 1$	$G = 2$	$G = 3$
$p = 1$	4132.0	4161.7	4214.8
$p = 2$	3771.9	3710.7	3848.5
$p = 3$	3672.3	3610.6	3892.0

3.2 Empirical Illustration

Table 1 presents BICs for various values of G and p and it can be seen that $G = 2$ and $p = 3$ are the preferred choices. There is strong support for models with breaks in steady states (since $G = 1$ receives little support), but a small number of breaks seems adequate (since there is little evidence for $G = 3$). In the remainder of this section, we set $G = 2$ and $p = 3$.

The evidence in favor of $G = 2$ suggests breaks are occurring in some of the steady states. But which ones? The estimated posterior mode for the cluster label, γ , is $(0, 0, 0, 1, 1)'$, suggesting only inflation and interest rates experienced changes in their steady states. The posterior mean is very similar to the posterior mode, indicating the clustering algorithm is clearly identifying which variables have breaks and which ones do not. If we rerun the MCMC algorithm, conditional on $\gamma = (0, 0, 0, 1, 1)'$, we can obtain parameter estimates which arise from a single model with a clear interpretation. This model is parameterized in terms of $\mu_{(\gamma=0)} = (\mu_{(\gamma=0)}^1, \mu_{(\gamma=0)}^2, \mu_{(\gamma=0)}^3)'$ (i.e. a 3×1 vector with elements being the steady states for output growth per capita, hours worked per capita and labor income share respectively), $(\mu_{1,(\gamma=1)}^1, \mu_{2,(\gamma=1)}^1)$ (i.e. these are the steady states in the two regimes for inflation) and $(\mu_{1,(\gamma=1)}^2, \mu_{2,(\gamma=1)}^2)$ (i.e. these are the steady states in the two regimes for interest rates). The error covariances are labelled with a similar notational convention where subscripts denote regimes and superscripts particular parameters within a regime. The estimated posterior means and standard deviations for some of the key parameters are reported in Table 2.

Most of the parameter estimates are similar to those found in a standard VAR, so we will focus our discussion on those which differ. Table 2 provides strong evidence of a large change in the steady state for inflation, with slightly weaker evidence in favor of a smaller change in the steady state for the interest rate. But note also that the regime change we are finding looks to be associated with a change in the volatility of both variables. Remember

Table 2: Posterior Means and Standard Deviations of Parameters.

parameter	$\mathbb{E}(\cdot y)$	$\sqrt{\text{Var}(\cdot y)}$	parameter	$\mathbb{E}(\cdot y)$	$\sqrt{\text{Var}(\cdot y)}$
$\mu_{(\gamma=0)}^1$	1.733	0.187	q_1	0.109	0.035
$\mu_{(\gamma=0)}^2$	-754.222	11.822	$\Sigma_{(\gamma=0)}^{1,1}$	10.465	1.014
$\mu_{(\gamma=0)}^3$	-72.592	1.425	$\Sigma_{(\gamma=0)}^{2,1}$	1.488	0.179
$\mu_{1,(\gamma=1)}^1$	5.769	1.319	$\Sigma_{(\gamma=0)}^{3,1}$	-1.083	0.154
$\mu_{1,(\gamma=1)}^2$	8.853	3.091	$\Sigma_{(\gamma=0)}^{2,2}$	0.436	0.043
$\mu_{2,(\gamma=1)}^1$	2.435	0.435	$\Sigma_{(\gamma=0)}^{3,2}$	-0.076	0.028
$\mu_{2,(\gamma=1)}^2$	4.168	0.700	$\Sigma_{(\gamma=0)}^{3,3}$	0.390	0.037
$\Sigma_{1,(\gamma=1)}^{1,1}$	3.136	1.252	$\Sigma_{2,(\gamma=1)}^{1,1}$	1.329	0.166
$\Sigma_{1,(\gamma=1)}^{2,1}$	0.558	0.782	$\Sigma_{2,(\gamma=1)}^{2,1}$	-0.104	0.058
$\Sigma_{1,(\gamma=1)}^{2,2}$	3.534	1.269	$\Sigma_{2,(\gamma=1)}^{2,2}$	0.366	0.044

that our approach allows for different regimes to have different means and different error variances. For both inflation and interest rates we are finding volatilities to be much lower in the second regime than the first regime.

