

# Efficient estimation and forecasting in dynamic factor models with structural instability\*

## PRELIMINARY AND INCOMPLETE - COMMENTS WELCOME

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### Abstract

We develop efficient Bayesian estimation algorithms for dynamic factor models with time-varying coefficients and stochastic volatilities for the purpose of monitoring and forecasting with possibly large macroeconomic datasets in the presence of structural breaks. One algorithm can approximate the posterior mean, and the second algorithm samples from the full joint parameter posteriors. We show that our proposed algorithms are fast, numerically stable, and easy to program, which makes them ideal for real time monitoring and forecasting using flexible factor model structures. We implement two forecasting exercises in order to evaluate the performance of our algorithms, and compare them with traditional estimation methods such as principal components and Markov-Chain Monte Carlo.

**Keywords:** dynamic factor model; time-varying parameters; volatility; variance discounting; forgetting factors; forecasting

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# 1 Introduction

The severity of recent financial crises and the strong contagion and interconnection between modern globalized economies, has lead economists to be interested in two major econometric exercises: the monitoring and analysis of the large amount of information provided in hundreds of macroeconomic and financial indicators; and the timely identification, estimation and forecasting of structural breaks and permanent shocks that can hit the economy. In the recent literature, dynamic factor models (DFMs) have been an influential empirical approach in dealing with the former issue<sup>1</sup>. In fact, the relevant literature is so vast and all sorts of dynamic factor models have been developed: to extract leading indicators (Stock and Watson, 1989); to forecast using large datasets (Stock and Watson, 2002); and to measure monetary policy using hundreds of variables (Bernanke, Boivin and Elias, 2005). At the same time the issue of structural breaks has been very important in all aspects of time-series research, especially for forecasting (Stock and Watson, 1996). Observation of episodes such as the Great Inflation, the Great Moderation and, of course, the recent Great Recession, have sparked a renewed interest for flexible econometric modelling. Therefore, given the turbulent times we live in, it is no surprise that both academics and researchers in central banks have been working over the past decade predominantly with models with drifting coefficients and stochastic volatilities, that can capture a wide range of nonlinearities and structural breaks; Cogley and Sargent (2001), Sims and Zha (2006), and Primiceri (2005) are a few influential examples of flexible macroeconomic modelling.

In this paper we develop efficient Bayesian estimation methods for time-varying parameter dynamic factor models. That is, we estimate unobserved factors coming from a dynamic factor model under a general and flexible form of structural breaks in the coefficients and volatilities. Our ultimate purpose is to accomplish in one comprehensive setting both needs of modern macroeconomists, i.e. to forecast with large datasets while accounting for structural instabilities. In that respect, we follow the standard practice in the macroeconomics literature over the past four decades and we work with DFMs which allow all parameters to drift at each point in time (Cogley and Sargent, 2005). Our paper adds to a vastly expanding recent literature arguing in favour of structural instabilities in the loadings, coefficients, and/or volatilities of dynamic factor models; see Banerjee et al. (2008), Del Negro and Otrok (2008), Stock and Watson (2009), Breitung and Eickmeier (2011), Eickmeier, Lemke and Marcellino (2011), Bates, Plagborg-Møller, Stock and Watson (2013), Cheng, Liao and Schorfheide (2013), Corradi and Swanson (2013), Korobilis (2013). However, the major contribution of this paper is that we develop algorithms for numerically stable and computationally efficient estimation of DFMs with time-varying parameters, that make monitoring and recursive forecasting using large macroeconomic datasets a feasible task.

We propose an estimation algorithm based on the concepts forgetting and variance discounting (Koop and Korobilis, 2013), which strike the balance between estimation accuracy and computational tractability in different ways. We propose a two-step estimation procedure which is simulation-free and can allow fast updating of the time-varying parameters as well as the factors and is appropriate for high dimensional factor models (e.g. with 100+

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<sup>1</sup>The only exception being the analysis of “large vector autoregressions” (Canova and Ciccareli, 2009; Banbura, Giannone, and Reichlin, 2010; Koop and Korobilis, 2013).

variables). We examine a simple case where we replace all time-varying covariance matrices with point estimates, and extend to the case where we fully incorporate uncertainty around the time-varying covariances. We show that computation is tractable, with zero probability of programming error or numerical instability occurring even when estimating the TVP-DFM with nonstationary data. We show that we don't have to impose any of the usual unrealistic identification and normalization restrictions that are regularly adopted in likelihood-based estimation of factor models; see Del Negro and Otrok (2008) and Korobilis (2013). Finally, we provide extensions of our algorithms in several directions which, with the cost of higher computational demands, can provide more accurate approximation to the posterior distribution of the time-varying coefficients and covariances.

While it is not obvious how to establish theoretical properties of estimators under very general TVP-DFM structures (see, for instance, the relevant discussion in Bates et al., 2013), we first establish using Monte Carlo experiments that using both our proposed algorithms we can estimate factors which are more accurate than principal components when the true data generating process is a DFM with structural instabilities. We also show that our algorithms are much more computationally stable than popular Markov Chain Monte Carlo (MCMC) algorithms for estimating models with time-varying parameters (Cogley and Sargent, 2005; Del Negro and Otrok, 2008).

In order to show the diverse benefits of the two proposed estimators, we use two datasets which admit a typical factor structure, but which also have very different characteristics in terms of the number of variables, number of time-series observations, and intensity of (expected) structural instabilities in the loadings. In the first empirical application we show the benefits of the three-step estimator in a recursive forecast exercise for German GDP. The factors are estimated from a large data set consisting of quarterly observations on 123 variables observed over the period 1978Q2-2013Q3 thus expanding on the factor forecast results based on PC factors in Schumacher (2007). We show that the factor forecasts from the TVP-DFM provide lower mean-squared forecast errors compared to principal components forecasts. An analysis of the sources of improvements reveals that it is mostly time variation in volatility that matters most, whereas time variation in factor VAR parameters play no role. In the second empirical application we show the benefits of the proposed Monte Carlo sampling algorithm by extracting a single common factor from sovereign bond spreads for 10 Eurozone countries (base country is Germany) for the period 1999M1-2012M12. This is a typical example of variables which comove together, and are subject to successive, massive structural breaks in the second half of the sample. We use the posterior distribution of the factor and the time-varying parameters and volatilities in order to obtain the full predictive density of the nonlinear spreads series. We show as well that the TVP-DFM estimated with Monte Carlo sampling gives at least 50% higher predictive likelihoods compared to estimates from a time-invariant DFM estimated with MCMC methods.

In the next section we present the general TVP-DFM structure we assume, and discuss the details and characteristics of each of the two proposed algorithms. We also provide details about the nature of the forecasting setting that is more appropriate for each algorithm. Section 3 evaluates estimation accuracy of both algorithms using Monte Carlo simulations. Section 4 demonstrates the superior forecasting performance obtained by estimating a TVP-DFM as opposed to a DFM with constant parameters estimated with principal components, MCMC or

the two-step estimator of Doz et al. (2011). Section 5 concludes and discusses the implication of this paper for further research.

## 2 The DFM with time-varying parameters

Our starting point is the standard factor model with factor VAR dynamics, which we extend by allowing all coefficients and volatilities to be time-varying. Let  $x_t$  be an  $p \times 1$  “large” vector of data, then the model we analyze takes the following form

$$x_t = \lambda_t f_t + \varepsilon_t, \quad (1)$$

$$f_t = B_t f_{t-1} + \eta_t, \quad (2)$$

where  $f_t$  is the  $k \times 1$  vector of factors,  $\lambda_t$  is the  $p \times k$  factor loadings,  $B_t$  is a  $k \times k$  matrix of VAR(1) coefficients<sup>2</sup>, and  $\varepsilon_t$  and  $\eta_t$  are disturbance terms. In line with the vast majority of the macroeconomic literature we assume that  $\varepsilon_t \sim N(0, V_t)$ , where  $V_t$  is a  $p \times p$  diagonal<sup>3</sup> covariance matrix, and  $\eta_t \sim N(0, Q_t)$ , where  $Q_t$  is a  $k \times k$  covariance matrix. Assuming that the initial condition of  $f_t$  is zero, then this model indirectly implies that  $f_t \sim N\left(0, (I_k - B_t L)^{-1} Q_t (I_k - B_t L)^{-1'}\right)$ . We assume that the  $\varepsilon_t$  are uncorrelated with either  $f_t$  or  $\eta_t$  at all leads and lags.

This model is quite general to allow for any kind of nonlinearities and/or structural instabilities that might occur in  $\lambda_t$  and  $\beta_t$ . Granger (2008) has formalized this argument and showed that by specifying parameters to change each time period, we can approximate complex forms of nonlinearities in our data. Finally, the DFM with structural instabilities also nests the typical time-invariant parameter DFM, when we restrict variation in all parameters.

What is missing so far from the time-varying parameter DFM is to define how the coefficients evolve, as well as properly define their initial conditions. We do this in the next subsections. Since we are dealing with a very rich model, for the sake of clarity in the next two subsections we separate our presentation into the specification and estimation of the time-varying parameters  $[\lambda_t, f_t, \beta_t]$ , and the specification and estimation of the time-varying covariances  $[V_t, Q_t]$ . Then in the next Section we discuss feasible algorithms for combined estimation of all model parameters, discuss their features, their computational feasibility, and the identification of this large model.

### 2.1 Specification and estimation of time-varying coefficients

The coefficients  $\lambda_t$  and  $\beta_t$  evolve as driftless random walks of the form

$$\lambda_t = \lambda_{t-1} + v_t, \quad (3)$$

$$\beta_t = \beta_{t-1} + v_t, \quad (4)$$

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<sup>2</sup>We assume for simplicity a VAR(1) structure with no intercept term just for notational simplicity. This shouldn't cause any concern since every higher-order VAR admits a VAR(1) representation.

