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Working Paper, No. 2021:9

**Provided in Cooperation with:** Department of Economics, School of Economics and Management, Lund University

*Suggested Citation:* Stauskas, Ovidijus (2021) : Uniform Theory for CCE under Heterogeneous Slopes and General Unknown Factors, Working Paper, No. 2021:9, Lund University, School of Economics and Management, Department of Economics, Lund

This Version is available at: https://hdl.handle.net/10419/260329

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# Uniform Theory for CCE Under Heterogeneous Slopes and General Unknown Factors

**Ovidijus Stauskas** 

May 2021



# Uniform Theory for CCE Under Heterogeneous Slopes and General Unknown Factors

Ovidijus Stauskas\*

May 18, 2021

#### Abstract

A recent study proposed by Westerlund (CCE in Panels with General Unknown Factors, Econometrics Journal, 21, 264-276, 2018) showed that a very popular Common Correlated Effects (CCE) estimator is significantly more applicable than it was thought before. Contrary to the usual stationarity assumption, common factors can in fact be much more general and not only unit root. This also helps to alleviate the uncertainty over deterministic model components since they can be treated as unknown, similarly to unobserved stochastic factors. While very promising, these theoretical results concern only the pooled (CCEP) version of the estimator for the homogeneous parameters, which does no take heterogeneous effects into account. Therefore, it is natural to generalize these findings to the case of unit-specific slopes. It is especially interesting, because many previous studies on heterogeneous slopes did not rigorously account for the usual situation when the factors are proxied by more explanatory variables than needed. As a result, the current setup introduces more uniformity to the CCE theory. We demonstrate that save for some regularity conditions, CCEP and the mean group (CCEMG) estimators are asymptotically normal and unbiased under heterogeneous slopes and general unknown factors.

### 1 Introduction

Consider the following panel data model often used in previous research (see e.g. Pesaran, 2006, or Karabiyik et al., 2017):

$$\mathbf{y}_i = \mathbf{X}_i \boldsymbol{\beta}_i + \mathbf{F} \boldsymbol{\gamma}_i + \boldsymbol{\varepsilon}_i \tag{1.1}$$

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$$\mathbf{X}_i = \mathbf{F} \mathbf{\Gamma}_i + \mathbf{V}_i, \tag{1.2}$$

where  $\mathbf{y}_i = [y_{i,1}, \dots, y_{i,T}]' \in \mathbb{R}^{T \times 1}$  for  $i = 1, \dots, N$ ,  $\mathbf{X}_i = [\mathbf{x}_{i,1}, \dots, \mathbf{x}_{i,T}]' \in \mathbb{R}^{T \times k}$  is the matrix of explanatory variables,  $\mathbf{V}_i = [\mathbf{v}_{i,1}, \dots, \mathbf{v}_{i,T}]' \in \mathbb{R}^{T \times k}$  and  $\boldsymbol{\varepsilon}_i = [\varepsilon_{i,1}, \dots, \varepsilon_{i,T}]' \in \mathbb{R}^{T \times}$  are matrix and vector of idiosyncratic errors and  $\mathbf{F} = [\mathbf{f}_1, \dots, \mathbf{f}_T]'$  is the matrix of unobservable common factors. Also,  $\mathbf{\Gamma}_i \in \mathbb{R}^{m \times k}$  and  $\gamma_i \in \mathbb{R}^{m \times 1}$  are individual-specific factor loadings and  $\boldsymbol{\beta}_i \in \mathbb{R}^{k+1}$  is the parameter vector of interest.

This is a setup of the so-called 'interactive effects' model, which helps to flexibly take unobserved heterogeneity in  $\mathbf{y}_i$  into account. While the standard 'fixed effects' models subsume heterogeneity into an additive unit– and time–specific constants, the current setup is much more general. This is because time– and unit–specific effects enter in a multiplicative way, and this allows for many time–specific (observed and unobserved) factors to which individuals respond differently through the loadings.<sup>1</sup> Moreover, because the factors can be stochastic, this gives a way to model cross-section dependence.

Clearly, examination of (1.1)–(1.2) reveals that estimation of  $\beta_i$  is problematic due to unobserved **F**. Using the structure of (1.1)–(1.2), we obtain a system

$$\mathbf{Z}_i = \mathbf{F}\mathbf{C}_i + \mathbf{U}_i,\tag{1.3}$$

where  $\mathbf{Z}_i = [\mathbf{y}_i, \mathbf{X}_i] \in \mathbb{R}^{T \times (k+1)}$ ,  $\mathbf{C}_i = \widetilde{\mathbf{C}}_i \mathbf{B}_i = [\gamma_i, \Gamma_i] \mathbf{B}_i = [\Gamma_i \beta_i + \gamma_i, \Gamma_i] \in \mathbb{R}^{m \times (k+1)}$  and  $\mathbf{U}_i = \widetilde{\mathbf{U}}_i \mathbf{B}_i = [\varepsilon_i, \mathbf{V}_i] \mathbf{B}_i = [\mathbf{V}_i \beta_i + \varepsilon_i, \mathbf{V}_i] \in \mathbb{R}^{T \times (k+1)}$ , where

$$\mathbf{B}_i = \begin{bmatrix} 1 & \mathbf{0}_{1 \times k} \\ \boldsymbol{\beta}_i & \mathbf{I}_k \end{bmatrix}.$$

This is known as static factor model, where following common correlated effects (CCE) procedure by Pesaran (2006), the estimator of **F** is given by

$$\widehat{\mathbf{F}} = \overline{\mathbf{Z}} = \mathbf{F}\overline{\mathbf{C}} + \overline{\mathbf{U}},\tag{1.4}$$

where  $\overline{\mathbf{A}} = \frac{1}{N} \sum_{i=1}^{N} \mathbf{A}_i$  is the cross-section average of arbitrary matrices  $\mathbf{A}_i$  for i = 1, ..., N. It is known that as  $N \to \infty$ ,  $\overline{\mathbf{U}} \to_p \mathbf{0}_{T \times (k+1)}$  under various empirically relevant assumptions (see e.g. Pesaran and Tosetti, 2011), where  $' \to_p'$  represents convergence in probability. Hence,  $\widehat{\mathbf{F}}$  is consistent for the space spanned by  $\mathbf{F}$ , which is sufficient to control their effect.

<sup>&</sup>lt;sup>1</sup>In fact, letting  $\mathbf{F} = [\mathbf{1}_T, \boldsymbol{\theta}]'$  and  $[a_i, 1]'$ , such that  $\mathbf{1}_T$  is a  $T \times 1$  vector of ones and  $\boldsymbol{\theta} = [\theta_1, \dots, \theta_T]'$  is a vector with time–specific parameters, we obtain  $\mathbf{F}\gamma_i = a_i\mathbf{1}_T + \boldsymbol{\theta}$ , thus fixed effects framework is a special case of the interactive effects.