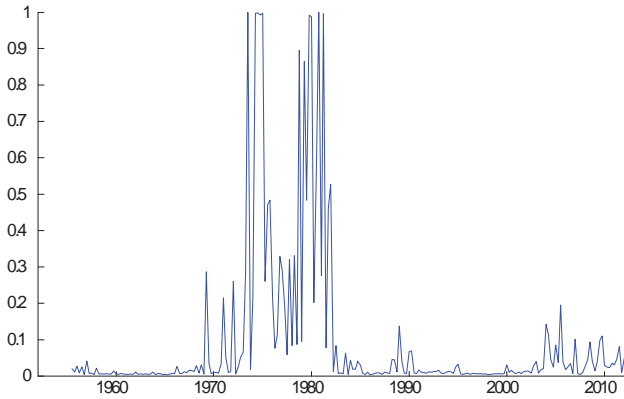


Figure 1: Probability of First Regime: $\mathbb{P}(\lambda_t = 1 | y)$.

Figure 1 presents evidence on when the two regimes are occurring. That is, it reports the estimated probabilities $P(\lambda_t = 1|y)$ for $t = 1, \dots, T$. Of course, the reader can figure out $P(\lambda_t = 2|y)$ since it is $1 - P(\lambda_t = 1|y)$. It can be seen that our econometric methodology is clearly finding changes in steady

states in interest rates and inflation to be associated with the period 1973-1983. This is the period after the collapse of the Bretton-Woods agreement and OPEC oil price shock up until the Great Moderation of the business cycle. This was a period of high and volatile inflation and interest rates. For these variables, our methodology finds sufficient differences from other periods, for a prolonged period, such as to indicate changes in their steady states. It is not finding the changes in behavior in the other variables (output growth, hours and labor share) during this period to be sufficiently different from other periods so as to indicate changes in steady states. These findings are plausible. In post-war experience, the 1973-1983 period was unique in terms of exceptionally high inflation and associated interest rate policies. However, the dynamic time series properties of the remaining real variables were not exceptional during 1973-1983 and our methodology is indicating the steady states for these variables have been constant over time.

It is interesting to note that we are not finding substantial evidence in favor of the Great Moderation period or the recent Great Recession as being associated with changes in long run steady states. The Great Moderation involves changes in volatilities. Our methodology does allow different regimes to be associated with different volatilities as well as changes in steady states. The fact that we are not finding the Great Moderation to be a different regime indicates the importance of steady state change in our model. Without changes in steady states (as appear not to have occurred during the Great Moderation), the changes in volatility are not large enough for our model to classify this as a different regime.

With regards to the Great Recession, there is little evidence that this is a third regime involving changes in steady states. That is, Table 1 indicates $G = 3$ is unlikely (see also Figure 1 where the probability of regime change does increase after 2007 but only slightly). This finding could reflect the fact that, even though the values of some of the variables have changed substantively, this does not necessarily mean their steady states have changed. Or, even if the steady states have changed, they are by definition long-run phenomena and it might take a long time for any econometric methodology to definitively identify such a change. Distinguishing between a temporary and a permanent change will, by its very nature, be something that requires a certain amount of data which is unavailable for the most recent years in our data set.

4 Conclusion

In this paper, we have developed an econometric methodology for multivariate macroeconomic models, based on Tadesse, Sha and Vannucci (2005), which differs from existing methods in that it allows both for clustering in terms of variables and in terms of regimes. That is, it automatically divides the variables into groups. Within each group, variables exhibit a common pattern (e.g. they can exhibit structural breaks at the same time). We apply this methodology to the case of the steady-state VAR of Villani (2009). We focus on the issue of breaks in long-run steady states, although we argue that the methodology could be useful in a wide variety of empirical macroeconomic contexts.

