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## **Robust Econometrics**

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## Robust Econometrics

### P. Čížek and W. Härdle<sup>\*</sup>

Econometrics often deals with data under, from the statistical point of view, non-standard conditions such as heteroscedasticity or measurement errors and the estimation methods need thus be either adopted to such conditions or be at least insensitive to them. The methods insensitive to violation of certain assumptions, for example insensitive to the presence of heteroscedasticity, are in a broad sense referred to as robust (e.g., to heteroscedasticity). On the other hand, there is also a more specific meaning of the word 'robust', which stems from the field of robust statistics. This latter notion defines robustness rigorously in terms of behavior of an estimator both at the assumed (parametric) model and in its neighborhood in the space of probability distributions. Even though the methods of robust statistics have been used only in the simplest setting such as estimation of location, scale, or linear regression for a long time, they motivated a range of new econometric methods recently, which we focus on in this chapter.

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The concepts and measures of robustness are introduced first (Section 1), followed by a most common types of estimation methods and their properties (Section 2). Various econometric methods based on these common estimators are discussed later in Section 3, covering tasks from time series regression over GMM estimation to simulation-based methods.

## 1 Measures of robustness

Robustness properties can be formulated within two frameworks: qualitative and quantitative robustness. *Qualitative robustness* is concerned with the situation in which the shape of the underlying (true) data distribution deviates slightly from the assumed model. It focuses on questions like stability and performance loss over a family of such slightly deviating distributions. *Quantitative robustness* considers the situation in which the sensitivity of estimators to a proportion of aberrant observations is studied.

A simple example can make this clear. Suppose one has collected a sample on an individual's income (after say 10 years of schooling) and one is interested in estimating the mean income. If  $\{x_i\}_{i=1}^n$  denotes the logarithm of this data and we suppose that they have a cumulative distribution function (cdf) F, assumed to be  $N(\mu, \sigma^2)$ , the maximum likelihood estimator (MLE) is  $\bar{x} = \int u dF_n(u) = T(F_n)$ , where  $F_n(u) = n^{-1} \sum_{i=1}^n I(x_i \leq u)$ , and  $\mu = \int u dF(u) = T(F)$ . Qualitative robustness asks here the question: how well will  $\mu$  be estimated if the true distribution is in some neighborhood of F? Quantitative robustness would concentrate on: will  $T(F_n)$  be bounded if some observations  $x_i \to \infty$ ? In fact, the last question is easy to answer: if  $x_i \to \infty$  for some  $i, T(F_n) = \bar{x} \to \infty$  as well. So we can say here in a loose sense that  $\bar{x}$  is not quantitatively robust.

#### Formalities

In the following we present a mathematical setup that allows us to formalize the robustness thoughts.

The notion of the sensitivity of an estimator T is put into theory by considering a model characterized by a cdf F and its neighborhood  $\mathcal{F}_{\varepsilon,G}$ : distributions  $(1-\varepsilon)F + \varepsilon G$ , where  $\varepsilon \in (0, 1/2)$  and G is an arbitrary probability distribution, which represents data contamination. Hence, not all data necessarily follow the pre-specified distribution, but the  $\varepsilon$ -part of data can come from a different distribution G. If  $H \in \mathcal{F}_{\varepsilon,G}$ , the estimation method T is then judged by how sensitive or robust are the estimates T(H) to the size of  $\mathcal{F}_{\varepsilon,G}$ , or alternatively, to the distance from the assumed cdf F. Two main concepts for robust measures analyze the sensitivity of an estimator to infinitesimal deviations,  $\varepsilon \to 0$ , and to finite (large) deviations,  $\varepsilon > 0$ , respectively. Despite generality of the concept, easy interpretation and technical difficulties often limit our choice to point-mass distributions (Dirac measures)  $G = \delta_x, x \in \mathbb{R}$ , which simply represents an (erroneous) observation at point  $x \in \mathbb{R}$ . This simplification is also used in the following text. The influence of infinitesimal contamination on an estimator is characterized by the *influence function*, which measures the relative change in estimates caused by an infinitesimally small amount  $\varepsilon$  of contamination at x(Hampel et al., 1986). More formally,

$$IF(x;T,F) = \lim_{\varepsilon \to 0} \frac{T\{(1-\varepsilon)F + \varepsilon\delta_x\} - T(F)}{\varepsilon}.$$
 (1)