As a result, we have two versions of CCE estimator, namely pooled (CCEP) and mean group (CCEMG):

$$\widehat{\boldsymbol{\beta}}_{P} = \left(\sum_{i=1}^{N} \mathbf{X}_{i}^{\prime} \mathbf{M}_{\widehat{F}} \mathbf{X}_{i}\right)^{-1} \sum_{i=1}^{N} \mathbf{X}_{i}^{\prime} \mathbf{M}_{\widehat{F}} \mathbf{y}_{i}, \qquad (1.5)$$

$$\widehat{\boldsymbol{\beta}}_{MG} = \frac{1}{N} \sum_{i=1}^{N} \widehat{\boldsymbol{\beta}}_{i} = \frac{1}{N} \sum_{i=1}^{N} (\mathbf{X}_{i}' \mathbf{M}_{\widehat{F}} \mathbf{X}_{i})^{-1} \mathbf{X}_{i}' \mathbf{M}_{\widehat{F}} \mathbf{y}_{i}, \qquad (1.6)$$

where  $\mathbf{M}_A = \mathbf{I}_T - \mathbf{P}_A = \mathbf{I}_T - \mathbf{A}(\mathbf{A}'\mathbf{A})^+\mathbf{A}'$  is a projection matrix for an arbitrary *T*-rowed matrix **A** and  $(\mathbf{A}'\mathbf{A})^+$  is the Moore-Penrose (MP) inverse of **A**'**A**. The estimator in (1.5) assumes that  $\boldsymbol{\beta}_i = \boldsymbol{\beta}$  for all i = 1, ..., N, while the one in (1.6) takes potential parameter heterogeneity into account. As was alluded in Pesaran (2006) and further extensively explored in Westerlund and Urbain (2015), CCEP estimator is asymptotically biased if  $\boldsymbol{\beta}_i = \boldsymbol{\beta}$  for all i = 1, ..., N is true, unless  $TN^{-1} \rightarrow 0$ . In fact, due to its complicated nature, this bias has attracted much attention within theoretical CCE literature (see e.g. Karabiyik et al., 2017, De Vos and Everaert, 2021, or De Vos and Stauskas, 2021).

On the other hand, if  $\beta_i$  is unit–specific, such that  $\beta_i = \beta + v_i$ , where  $v_i$  is mean-zero random variable, both (1.5) and (1.6) are asymptotically normal and unbiased with no restrictions on N, T expansion rate. The reason for such elegant property is the fact that the stochastic component  $v_i$  dominates the asymptotic distribution. The parameter heterogeneity assumption is very popular in applied literature, where individual-specific economic relationships are the focus, while it is important to control for possible unobserved heterogeneity and cross-section dependence. For instance, in macroeconomic setting this need arises in estimation of cross-country growth regressions (see e.g. Eberhardt and Teal, 2011, or Eberhardt and Presbitero, 2015) or analysis of real estate price elasticity (see e.g. Holly et al., 2010). An example from microeconomics is the average treatment effect (see Petrova and Westerlund, 2020).

The aim of the current study is to consider CCEP and CCEMG estimators and their convenient properties under  $\beta_i = \beta + v_i$  in the light of new theoretical findings that previously concerned mostly homogeneous  $\beta$ . Firstly, we focus on **F**, which was assumed to be stationary in the previous bulk of literature. In particular,  $T^{-1}\mathbf{F}'\mathbf{F}$  is usually assumed to have a constant positive definite limit. Although Kapetanios et al. (2011) allow unit root factors, such setup is rather specific and it ignores other empirically relevant scenarios. Instead, we adopt

the framework employed by Westerlund (2018) in case of homogeneous  $\beta$ . It allows many different candidates for **F** without any knowledge thereof, save for some regularity conditions which ensure that  $\mathbf{D}_{T,F}^{-1}\mathbf{F}'\mathbf{F}\mathbf{D}_{T,F}^{-1}$  has (almost surely) positive definite limit as  $T \to \infty$ , where the matrix  $\mathbf{D}_{T,F}$  will be described below together with our assumptions. Examples of such factors include (mixtures of) polynomial trends of finite order, stochastic series of finite integration order, (near) unit root series or stationary series with absolute summable autocovariances. This approach is especially convenient, as it alleviates uncertainty over the deterministic model components, since **F** can absorb the time specific components a researcher is unsure of.

Secondly, we derive the asymptotic distributions following Karabiyik et al. (2017), who showed that the asymptotic behavior of  $(\mathbf{D}_{T,\hat{F}}^{-1} \mathbf{\hat{F}}' \mathbf{\hat{F}} \mathbf{D}_{T,\hat{F}}^{-1})^+$  differs depending on whether m = k + 1 or m < k + 1. In the latter case, given that  $\boldsymbol{\beta}$  is homogeneous, we obtain extra nonestimable bias components as a price for the asymptotic boundedness of the second moment matrix. If, however, the slopes are heterogeneous, it turns out that the analysis is very different from the standard steps in Pesaran (2006) and that the higher moment conditions of the idiosyncratic components  $\mathbf{v}_{i,t}$  and  $\varepsilon_{i,t}$  are necessary to derive the asymptotic distributions. To our knowledge, De Vos and Stauskas (2021) were the first to address this previously unnoticed issue for CCEP and CCEMG. Therefore, it is important to understand how this new approach squares with non-stationary factors. As a result, we show that under individual specific coefficients both CCEP and CCEMG estimators are still asymptotically normal and unbiased given the general unknown factors. This further demonstrates a wide range of applicability of the CCE type estimators and provides a more uniform theoretical framework for the heterogeneous slope analysis.

#### 2 Assumptions

We state and discuss assumptions under which we work in this paper. Throughout the paper we use the following notation:  $rk(\mathbf{A})$  represents the rank of an arbitrary matrix  $\mathbf{A}$ , while  $vec(\mathbf{A})$  vectorizes  $\mathbf{A}$  by putting its columns on top of each other and  $\otimes$  stands for Kronecker product. Moreover,  $\|\mathbf{A}\| = \sqrt{tr(\mathbf{A}'\mathbf{A})}$  is the Frobenius (Euclidean) norm and  $tr(\mathbf{A})$  is the trace, while  $'\rightarrow_d'$  and  $'\Rightarrow'$  stand for convergence in distribution and weak convergence, respectively. Next,  $\mathbf{x}_n = O_p(a_n)$  means that a random vector sequence  $\mathbf{x}_n$  is at most of order  $a_n$  in probability, where  $a_n$  is some deterministic sequence, while  $\mathbf{x}_n = o_p(a_n)$  means it is

of smaller order in probability than  $a_n$ . Finally,  $M < \infty$  is some generic positive constant, which is not necessarily always of the same value when applied to different statements.

