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ECONOMETRIC THEORY REVIEW QUESTIONS

Monte Carlo tests

1. Consider the linear regression model

$$y = X\beta + u \quad (1)$$

where y is a $T \times 1$ vector of observations on a dependent variable, X is a $T \times k$ fixed matrix of explanatory variables (observed), $\beta = (\beta_1, \dots, \beta_k)'$, and u is a $T \times 1$ vector of unobserved error terms.

- (a) Suppose the elements of u are independent and identically distributed according to a $N[0, \sigma^2]$ distribution, where σ^2 is an unknown constant, and $k > 1$. We wish to build a confidence interval with level 0.95 for the ratio $\theta = \beta_2/\beta_1$. Propose a method for doing this.
- (b) Suppose the elements of u are independent and identically distributed according to a $\sigma t(1)$ distribution, where $t(1)$ represents a Student t distribution with 1 degree of freedom and σ is an unknown constant. Propose a method for testing the hypothesis $H_0 : \beta_1 = 1$ at level $\alpha = 0.05$ in the context of this model such the size of the test is exactly equal to $\alpha = 0.05$.

References

DUFOUR, J.-M. (2006): "Monte Carlo Tests with Nuisance Parameters: A General Approach to Finite-Sample Inference and Nonstandard Asymptotics in Econometrics," *Journal of Econometrics*, 133(2), 443–477.