<sup>3</sup>This not be the case in approximate factor models, where  $V_t$  can allow for *some* correlation. Since we are interested in likelihood-based estimation, we follow Lopes and West (2004) and others who assume a diagonal covariance matrix.

where  $\beta_t = \text{vec}(B_t')$ , and  $v_t \sim N(0, R_t)$  and  $w_t \sim N(0, W_t)$  are iid errors, uncorrelated with each other as well as  $\varepsilon_t$  and  $\eta_t$  at all leads and lags. This is a standard assumption in the vast majority of the macroeconomics literature at least since Cooley (1971); see Koop and Korobilis (2010) for a review.

Starting with  $[\lambda_t, f_t, \beta_t]$ , in order to simplify their estimation we note that the model can be divided into three simple conditionally linear state-space models: Conditional on estimates of the factors, equations (1) and (3) solely contain the loadings  $\lambda_t$  as a state variable, whereas equations (2) and (4) solely have  $\beta_t$  as the state variable. Conditional on all model parameters, including  $\lambda_t$  and  $\beta_t$ , equations (1) and (2) form a linear state-space model with state variable  $f_t$ . As long as the errors in all equations are uncorrelated with each other, sequential estimation of each state variable conditional on all other parameters and data (e.g. using the EM algorithm or the Gibbs sampler), is quite natural and can provide an exact, consistent approximation to the joint posterior of the states  $[\lambda_t, f_t, \beta_t]$ . However, exact estimation using iterative algorithms such as the Gibbs sampler is subject to identification and numerical problems<sup>4</sup>, and computation becomes nearly infeasible when considering recursive forecasting.<sup>5</sup>

Therefore our first approximation is to consider estimating  $[\lambda_t, f_t, \beta_t]$  sequentially from conditionally linear state-space models, but not necessarily within a (Markov Chain) Monte Carlo scheme. We expand on this issue later in the next section. At this point it is worth noting that as we are dealing with linear state-space models, the Kalman filter is an integral part of our estimation approach. However, in our model, we have to estimate large state covariance matrices, which makes it necessary to stabilize the Kalman filter estimation numerically. In our model it is the case that  $R_t$  and  $W_t$  can be of massive dimensions<sup>6</sup> and thus their accurate estimation using standard likelihood-based formulas (e.g. based on the residual sum of squares) is questionable. The information in the data might not be sufficient to accurately estimate these covariance matrices, or their eigenvalues might become high and conflict information in our prior or historical data; see Kulhavy and Zarrop (1993) for more details. In order to deal with this issue we follow Koop and Korobilis (2013) and several others, and allow  $R_t$  and  $W_t$  to be proportional to the filtered covariance matrices of  $\lambda_{t-1}|x^{t-1}$  and  $\beta_{t-1}|x^{t-1}$ , respectively, where  $x^t = (x_1, \dots, x_t)$  denotes all the data information available at time  $t$ . If we define the covariance matrices  $P_{t-1|t-1}^\lambda = \text{cov}(\lambda_{t-1}|x^{t-1})$  and  $P_{t-1|t-1}^\beta = \text{cov}(\beta_{t-1}|x^{t-1})$ , which are readily available from the Kalman filter at time  $t$ , we have

$$R_t = (\mu_1^{-1} - 1) P_{t-1|t-1}^\lambda, \quad (5)$$

$$W_t = (\mu_2^{-1} - 1) P_{t-1|t-1}^\beta, \quad (6)$$

where  $0 < \mu_1, \mu_2 \leq 1$  are *forgetting factors* which allow to discount past data more. Notice that  $P_{t-1|t-1}^\lambda$  and  $P_{t-1|t-1}^\beta$  are readily available at time  $t$  from the Kalman filtering algorithm.

<sup>4</sup>See for instance the discussion in Del Negro and Otrok (2008).

<sup>5</sup>The full model can be viewed as a nonlinear state-space model with state  $\theta_t = [\lambda_t, f_t, \beta_t]$  which can be estimated using nonlinear filters such as the Extended Kalman Filter or the Uncented Kalman Filter; see Koopman et al. (2010). We have found both techniques highly unstable in the presence of the (possibly) large dimension of the loadings matrix  $\lambda_t$ .

<sup>6</sup>For instance, if we consider empirical applications such as the one by Stock and Watson (2005) with 132 variables in  $x_t$ , 10 factors in  $f_t$  and 12 lags  $p$ , it will be the case that  $R_t$  will be a  $1320 \times 1320$  matrix while  $W_t$  will be a  $1200 \times 1200$  matrix.

Koop and Korobilis (2012, 2013) explain in detail why this is a good approximation and how to interpret and estimate the forgetting factors  $\mu_1, \mu_2$ . The Kalman filter with forgetting factor can be used both in adaptive filtering, as well as when using simulation. Details of the Kalman filter and smoother in the presence of forgetting are given in the Appendix.

## 2.2 Specification and estimation of time-varying covariance matrices

One can typically specify multivariate stochastic volatility models for the covariances as Del Negro and Otrok (2013), or multivariate GARCH models as in Sentana and Fiorentini (2001). Such specifications of the volatilities will typically rely on computationally intensive Monte Carlo sampling methods or complex numerical optimization procedures. Our proposal for feasible estimation of the covariance matrices relies on two estimators.

**Exponentially Weighted Moving Average:** In the first case we follow Koop and Korobilis (2013) and we assume that  $V_t$  and  $Q_t$  are not random variables. Given initial values  $V_0 = \text{diag}(\underline{V})$  and  $Q_0 = \underline{Q}$ , we obtain point estimates of  $V_t$  and  $Q_t$  from exponentially weighted moving average (EWMA) filters of the form

$$\widehat{V}_t = \delta_1 \widehat{V}_{t-1} + (1 - \delta_1) \text{diag}(\widehat{\varepsilon}_t \widehat{\varepsilon}_t'), \quad (7)$$

$$\widehat{Q}_t = \delta_2 \widehat{Q}_{t-1} + (1 - \delta_2) \widehat{\eta}_t \widehat{\eta}_t', \quad (8)$$

where  $\widehat{\varepsilon}_t$ , and  $\widehat{\eta}_t$  are residuals in the measurement and state equations at time  $t$ , and  $0 < \delta_1, \delta_2 \leq 1$  are *decay factors* giving increasingly more weight to recent data the lower their values are.

**Wishart matrix discounting:** In the second case, given priors  $V_0 \sim iG(\underline{S}, \underline{v})$  and  $Q_0 \sim iW(\underline{\Psi}, \underline{n})$ , we use Wishart matrix discounting (WMD) models (West and Harrison, 1997) of the form

$$V_t \sim iW(S_t, n_t), \quad (9)$$

$$Q_t \sim iW(\Psi_t, v_t), \quad (10)$$

where  $n_t = \delta_1 n_{t-1} + 1$  and  $S_t = (1 - \delta_1) S_{t-1} + \delta_1 \left[ S_{t-1}^{1/2} \widetilde{V}_{t-1}^{-1/2} \text{diag}(\widehat{\varepsilon}_t \widehat{\varepsilon}_t') \widetilde{V}_{t-1}^{-1/2} S_{t-1}^{1/2} \right]$ ,  $v_t = \delta_2 v_{t-1} + 1$  and  $\Psi_t = (1 - \delta_2) \Psi_{t-1} + \delta_2 \left[ \Psi_{t-1}^{1/2} \widetilde{Q}_{t-1}^{-1/2} \widehat{\eta}_t \widehat{\eta}_t' \widetilde{Q}_{t-1}^{-1/2} \Psi_{t-1}^{1/2} \right]$ . In the equations above  $iW$  denotes the inverse wishart distribution with mean  $E(V_t) = S_t / (n_t - 2)$  and harmonic mean  $E(V_t^{-1})^{-1} = S_t / (n_t + p - 1)$  (similarly for  $Q_t$ ). Details on how to compute the matrices  $\widetilde{V}_{t-1}$  and  $\widetilde{Q}_{t-1}$  are derived in the appendix.

Both estimators discount older observations faster as  $\delta_1, \delta_2$  get lower, by placing more weight on the current (time  $t$ ) squared idiosyncratic components  $\varepsilon_t \varepsilon_t'$  and residuals  $\eta_t \eta_t'$ . This feature might not be so clear for the Wishart matrix discounting case, but after marginalizing  $\widetilde{V}_{t-1}$  we can show that the point prediction for  $V_t$  is equivalent to the EWMA estimator (see Windle and Carvalho, 2013, for a proof).

### 3 Algorithms for combined model estimation: computation, stability, and model identification

#### 3.1 A simple two-step, one iteration algorithm

We can now examine how to implement combined estimation of all model parameters. Here we build on the work of Koop and Korobilis (2014), as well as Doz et al. (2011, 2012). In particular, we can obtain a recursive solution for the time-varying parameters and the time-varying covariances using a single iteration of the different filters from time  $t = 1, \dots, T$ , without the need to rely on simulation. In order to achieve this we note that for both the EWMA and the WMD we need to compute the time  $t$  residuals  $\hat{\varepsilon}_t$  and  $\hat{\eta}_t$  based on the equations (1) and (2), respectively. Of course, these residuals need to be computed for any other likelihood-based estimator of the covariance matrix, e.g. an OLS estimator of the covariance or stochastic volatility. Our approximation entails that once we observe data at time  $t$  we estimate the covariance matrices using the Kalman filter prediction errors which are defined as

$$\hat{\varepsilon}_t = x_t - \lambda_{t|t-1}f_t, \quad (11)$$

$$\hat{\eta}_t = f_t - B_{t|t-1}f_{t-1}, \quad (12)$$

conditional on preliminary factor estimates. The prediction errors are easy to compute, since at time  $t$  we are using the known values  $\lambda_{t|t-1}$  and  $\beta_{t|t-1} = \text{vec}(B'_{t|t-1})$  instead of the unknown  $\lambda_t$  and  $\beta_t$ . Once these residuals are calculated, we can update  $V_t, Q_t$  which allows straightforward update of  $\lambda_t, \beta_t$  using the Kalman filter. Therefore, using this approximation to obtaining the time  $t$  residuals and with the assistance of our simple recursive EWMA and WMD estimators for the covariance matrices, we can define a simple two-step estimator in the spirit of the two-step estimator that Doz et al. (2011) have proposed in the constant parameter DFM. The full algorithm involves the following steps:

**Algorithm 1: Two-step, one iteration**

0. Obtain the principal component estimate of the factors  $f_t^{PC}$ , and initialize all parameters  $(\lambda_0, \beta_0, V_0, Q_0)$
1. Estimate  $(\lambda_t, \beta_t)$  and  $(V_t, Q_t)$  using the Kalman filter and smoother with forgetting and covariance discounting conditional on  $f_t = f_t^{PC}$ 
  - (a) For  $t = 1, \dots, T$ 
    - Estimate  $V_t$  based on the residual  $\hat{\varepsilon}_t = x_t - \hat{\lambda}_{t|t-1}f_t$ , and  $Q_t$  based on the residual  $\hat{\eta}_t = f_t - \hat{B}_{t|t-1}f_{t-1}$  using either the EWMA or the WMD estimators
    - Update  $\lambda_t$  and  $\beta_t$  given  $V_t, Q_t, x_t$ , and  $f_t$
  - (b) For  $t = T, \dots, 1$  run a typical (e.g. a fixed interval) smoother
2. Estimate  $f_t$  using the Kalman filter and smoother, where all parameters of the state-space model are known from the previous steps

The algorithm described above has several advantages. Estimation is quite simple since we need to run once three Kalman filters - one for each conditionally linear state-space model - and not iterate over these steps thousands of times as in MCMC algorithms. The recursive estimators for the covariances are also computationally efficient. Thus we can have an estimate in seconds even for the most demanding models. Most importantly, identification of the factors is guaranteed, at least to the level that identification of principal components is guaranteed, see Bai and Ng (2013). We can explain this very important issue intuitively. First, notice that the time-varying parameters and covariances in step 1 are estimated conditional on the PC estimates of the factors, that is the factors are given in our information set. Additionally, there is no identification issue between time-variation in the mean  $(\lambda_t, \beta_t)$  and time-variation in the covariances  $(V_t, Q_t)$  of each of the DFM equations. This is a feature which results from the approximation of the time  $t$  residuals using the parameters  $(\hat{\lambda}_{t|t-1}, \hat{\beta}_{t|t-1})$  instead of the unknown. As a result, we can estimate  $V_t, Q_t$  conditional on quantities which are all known at time  $t$ , and then subsequently update  $\lambda_t, \beta_t$  given time  $t$  estimates of the time-varying covariances. Then in a recursive manner, at time  $t + 1$  we follow exactly the same procedure, until we reach the last observation.<sup>7</sup>

Finally, we need to note that the procedure described above can be used for both the point (EWMA) and full Bayesian (WMD) estimators of the covariance matrices  $V_t$  and  $Q_t$ . In the case of the EWMA estimator this is straightforward, since it immediately provides a single value for the covariance matrices. For the WMD we obtain a full posterior distribution for these covariance matrices. Therefore, in light of avoiding the need to simulate from this posterior using computationally intensive Monte Carlo methods, we can simply feed the harmonic mean estimates  $E(V_t^{-1})^{-1} = S_t / (n_t + p - 1)$  and  $E(Q_t^{-1})^{-1} = \Psi_t / (v_t + k - 1)$  into the Kalman filter.

### 3.2 Extensions of the basic framework

In computationally demanding big-data applications, such as forecasting GDP or inflation using large panels with more than 100 macroeconomic variables (Stock and Watson, 2002) or constructing factors from vast dimensional covariance matrices of returns, the algorithm presented above provides a feasible approach to estimating the parameters of the TVP-DFM. In other applications which involve smaller datasets, the algorithm above can be modified to provide higher estimation precision. We discuss here such possibilities.

First, notice that for the WMD estimator, the algorithm above does not allow to obtain samples from the joint posterior of the time-varying parameters and covariances. As we show

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<sup>7</sup>Note that smoothing, i.e. running backward recursions to obtain estimates at time  $t$  given information at time  $t + s, s > 0$ , can be implemented using exact formulas, since it only depends on having estimates of all parameters from the forward recursions. In our algorithm we are using the Kalman smoother because we find it very useful in getting more precise estimates. Nevertheless, use of the Kalman smoother is not necessary if one wishes to pursue online estimation and forecasting. In this case only the forward iteration of the Kalman filter can be used, and there is no need to re-estimate the model from time 0 every time we want to forecast (in which case, the gains in computation are massive). See Koop and Korobilis (2012) for an example.



in the appendix, these joint posteriors are of the form

$$\begin{aligned}\lambda_t, V_t &\sim NIW\left(\lambda_{t|T}, P_{t|T}^\lambda, S_{t|T}, v_{t|T}\right), \\ \beta_t, Q_t &\sim NIW\left(\beta_{t|T}, P_{t|T}^\beta, \Psi_{t|T}, n_{t|T}\right).\end{aligned}$$

where *NIW* denotes the Normal-Inverse-Wishart distribution, and exact details of the hyperparameters are given in the Appendix. In this case, we can use Monte Carlo Integration to obtain samples from this distribution which involves iteratively sampling  $V_t$  from an inverse Wishart distribution, and then sampling  $\lambda_t$  from a Normal distribution conditional on  $V_t$ . We can proceed similarly for  $\beta_t, Q_t$ . This procedure can provide samples from the approximate posterior of the model parameters. Conditional on these, we can use the simple Kalman filter/smoothing or the simulation smoother (Carter and Kohn, 1994) to obtain samples from the posterior distribution of the factors.

Another possibility is to iterate steps 1 and 2 of our basic algorithm where in the second iteration and beyond we can estimate  $(\lambda_t, \beta_t)$  and  $(V_t, Q_t)$  conditional on the estimate of  $f_t$  from the previous step. The resulting Expectation Conditional Maximization (Gelman, Carlin, Stern and Rubin, 2004) resembles the EM algorithm extension proposed by Doz et al. (2012). There are advantages and disadvantages of implementing this approach. On the one hand, we can possibly get better a approximation of the posterior, e.g. if we iterate multiple times we not only condition on  $f_t$  from the previous iteration, but we can also calculate the residuals  $\hat{\varepsilon}_t$  and  $\hat{\eta}_t$  using estimates of  $\lambda_{t|T}$  and  $\beta_{t|T}$  from the previous iteration.<sup>8</sup> On the other hand, there is no guarantee that the system is identified. In this case we need to use identification and normalization restrictions in order to properly identify the factors and the time-varying parameters. Zero restrictions are typically applied in the loadings  $\lambda_t$  and covariances  $Q_t$  and  $V_t$ , as in Geweke and Zhou (1996) and Aguilar and West (2000). Alternatively, some initial conditions can be fixed instead of being considered random, e.g. setting  $\lambda_0 = 0$  instead of the diffuse prior  $\lambda_0 \sim N(0, 100)$ ; see Del Negro and Otrok (2008) for more information on this issue. Additionally, when iterating this algorithm multiple times we need to have a stopping rule (e.g. converge of the likelihood to a fixed value), which is guaranteed theoretically but is not always practically feasible, especially in high-dimensional dynamic factor models.

## 4 Simulations

In this Section we carry out a small Monte Carlo study to numerically evaluate the performance of the algorithms to accurately track the true factors coming from a DFM with parameters that evolve as random walks. In particular, we generate artificial observations for the following data generating process which broadly follows Banerjee, Marcellino and Masten

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<sup>8</sup>We remind that in the one-iteration case, these parameters are replaced with  $\lambda_{t|t-1}$  and  $\beta_{t|t-1}$  which are obtained from the previous period estimates of the Kalman filter.

(2008) and Bates et al. (2013)

$$\begin{aligned}
x_{it} &= \lambda_{it}f_t + \underline{V}_i^{1/2}\epsilon_{it}, \\
\lambda_{it} &= \lambda_{it-1} + (c^*)\epsilon_{it}, \\
\lambda_{i0} &\sim N(0, \underline{a}), \quad \underline{a} \sim U(0, 1) \\
f_t &= B_t f_{t-1} + \underline{Q}^{1/2}\epsilon_t, \quad B_t = \beta_t I_k, \\
\beta_t &= \beta_{t-1} + (\underline{d}T^{-1})\epsilon_t, \\
\beta_0 &= \underline{b}.
\end{aligned}$$

where  $i = 1, \dots, N$  and  $t = 1, \dots, T$ , and  $\epsilon_t$  denote standard Normal disturbances which are of appropriate dimensions for each equation they appear. In such a rich specification there are many choices that need to be made. First, we simplify the structure of the covariance matrices<sup>9</sup> in the factor and VAR equations () and (), respectively, by assuming that  $\underline{V}_i \sim U(0, 1)$  and  $\underline{Q} = \text{diag}(q_1, \dots, q_k)$  where  $q_j \sim U(0, 1)$  for all  $j = 1, \dots, k$ . This assumption allows us to focus on the actual effect of time variation in the parameters  $\lambda_t$  and  $\beta_t$  on the final factor estimates. We also set  $\underline{b} = 0.5$  and  $\underline{d} = 0.4$ .

The crucial parameter in our simulation is the one controlling the amount of time-variation in the loadings<sup>10</sup>, i.e. the parameter  $c^*$ . We specify three different values of  $c^*$  which correspond to slow, medium and fast changes in  $\lambda_{it} \forall i$ . For the slow and medium variation we follow Bates et al. (2005) and specify  $c^* = \underline{c}T^{-3/4}$  with  $\underline{c} = 2$  and  $3.5$ , respectively. For the faster time-variation we set  $c^* = 4.5T^{-3/4}$ .