Assumption 1 (Idiosyncratic errors)  $\varepsilon_{i,t}$  and  $\mathbf{v}_{i,t}$  are stationary and independent across *i* with absolutesummable autocovariances,  $\mathbb{E}(\varepsilon_{i,t}) = 0$ ,  $\mathbb{E}(\mathbf{v}_{i,t}) = \mathbf{0}_{k\times 1}$ ,  $\sigma_i^2 = \mathbb{E}(\varepsilon_{i,t}^2)$ ,  $\Sigma_{\mathbf{V}_i} = \mathbb{E}(\mathbf{v}_{i,t}\mathbf{v}'_{i,t})$ ,  $\Omega_i = \mathbb{E}(\varepsilon_i\varepsilon'_i)$ , with  $\Omega_i$ ,  $\Sigma_{\mathbf{V}_i}$  positive definite and  $\mathbb{E}(\varepsilon_{i,t}^6) < M$ ,  $\mathbb{E}(||\mathbf{v}_{i,t}||^8) < M$  for all *i* and *t*. Moreover,  $\frac{1}{N}\sum_{i=1}^N \sigma_i^2 \to \sigma^2 < M$  and  $\frac{1}{N}\sum_{i=1}^N \Sigma_{\mathbf{V}_i} \to \Sigma_{\mathbf{V}}$  with  $||\Sigma_{\mathbf{V}}|| < M$  as  $N \to \infty$ , and we define  $\Sigma_{\mathbf{U}_i} = \mathbb{E}(\mathbf{u}_{i,t}\mathbf{u}'_{i,t}) = \mathbf{B}'\mathbb{E}(\widetilde{\mathbf{u}}_{i,t}\widetilde{\mathbf{u}}'_{i,t})\mathbf{B} = \mathbf{B}'\Sigma_{\widetilde{\mathbf{U}}_i}\mathbf{B}$  and  $\frac{1}{N}\sum_{i=1}^N \Sigma_{\mathbf{U}_i} \to \mathbf{B}'\Sigma_{\widetilde{\mathbf{U}}}\mathbf{B} = \Sigma_{\mathbf{U}}$  positive definite, where  $\Sigma_{\widetilde{\mathbf{U}}_i} = [[\sigma_i^2, \mathbf{0}_{1\times k}]', [\mathbf{0}_{k\times 1}, \Sigma_{\mathbf{V}_i}]']$  and  $\Sigma_{\widetilde{\mathbf{U}}} = [[\sigma^2, \mathbf{0}_{1\times k}]', [\mathbf{0}_{k\times 1}, \Sigma_{\mathbf{V}_i}]']$  and  $\mathbf{B}$  comes from  $\mathbf{B}_i = \mathbf{B} + \widetilde{\mathbf{B}}_i$ , such that  $\widetilde{\mathbf{B}}_i = [[0, \mathbf{v}_i]', [\mathbf{0}_{k\times 1}, \mathbf{0}_{k\times k}]']$ .

**Assumption 2** (Common factors) Consider the  $m \times m$  matrix  $\mathbf{D}_{T,F} = \text{diag}(T^{p_1}, ..., T^{p_m})$  with  $p_j \ge 1/2$  for all j. Given this matrix, the following holds:

- (*i*)  $T^{\kappa} \cdot \mathbb{E}(\|\mathbf{D}_{T,F}^{-1}\mathbf{F}'\mathbf{F}\mathbf{D}_{T,F}^{-1} \mathbf{\Sigma}_F\|^2) \leq M$  for some  $\kappa > 0$  and some  $m \times m$  matrix  $\mathbf{\Sigma}_F$ , which is such that  $\mathbb{E}(\|\mathbf{\Sigma}_F\|^2) \leq M$  and  $\mathbb{P}(\mathrm{rk}(\mathbf{\Sigma}_F) = m) = 1$ .
- (*ii*)  $N \cdot \mathbb{E}(\|\mathbf{D}_{T,F}^{-1}\mathbf{F}'\overline{\mathbf{V}}\|^2) \leq M$  and  $\mathbb{E}(\|\mathbf{D}_{T,F}^{-1}\mathbf{F}'\mathbf{V}_i\|^2) \leq M$  for all *i*. The same is true when  $\overline{\mathbf{V}}$  and  $\mathbf{V}_i$  are replaced by  $\overline{\mathbf{\varepsilon}}$  and  $\mathbf{\varepsilon}_i$ , respectively.

**Assumption 3** (Factor loadings) The  $C_i$  are generated according to

$$\mathbf{C}_{i} = \widetilde{\mathbf{C}}_{i} \mathbf{B}_{i} = (\widetilde{\mathbf{C}} + \widetilde{\boldsymbol{\eta}}_{i}) \mathbf{B}_{i} = \mathbf{C} + \boldsymbol{\eta}_{i}, \qquad \operatorname{vec}(\widetilde{\boldsymbol{\eta}}_{i}) \sim \operatorname{IID}(\mathbf{0}_{m(1+k)}, \boldsymbol{\Omega}_{\widetilde{\boldsymbol{\eta}}}), \qquad (2.1)$$

where  $\widetilde{\mathbf{C}} = \mathbb{E}(\widetilde{\mathbf{C}}_i) = [\gamma, \Gamma], \Omega_{\widetilde{\eta}} = \mathbb{E}(\operatorname{vec}(\widetilde{\eta})\operatorname{vec}(\widetilde{\eta})')$  positive definite and  $\|\widetilde{\mathbf{C}}\|, \|\Omega_{\widetilde{\eta}}\| < M$ .

**Assumption 4** (*Rank condition*) If m < k + 1, then  $\overline{\mathbf{C}} = [\overline{\mathbf{C}}_m, \overline{\mathbf{C}}_{-m}]$ , where  $\overline{\mathbf{C}}_m$  and  $\overline{\mathbf{C}}_{-m}$  are  $m \times m$  and  $m \times (k + 1 - m)$ , respectively, whereas if m = k + 1, then  $\overline{\mathbf{C}} = \overline{\mathbf{C}}_m$ . In both cases,  $\operatorname{rk}(\overline{\mathbf{C}}_m) = m$  and  $\|\overline{\mathbf{C}}\| \leq M$ .