Our empirical illustration, using a moderately-sized VAR, indicates that the methodology works well and leads to parsimonious representations. Instead of allowing for breaks in the steady states (and error covariance matrices) of all variables (as would be done in a conventional structural break model) or allowing for breaks in dozens or hundreds of VAR coefficients (as would be done in a Markov-switching VAR or TVP-VAR), our methodology indicates breaks are occurring in the steady states of only two variables.

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Technical Appendix

The Model

Write the steady state VAR as:

$$(y_t - \mu_{\lambda_t}) - A_1(y_{t-1} - \mu_{\lambda_t}) - \cdots - A_p(y_{t-p} - \mu_{\lambda_t}) = \varepsilon_t, \quad \varepsilon_t \sim N(0, \Sigma_{\lambda_t}), \quad (6)$$

where $\lambda_t \in \{1, 2, \dots, G\}$ denotes regimes and $A_i, i = 1 \dots, p$ are $n \times n$ matrices of VAR coefficients such that y_t is stationary (the companion matrix of $A = (A_1, \dots, A_p)$ has roots outside the unit circle). Let $\gamma = (\gamma_1, \dots, \gamma_n)'$ be a vector of cluster labels: if $\gamma_j = 0$, then $\mu_{\lambda_t}^j$, the j -th component of μ_{λ_t} , are the same for all $\lambda_t \in \{1, \dots, G\}$, i.e., $\mu_1^j = \cdots = \mu_G^j$; otherwise, they are different. Defining $y_t^* = A(L)y_t$, we have

$$y_t^* \sim N(A(1)\mu_{\lambda_t}, \Sigma_{\lambda_t}),$$

where $A(1) = I - \sum_{i=1}^p A_i$. Let $y^* = (y_1^*, \dots, y_T^*)$.

The Prior

For the variable selection indicator, we assume that its elements are i.i.d. Bernoulli random variables, i.e., $\gamma_j \sim \text{Ber}(\psi)$, with joint density

$$p(\gamma) = \prod_{i=1}^n \psi^{\gamma_i} (1 - \psi)^{1 - \gamma_i},$$

where ψ can be elicited as the proportion of variables expected a priori to exhibit multiple changes in steady states. In our application we set $\psi = 0.5$. The regime labels $\lambda_t, t = 1, \dots, T$ are i.i.d. discrete random variables with a hierarchical prior given by $\mathbb{P}(\lambda_t = j) = q_j \geq 0$ with $\sum_{i=1}^G q_i = 1$. In turn, $q = (q_1, \dots, q_G)$ is a random variable with a symmetric Dirichlet prior, $q \sim \text{Dir}(\alpha_0, \dots, \alpha_0)$, where α_0 is set to be 3 in our application.

The prior for $a = \text{vec}A' = \text{vec}([A_1, \dots, A_p]')$ is Normal with mean and covariance matrix obtained as follows: we first estimate the VAR coefficients in the time-varying intercept model

$$y_t = \tilde{\mu}_t + \tilde{A}_1 y_{t-1} + \cdots + \tilde{A}_p y_{t-p} + v_t, \quad v_t \sim N(0, \Omega),$$

with a random walk state equation

$$\tilde{\mu}_t = \tilde{\mu}_{t-1} + w_t, \quad w_t \sim N(0, Q),$$

where Q is a diagonal matrix. Then the prior mean is set to be $\mathbb{E}(\tilde{A} | y)$ with prior covariance matrix $0.01^2 \times I$, i.e., $a \sim N(a_0, 0.01^2 \times I)$, where $a_0 = \text{vec}(\mathbb{E}(\tilde{A} | y)')$.

Finally, we assume the following natural conjugate priors for μ_1, \dots, μ_G and $\Sigma_1, \dots, \Sigma_G$:

$$\begin{aligned} \mu_{(\gamma=0)} | A(1)_{(\gamma=0)}, \Sigma_{(\gamma=0)} &\sim N(\eta_0, h_0 A(1)_{(\gamma=0)}^{-1} \Sigma_{(\gamma=0)} A(1)_{(\gamma=0)}^{-1'}), \\ \mu_{j,(\gamma=1)} | A(1)_{(\gamma=1)}, \Sigma_{j,(\gamma=1)} &\sim N(\eta_0, h_1 A(1)_{(\gamma=1)}^{-1} \Sigma_{j,(\gamma=1)} A(1)_{(\gamma=1)}^{-1'}), \\ \Sigma_{(\gamma=0)} &\sim IW(\delta + n - n_\gamma, Q_0), \\ \Sigma_{j,(\gamma=1)} &\sim IW(\delta + n_\gamma, Q_1). \end{aligned}$$