For all simulation results we generate from the above DFM data generating process with one factor and one lag, and we respectively estimate models with one factor (and one lag when not using principal components). Our interest lies on factor estimation, therefore, we do not implement model selection and assessment of misspecification. For application of deterministic and stochastic model selection techniques using predictive likelihoods the reader is referred to Koop and Korobilis (2013) and Korobilis (2013), respectively. Estimation accuracy is assessed with the *SFF0* statistic which is defined as

$$SFF0 = \frac{\text{tr}(f_0' \hat{f} (\hat{f}' \hat{f}) \hat{f}' f_0)}{\text{tr}(f_0' f_0)},$$

where  $f_0$  is the true factor and  $\hat{f}$  is the estimated factor. *SFF0* is standardized to have values between zero and one, with one meaning that the estimated factors completely fit the true factors.

First we implement a simulation exercise with small  $T$  and  $n$ , in order to assess both the fast two-step estimator and the computationally more demanding Monte Carlo estimator. Table 1 presents mean *SFF0* statistics when generating combinations of small DFMs with

<sup>9</sup>Basically, the results presented here do not change qualitatively if we instead generate diagonal covariance matrices following geometric random walks (stochastic volatility model).

<sup>10</sup>We have found that time-variation in the persistence of the factors ( $\beta_t$ ) is not of paramount importance for factor estimation, at least compared to time-variation in the loadings ( $\lambda_t$ ). This finding is in-line with the Monte Carlo results of Banerjee, Marcellino and Masten (2008, Section 3.4).

$T = 40, 80, 120$  and  $n = 10, 20$ . The columns present results for our two-step estimator with known covariance matrices (2STVP), the Monte Carlo estimator (MCTVP), the 2-step estimator of Doz et al. (2011) for the constant parameter DFM (2SC), and the principal components nonparametric estimator (PC).

Table 1. Mean SFF0 statistics

T	n	2STVP	MCTVP	2SC	PC
40	10	0.8169	0.8315	0.8223	0.8031
40	20	0.8684	0.8763	0.8595	0.8478
80	10	0.8119	0.8205	0.8094	0.7874
80	20	0.8747	0.8765	0.8578	0.8445
120	10	0.7950	0.8040	0.7950	0.7712
120	20	0.8667	0.8607	0.8499	0.8345

In Table 2 we generate a set of models with larger time-series and cross-sectional dimensions, using combinations of  $T = 50, 100, 200, 500$  and  $n = 50, 100, 200, 500$ . Here we only assess the 2STVP estimator versus Doz et al. (2011) and the principal components.

Table 2. Mean SFFO statistics

T	N	$c^* = 5 \times T^{-3/4}$			$c^* = 3.5 \times T^{-3/4}$			$c^* = 2 \times T^{-3/4}$		
		2STVP	2SC	PC	2STVP	2SC	PC	2STVP	2SC	PC
50	50	0.9085	0.8820	0.8782	0.8971	0.8880	0.8795	0.8870	0.8915	0.8784
50	100	0.8905	0.8553	0.8515	0.9089	0.8992	0.8875	0.8992	0.9057	0.8885
50	200	0.8678	0.8372	0.8327	0.9056	0.9002	0.8856	0.9257	0.9314	0.9137
50	500	0.8447	0.8255	0.8213	0.9254	0.9225	0.9053	0.9350	0.9403	0.9199
100	50	0.9157	0.8889	0.8870	0.9155	0.9020	0.8962	0.9085	0.9088	0.9003
100	100	0.8965	0.8621	0.8598	0.9204	0.9068	0.8992	0.9362	0.9368	0.9262
100	200	0.8755	0.8436	0.8415	0.9285	0.9211	0.9108	0.9469	0.9506	0.9384
100	500	0.8514	0.8301	0.8284	0.9399	0.9396	0.9269	0.9651	0.9686	0.9551
200	50	0.9191	0.8909	0.8898	0.9282	0.9128	0.9095	0.9346	0.9316	0.9262
200	100	0.9008	0.8651	0.8642	0.9336	0.9189	0.9135	0.9468	0.9463	0.9384
200	200	0.8793	0.8462	0.8451	0.9418	0.9346	0.9271	0.9622	0.9638	0.9546
200	500	0.8551	0.8338	0.8326	0.9535	0.9537	0.9437	0.9713	0.9741	0.9651
500	50	0.9192	0.8914	0.8909	0.9293	0.9140	0.9120	0.9393	0.9324	0.9292
500	100	0.9023	0.8675	0.8671	0.9363	0.9202	0.9162	0.9575	0.9544	0.9494
500	200	0.8799	0.8480	0.8477	0.9465	0.9389	0.9330	0.9651	0.9651	0.9589
500	500	0.8544	0.8343	0.8338	0.9591	0.9594	0.9518	0.9801	0.9823	0.9763

Note: Results are based on 2000 generated datasets from the homoskedastic DFM with time-varying parameters described in the main text. The two-step estimator of the DFM with time-varying parameters is denoted as 2STVP. Results from the two-step estimator of the constant parameter DFM (Giannone, Reichlin and Sala, 2005) are in the columns labelled 2SC. Finally, SFFO statistics based on principal components are in the columns labelled PC.

## 5 Assessment based on real data

In this section we evaluate empirically the performance of each of the two algorithms using two datasets which are quite different in nature and call for a different treatment using factor methods. The first one is a typical forecasting exercise where the target is to forecast GDP using a large macroeconomic panel of hundreds of stationary variables. In the second empirical analysis we use factor methods to extract a common component from a small number of nonstationary financial variables (bond yields), and our purpose is to forecast the variables themselves. We show that there are potential forecasting benefits for considering a nonlinear factor specification versus using principal components, and we also provide solid evidence that our estimation methodology is more stable than Markov Chain Monte Carlo (MCMC) estimation of the TVP-DFM.

### 5.1 Forecasting using large panels

The first empirical exercise evaluates factor forecasts for German GDP growth with recent data including the Great Recession. The recursive forecast simulation is in the spirit of Stock and Watson (2002). The large data set consists of quarterly observations on 123 variables observed over the period 1978Q2-2013Q3. The data is taken from Pirschel and Wolters (2014) and represents an updated version of the data used in Schumacher (2007), where PC factor forecasts have been addressed. The time series used here are described in detail in the appendix of Schumacher (2007).

The initial sample period starts in 1978Q2 and ends in 2002Q2. Given that sample, the factor models are estimated, forecasts derived and stored. Then, the end of the sample period is expanded by one quarter, and the forecasts are repeatedly computed. We end up with a sequence of forecasts and forecast errors. As a summary statistic, we compute the mean-squared forecast error (MSE). In the Tables below, we report the MSE of a factor model relative to the MSE of a benchmark AR model. The key competitor to the TVP-DFM is the diffusion index ARDL model by Stock and Watson (2002). We use forecast equations with up to four factors. The AR and lag order of the factors is specified using the BIC, which is applied recursively with a maximum lag order of four.

To estimate the TVP-DFM, we employ the two-step algorithm from Section 2.1 given the large size of the data set. To estimate drifting volatilities we employ both EWMA and WMD. To specify the model, we consider up to four factors. Initial conditions are diffuse:  $f_0 \sim N(0_{k \times 1}, 4 \times I_k)$ ,  $\text{vec}(\lambda_0) \sim N(0_{nk \times 1}, 4 \times I_{nk})$ ,  $\underline{V} = I_n$ ,  $\underline{Q} = \text{cov}(f_t^{PC})$  for volatilities, and  $\beta_0$  has a Minnesota prior as in Koop and Korobilis (2013). Note that the covariances of  $\lambda_0$  and  $\beta_0$  also initialize  $R_t$  and  $W_t$ , respectively, in (5) and (6). We also have to specify the variance discounting parameters: The forgetting factors  $\mu_1$  and  $\mu_2$  reflect the different degrees of time variation in the loadings and VAR polynomial parameters, respectively.  $\delta_1$  and  $\delta_2$  determine the time variation in the volatility of idiosyncratic components and factor VAR residuals. Thus, we can choose between different combinations of time variation and volatility. To explore which of these potentially different sources of time variation matter most with respect to forecasting accuracy, we choose a large grid of the discounting factors and the number of factors. In particular, we compare 900 model specifications, where  $\mu$  range from 0.96 to 1.00, see Koop and Korobilis (2013), and the  $\delta$  cover the range from 0.83 to 0.99.

The forecast results for a subset of good models are summarized in Table 2 with EWMA drifting volatilities in Panel A and with Wishart matrix discounting in Panel B. We report forecasts for horizons up to four.