**Assumption 5** (Independence)  $\mathbf{f}_t, \varepsilon_{i,s}, \mathbf{v}_{j,l}, \widetilde{\boldsymbol{\eta}}_n$  are mutually independent for all i, j, n, t, s, l.

Assumption 6 (Slope heterogeneity) The heterogeneous slope coefficients follow

 $\boldsymbol{\beta}_i = \boldsymbol{\beta} + \boldsymbol{v}_i, \quad \boldsymbol{v}_i \sim IID(\boldsymbol{0}_{k \times 1}, \boldsymbol{\Omega}_{\boldsymbol{v}_i})$ 

with  $\Omega_{v_i}$  a finite nonnegative definite  $k \times k$  matrix such that  $\frac{1}{N} \sum_{i=1}^{N} \Omega_{v_i} \rightarrow \Omega_v$  and the  $v_i$  are independent of  $\mathbf{f}_t, \varepsilon_{i,s}, \mathbf{v}_{j,l}, \tilde{\boldsymbol{\eta}}_n$  for all i, j, n, t, s, l and  $\mathbb{E}(\|\boldsymbol{v}_i\|^6) < M$ .

Here, Assumption 2 comes from Westerlund (2018) and it helps to fully generalize the factor structure. It is formulated as a high level moment condition and it avoids imposing a specific form on **F**. This is convenient, because it allows to carry out the distribution analysis under many possible scenarios simultaneously as  $\mathbf{D}_{T,F}^{-1}\mathbf{F}'\mathbf{F}\mathbf{D}_{T,F}^{-1}$  is an important driver of the distribution. To illustrate (i) and (ii) in Assumption 2, one of empirically relevant scenarios is the polynomial trend of a finite order *m*. In particular, let  $\mathbf{f}_t = \mathbf{t}_t = [1, t, t^2, \dots, t^{m-1}]' \in \mathbb{R}^{m \times 1}$ , and  $\mathbf{r}_t \in \mathbb{R}^{p \times 1}$  be zero mean white noise with  $\mathbb{E}(\mathbf{r}_t \mathbf{r}'_t) = \mathbf{I}_p$  for simplicity. Then, by defining  $\mathbf{D}_{T,F} = \text{diag}[T^{1/2}, T^{3/2}, \dots, T^{(m+1)/2}]$ , we obtain

(i) 
$$\mathbf{D}_{T,F}^{-1} \mathbf{F}' \mathbf{F} \mathbf{D}_{T,F}^{-1} = \mathbf{D}_{T,F}^{-1} \sum_{t=1}^{T} \mathbf{t}_{t} \mathbf{t}_{t}' \mathbf{D}_{T,F}^{-1} \to \int_{s=0}^{1} \mathbf{s}_{1,m} \mathbf{s}_{1,m}' ds$$
,  
(ii)  $\mathbf{D}_{T,F}^{-1} \mathbf{F}' \mathbf{R} = \mathbf{D}_{T,F}^{-1} \sum_{t=1}^{T} \mathbf{t}_{t} \mathbf{r}_{t}' \Rightarrow \int_{s=0}^{1} \mathbf{s}_{1,m} d\mathbf{W}_{\mathbf{r}}(s)'$ 

as  $T \to \infty$ , where  $\mathbf{W}_{\mathbf{r}}(s)$  is the *p*-variate Wiener process generated by  $\{\mathbf{r}_s\}_{s=1}^t$ , and the typical elements in (i) and (ii) are  $\int_{s=0}^1 s^j s^k ds$  for j, k = 0, ..., m-1 or  $\int_{s=0}^1 s^j dW_{r,k}(s)$  for j = 0, ..., m-1 and k = 1, ..., p, respectively. Also, the matrix in (i) does not have to be deterministic. Following Phillips (1987), we can define  $\mathbf{f}_t = \mathbf{h}_t = \mathbf{\Theta}(\mathbf{c})\mathbf{h}_{t-1} + \mathbf{w}_t \in \mathbb{R}^{m \times 1}$ , which is a vector autoregressive process constituted of heterogeneous near unit root coordinates, such that  $\mathbf{\Theta}(\mathbf{c}) = \text{diag} \left[\theta(c_1), \ \theta(c_2), \ \ldots, \ \theta(c_m)\right]$ . Here,  $\theta(c_l) = \exp(c_l/T) = 1 + c_l/T + o(1)$ for l = 1, ..., m with  $c_l < 0$  ( $\mathbf{c} \to \mathbf{0}_m$  gives a simple unit root process) and  $\mathbf{h}_0 = \mathbf{0}_m$ . Also,  $\mathbf{w}_t$  is independent and identically distributed (IID) with  $\mathbb{E}(\mathbf{w}_t) = \mathbf{0}_m$  and  $\mathbb{E}(\mathbf{w}_t \mathbf{w}_t') = \mathbf{I}_m$ . Letting  $\mathbf{D}_{T,F} = T\mathbf{I}_m$ , we obtain as  $T \to \infty$ 

(i) 
$$\mathbf{D}_{T,F}^{-1} \mathbf{F}' \mathbf{F} \mathbf{D}_{T,F}^{-1} = \mathbf{D}_{T,F}^{-1} \sum_{t=2}^{T} \mathbf{h}_t \mathbf{h}'_t \mathbf{D}_{T,F}^{-1} \Rightarrow \int_{s=0}^{1} \mathbf{J}_{\mathbf{c}}(s) \mathbf{J}_{\mathbf{c}}(s)' ds$$
  
(i)  $\mathbf{D}_{T,F}^{-1} \mathbf{F}' \mathbf{R} = \mathbf{D}_{T,F}^{-1} \sum_{t=2}^{T} \mathbf{h}_t \mathbf{r}'_t \Rightarrow \int_{s=0}^{1} \mathbf{J}_{\mathbf{c}}(s) d\mathbf{W}_{\mathbf{r}}(s)',$ 

where  $\mathbf{J}_{\mathbf{c}}(s) = \int_{u=0}^{s} \operatorname{diag} \left[ \exp[c_1(s-u)], \ldots, \exp[c_m(s-u)] \right] d\mathbf{W}_{\mathbf{w}}(u) \in \mathbb{R}^{m \times 1}$  is the Ornstein-Uhlenbeck process and  $\mathbf{W}_{\mathbf{w}}(u)$  is the *m*-variate Wiener process generated by  $\{\mathbf{w}_s\}_{s=1}^t$ . In the Supplementary material, we provide more complicated examples of such limiting matrices. Note that despite only weak convergence in such cases, by employing arguments from Park and Phillips (2001), the sample space can be enlarged such that  $\mathbf{D}_{T,F}^{-1}\mathbf{F}'\mathbf{F}\mathbf{D}_{T,F}^{-1} \to \mathbf{\Sigma}_F$  almost surely.