For each point x, the influence function reveals the rate at which the estimator T changes if a wrong observation appears at x. In the case of sample mean  $\bar{x} = T(F_n)$  for  $\{x_i\}_{i=1}^n$ , we obtain

$$IF(x;T,F_n) = \lim_{\varepsilon \to 0} \left[ (1-\varepsilon) \int u dF_n(u) + \varepsilon \int u d\delta_x(u) - \int u dF_n(u) \right] / \varepsilon$$
$$= \lim_{\varepsilon \to 0} \left[ -\int u dF_n(u) + \int u d\delta_x(u) \right] = x - \bar{x}.$$

The influence function allows us to define various desirable properties of an estimation method. First, the largest influence of contamination on estimates can be formalized by the *gross-error sensitivity*,

$$\gamma(T,F) = \sup_{x \in \mathbb{R}} IF(x;T,F), \qquad (2)$$

which under robustness considerations be finite and small. Even though such a measure can depend on F in general, the qualitative results (e.g.,  $\gamma(T, F)$ being bounded) are typically independent of F. Second, the sensitivity to small changes in data, for example moving an observation from x to  $y \in \mathbb{R}$ , can be measured by the *local-shift sensitivity* 

$$\lambda(T,F) = \sup_{x \neq y} \frac{\|IF(x;T,F) - IF(y;T,F)\|}{\|x - y\|}.$$
(3)

Also this quantity should be relatively small since we generally do not expect that small changes in data cause extreme changes in values or sensitivity of estimates. Third, as an unlikely large or distant observations may represent data errors, their influence on estimates should become zero. Such a property is characterized by the *rejection point*,

$$\rho(T, F) = \inf_{r>0} \{ r : IF(x; T, F) = 0, \|x\| \ge r \},$$
(4)

which indicates the non-influence of large observations.

Alternatively, behavior of the estimator T can be studied for any finite amount  $\varepsilon$  of contamination. The most common property looked at in this context is the estimator's bias  $b(T, H) = E_H\{T(H)\} - E_F\{T(F)\}$ , which measures a distance between the estimates for clean data, T(F), and contaminated data,  $T(H), H \in \mathcal{F}_{\varepsilon,G}$ . The corresponding maximum-bias curve measures the maximum bias of T on  $\mathcal{F}_{\varepsilon,G}$  at any  $\varepsilon$ :

$$B(\varepsilon, T) = \sup_{x \in \mathbb{R}} b\{T, (1 - \varepsilon)F + \varepsilon \delta_x\}.$$
(5)

Although the computation of this curve is rather complex, Berrendero and Zamar (2001) provide general methodology for its computation in the context of linear regression.

The maximum-bias curve is not only useful on its own, but allows us to define further scalar measures of robustness. The most prominent is the *breakdown point* (Hampel, 1971), which is defined as the smallest amount  $\varepsilon$  of contamination that can cause an infinite bias:

$$\varepsilon^*(T) = \inf_{\varepsilon \ge 0} \{ \varepsilon : B(\varepsilon, T) = \infty \}.$$
(6)

The intuitive aim of this definition specifies the breakdown point  $\varepsilon^*(T)$  as the smallest amount of contamination that makes the estimator T useless. Note that in most cases  $\varepsilon^*(T) \leq 0.5$  (He and Simpson, 1993). This definition and the upper bound however apply only in simple cases, such as location or linear regression estimation (Davies and Gather, 2005). The most general definition of breakdown point formalizes the idea of "useless" estimates in the following way: an estimator is said to break down if, under contamination, it is not random anymore, or more precisely, it can achieve only a finite set of values (Genton and Lucas, 2003). This definition is based on the fact that estimates are functions of observed random samples and are thus random quantities themselves unless they fail. Although the latter definition includes the first one, the latter one may generally depend on the underlying model F, for example in time-series context.