where $IW(\cdot, \cdot)$ denotes the inverse-Wishart distribution. The degree of freedom parameter, δ , is set to be n , while $\eta_0 = 0$ and $h_0 = h_1 = 10$ to indicate weak prior information. Finally, we take $Q_0 = 1/\tau_0 I$ and $Q_1 = 1/\tau_1 I$, where τ_0 and τ_1 are chosen as suggested in Tadesse, Sha and Vannucci (2005).

MCMC Algorithm

Our posterior simulator is based on the collapsed sampler proposed in Tadesse, Sha and Vannucci (2005). Specifically, we sample the parameters and latent variables marginally of μ_1, \dots, μ_G and $\Sigma_1, \dots, \Sigma_G$. Note that given γ and a , $p(y^*, \lambda | q, \gamma, a)$, the joint distribution of (y^*, λ) marginal of μ_1, \dots, μ_G and $\Sigma_1, \dots, \Sigma_G$, is available analytically (see equation 7). Using derivations similar to Tadesse, Sha and Vannucci (2005), page 605, it can be shown that

$$\begin{aligned} p(y^*, \lambda | q, \gamma, a) &= \pi^{-Tn/2} \prod_{k=1}^G \{ K_{k(\gamma=1)} | Q_{1(\gamma=1)} |^{(\delta+n_\gamma-1)/2} | Q_{1(\gamma=1)} + S_{k(\gamma=1)} |^{-(T_k+\delta+n_\gamma-1)/2} \} \\ &\quad \times H_{(\gamma=0)} | Q_{0(\gamma=0)} |^{(\delta+n-n_\gamma-1)/2} | Q_{0(\gamma=0)} + S_{0(\gamma=0)} |^{-(T+\delta+n-n_\gamma-1)/2}, \end{aligned} \tag{7}$$

where

$$\begin{aligned}
K_{k(\gamma=1)} &= q_k^{T_k} (1 + h_1 T_k)^{-n_\gamma/2} \prod_{j=1}^{n_\gamma} \frac{\Gamma((T_k + \delta + n_\gamma - j)/2)}{\Gamma((\delta + n_\gamma - j)/2)}, \\
H_{(\gamma=0)} &= (1 + h_0 T)^{-(n-n_\gamma)/2} \prod_{j=1}^{n-n_\gamma} \frac{\Gamma((T + \delta + n - n_\gamma - j)/2)}{\Gamma((\delta + n - n_\gamma - j)/2)}, \\
S_{k(\gamma=1)} &= \sum_{t \in C_j} (y_{t(\gamma=1)}^* - \bar{y}_{t(\gamma=1)}^*) (y_{t(\gamma=1)}^* - \bar{y}_{t(\gamma=1)}^*)' \\
&\quad + \frac{T_k}{h_1 T_k + 1} (A(1)_{(\gamma=1)} \eta_{0(\gamma=1)} - \bar{y}_{t(\gamma=1)}^*) (A(1)_{(\gamma=1)} \eta_{0(\gamma=1)} - \bar{y}_{t(\gamma=1)}^*)', \\
S_{0(\gamma=0)} &= \sum_{t=1}^T (y_{t(\gamma=0)}^* - \bar{y}_{t(\gamma=0)}^*) (y_{t(\gamma=0)}^* - \bar{y}_{t(\gamma=0)}^*)' \\
&\quad + \frac{T}{h_0 T + 1} (A(1)_{(\gamma=0)} \eta_{0(\gamma=0)} - \bar{y}_{t(\gamma=0)}^*) (A(1)_{(\gamma=0)} \eta_{0(\gamma=0)} - \bar{y}_{t(\gamma=0)}^*)',
\end{aligned}$$

$n_\gamma = \sum_{i=1}^n \gamma_i$, T_k is the number of λ_t that are equal to k , i.e., $T_k = \sum_{t=1}^T 1(\lambda_t = k)$, $\bar{y}_{t(\gamma=1)}^*$ and $\bar{y}_{t(\gamma=0)}^*$ are the sample means of $y_{t(\gamma=1)}^*$ and $y_{t(\gamma=0)}^*$ respectively.