The rest of the assumptions are similar to the ones in Pesaran (2006) or Karabiyik et al.

(2017). One assumption which is different between those two important studies and is used here is the random factor loadings. As Westerlund and Urbain (2013) demonstrate, under the random loadings it is possible to obtain consistent estimate of  $\beta_i$  even if m > k + 1 provided that  $\gamma_i$  and  $\Gamma_i$  are independent. However, this is unlikely in practice and we acknowledge this by letting  $\Omega_{\tilde{\eta}}$  be only positive definite and not block-diagonal. A more significant difference is reflected in higher moment conditions in Assumption 1 and Assumption 6. The intuition for this requirement is as follows. Provided that the condition  $m \le k + 1$  is taken into account properly, some terms that used to be treated as negligible in, for example, the standard analysis in equation (56) and further in Pesaran (2006) are now at most  $O_p(\sqrt{N}T^{-1})$ . Therefore, in order to derive the asymptotic distributions without any restrictions on N, Texpansion rate, the price of higher moment requirements comes into play. Interestingly, these assumptions are closer to the principal components setup of Bai and Ng (2002).

**Remark 1.** Assumption 4 makes it more difficult to put many unknown deterministic components in **F**. However, letting  $\mathbf{F} = [\mathbf{F}_1, \mathbf{F}_2]$ , where  $\mathbf{F}_1 \in \mathbb{R}^{T \times m_1}$ ,  $\mathbf{F}_2 \in \mathbb{R}^{T \times (m-m_1)}$  and it represents  $m - m_1$  known factors, then they can be estimated unrestrictedly. An example of this is individual fixed effects that are common in many empirical applications.

**Remark 2.** Note that the cross-section independence of  $\widetilde{\mathbf{U}}_i$  comes purely for convenience. We can relax this along the lines of Pesaran and Tosetti (2011) by requiring that  $\widetilde{\mathbf{u}}_t = (\mathbf{M} \otimes \mathbf{I}_m) \boldsymbol{\nu}_t$ , where  $\widetilde{\mathbf{u}}_t \in \mathbb{R}^{N(k+1)\times 1}$  is a cross-section stack of  $\widetilde{\mathbf{u}}_{i,t}$  and  $\boldsymbol{\nu}_t$  obeys Assumption 1. Here, **M** is an  $N \times N$  'network matrix' with bounded row and column norms.

### **3** Asymptotic Results

#### 3.1 CCEMG Results

In this section we derive the asymptotic distribution based on (1.6). As suggested by the previous literature, it must be driven by the coefficient heterogeneity component.

**Theorem 1.** Under Assumptions 1–6, as  $N, T \rightarrow \infty$  unrestrictedly,

$$\sqrt{N}(\widehat{\boldsymbol{\beta}}_{MG} - \boldsymbol{\beta}) = \frac{1}{\sqrt{N}} \sum_{i=1}^{N} \boldsymbol{v}_i + o_p(1) \rightarrow_d \mathcal{N}(\boldsymbol{0}_k, \boldsymbol{\Omega}_{\boldsymbol{v}}),$$

where  $\mathbf{\Omega}_{\boldsymbol{v}} = \lim_{N \to \infty} \frac{1}{N} \sum_{i=1}^{N} \mathbb{E}(\boldsymbol{v}_i \boldsymbol{v}_i').$ 

As can be seen, indeed the distribution is driven by the heterogeneity component of the coefficients and the distribution is bias-free. We retain the  $\sqrt{N}$  rate of consistency. These findings coincide with the ones in Pesaran (2006) or Kapetanios et al. (2011), where the analysis was done either under stationary or pure unit root **F**, respectively. We can see that the result remains robust to a way more general factor structure and to the correctly accounted case of  $m \le k + 1$ . Also, the results stay unchanged if m = k + 1. Therefore, this result is reassuring for practical purposes. It implies that usage of excess k + 1 - m cross-section averages to control for common factors does not induce a non-estimable bias term, which should be dealt with either by imposing restrictions on N, T expansion rate or employing bootstrap methods (see e.g. De Vos and Stauskas, 2021).

#### 3.2 CCEP Results

It is clearly possible to pool information from the heterogeneous coefficients by using CCEP estimator. Again, the previous literature suggests that the asymptotic distribution should be driven by  $v_i$ . Therefore, we derive the asymptotic distribution based on (1.5).

**Theorem 2.** Under Assumptions 1–6, as  $N, T \rightarrow \infty$  unrestrictedly,

$$\begin{split} \sqrt{N}(\widehat{\boldsymbol{\beta}}_{P} - \boldsymbol{\beta}) &= \boldsymbol{\Sigma}_{\mathbf{V}}^{-1} \frac{1}{\sqrt{N}} \sum_{i=1}^{N} \left( T^{-1} \mathbf{V}_{i}^{\prime} \mathbf{V}_{i} \right) \boldsymbol{v}_{i} + o_{p}(1) \\ &\rightarrow_{d} \mathcal{N} \left( \mathbf{0}_{k}, \boldsymbol{\Sigma}_{\mathbf{V}}^{-1} \boldsymbol{\Psi}_{v} \boldsymbol{\Sigma}_{\mathbf{V}}^{-1} \right), \end{split}$$

where  $\mathbf{\Psi}_{\boldsymbol{v}} = \lim_{N \to \infty} \frac{1}{N} \sum_{i=1}^{N} \mathbb{E} \left[ \left( T^{-1} \mathbf{V}_{i}' \mathbf{V}_{i} \right) \mathbf{\Omega}_{\boldsymbol{v}_{i}} \left( T^{-1} \mathbf{V}_{i}' \mathbf{V}_{i} \right) \right].$ 

This result is in nature similar to the one in Theorem 2. Again, given Assumption 5, the coefficient heterogeneity component  $v_i$  dominates the asymptotic distribution because it is independent from  $V_i$ . The estimator is  $\sqrt{N}$ -consistent under general unknown factors. Even under pooled estimator and potentially non-stationary factors the asymptotic distribution is correctly centered at zero and the result is robust to  $m \le k + 1$  condition. Clearly, under m = k + 1 this result remains unchanged, similarly to the result in Theorem 1.