### 2 Estimation approaches

Denote by  $F_n$  an empirical distribution function (edf) corresponding to a sample  $\{x_i\}_{i=1}^n \in \mathbb{R}$  drawn from a model based on probability distribution F. Most estimation methods can be defined as an extremum problem, minimizing a contrast  $\int h(z,\theta)dF(z)$  over  $\theta$  in a parameter space, or as a solution of an equation,  $\int g(z,\theta)dF(z) = 0$  in  $\theta$ . The estimation for a given sample utilizes finite-sample equivalents of these integrals,  $\int h(z,\theta)dF_n(z)$  and  $\int g(z,\theta)dF_n(z)$ , respectively.

Consider the pure location model  $X_i = \mu + \sigma \varepsilon_i$ , i = 1, ..., n, with a known scale  $\sigma$  and  $\varepsilon \sim F$ . The cdf of X is then  $F\{(x - \mu)/\sigma\}$ . With a quadratic contrast function  $h(x, \theta) = (x - \theta)^2$ , the estimation problem is to minimize  $\int (x - \theta)^2 dF\{(x - \mu)/\sigma\}$  with respect to  $\theta$ . For known F, this leads to  $\theta = \mu$ and one sees that, without loss of generality, one can assume  $\mu = 0$  and  $\sigma = 1$ . For the sample  $\{x_i\}_{i=1}^n$  characterized by edf  $F_n$ , the location parameter  $\mu$  is estimated by

$$\hat{\mu} = \underset{\theta}{\arg\min} \int (x-\theta)^2 dF_n(x) = n^{-1} \sum_{i=1}^n x_i = \bar{x}$$

Note that for  $g(x, \theta) = x - \theta$ , the parameter  $\mu$  is the solution to  $\int g(x, \theta) dF(x) = 0$ . The estimator may therefore be alternatively defined through  $\mu = T(F) = \int u dF(u)$ .

As indicated in the introduction, this standard estimator of location performs unfortunately rather poorly under the sketched contamination model. Estimating a population mean by the least squares (LS) or sample mean  $\bar{x} = T(F_n)$  has the following properties. First, the influence function (1)

$$IF(x;T,F) = \lim_{\varepsilon \to 0} \frac{T\{(1-\varepsilon)F + \varepsilon\delta_x\} - T(F)}{\varepsilon}$$
  
= 
$$\lim_{\varepsilon \to 0} \frac{\{(1-\varepsilon)\int udF(u) + \varepsilon x\} - \int udF(u)}{\varepsilon}$$
  
= 
$$\lim_{\varepsilon \to 0} \varepsilon^{-1}\{-\varepsilon\int udF(u) + \varepsilon x\}$$
  
= 
$$x - \int udF(u) = x - T(F).$$

Hence, the gross-error sensitivity (2)  $\gamma(T, F) = \infty$ , the local-shift sensitivity (3)  $\lambda(T, F) = 0$ , and the rejection point (4)  $\rho(T, F) = \infty$ . Second, the maximum-bias (5) is infinite for any  $\varepsilon > 0$  since

$$\sup_{x \in \mathbb{R}} \|T\{(1-\varepsilon)F + \varepsilon\delta_x\} - T(F)\| = \sup_{x \in \mathbb{R}} \|-\varepsilon T(F) + \varepsilon x\| = \infty.$$

Consequently, the breakdown point (6) of the sample mean  $\bar{x} = T(F_n)$  is zero,  $\varepsilon^*(T) = 0$ .