Table 2: Relative MSE for forecasting German GDP growth

Panel A: EWMA										
		parameter specification					Relative MSE at horizon			
		$r$	$\delta_1$	$\delta_2$	$\mu_1$	$\mu_2$	1	2	3	4
1	TVP-DFM	2	0.83	0.83	1.00	1.00	0.77	0.95	0.98	1.08
2	TVP-DFM	3	0.83	0.83	1.00	1.00	0.77	0.95	0.98	1.09
3	TVP-DFM	2	0.87	0.83	1.00	1.00	0.77	0.95	0.98	1.08
4	TVP-DFM	3	0.87	0.83	1.00	1.00	0.77	0.95	0.98	1.09
5	TVP-DFM	2	0.99	0.83	1.00	1.00	0.76	0.96	1.00	1.10
6	TVP-DFM	3	0.99	0.83	1.00	1.00	0.77	0.96	1.00	1.12
7	TVP-DFM	2	0.83	0.99	1.00	1.00	0.82	1.04	1.09	1.10
8	TVP-DFM	3	0.83	0.99	1.00	1.00	0.83	1.06	1.10	1.20
9	TVP-DFM	2	0.99	0.99	1.00	1.00	0.82	1.07	1.12	1.24
10	TVP-DFM	3	0.99	0.99	1.00	1.00	0.83	1.08	1.13	1.24
11	TVP-DFM	2	0.99	0.99	0.98	0.98	0.82	1.07	1.12	1.24
12	TVP-DFM	3	0.99	0.99	0.98	0.98	0.83	1.08	1.13	1.24
13	PC	1	-	-	-	-	0.86	1.02	1.02	1.08
14	PC	2	-	-	-	-	0.87	1.01	1.01	1.09
15	PC	3	-	-	-	-	0.91	1.02	1.01	1.09
16	PC	4	-	-	-	-	0.94	1.06	1.08	1.15
17	AR	-	-	-	-	-	1.00	1.00	1.00	1.00
Panel B: WMD										
		parameter specification					Relative MSE at horizon			
		$r$	$\delta_1$	$\delta_2$	$\mu_1$	$\mu_2$	1	2	3	4
1	TVP-DFM	2	0.83	0.83	1.00	1.00	0.77	0.95	0.98	1.08
2	TVP-DFM	3	0.83	0.83	1.00	1.00	0.77	0.95	0.98	1.10
3	TVP-DFM	2	0.87	0.83	1.00	1.00	0.77	0.95	0.98	1.08
4	TVP-DFM	3	0.87	0.83	1.00	1.00	0.77	0.95	0.98	1.08
5	TVP-DFM	2	0.99	0.83	1.00	1.00	0.76	0.95	0.98	1.08
6	TVP-DFM	3	0.99	0.83	1.00	1.00	0.76	0.95	0.99	1.10
7	TVP-DFM	2	0.83	0.99	1.00	1.00	0.81	1.02	1.06	1.17
8	TVP-DFM	3	0.83	0.99	1.00	1.00	0.80	1.02	1.05	1.16
9	TVP-DFM	2	0.99	0.99	1.00	1.00	0.80	1.03	1.07	1.18
10	TVP-DFM	3	0.99	0.99	1.00	1.00	0.80	1.03	1.07	1.18
11	TVP-DFM	2	0.99	0.99	0.98	0.98	0.96	1.43	1.64	1.95
12	TVP-DFM	3	0.99	0.99	0.98	0.98	0.95	1.49	1.77	2.18
13	PC	1	-	-	-	-	0.86	1.02	1.02	1.08
14	PC	2	-	-	-	-	0.87	1.01	1.01	1.09
15	PC	3	-	-	-	-	0.91	1.02	1.01	1.09
16	PC	4	-	-	-	-	0.94	1.06	1.08	1.15
17	AR	-	-	-	-	-	1.00	1.00	1.00	1.00

The results of Table 2, Panel A, can be summarized as follows: The PC factor forecasts

(rows 13-16) can outperform the AR benchmark (row 17) for  $h = 1$ , but not at longer horizons. The best TVP-DFM can outperform the benchmark up to three quarters, complementing existing results on the limits of GDP growth forecastability in Germany in Schumacher (2007). Generally, TVP-DFM with two or three factors do best. Compared to PC factor forecasts, most of the displayed TVP-DFM perform better at all horizons in terms of relative MSE (rows 1-6). In particular, TVP-DFM do best mainly due to the volatility in the factor VAR residuals, as  $\delta_2 = 0.83$  leads to better forecast compared to  $\delta_2 = 0.99$ , (compare rows 1-6 to 7-12). Volatility in the idiosyncratic components does not seem to have a huge impact given the factor VAR residual volatility with  $\delta_2 = 0.83$  (compare rows 1-6): setting  $\delta_1 = 0.83$ ,  $\delta_1 = 0.87$  or  $\delta_1 = 0.99$  yields quite similar forecast results. Setting very slow moving volatilities  $\delta_1 = \delta_2 = 0.99$  (rows 9-10) leads to a decline in forecast accuracy at all horizons, such that the forecasts are uninformative compared to the benchmark for  $h = 2, 3$ . Time-varying loadings or VAR parameters cannot improve the forecasts. Specifying very slow moving volatilities  $\delta_1 = \delta_2 = 0.99$  and moderate time variation in the loadings and VAR parameters  $\mu_1 = \mu_2 = 1.00$  worsens the forecast performance considerably (rows 11-12). The best models have  $\mu_1 = \mu_2 = 1.00$ , implying no time variation at all. But overall, we find that variations in the volatility seems to matter most for forecasting, see also Eickmeier, Marcellino and Lemke (2013).

If we compare results between Panel A with EWMA volatilities and Panel B with WMD, we see no sharp differences. The best models with WMD seem to perform slightly better than the corresponding EWMA models.

## 5.2 Forecasting sovereign bond yields

Another dataset which has an evident factor structure, is subject to structural changes, and which has attracted much attention during the post-2009 Eurozone debt crisis, involves 10-year sovereign bond yields as spreads from the 10-year yield of the German bund. We collect data for ten Eurozone countries, namely Austria, Belgium, Finland, France, Greece, Ireland, Italy, Netherlands, Portugal, and Spain, for the period 1999m1-2012m12. This is a small panel of countries, and we have relatively short time series dimension for being in the monthly frequency. However, there are evident breaks in these data as shown in Figure XXXX: around the end of 2008 there is an explosion of volatility due to the Global financial crisis. The Eurozone crisis starts around the end of 2009, exacerbates in mid-2010 with Greece being on the verge of a default, and abruptly peaks around mid 2011 and early 2012 (depending on the country).



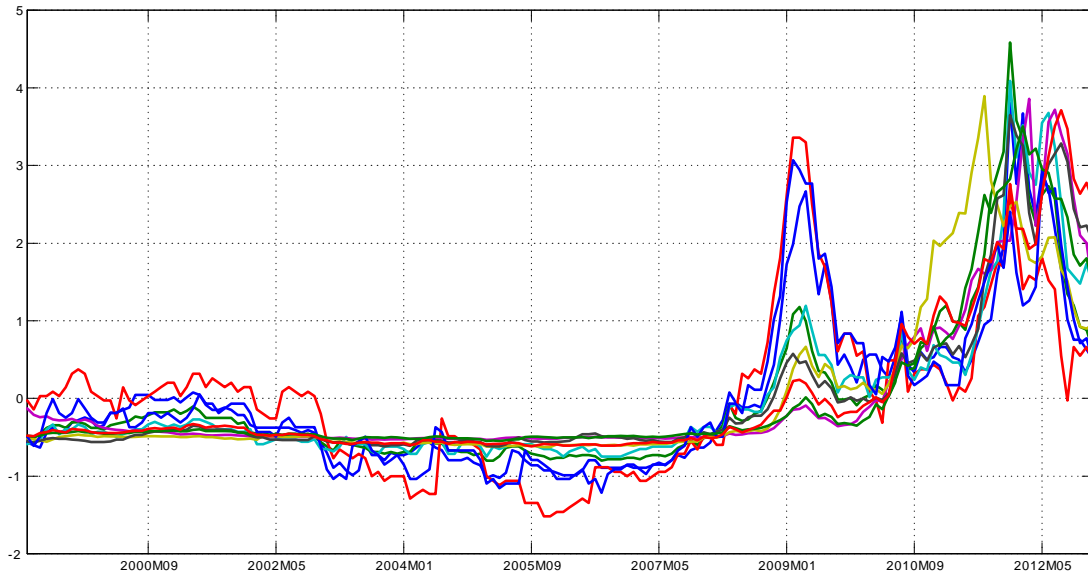


Figure 1. Returns on 10-year bond for 10 Eurozone countries, 1999m1-2012m12. The data are expressed as spreads from the 10-year yield of the German bund, and then standardized (mean zero, variance one) in order to be of comparable scale.

While the relevant literature either identifies one factor or two factors, i.e. a so-called “core” factor (Austria, Belgium, Finland, France, Netherlands) and a “periphery” factor (GI-IPS), we prefer to adopt a single-factor approach in order to focus on the properties of different estimators without having to worry for the moment about uncertainty regarding the number of factors<sup>11</sup>. What is more important here is that we are dealing with a nonstationary dataset. Despite having a variable expressed as a spread, the time-series process is explosive. Interestingly this implies that simple principal component analysis in nonstationary data is equivalent to estimating a sample mean: indeed, with few exceptions, the loadings of the first principal component from this dataset, degenerate to 1, thus implying that the PC is an equally weighted average. Maximum likelihood estimation of the factor model can provide a possibly more accurate solution in this case, and assign varying weights to the estimate of the factor.

Therefore, we estimate the TVP-DFM using the two recursive estimators we have proposed in this paper, and we contrast these to MCMC estimation of the TVP-DFM with random walk stochastic volatility of the form introduced in Kim, Shephard and Chib (1998). For the purpose of forecasting we are also estimating using MCMC a time-invariant DFM with diffuse priors. The reader is referred to the Appendix for details regarding specification and estimation of the TVP-DFM with stochastic volatility, and the simple, constant parameter DFM. In the Appendix we also make an additional empirical assessment of the accuracy of the different methods in recovering the time-varying volatilities and the factors. What we present here analytically is the settings we have used for each model. We do that in Table XX,

<sup>11</sup>While the tradition is to choose the number of factors using some criterion, the Bayesian forecaster can simply use a model selection prior (e.g. SSVS), a shrinkage priors (e.g. Bayesian LASSO), or a model averaging prior (Zellner’s g-prior); see Koop and Korobilis (2010) for more details of priors and acronyms.

where the reader can see that wherever possible we are using diffuse priors, plus we are using the same priors (initial conditions) for all parameters which are common among different model specifications.