#### 3.3 Inference

In order to use the results from Theorem 1 and 2 for statistical inference, we need to estimate  $\Omega_v$  and  $\Sigma_V^{-1} \Psi_v \Sigma_V^{-1}$  consistently. For this, we analyze two versions of robust variance matrix estimator for CCEP and CCEMG estimators proposed by Pesaran (2006). In particular,

$$\widehat{\boldsymbol{\Theta}} = \left(\frac{1}{N}\sum_{i=1}^{N}\widehat{\mathbf{Q}}_{i}\right)^{-1} \left(\frac{1}{N(N-1)}\sum_{i=1}^{N}\widehat{\mathbf{Q}}_{i}(\widehat{\boldsymbol{\beta}}_{i}-\widehat{\boldsymbol{\beta}}_{MG})(\widehat{\boldsymbol{\beta}}_{i}-\widehat{\boldsymbol{\beta}}_{MG})'\widehat{\mathbf{Q}}_{i}\right) \left(\frac{1}{N}\sum_{i=1}^{N}\widehat{\mathbf{Q}}_{i}\right)^{-1},$$
(3.1)

where  $\widehat{\mathbf{Q}}_i = T^{-1} \mathbf{X}'_i \mathbf{M}_{\widehat{F}} \mathbf{X}_i$  and

$$\widehat{\mathbf{\Omega}}_{\boldsymbol{v}} = \frac{1}{N(N-1)} \sum_{i=1}^{N} (\widehat{\boldsymbol{\beta}}_{i} - \widehat{\boldsymbol{\beta}}_{MG}) (\widehat{\boldsymbol{\beta}}_{i} - \widehat{\boldsymbol{\beta}}_{MG})'.$$
(3.2)

Both (3.1) and (3.2) show a good small sample performance in case of stationary factors. Theorem 3 establishes the consistency results under general unknown factors.

**Theorem 3.** Under Assumptions 1–6, as  $N, T \rightarrow \infty$  unrestrictedly,

$$N\widehat{\mathbf{\Theta}} o_p \mathbf{\Sigma}_{\mathbf{V}}^{-1} \mathbf{\Psi}_{v} \mathbf{\Sigma}_{\mathbf{V}}^{-1}$$
, and  $N\widehat{\mathbf{\Omega}}_{v} o_p \mathbf{\Omega}_{v}$ .

The result in Theorem 3 implies that

$$t_{\widehat{\boldsymbol{\beta}}_{MG}} = \frac{\mathbf{a}_{j}^{\prime}(\widehat{\boldsymbol{\beta}}_{MG} - \boldsymbol{\beta})}{\sqrt{\mathbf{a}_{j}^{\prime}\widehat{\boldsymbol{\Omega}}_{v}\mathbf{a}_{j}}} \rightarrow_{d} \mathcal{N}(0, 1), \ t_{\widehat{\boldsymbol{\beta}}_{P}} = \frac{\mathbf{a}_{j}^{\prime}(\widehat{\boldsymbol{\beta}}_{P} - \boldsymbol{\beta})}{\sqrt{\mathbf{a}_{j}^{\prime}\widehat{\boldsymbol{\Theta}}\mathbf{a}_{j}}} \rightarrow_{d} \mathcal{N}(0, 1)$$
(3.3)

as  $N, T \to \infty$ , where  $\mathbf{a}_j$  is a vector of zeros with 1 in the *j*-th coordinate for j = 1, ..., k. We will further evaluate these theoretical predictions regarding the variance estimators and test statistics in Monte Carlo simulations.

**Remark 3.** The results in Theorem 3 can be generalized to weak cross-section dependence–robust covariance matrices from Pesaran and Tosetti (2011).

## 4 Monte Carlo Study

In this section we carry out a small-scale Monte Carlo exercise to evaluate the performance of CCEP and CCEMG when factors are non-stationary. We will consider four scenarios,

where T1 and T2 reflect deterministic trends, while R1 and R2 describe the effect of stochastic trends. In particular,

- T1.  $\mathbf{f}_t = [1, t]'$ , which corresponds to incidental trend setting.
- T2.  $\mathbf{f}_t = [1, t, t^2]'$ , which augments the trend further.
- R1.  $\mathbf{f}_t = [1, g_t]'$ , where  $g_t = g_{t-1} + u_t$ , such that  $u_t \sim \mathcal{N}(0, 1)$ .
- R2.  $\mathbf{f}_t = [1, t, g_t]'$ , which effectively makes  $\mathbf{y}_i$  a unit root process with an incidental drift.

These versions of  $\mathbf{f}_t$  are transparent, yet more complex than in Westerlund (2018), because we combine deterministic and stochastic factors. Further, model error components are generated as follows:

$$\mathbf{v}_{i,t} = \rho_{\mathbf{v}} \mathbf{v}_{i,t-1} + \sqrt{1 - \rho_{\mathbf{v}}^2} \mathbf{e}_{i,t}, \quad \mathbf{e}_{i,t} \sim \mathcal{N}(\mathbf{0}_{k \times 1}, \sigma_{\mathbf{e},i}^2 \mathbf{I}_k)$$
(4.1)

$$\varepsilon_{i,t} = \rho_{\varepsilon} \varepsilon_{i,t-1} + \sqrt{1 - \rho_{\varepsilon}^2 \xi_{i,t}}, \quad \xi_{i,t} \sim \mathcal{N}(0, \sigma_{\xi,i}^2)$$
(4.2)

$$\widetilde{\mathbf{C}}_{i} = \widetilde{\mathbf{C}} + \widetilde{\eta}_{i} \mathbf{1}_{k+1}^{\prime}, \quad \widetilde{\eta}_{i} \sim \mathcal{N}(\mathbf{0}_{m \times 1}, \sigma_{\eta}^{2} \mathbf{I}_{m}),$$
(4.3)

where  $\rho_{\mathbf{v}} = \rho_{\varepsilon} = 0.8$  to introduce a degree of persistence. Also,  $\sigma_{\mathbf{e},i}^2 = \sigma_{\mathbf{e}}^2 + (w_{\mathbf{e},i} - 1)$ ,  $\sigma_{\xi,i}^2 = \sigma_{\xi}^2 + (w_{\xi,i} - 1)$ , where  $w_{\mathbf{e},i}$  and  $w_{\xi,i} \sim \chi^2(1)$ . We set  $\sigma_{\mathbf{e}}^2 = \sigma_{\xi}^2 = 2$  and  $\sigma_{\eta}^2 = 1$ . Here,  $\widetilde{\mathbf{C}}$  is a constant matrix, such that  $\operatorname{rk}(\widetilde{\mathbf{C}}) = m$  and thus  $\operatorname{rk}(\overline{\mathbf{C}}) = m$  almost surely. Note that (4.3) gives an extreme case because  $\Gamma_i$  and  $\gamma_i$  are perfectly correlated within an individual. This setup is more complex than in Westerlund (2018) due to dynamics and heterogeneity in the errors components, similarly to Kapetanios et al. (2011). Finally,

