

Introductory Econometrics

Lecture 17: Linear regression without strong exogeneity

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Strong exogeneity and the conditional expectation function (CEF)

- Consider the linear regression model

$$Y_i = \beta_0 + \beta_1 X_i + U_i.$$

- When the errors are strongly exogenous, i.e. $E[U_i | X_i] = 0$, the linear regression model defines the CEF of Y conditional on X :

$$\begin{aligned} CEF_Y(X_i) &= E[Y_i | X_i] \\ &= E[\beta_0 + \beta_1 X_i + U_i | X_i] \\ &= \beta_0 + \beta_1 X_i + E[U_i | X_i] \\ &= \beta_0 + \beta_1 X_i \end{aligned}$$

Weak exogeneity

$$\begin{aligned}Y_i &= \beta_0 + \beta_1 X_i + U_i, \\E[U_i] &= 0\end{aligned}$$

- Suppose the errors are only weakly exogenous:

$$E[U_i X_i] = 0.$$

- In this case,

$$CEF_Y(X_i) \neq \beta_0 + \beta_1 X_i.$$

- Question: What does the econometrician estimate when he runs a linear regression and the regressors are not strongly exogenous?

Linear regression as a misspecified CEF

- Suppose that

$$E[Y_i | X_i] = g(X_i),$$

where g is some unknown nonlinear function. Thus, the true CEF is $g(X_i) \neq \beta_0 + \beta_1 X_i$.

- Define

$$V_i = Y_i - E[Y_i | X_i],$$

so we can write the true model as

$$\begin{aligned} Y_i &= g(X_i) + V_i, \\ E[V_i | X_i] &= 0. \end{aligned}$$

- Write

$$\begin{aligned} Y_i &= g(X_i) + V_i \\ &= \beta_0 + \beta_1 X_i - \beta_0 - \beta_1 X_i + g(X_i) + V_i \end{aligned}$$

or

$$Y_i = \beta_0 + \beta_1 X_i + U_i,$$

where

$$U_i = V_i + g(X_i) - \beta_0 - \beta_1 X_i.$$

- Can we find β_0 and β_1 so that $E[U_i] = 0$ and $E[X_i U_i] = 0$? If yes, how can we interpret such β_0 and β_1 ?

$$U_i = V_i + g(X_i) - \beta_0 - \beta_1 X_i.$$

- Note that

$$\begin{aligned} E[U_i] &= E[V_i + g(X_i) - \beta_0 - \beta_1 X_i] \\ &= E[V_i] + E[g(X_i) - \beta_0 - \beta_1 X_i] \\ &= E[g(X_i) - \beta_0 - \beta_1 X_i], \end{aligned}$$

and

$$\begin{aligned} E[U_i X_i] &= E[(V_i + g(X_i) - \beta_0 - \beta_1 X_i) X_i] \\ &= E[V_i X_i] + E[(g(X_i) - \beta_0 - \beta_1 X_i) X_i] \\ &= E[(g(X_i) - \beta_0 - \beta_1 X_i) X_i]. \end{aligned}$$

- Thus, to have $E[U_i] = E[U_i X_i] = 0$, we need to find β_0 and β_1 such that

$$\begin{aligned} E[g(X_i) - \beta_0 - \beta_1 X_i] &= 0 \\ E[(g(X_i) - \beta_0 - \beta_1 X_i) X_i] &= 0. \end{aligned}$$

Linear approximation of the CEF

- ▶ Consider the following approximation problem:

$$\min_{b_0, b_1} E \left[(g(X_i) - b_0 - b_1 X_i)^2 \right].$$

- ▶ We are approximating the CEF by linear functions.
- ▶ Among the linear functions, we are looking for the best linear approximation in the mean squared error (MSE) sense.

$$\min_{b_0, b_1} MSE(b_0, b_1),$$

$$MSE(b_0, b_1) = E[(g(X_i) - b_0 - b_1 X_i)^2].$$

- Let β_0 and β_1 denote the solution:
 $(\beta_0, \beta_1) = \arg \min_{b_0, b_1} MSE(b_0, b_1).$
- The first-order conditions are:

$$\frac{\partial MSE(\beta_0, \beta_1)}{\partial b_0} = -2 \cdot E[g(X_i) - \beta_0 - \beta_1 X_i] = 0.$$

$$\frac{\partial MSE(\beta_0, \beta_1)}{\partial b_1} = -2 \cdot E[(g(X_i) - \beta_0 - \beta_1 X_i) X_i] = 0.$$

Linear regression as the best linear approximation of the CEF

- We have

$$\begin{aligned}Y_i &= \beta_0 + \beta_1 X_i + U_i, \\U_i &= V_i + g(X_i) - \beta_0 - \beta_1 X_i.\end{aligned}$$

- With $(\beta_0, \beta_1) = \arg \min_{b_0, b_1} E[(g(X_i) - b_0 - b_1 X_i)^2]$,

$$E[U_i] = 0 \text{ and } E[U_i X_i] = 0.$$

- Thus, the linear regression model gives us the best linear approximation of the CEF (in the MSE sense).

Misspecification and heteroskedasticity

- We have

$$\begin{aligned}Y_i &= \beta_0 + \beta_1 X_i + U_i, \\U_i &= V_i + g(X_i) - \beta_0 - \beta_1 X_i.\end{aligned}$$

- Suppose that the "true" error V_i is homoskedastic:
 $E[V_i^2 | X_i] = \sigma_V^2$ for all X_i .
- U_i is heteroskedastic if $g(X_i) \neq \beta_0 + \beta_1 X$:

$$\begin{aligned}E[U_i^2 | X_i] &= E[(V_i + g(X_i) - \beta_0 - \beta_1 X_i)^2 | X_i] \\&= E[V_i^2 + (g(X_i) - \beta_0 - \beta_1 X)^2 + \\&\quad + 2V_i(g(X_i) - \beta_0 - \beta_1 X_i) | X_i] \\&= \sigma_V^2 + (g(X_i) - \beta_0 - \beta_1 X)^2.\end{aligned}$$