Table XX. Initial conditions and priors used in different models

Parameter	TVP-DFM		
	2S-EWMA	2S-WMD	MCMC
$\lambda_t$		$\lambda_0 \sim N(0, 4 \times I)^a$	
$\beta_t$		$\beta_0 \sim N(0, 1 \times I)^a$	
$f_t$		$f_0 \sim N(0, 4 \times I)^a$	
$R_t$		FF with $\mu_1 = 0.99^a$	
$W_t$		FF with $\mu_2 = 0.99^a$	
$V_t$	$V_{0,i} \equiv 0.1^b$	$V_{0,i} \sim IW(I, 1 + 2)^{c,b}$	$\log(V_{0,i}) \sim N(\log(0.5), 0)^b$
$Q_t$	$Q_0 \equiv 0.1$	$Q_0 \sim IW(I, k + 2)^c$	$\log(Q_0) \sim N(\log(0.5), 0)$
DFM			
Parameter	MCMC		
$\lambda$		$\lambda \sim N(0, 4 \times I)$	
$\beta$		$\beta \sim N(0, 1 \times I)$	
$f_t$		$f_0 \sim N(0, 4 \times I)$	
$V$		$V_i \sim IG(0.01, 0.01)^b$	
$Q$		$Q \sim IG(0.01, 0.01)$	

<sup>a</sup>These coefficients are common in all three specifications of the TVP-DFM

<sup>b</sup> $V_{0,i}$  (similarly,  $V_i$ ) denotes the  $i$ -th diagonal element of  $V_t$  (similarly,  $V$ ),  $i = 1, \dots, 10$ .

<sup>c</sup>The IW for a univariate variable is equivalent to the Inverse Gamma (IG) distribution.

What we need to keep from this Table is that the major differences in the three estimators of the TVP-DFM occur in the specification of the volatility. For these parameters we can be fairly noninformative when using the Wishart matrix discounting method (2S-WMD), but we have to be very informative for the other two methods. For the EWMA specification of  $V_t$  and  $Q_t$  our prior (initial condition) is informative, since it is just a scalar initial value. For the MCMC estimation we can define a starting value from the Normal distribution, however, for identification reasons we have to normalize<sup>12</sup> the volatilities to start from a fixed point which explains why our prior variance is zero. We need also to note that for identification of the factors we normalize the first element of  $\lambda_t$  to be 1 (and, hence, not time-varying); see Del Negro and Otrok (2008) for an explanation why such restrictions are needed. In the 2S-EWMA and 2S-WMD specifications, according to our discussion in Section XX, we need not use any normalization or identification restrictions to obtain the common factor so that estimation and numerical convergence is always guaranteed.

Regarding the forecast evaluation using the three estimation methods of the TVP-DFM, we calculate posterior predictive likelihoods<sup>13</sup> which means that we need to use posterior

<sup>12</sup>For forecasting we presumably can ignore identification issues (at least, when we are referring to identification of the factors), however, allowing less informative priors for the log-volatilities can have catastrophic consequences for forecast uncertainty.

<sup>13</sup>The posterior predictive likelihood is obtained by evaluating the whole predictive density obtained from each model, at the out-of-sample observation of interest. This is a measure which takes into account both the

simulation (Monte Carlo) to obtain samples from the predictive density. Note that with the MCMC we have by definition Monte Carlo samples from the posterior of all parameters, and eventually the predictive density. The estimated predictive likelihoods are presented in Table X below. These are quoted relative to the predictive likelihood of a Bayesian time-invariant DFM estimated using diffuse (noninformative) priors.

Table X. Relative PL's for the bond yield data

	$h = 1$	$h = 3$	$h = 6$	$h = 9$	$h = 12$
<u>2S-EWMA</u>					
Austria	1.05	1.00	0.89	0.77	0.74
Belgium	0.90	0.86	0.89	0.82	0.80
Finland	1.03	0.95	0.93	0.86	0.80
France	1.17	1.15	1.05	1.09	1.01
Greece	1.85	1.79	1.73	1.86	1.88
Ireland	1.45	1.09	0.95	0.85	0.77
Italy	2.90	2.81	3.03	4.62	4.20
Netherlands	0.95	0.89	0.92	0.81	0.76
Portugal	1.04	1.05	1.22	1.13	1.16
Spain	1.17	1.01	0.90	0.81	0.78
<u>2S-WMD</u>					
Austria	1.17	1.08	0.98	0.88	0.82
Belgium	0.95	0.91	0.96	0.89	0.86
Finland	1.19	1.05	1.01	0.89	0.85
France	1.17	1.17	1.10	1.19	1.08
Greece	1.91	1.98	1.93	1.82	1.52
Ireland	1.53	1.15	0.98	0.91	0.83
Italy	3.41	3.08	3.18	5.07	4.64
Netherlands	1.06	0.98	1.03	0.87	0.81
Portugal	1.05	1.00	1.16	1.14	1.15
Spain	1.29	1.10	0.99	0.89	0.87
<u>MCMC</u>					
Austria	1.32	1.15	0.99	0.91	0.84
Belgium	1.04	0.95	0.96	0.92	0.87
Finland	1.20	1.02	0.91	0.77	0.79
France	1.13	1.16	1.06	1.14	1.05
Greece	2.79	2.67	2.55	2.43	1.86
Ireland	1.82	1.28	1.09	0.95	0.84
Italy	2.11	1.99	2.11	3.03	2.87
Netherlands	0.90	0.88	0.95	0.86	0.82
Portugal	0.97	0.97	1.12	1.06	1.12
Spain	1.22	1.02	0.95	0.84	0.83

From the table above we can make the following observations

accuracy of forecasts of the mean, as well as the total forecast uncertainty; see for example CITE. This should not be confused with the prior predictive (marginal) likelihood which is an in-sample measure of fit.

1. There is a strong case for using a DFM with structural instabilities for the Eurozone data, compared to a constant parameter DFM. Short-run predictability is greatly improved by the presence of stochastic volatility and time-variation in loadings and VAR coefficients. This is more evident, as one would expect, for countries in the periphery such as Italy and Greece.
2. Our proposed estimation methods compare as well in achieving similar predictive likelihoods to MCMC. In some cases the TVP-DFMs we have estimated with the two-step algorithms have lower PLs than MCMC, but in a several cases they improve the fit of the model a lot (e.g. in the case of Italy for the 2S-WMD algorithm).
3. We should also consider in this evaluation that the Monte Carlo versions of our two-step algorithms are several times faster than MCMC.<sup>14</sup> Additionally, we haven't imposed any identification restrictions to obtain our results. This is not the case for the MCMC algorithm, where identification is far more challenging. More discussion on this is provided in Appendix B.
4. Our algorithms can also be extended in several directions. For example, the results above suggest that for some countries (e.g. Belgium) a TVP-DFM might not be appropriate, and one might be better-off with a constant parameter DFM. Similar results have been found in the macro-finance literature, e.g. Sims and Zha (2006) show that the optimal specification for a monetary VAR is one that allows coefficients to change only in the interest rate equation (and be constant in the other equations in their system). If we allow each DFM equation to have a different forgetting factor for  $\lambda_t$ , that is, if we make  $\mu_1$  a diagonal matrix instead of a scalar, we can allow some countries to have constant loadings while others to have time-varying.
5. In a similar spirit, one can optimize the model in terms of all the forgetting and decay factors used. Windle and Carvalho (2013) use a Metropolis-Hastings step to optimize the respective decay factors in their model, however, adopting such an approach means that we lose the simplicity of using our two-step approach and we instead have to adopt a more complex MCMC scheme in order to obtain the EWMA and WMD estimates. Koop and Korobilis (2013) and Dangl and Halling (2012) use an alternative method where they define a grid of values for their decay/forgetting factors, and they chose as the optimal model the one that maximizes the time  $t$  predictive likelihood.

There several such extensions along the lines of points 4 and 5 above, which could be exciting ideas for future research. In this paper we avoid to go in such depths, as our purpose is to establish that the proposed algorithms work with a minimal amount of tuning. For example, if we optimize with respect to the forgetting/decay factors, then it is not clear if the benefits of our estimation approach come from the simplicity of the algorithm or because of the fact that we are taking into account uncertainty about the amount of time variation in the DFM system.

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<sup>14</sup>Exact times depends on the programming language, machine hardware, and number of Monte Carlo iterations. Indicatively we mention here that it takes exactly 1/5 of the time to obtain 5,000 iterations from the 2S-WMD algorithm compared to the MCMC algorithm (in a PC with "typical" specifications, i.e. a Core i7 4770K machine, running Windows 7 with MATLAB 2013a 64-bit installed).

## 6 Conclusions

In this paper, we develop fast and efficient Bayesian estimation algorithms for dynamic factor models with time-varying coefficients and stochastic volatilities. The models can be estimated on large macroeconomic datasets and are well-suited for real-time monitoring and forecasting. We propose two variants of the estimation procedure: One algorithm can approximate the posterior mean and tackle very large data sets, and the second algorithm samples from the full joint parameter posteriors, is therefore computationally a bit more demanding and thus suited for medium-sized data sets.

In simulations, we show that our proposed algorithms are fast and accurate in the presence of structural breaks. We also carry out two forecasting exercises to illustrate the properties of the estimators further: The first exercise aims at forecasting German GDP growth recursively given a dataset of more than hundred time series. The other exercise addresses the predictability of government bond spreads in the Euro area countries. Both exercises cover the recent period as evaluation period, a period which was subject to severe financial turbulences and an unprecedented break-down in real economic activity. In these periods, we can show considerable advantages of the time-varying model in forecast performance over models, which do not allow for structural instabilities.

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## A. Technical Appendix

Consider the state space model of the form

$$\begin{aligned} y_t &= H_t x_t + v_t, \\ x_t &= x_{t-1} + w_t, \end{aligned}$$

where the noise processes  $v_t$  and  $w_t$  are white, zero-mean, uncorrelated, and have covariance matrices  $\Sigma_t$  and  $\Omega_t$ , respectively. Here we use a notation where the discount (forgetting) factor of  $\Omega_t$  is  $\lambda$ , and the discount (decay) factor of  $\Sigma_t$  is  $\delta$ . In the next two subsections we show how to obtain an estimate the state  $x_t$  when  $\Sigma_t$  is known (EWMA estimator) or unknown (inverse Wishart process estimator). Therefore, the filters/smoothers presented below can be used to compute the first step of both algorithms suggested in the text, that is for estimation of the time-varying parameters of  $\lambda_t$  and  $\beta_t$ . The second step in both algorithms (estimation of the factors  $f_t$ ) is always based on the typical Kalman filter/smoothers recursions; see for example Durbin and Koopman (2001).