Thus, none of robustness measures characterizing the change of T under contamination of data (even infinitesimally small) is finite. This behavior, typical for LS-based methods, motivated alternative estimators that have the desirable robust properties. In this section, the M-estimators, S-estimators, and  $\tau$ -estimators are discussed as well as some extensions and combination of these approaches. Even though there is a much wider range of robust estimation principles, we focus on those already studied and adopted in various areas of econometrics.

#### 2.1 *M*-estimators

To achieve more flexibility in accommodating requirements on robustness, Huber (1964) proposed the *M*-estimator by considering a general extremum estimator based on  $\int \rho(z,\theta)dF(z)$ , thus minimizing  $\int \rho(z,\theta)dF_n(z)$  in finite samples. Providing that the first derivative  $\psi(z,\theta) = \partial \rho(z,\theta)/\partial \theta$  exists, an *M*-estimator can be also defined by an implicit equation  $\int \psi(z,\theta)dF_n(z) = 0$ .

This extremely general definition is usually adopted to a specific estimation problem such as location, scale, or regression estimation. In a univariate location model, F(z) can be parametrized as  $F(z - \theta)$  and hence one limits  $\rho(z,\theta)$  and  $\psi(z,\theta)$  to  $\rho(z - \theta)$  and  $\psi(z - \theta)$ . In the case of scale estimation,  $F(z) = F(z/\theta)$  and consequently  $\rho(z,\theta) = \rho(z/\theta)$  and  $\psi(z,\theta) = \psi(z/\theta)$ . In linear regression, z = (x, y) and a zero-mean error term  $\varepsilon = y - x^{\top}\theta$ . Analogously to the location case, one can then consider  $\rho(z,\theta) = \rho(y - x^{\top}\theta)$ and  $\psi(z,\theta) = \psi(y - x^{\top}\theta)x$ , or more generally,  $\rho(z,\theta) = \rho(y - x^{\top}\theta,x)$  and  $\psi(z,\theta) = \psi(y - x^{\top}\theta,x)$  (GM-estimators). Generally, we can express  $\rho(z,\theta)$ as  $\rho\{\eta(z,\theta)\}, \psi\{\eta(z,\theta)\}$ , where  $\eta(z,\theta) \sim F$ .

Some well-known choices of univariate objective functions  $\rho$  and  $\psi$  are given in Table 1; functions  $\rho(t)$  are usually assumed to be non-constant, nonnegative, even, and continuously increasing in |t|. This documents flexibility of the concept of *M*-estimators, which include LS and quantile regression as special cases.

On the other hand, many of the  $\rho$  and  $\psi$  functions in Table 1 depend

= 1000000000000000000000000000000000000		
	ho(t)	$\psi(t)$
Least squares	$t^2$	2t
Least absolute deviation	t	$\operatorname{sign}(t)$
Quantile estimation	$\{\tau - I(x < 0)\}x$	$\tau - I(x < 0)$
Huber: for $ t  \le c$	$t^2$	2t
for $c <  t $	c t	$c \operatorname{sign}(t)$
Hampel: for $ t  \leq a$	$t^2$	2t
for $a <  t  \le b$	a t	$a \operatorname{sign}(t)$
for $b <  t  \le c$	$\frac{ac}{c-b}t - \frac{a}{c-b}t^2\operatorname{sign}(t)$	a(c- t )/(c-b)
for $c <  t $	a t	0
Biweight (Tukey)	$-(c^2 - t^2)^3 I( t  \le c)/6$	$t(c^2 - t^2)^2 I( t  \le c)$
Sine (Andrews)	$-c\cos(x/c)I( t  \le \pi c)$	$\sin(x/c)I( t  \le \pi c)$

Table 1: Examples of  $\rho$  and  $\psi$  functions used with *M*-estimators.

on one or more constants  $a, b, c \in \mathbb{R}$ . If an estimator T is to be invariant to the scale of data, one can apply the estimator to rescaled data, that is, to minimize  $\int \rho\{(z-\theta)/s\}dF_n(z)$  or to solve  $\int \psi\{(z-\theta)/s\}dF_n(z) = 0$  for a scale estimate s like the median absolute deviation (MAD). Alternatively, one may also estimate parameters  $\theta$  and scale s simultaneously by considering  $\rho(z, \{\theta, s\}) = \rho\{(z-\theta)/s\}$  or

$$\psi(z, \{\theta, s\}) = \{\psi_l(z, \{\theta, s\}), \psi_s(z, \{\theta, s\})\}.$$