$$\boldsymbol{\beta}_i = \mathbf{1}_k + \boldsymbol{v}_i, \quad \boldsymbol{v}_i \sim \mathcal{N}(\mathbf{0}_{k \times 1}, \sigma_{\boldsymbol{v}}^2 \mathbf{I}_k)$$
(4.4)

where  $\sigma_v^2 = 0.02$  is directly taken from Pesaran and Tosetti (2011) as it ensures that the parameters are not too far from the mean. We set k = 3, therefore we maintain m < k + 1 for all the factor scenarios, which is an important aspect of our theory. We run 1000 simulation rounds for  $N, T \in \{25, 50, 100, 200, 500\}$  and allow for 20 burn-in values in order to eliminate the effect of initial values. We report 5% empirical size, bias and root mean-squared error (RMSE). In the Supplement, we provide additional simulations, where we increase  $\sigma_\eta^2$  and  $\sigma_v^2$  and also simulate  $v_i$  from a different distribution.

We begin with Table 1 and Table 2, which involve deterministic components only. We see that the bias and RMSE generally decline with N and T as expected and the size does not

suffer from significant distortions. Slight jumps in bias occur when *T* starts dominating *N*. The *t*-test becomes a little oversized when, again, T >> N and *N* is rather small. This is expected, because approximation of the factor space is not ideal and this is especially visible for T2 (in Table 2), where the quadratic trend dominates. In general, both CCEP and CCEMG perform similarly for the same *N*, *T* combination, and for larger *N*, *T* values the empirical size hovers around the nominal 5% level. These results are strikingly different from Monte Carlo results in Westerlund (2018) for deterministic trends, where  $\beta$  is homogeneous and huge size distortions occur.

Going to Table 3 and Table 4, a very important observation is that the overall results are very similar to the ones in Table 1 and Table 2. Again, we see a similar performance of both CCEP and CCEMG under R1 and R2. That is, the size distortions occur when *T* heavily dominates *N*. Again, the performance of CCEP and CCEMG is similar even when the most significant distortions occur, which happens in case of R2 – the most complex scenario combining both deterministic and stochastic trends. Overall, for large *N*, *T* with no restrictions, the size is close to the nominal 5% level.

The patterns reported in Table 1 – Table 4 resemble the results in De Vos and Stauskas (2021), where different stress tests for CCEP and CCEMG estimators under heterogeneous slopes were evaluated under purely stationary factors. This suggests that our theoretical predictions are borne out well and the nature of the factors essentially does not matter as long as the regularity conditions are satisfied. Clearly, while both estimators are theoretically unbiased, some remainder exists for the finite N and T. Hence, the similarity between t-test performance for the stationary and non-stationary cases suggests that the inference under trending factors for finite N and T could potentially be enhanced via bootsrapping procedures, as was demonstrated in this other paper for stationary factors only.

#### 5 Conclusions

In this study we discussed the effect of non-stationary factors in case of a popular CCE estimator. Specifically, we extended the framework of general unknown factors from West-erlund (2018) to heterogeneous slopes. As our theorems showed and simulations confirmed, irrespective of the nature of the common factors, both CCEP and CCEMG are asymptotically normal and unbiased. The results hold even if we over-control for the number of factors, therefore this study further stresses flexibility and wide applicability of the CCE procedure.

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			CCEP			CCEMG		
N	Т	5% size	Bias $\times 100$	RMSE×100	5% size	Bias $\times 100$	RMSE×100	
25	25	6.9	0.989	8.204	6.3	1.050	8.565	
25	50	7.7	1.149	6.830	7.4	1.296	6.832	
25	100	8.5	1.422	5.586	7.8	1.462	5.422	
25	200	9.6	1.114	4.629	8.3	1.367	4.362	
25	500	9.1	1.049	3.936	9.0	1.205	3.611	
50	25	6.2	0.109	5.996	6.0	0.457	6.144	
50	50	6.5	0.383	4.984	6.7	0.683	4.922	
50	100	7.3	0.687	4.003	6.8	0.951	3.935	
50	200	6.2	0.732	3.335	6.4	0.836	3.155	
50	500	7.7	0.800	2.831	7.0	0.802	2.559	
100	25	6.1	0.445	4.129	5.7	0.678	4.192	
100	50	5.4	0.183	3.378	5.5	0.397	3.357	
100	100	5.4	0.289	2.644	5.3	0.295	2.671	
100	200	5.5	0.433	2.323	6.1	0.516	2.204	
100	500	6.7	0.266	2.006	5.8	0.385	1.783	
200	25	5.6	0.142	2.950	6.0	0.182	3.163	
200	50	5.2	0.275	2.381	5.8	0.350	2.460	
200	100	5.5	0.119	1.966	5.7	0.148	1.938	
200	200	4.7	0.135	1.675	5.1	0.218	1.585	
200	500	5.2	0.064	1.412	5.5	0.131	1.238	
500	25	6.0	0.097	1.933	6.2	0.123	1.994	
500	50	4.0	0.166	1.505	5.0	0.119	1.525	
500	100	4.6	0.146	1.272	4.3	0.111	1.207	
500	200	4.5	-0.020	1.011	4.0	0.010	0.968	
500	500	5.8	0.019	0.912	4.4	0.052	0.793	

Table 1: Simulation results for T1

Notes: "T1" refers to the case when  $\mathbf{f}_t = [1, t]'$ . Also  $\{\rho_{\mathbf{v}}, \rho_{\varepsilon}, \sigma_{\mathbf{e}}^2, \sigma_{\xi}^2, \sigma_{\eta}^2, \sigma_{v}^2\} = \{0.8, 0.8, 2, 2, 1, 0.02\}$ .