### A.1 Kalman filter and smoother with covariance discounting

For chosen initial conditions  $x_0, P_0, \Sigma_0$  and discounting factors  $\lambda, \delta$ , and given fixed values for the system matrices  $H_t$  for all  $t$ , the algorithm for updating the unknown state  $x_t$  along with the unknown covariances  $\Sigma_t, \Omega_t$ , is as follows

#### Kalman-EWMA filter

For  $t = 1, \dots, T$  run the following recursions

$x_{t t-1} = x_{t-1 t-1},$	predicted mean
$\Omega_t = (\lambda^{-1} - 1) P_{t-1 t-1},$	forgetting step
$P_{t t-1} = P_{t-1 t-1} + \Omega_t,$	predicted covariance
$\tilde{v}_t = (y_t - H_t x_{t t-1}),$	measurement innovation
$\Sigma_{t t} = \delta \Sigma_{t-1 t-1} + (1 - \delta) \tilde{v}_t \tilde{v}_t',$	EWMA covariance estimate
$K_t = P_{t t-1} x_t' (\Sigma_t + x_t P_{t t-1} x_t')^{-1},$	Kalman gain
$x_{t t} = x_{t t-1} + K_t \tilde{v}_t,$	updated mean
$P_{t t} = P_{t t-1} - K_t x_t P_{t t-1}.$	updated covariance

#### Fixed interval smoother

Given  $x_T$  and  $P_{T|T}$  from the last run of the Kalman filter, the fixed interval smoother for  $x_{t|t+1}, t = T - 1, \dots, 1$ , is as follows

$$\begin{aligned} x_{t|t+1} &= x_{t|t} + U_t^x (x_{t+1|t+1} - x_{t+1|t}), \\ P_{t|t+1} &= P_{t|t} + U_t^x (P_{t+1|t+1} - P_{t+1|t}) U_t^{x'}, \\ U_t^x &= P_{t|t} (P_{t+1|t})^{-1}. \end{aligned}$$

## A.2 Sequential Bayes learning with covariance discounting

Given the initial conditions

$$\begin{aligned} x_0 &\sim N(x_0, P_0), \\ \Sigma_0 &\sim iW(S_0, n_0), \end{aligned}$$

the time  $t$  priors of  $x_t, \Sigma_t$  are

$$\begin{aligned} x_t | y^{t-1} &\sim N(x_{t|t-1}, P_{t|t-1}), \\ \Sigma_t | y^{t-1} &\sim iW(S_{t|t-1}, n_{t|t-1}), \end{aligned}$$

where  $x_{t|t-1} = x_{t-1|t-1}$ ,  $P_{t|t-1} = P_{t-1|t-1} + \Omega_t$ ,  $\Omega_t = (\lambda^{-1} - 1) P_{t-1|t-1}$ ,  $S_{t|t-1} = S_{t-1|t-1}$ , and  $n_{t|t-1} = \delta n_{t-1|t-1}$ .

Given these priors, the joint time  $t$  posterior of  $x_t, \Sigma_t$  is of the form

$$x_t, \Sigma_t | y^t \sim NIW(x_{t|t}, P_{t|t}^\lambda, S_{t|t}, n_{t|t}),$$

where  $x_{t|t} = x_{t|t-1} + P_{t|t-1} H_t \Xi_t^{-1} \tilde{\varepsilon}_t$  and  $P_{t|t} = P_{t|t-1} - P_{t|t-1} H_t' \Xi_t^{-1} H_t P_{t|t-1}$ , with  $\tilde{\varepsilon}_t = y_t - H_t x_{t|t-1}$  the innovation error of the Kalman filter and  $\Xi_t = H_t P_{t|t-1} H_t' + \Sigma_t$  its covariance matrix. Additionally, we have that  $n_{t|t} = \delta n_{t-1|t-1} + 1$  and  $S_{t|t} = (1 - a_t) S_{t-1|t-1} + a_t \left[ S_{t-1|t-1}^{1/2} \Xi_{t-1}^{-1/2} (\varepsilon_t \varepsilon_t') \Xi_{t-1}^{-1/2} S_{t-1|t-1}^{1/2} \right]$  with  $a_t = n_t^{-1}$  and  $\Xi_{t-1} = \Sigma_{t-1} + H_{t-1} P_{t-1|t-1} H_{t-1}'$ ; see also Triantafyllopoulos (2007).

In order to sample from  $x_t$  and  $\Sigma_t$  we use a Monte Carlo scheme that allows us to sample sequentially from  $\Sigma_t | y^t$  and  $x_t | \Sigma_t, y^t$ . However, as we iterate forward over time we also need to iterate backwards to obtain smoothed estimates. Therefore, we first get a draw from  $\Sigma_t | y^t$  by running the filtering and smoothing recursions, and then we obtain  $x_t | \Sigma_t, y^t$  using also filtering and smoothing recursions. In particular, for  $s = 1, \dots, S$  samples from the posterior of the parameters of interest, we iterate over the following equations

- Obtain a sample  $\Sigma_t$  by generating a draw from

$$\Sigma_t^{(s)} | y^t \sim iW(S_{t|T}, n_{t|T}). \quad (\text{A.1})$$

In order to obtain  $S_{t|T}, n_{t|T}$  where we first run the forward recursions for  $t = 1, \dots, T$  and estimate

$$\text{i) } n_{t|t} = \delta n_{t-1|t-1} + 1 \text{ and } S_{t|t} = (1 - a_t) S_{t-1|t-1} + a_t \left[ S_{t-1|t-1}^{1/2} \Xi_{t-1}^{-1/2} \varepsilon_t \varepsilon_t' \Xi_{t-1}^{-1/2} S_{t-1|t-1}^{1/2} \right].$$

and then run the backward recursions for  $t = T - 1, \dots, 1$  and estimate

$$\text{ii) } n_{t|T} = (1 - \delta) n_{t|t} + \delta n_{t+1|T} \text{ and } S_{t|T}^{-1} = (1 - \delta) S_{t|t}^{-1} + \delta S_{t+1|T}^{-1}$$

- Obtain a sample  $x_t$  by generating a draw from

$$x_t^{(s)} | \Sigma_t^{(s)}, y^s \sim N(x_{t|T}, P_{t|T}). \quad (\text{A.2})$$

In a similar fashion, we first run the forward Kalman filter iterations for  $t = 1, \dots, T$  and obtain

$$\text{i) } x_{t|t} = x_{t|t-1} + P_{t|t-1} H_t \left( \Xi_t^{(s)} \right)^{-1} \tilde{\varepsilon}_t \text{ and } P_{t|t} = P_{t|t-1} - P_{t|t-1} H_t' \left( \Xi_t^{(s)} \right)^{-1} H_t P_{t|t-1}$$

$$\text{where now } \Xi_t^{(s)} = H_t P_{t|t-1} H_t' + \Sigma_t^{(s)}.$$

Subsequently we can run the backward Kalman filter recursions to obtain

$$\text{ii) } x_{t|t+1} = x_{t|t} + U_t^x (x_{t+1|t+1} - x_{t+1|t}) \text{ and } P_{t|t+1} = P_{t|t} + U_t^x (P_{t+1|t+1} - P_{t+1|t}) U_t^{x'}, \text{ where}$$

$$U_t^x = P_{t|t} (P_{t+1|t})^{-1}.$$

This sampling procedure makes it trivial to analyze (nonlinear) features of the parameter posteriors (e.g. impulse response functions, or posterior predictive likelihoods), since we can simply then use Monte Carlo Integration; see Koop (2003) for details.

Subsequently, in our second algorithm we use equation (A.1) to sample  $V_t$  and  $Q_t$ , and equation (A.2) to sample  $\lambda_t$  and  $\beta_t$ , given their conditional state-space forms. Note that  $V_t$  is diagonal so one can either use the posterior expression (A.1) using the restriction that  $S_{t|t}$  and  $S_{t|T}$  are diagonal matrices, or sample each diagonal element of  $V_t$  from equivalent univariate inverse Gamma posterior; see West and Harrison (1997) for more details.

## B. Additional results

In this section we present evidence on the way our estimation algorithms fit patterns in the data. For the Eurozone bond spreads data we present estimates of the volatilities and factors that pertain to the full sample 1999:M1-2012:M12. Figures B1-B3 present estimates of the idiosyncratic volatilities for each of the 10 countries in the data, which can be found along the main diagonal of the time-varying covariance matrix  $V_t$ . Figure B1 corresponds to EWMA point estimates, while Figures B2 and B3 correspond to WMD and MCMC (Gibbs sampler - see Del Negro and Otrok, 2008, for computational details) where posterior medians (solid line) with the 16th and 84th quantile are plotted. These plots of the volatilities show the part of our model which is not due to comovements captured in the common component  $\lambda_t f_t$ , rather they are attributed to the individual characteristics of each country (in the error term  $\varepsilon_t$ ). This explains why for the peripheral countries (Greece, Italy, Ireland, Portugal, Spain) there is a large part of unexplained volatility<sup>15</sup> during the Eurozone crisis 2010-2012, while for core countries (Austria, Belgium, Finland, France, Netherlands) the major spikes in their volatility occurs both during the Eurozone crisis and during the Global crisis 2007-2009

<sup>15</sup>This “unexplained volatility” could potentially be explained by macroeconomic fundamentals such as the debt-to-gdp ratio, but is definitely not due to comovements among Eurozone countries