Let us now turn to the question how the choice of functions  $\rho$  and  $\psi$  determines the robust properties of M-estimators. First, the influence function of an M-estimator can generally depend on several quantities such as its asymptotic variance or the position of explanatory variables in the regression case, but the influence function is always proportional to function  $\psi(z, b)$ . Thus, the finite gross-error sensitivity,  $\gamma(T, F) < \infty$ , requires bounded  $\psi(t)$  (which is not the case of LS). Similarly, the finite rejection point,  $\rho(T, F) < \infty$ , leads to  $\psi(t)$  being zero for all sufficiently large t (the M-estimators defined by such a  $\psi$ -function are called redescending). Hampel et al. (1986) shows how, for a given bound on  $\gamma(T, F)$ , one can determine the most efficient choice of  $\psi$  function (e.g., the skipped median,  $\psi(t) = \operatorname{sign}(t)I(|t| < K), K > 0$ , in the location case).

More formally, the optimality of M-estimators in the context of qualitative robustness can be studied by the *asymptotic relative efficiency* (ARE) of an estimator  $\hat{\theta}^1$  relative to another estimator  $\hat{\theta}^2$ :

$$ARE(\hat{\theta}^1, \hat{\theta}^2) = \frac{\text{as. } \operatorname{var}(\theta^1)}{\text{as. } \operatorname{var}(\hat{\theta}^2)}.$$
(7)

For example, at the normal distribution with  $\hat{\theta}^1$  and  $\hat{\theta}^2$  being the least absolute deviation (LAD) and LS estimators, ARE equals  $2/\pi \approx 0.64$ . Under the Student cdf  $t_5$ , the ARE of the two estimators climbs up to  $\approx 0.96$ . For Huber's M-estimator, we see that its limit cases are the median for  $c \to 0$ and the mean for  $c \to \infty$ . At the normal distribution and for c = 1.345, we have ARE of about 0.95. This means that this *M*-estimator is almost as efficient as MLE, but does not lose so drastically in performance as the standard mean under contamination because of the bounded influence function.

Whereas the influence function of M-estimators is closely related to the choice of its objective function, the global robustness of M-estimators is in a certain sense independent of this choice. Maronna et al. (1979) showed in linear regression that the breakdown point of M-estimators is bounded by 1/p, where p is the number of estimated parameters. As a remedy, several authors proposed *one-step* M-estimators that are defined, for example, as the first step of the iterative Newton-Raphson procedure, used to minimize  $\int \rho(z,\theta) dF(z)$ , started from initial robust estimators  $\hat{\theta}^0$  of parameters and  $\hat{s}^0$  of scale (see Welsh and Ronchetti, 2002, for an overview). Possible initial estimators can be those discussed in Sections 2.2 and 2.3. For example for an M-estimator of location  $\hat{\theta}$  defined by a function  $\psi(x,\theta) = \psi(x - \theta)$ , its

one-step counterpart can be defined at sample  $\{x_i\}_{i=1}^n$  by

$$\hat{\theta} = \hat{\theta}^0 + \hat{s}^0 \sum_{i=1}^n \psi\left(\frac{x_i - \hat{\theta}^0}{\hat{s}^0}\right) \left/ \sum_{i=1}^n \psi'\left(\frac{x_i - \hat{\theta}^0}{\hat{s}^0}\right),\right.$$

where  $\hat{\theta}^0$  and  $\hat{s}^0$  represent initial robust estimators of location and scale like the median and MAD, respectively. Such one-step estimators, under certain conditions on the initial estimators, preserve the breakdown point of the initial estimators, and at the same time, have the same first-order asymptotic distribution as the original *M*-estimator (Simpson et al., 1992, and Welsh and Ronchetti, 2002). Further development of such ideas include an adaptive choice of parameters of function  $\psi$  in the iterative step (Gervini and Yohai, 2002).