The posterior simulator now consists of the following four steps:

- (1) sample $\gamma|y, \lambda, q, a$;
- (2) sample $\lambda|y, \gamma, q, a$;
- (3) sample $q|y, \lambda, \gamma, a$;
- (4) sample $a|y, \lambda, \gamma, q$;

The details of Steps (1)-(2) are given in Tadesse, Sha and Vannucci (2005) equations (10)-(12) and the discussion in their subsections 5.1–5.2, with the likelihood given in (7). Step 3 is a simple Gibbs step as (conditional on λ), q has a Dirichlet distribution: $q|y, \lambda, \gamma, a \sim Dir(\alpha_1, \dots, \alpha_G)$, where $\alpha_k = \alpha_0 + T_k$ and T_k is the number of λ_t that are equal to k . To avoid the label-switching problem, we impose the restriction that $q_1 \leq \dots \leq q_G$. Such a draw can be obtained, for example, by rejection sampling. To implement Step 4, recall that the prior for a is $a \sim N(a_0, 0.01^2 \times I)$. Since the prior is tight, we can use $p(a)$ as the proposal density in an independence-chain sampler. Specifically, given the current draw a , a candidate draw a^c is generated from $N(a_0, 0.01^2 \times I)$. If the characteristic roots of the companion matrix associated with a^c are

all within the unit circle, we accept a^c with probability $\min\{\alpha_{\text{MH}}, 1\}$, where

$$\alpha_{\text{MH}} = \frac{p(y^{*c}, \lambda|q, \gamma, a^c)}{p(y^*, \lambda|q, \gamma, a)},$$

$y_t^{*c} = A^c(L)y_t$ and $A^c(L)$ is the lag polynomial associated with a^c ; otherwise, retain the draw a . Since a is a high-dimensional vector, in our implementation we divide A into several blocks. In particular, each row of A constitutes a block, and each block is sampled sequentially.

Posterior results in the empirical application are based on 50000 posterior draws, following a burn-in period of 1000. In order to investigate MCMC convergence, the following table presents the convergence diagnostic developed in Geweke (1992) for the parameters considered in Table 2 in the body of the paper. If the MCMC algorithm has converged then Geweke's convergence diagnostic has a standard Normal distribution. In the table, it can be seen that the diagnostics are all less than 1.96, indicating that convergence has taken place.

Table 3: Geweke's convergence diagnostics.

$\mu_{(\gamma=0)}^1$	1.714	q_1	-0.219
$\mu_{(\gamma=0)}^2$	1.164	$\Sigma_{(\gamma=0)}^{1,1}$	0.614
$\mu_{(\gamma=0)}^3$	0.738	$\Sigma_{(\gamma=0)}^{2,1}$	0.217
$\mu_{1,(\gamma=1)}^1$	0.655	$\Sigma_{(\gamma=0)}^{3,1}$	0.232
$\mu_{1,(\gamma=1)}^2$	-0.527	$\Sigma_{(\gamma=0)}^{2,2}$	0.559
$\mu_{2,(\gamma=1)}^1$	0.526	$\Sigma_{(\gamma=0)}^{3,2}$	0.112
$\mu_{2,(\gamma=1)}^2$	-0.069	$\Sigma_{(\gamma=0)}^{3,3}$	-1.387
$\Sigma_{1,(\gamma=1)}^{1,1}$	-0.580	$\Sigma_{2,(\gamma=1)}^{1,1}$	0.748
$\Sigma_{1,(\gamma=1)}^{2,1}$	-0.205	$\Sigma_{2,(\gamma=1)}^{2,1}$	0.541
$\Sigma_{1,(\gamma=1)}^{2,2}$	0.385	$\Sigma_{2,(\gamma=1)}^{2,2}$	1.561