		CCEP				CCEMG			
N	Т	5% size	Bias $\times 100$	RMSE $\times 100$	5% size	Bias $\times 100$	RMSE ×100		
25	25	8.3	2.086	8.123	6.7	2.333	8.136		
25	50	9.4	2.045	7.012	8.7	2.439	6.827		
25	100	8.5	1.780	5.582	10.0	2.149	5.506		
25	200	11.8	2.090	4.776	9.9	2.331	4.471		
25	500	11.4	1.717	3.900	11.2	1.953	3.560		
50	25	6.7	0.749	5.711	6.1	0.995	5.937		
50	50	7.7	0.852	4.851	5.4	1.097	4.654		
50	100	7.6	1.113	3.931	7.3	1.282	3.795		
50	200	7.9	1.003	3.352	8.1	1.235	3.224		
50	500	7.5	0.985	2.708	7.6	1.205	2.426		
100	25	6.1	0.488	3.991	5.8	0.775	4.212		
100	50	6.1	0.412	3.419	6.1	0.504	3.387		
100	100	6.5	0.383	2.803	6.0	0.595	2.678		
100	200	6.0	0.519	2.279	6.2	0.628	2.184		
100	500	7.7	0.588	2.004	8.5	0.737	1.825		
200	25	5.7	0.341	2.859	6.9	0.396	2.898		
200	50	4.1	0.289	2.259	4.7	0.372	2.295		
200	100	5.0	0.318	1.910	5.4	0.380	1.905		
200	200	5.8	0.219	1.640	6.5	0.325	1.595		
200	500	5.0	0.318	1.391	5.5	0.368	1.260		
500	25	4.0	0.124	1.707	4.2	0.042	1.751		
500	50	6.2	0.089	1.564	5.8	0.096	1.535		
500	100	4.7	0.143	1.206	4.9	0.194	1.172		
500	200	5.4	0.102	1.022	5.5	0.129	0.980		
500	500	4.8	0.095	0.888	5.8	0.122	0.806		

Table 2: Simulation results for T2

**Notes:** "T2" refers to the case when  $\mathbf{f}_t = [1, t, t^2]'$ . Also,  $\{\rho_{\mathbf{v}}, \rho_{\varepsilon}, \sigma_{\mathbf{e}}^2, \sigma_{\xi}^2, \sigma_{\eta}^2, \sigma_{v}^2\} = \{0.8, 0.8, 2, 2, 1, 0.02\}$ .

			CCEP			CCEMG		
N	Т	5% size	Bias $\times 100$	RMSE ×100	5% size	Bias $\times 100$	RMSE ×100	
25	25	8.6	1.468	8.645	8.8	1.614	9.002	
25	50	8.1	1.396	7.100	7.8	1.526	7.161	
25	100	8.2	1.136	5.492	7.3	1.455	5.500	
25	200	8.9	1.163	4.610	8.2	1.226	4.443	
25	500	8.1	1.160	3.838	8.3	1.310	3.586	
50	25	5.5	0.641	6.123	6.0	0.762	6.250	
50	50	6.9	0.377	4.915	7.4	0.524	5.067	
50	100	7.4	0.534	3.955	5.3	0.668	3.831	
50	200	7.5	0.602	3.306	7.0	0.745	3.111	
50	500	8.4	0.631	2.902	7.7	0.783	2.569	
100	25	5.6	0.195	4.352	6.5	0.302	4.368	
100	50	5.7	0.244	3.468	5.1	0.184	3.320	
100	100	6.4	0.216	2.797	5.9	0.259	2.792	
100	200	6.3	0.178	2.359	6.5	0.320	2.236	
100	500	5.5	0.313	1.927	5.5	0.400	1.710	
200	25	4.7	-0.012	2.902	4.6	0.065	2.952	
200	50	5.8	0.287	2.459	5.8	0.258	2.443	
200	100	5.0	0.126	1.965	4.6	0.112	1.927	
200	200	5.7	0.201	1.650	5.3	0.214	1.548	
200	500	5.3	0.214	1.384	6.6	0.209	1.278	
500	25	5.1	0.037	1.865	3.3	0.074	1.854	
500	50	5.1	-0.001	1.536	5.1	0.085	1.550	
500	100	5.2	0.097	1.247	5.9	0.081	1.242	
500	200	5.3	0.072	1.048	5.0	0.076	0.964	
500	500	5.1	0.082	0.911	5.3	0.055	0.818	

Table 3: Simulation results for R1

**Notes:** "R1" refers to the case when  $\mathbf{f}_t = [1, g_t]'$ , where  $g_t = g_{t-1} + u_t$ , such that  $u_t \sim \mathcal{N}(0, 1)$ . Also,  $\{\rho_{\mathbf{v}}, \rho_{\varepsilon}, \sigma_{\mathbf{e}}^2, \sigma_{\xi}^2, \sigma_{\eta}^2, \sigma_{v}^2\} = \{0.8, 0.8, 2, 2, 1, 0.02\}.$ 

		CCEP				CCEMG		
N	Т	5% size	Bias $\times 100$	RMSE ×100	5% size	Bias $\times 100$	$RMSE \times 100$	
25	25	7.5	1.858	7.982	7.7	1.928	8.362	
25	50	9.4	2.199	6.832	8.2	2.410	6.769	
25	100	10.5	2.236	5.546	9.7	2.502	5.336	
25	200	8.7	1.820	4.646	9.4	2.144	4.387	
25	500	12.5	1.966	3.933	12.3	2.201	3.633	
50	25	4.8	0.876	5.604	5.4	0.934	5.764	
50	50	5.9	1.246	4.659	5.7	1.405	4.559	
50	100	7.2	0.861	3.896	7.3	1.138	3.846	
50	200	8.3	0.987	3.365	9.1	1.212	3.153	
50	500	9.0	1.020	2.879	9.0	1.270	2.597	
100	25	6.4	0.639	4.158	6.8	0.826	4.462	
100	50	6.3	0.364	3.462	5.4	0.445	3.350	
100	100	6.7	0.573	2.802	7.9	0.726	2.838	
100	200	6.8	0.592	2.293	6.0	0.708	2.175	
100	500	5.4	0.494	1.935	7.4	0.643	1.792	
200	25	5.0	0.358	2.845	4.0	0.533	2.795	
200	50	5.4	0.351	2.366	4.9	0.283	2.344	
200	100	4.3	0.278	1.915	5.0	0.418	1.911	
200	200	4.8	0.266	1.654	5.7	0.334	1.588	
200	500	5.4	0.224	1.437	5.7	0.316	1.276	
500	25	5.1	0.092	1.854	5.6	0.167	1.898	
500	50	5.4	0.214	1.493	5.9	0.215	1.507	
500	100	4.8	0.085	1.252	5.0	0.127	1.211	
500	200	5.1	0.135	1.022	4.7	0.140	0.973	
500	500	5.8	0.126	0.906	4.9	0.173	0.813	

Table 4: Simulation results for R2

**Notes:** "R2" refers to the case when  $\mathbf{f}_t = [1, t, g_t]'$ , where  $g_t = g_{t-1} + u_t$ , such that  $u_t \sim \mathcal{N}(0, 1)$ . Also,  $\{\rho_{\mathbf{v}}, \rho_{\varepsilon}, \sigma_{\mathbf{e}}^2, \sigma_{\xi}^2, \sigma_{\eta}^2, \sigma_v^2\} = \{0.8, 0.8, 2, 2, 1, 0.02\}.$