#### 2.2 S-estimators

An alternative approach to *M*-estimators achieving high breakdown point (HBP) was proposed by Rousseeuw and Yohai (1984). The *S*-estimators are defined by minimization of a scale statistics  $s^2(z, b) = s\{\eta(z, b)\}$  defined as the *M*-estimate of scale,

$$\int \rho[\eta(z,b)/s\{\eta(z,b)\}]dF_n(z) = K = \int \rho(t)dF(t),$$

at the model distribution F; the functions  $\rho$  and  $\eta$  are those defining Mestimators in Section 2.1. More generally, one can define S-estimators by means of any scale-equivariant statistics  $s^2$ , that is,  $s\{c\eta(z,b)\} = |c|s\{\eta(z,b)\}$ . Under this more general definition, S-estimators include as special cases LS and LAD estimators. Further, they encompass several well-known robust methods including least median of squares (LMS) and least trimmed squares (LTS): whereas the first defines the scale statistics  $s^2\{\eta(z,b)\}$  as the median of squared residuals  $\eta(z,b)$ , the latter used the scale defined by the sum of h smallest residuals  $\eta(z,b)$ . In order to appreciate the difference to Mestimators, it is worth pausing for a moment and to present LMS, the most prominent representative of S-estimators, in the location case:

$$\underset{\theta}{\operatorname{arg\,min\,med}} \{(x_1 - \theta)^2, \dots, (x_n - \theta)^2\}.$$

Due to its definition, the S-estimators have the same influence function as the M-estimator constructed from the same function  $\rho$ . Contrary to Mestimators, they can achieve the highest possible breakdown point  $\varepsilon^* = 0.5$ . For example, this is the case of LMS and LTS. For Gaussian data, the most efficient (in the sense of ARE (7) among the S-estimators with  $\varepsilon^* = 0.5$  is however the one corresponding to K = 1.548 and  $\rho$  being the Tukey biweight function, see Table 1. Given the HBP of S-estimators, their maximum-bias behavior is of interest too. Although it depends on the function  $\rho$  and constant K (Berrendero and Zamar, 2001), Yohai and Zamar (1993) proved that LMS minimizes maximum bias among a large class of (residual admissible) estimators, which includes most robust methods.

An important shortcoming of HBP S-estimation is however its low ARE: under Gaussian data, efficiency relative to LS varies from 0% to 27%. Thus, S-estimators are often used as initial estimators for other, more efficient methods. Nevertheless, if an S-estimator is not applied directly to sample observations, but rather to the set of all pairwise differences of sample observations, the resulting generalized S-estimator exhibits higher relative efficiency for Gaussian data, while preserving its robust properties (Croux et al., 1994; Stromberg et al., 2000).

#### 2.3 $\tau$ -estimators

The S-estimators improve upon M-estimators in terms of their breakdownpoint properties, but at the cost of low Gaussian efficiency. Although onestep M-estimators based on an initial S-estimate can remedy this deficiency to a large extent, their exact breakdown properties are not known. One of alternative approaches, proposed by Yohai and Zamar (1988), extend the principle of S-estimation in the following way. Assuming that  $\rho_1$  and  $\rho_2$ are non-negative, even, and continuous functions, the M-estimate  $s^2(z, \theta) =$  $s^2\{\eta(z, \theta)\}$  of scale can be defined as in the case of S-estimation,

$$\int \rho_1[\eta(z,\theta)/s\{\eta(z,\theta)\}]dF_n(z) = K = \int \rho_1(t)dF(t).$$