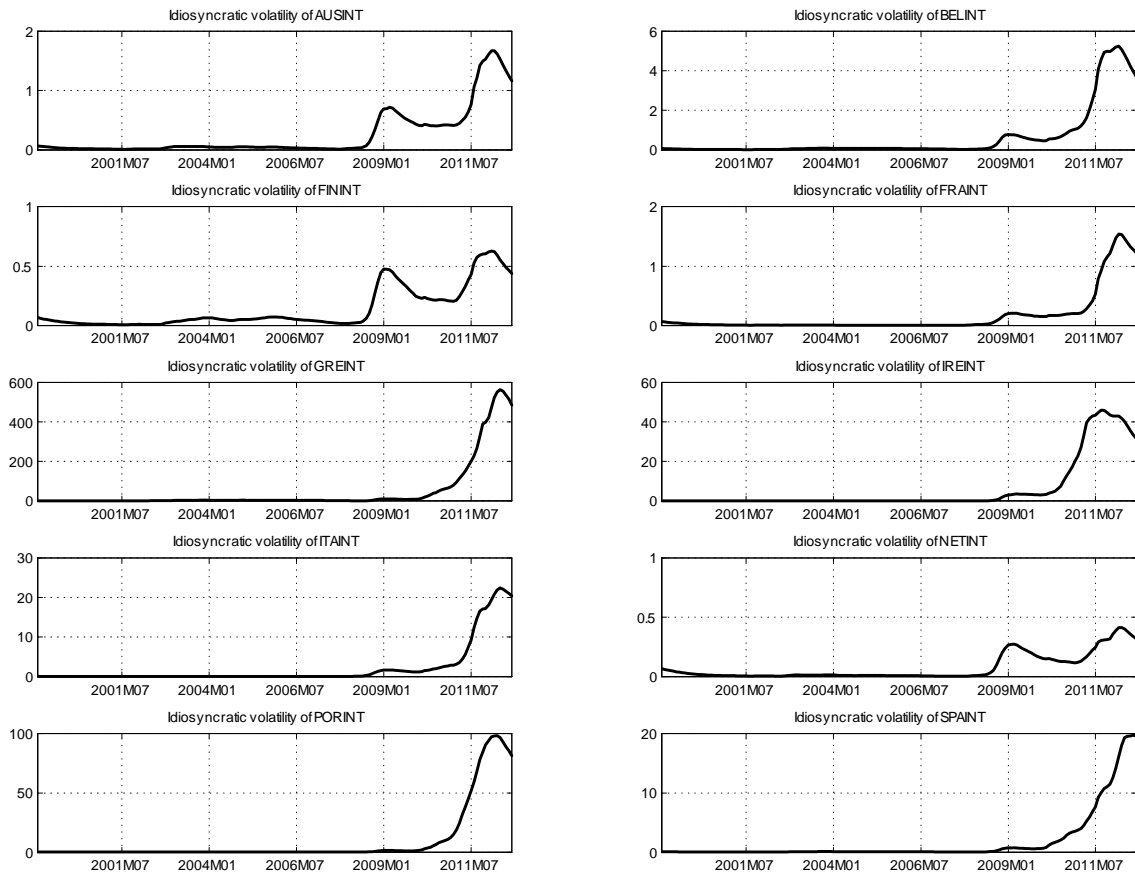


Figure B1. Idiosyncratic volatilities for each of the 10 countries in our dataset. Solid lines are posterior means/medians.

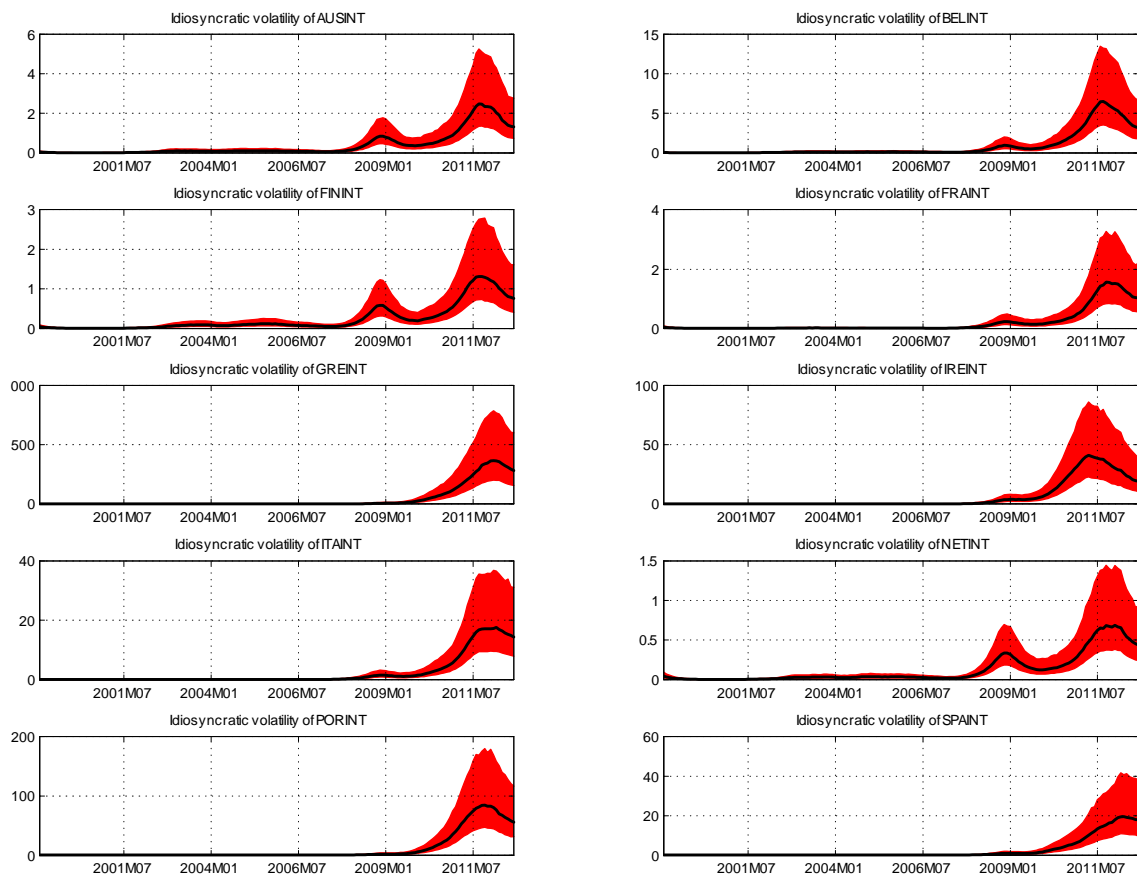


Figure B2. Idiosyncratic volatilities for each of the 10 countries in our dataset, WMD two-step estimates. Solid lines are posterior medians, and shaded areas are 16th/84th quantile range.

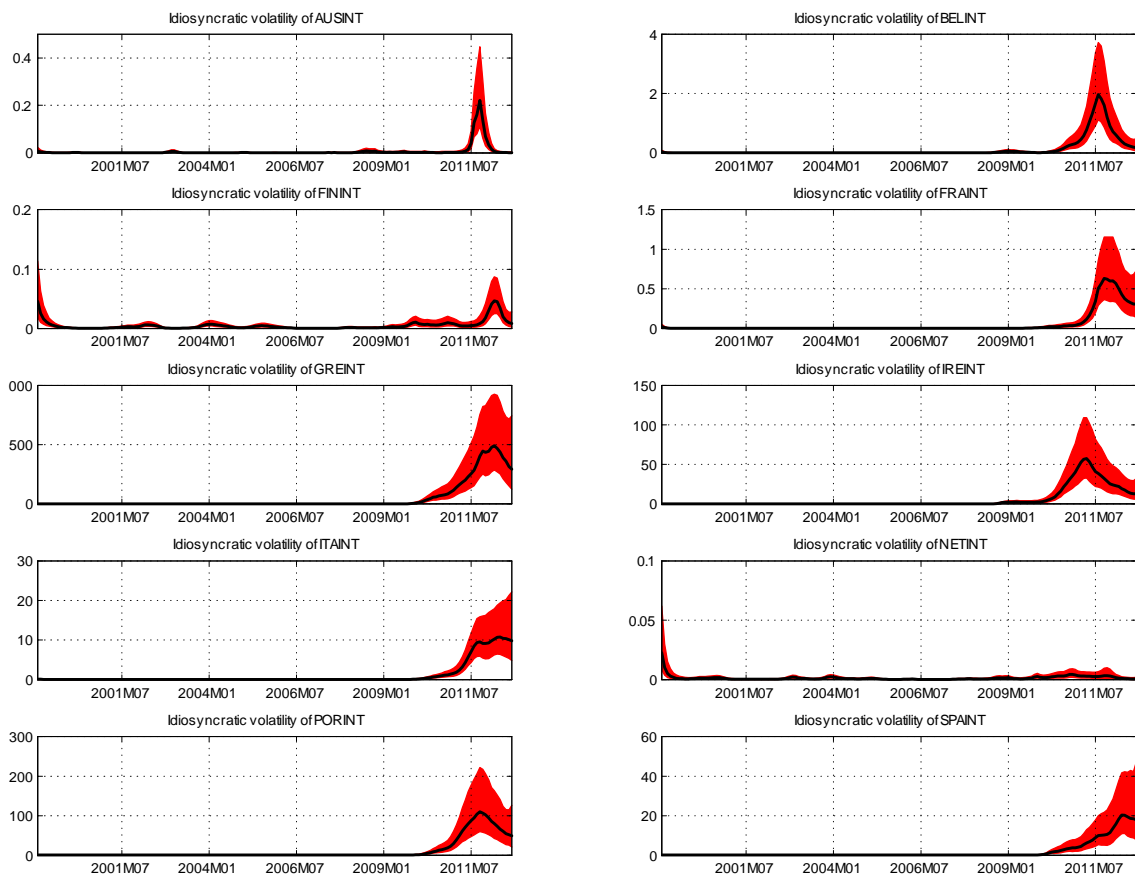


Figure B3. Idiosyncratic volatilities for each of the 10 countries in our dataset, MCMC estimates. Solid lines are posterior medians, and shaded areas are 16th/84th quantile range.

Regarding the estimates of these volatilities, the similarity between the approximate two-step approaches and the “exact” MCMC approach<sup>16</sup> is striking.

<sup>16</sup>Note that even MCMC methods are Monte Carlo methods to approximate the exact posterior distribution, so they might also be subject to an approximation error.