Next, the  $\tau$ -estimate of scale is defined by

$$\tau^2(z,\theta) = s^2\{\eta(z,\theta)\} \int \rho_2[\eta(z,\theta)/s\{\eta(z,\theta)\}] dF_n(z)$$

and the corresponding  $\tau$ -estimator of parameters  $\theta$  is then defined by minimizing the  $\tau$ -estimate of scale,  $\tau^2(z, \theta)$ . As a generalization of S-estimation, the  $\tau$ -estimators include S-estimators as a special case for  $\rho_1 = \rho_2$  because then  $\tau^2(z,\theta) = \theta s^2(z,\theta)$ . On the other hand, if  $\rho_2(t) = t^2$ ,  $\tau^2(z,\theta) = \int \eta^2(z,\theta) dF_n(z)$  is just the standard deviation of model residuals. Compared to S-estimators, the class of  $\tau$  estimators can improve in terms relative Gaussian efficiency because its breakdown depends only on function  $\rho_1$ , whereas its asymptotic variance is function of both  $\rho_1$ and  $\rho_2$ . Thus,  $\rho_1$  can be defined to achieve the breakdown point equal to 0.5 and  $\rho_2$  consequently adjusted to reach a pre-specified relative efficiency for Gaussian data (e.g., 95%).

## 3 Methods of robust econometrics

The concepts and methods of robust estimation discussed in Sections 1 and 2 are typically proposed in the context of a simple location or linear regression models, assuming independent, continuous, and identically distributed random variables. This however rarely corresponds to assumptions typical for most econometric models. In this section, we therefore present an overview of developments and extensions of robust methods to various econometric models. As the *M*-estimators are closest to the commonly used LS and MLE, most of the extensions employ *M*-estimation. The HBP techniques are not that frequently found in the economics literature (Zaman et al., 2001; Sapra, 2003) and are mostly applied only as a diagnostic tool.

In the rest of this section, robust estimation is first discussed in the

context of models with discrete explanatory variables, models with timedependent observations, and models involving multiple equations. Later, robust alternatives to general estimation principles, such as MLE and generalized method of moments (GMM), are discussed. Before doing so, let us mention that dangers of data contamination are not only studied only from the theoretical point of view. There is a number of studies that check the presence of outliers in real data and their influence on estimation methods. For example, there is evidence of data contamination and its adverse effects on LS and MLE in the case of macro economic time series (Balke and Fomby, 1994; Atkinson, Koopman, and Shephard, 1997), in financial time series (Sakata and White, 1998; Franses, van Dijk, and Lucas, 2004), marketing data (Franses, Kloek, and Lucas, 1999), and many other areas. These adverse effects include biased estimates, masking of structural changes, and creating seemingly nonlinear structures, for instance.

#### 3.1 Discrete variables

To achieve a HBP, many robust methods such as LMS often eliminate a large portion of observations from the calculation of their objective function. This can cause non-identification of parameters associated with categorical variables. For example, having data on income  $\{y_i\}_{i=1}^n$  of men and women, where gender is indicated by  $\{d_i\}_{i=1}^n \in \{0,1\}$ , one can estimate the mean income of men and women by a simple regression model  $y_i = a + bd_i$ . If a HBP method such as LMS or LTS is used to estimate the model and it eliminates a large portion of observations from the calculation (e.g., one half of them), the remaining data could easily contain only income of men or only income of women, and consequently, the mean income of one of the groups could not be then identified. Even though this seems unlikely in our simple example, it becomes more pronounced as the number of discrete variables grows, see Hubert and Rouseeuw (1997) for an example.

A common strategy employs a robust estimator with a HBP for a model with only continuous variables, and using this initial estimate, the model with all variables is estimated by an M-estimator. Such a combined procedure preserves the breakdown point of the HBP estimator: even though a misclassified values of categorical explanatory variables can bias the estimates, this bias will be bounded in common models as the categorical variables are bounded as well. See Hubert and Rousseeuw (1997) and Maronna and Yohai (2000), who combine an initial S-estimator with an M-estimator.

#### 3.2 Time series

In time series, there are several issues not addressed by the standard theory of robust estimation because of time-dependency of observations. First, the asymptotic behavior of various robust methods has to be established; see Koenker and Machado (1999), Koenker and Xiao (2002) for  $L_1$  regression, Künsch (1984) and Bai (1997) for *M*-estimators and Sakata and White (2001), Zinde-Walsh (2002), and Čížek (2005) for various S-type estimators. In these cases, the results are usually established for general nonlinear models.

Second, the effects of data contamination are more complex and wide spread due to time-dependency: an error in one observation is transferred, by means of a model, to other ones close in time. The possible effects of outliers in time series are elaborated by Chen and Liu (1993) and Tsay et al. (2000), for instance. The first work also offers a sequential identification of outliers (an alternative procedure based on  $\tau$ -estimators is offered by Bianco et al., 2001). Consequently, the robust properties in time series differ from those experienced in cross-sectional data. For example, the breakdown point is asymptotically zero in the case of *M*-estimators (Sakata and White, 1995) and can be much below 0.5 for various *S*-estimators (Genton and Lucas, 2003).

A further issue specific to time series is testing for stationarity of a series. Effects of outliers are in this respect similar to those of neglected structural changes. To differentiate between random outliers and real structural changes, robust tests for change-point detection were proposed by Gagliardini et al. (2005), Fiteni (2002), and Fiteni (2004); the last paper uses  $\tau$ estimation. The asymptotics of *M*-estimators under unit-root assumption and the corresponding tests were established, for example, by Lucas (1995), Koenker and Xiao (2004), and Haldrup et al. (2005). An early reference is Franke et al. (1984).

#### 3.3 Multivariate regression

An important application of robust methods in economics concerns the multivariate regression case. This is relatively straightforward with exogenous explanatory variables only, see Koenker and Portnoy (1990), Bilodeau and Duchesne (2000), and Lopuhaä (1992) for the M-, S-, and  $\tau$ -estimation, respectively. Estimating general simultaneous equations models has to mimick either three-stage LS or full information MLE (Marrona and Yohai, 1997). Whereas Koenker and Portnoy (1990) follow with the weighted LAD the first approach, Krishnakumar and Ronchetti (1997) use M-estimation together with the second strategy.

#### 3.4 General estimation principles

There are naturally many more model classes, for which one can construct robust estimation procedures. Since most econometric models can be estimated by means of MLE or GMM, it is however easier to concentrate on robust counterparts of these two estimation principles. There are other estimation concepts, such as nonparametric smoothing, that can employ robust estimation (Härdle, 1982), but they go beyong the scope of this chapter.

First, recent contributions to robust MLE can be split to two groups. One simply defines a weighted maximum likelihood, where weights are computed from an initial robust fit (Windham, 1995; Markartou et al., 1997). Alternatively, some erroneous observations can be excluded completely from the likelihood function (Clarke, 2000; Marazzi and Yohai, 2004). This approach requires existence of an initial robust estimate, and thus, it is not useful for models, for which there are no robust methods available. The second approach is motivated by the *S*-estimation, namely LTS, and defines the maximum trimmed likelihood as an estimator maximizing the product of the *h* largest likelihood contribution; that is, those corresponding only to *h* most likely observations (Hadi and Luceno, 1997). This estimator was studied mainly in the context of generalized linear models (Müller and Neykov, 2003), but its consistency is established in a much wider class of models (Čížek, 2004).

Second, more widely used GMM also attracted attention from its robustness point of view. A special case, instrumental variable estimation, was studied, for example, by Wagenvoor and Waldman (2002) and Kim and Muller (2006). See also Chernozhukov and Hansen (2006) for instrumental variable quantile regression. More generally, Ronchetti and Trojani (2001) proposed an *M*-estimation-based generalization of GMM, studied its robust properties, and design corresponding tests. This work became a starting point for others, who extended the methodology of Ronchetti and Trojani (2001) to robustify simulation-based methods of moments (Genton and Ronchetti, 2003; Ortelli and Trojani, 2005).

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