

## BUGS for a Bayesian analysis of stochastic volatility models

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**Summary** This paper reviews the general Bayesian approach to parameter estimation in stochastic volatility models with posterior computations performed by Gibbs sampling. The main purpose is to illustrate the ease with which the Bayesian stochastic volatility model can now be studied routinely via BUGS (Bayesian inference using Gibbs sampling), a recently developed, user-friendly, and freely available software package. It is an ideal software tool for the exploratory phase of model building as any modifications of a model including changes of priors and sampling error distributions are readily realized with only minor changes of the code. However, due to the single move Gibbs sampler, convergence can be slow. BUGS automates the calculation of the full conditional posterior distributions using a model representation by directed acyclic graphs. It contains an expert system for choosing an effective sampling method for each full conditional. Furthermore, software for convergence diagnostics and statistical summaries is available for the BUGS output. The BUGS implementation of a stochastic volatility model is illustrated using a time series of daily Pound/Dollar exchange rates.

**Keywords:** *Stochastic volatility, Gibbs sampler, BUGS, Heavy-tailed distributions, Non-Gaussian nonlinear time series models, Leverage effect.*

### 1. INTRODUCTION

The stochastic volatility (SV) model introduced by Tauchen and Pitts (1983) and Taylor (1982) is used to describe financial time series. It offers an alternative to the ARCH-type models of Engle (1982) and Bollerslev (1986) for the well-documented time-varying volatility exhibited in many financial time series. The SV model provides a more realistic and flexible modelling of financial time series than the ARCH-type models, since it essentially involves two noise processes, one for the observations, and one for the latent volatilities. The so-called observation errors account for the variability due to measurement and sampling errors whereas the process errors assess variation in the underlying volatility dynamics (see, for example, Taylor (1994), Ghysels *et al.* (1996), and Shephard (1996) for the comparative advantages of the SV model over the ARCH-type models).

Unfortunately, classical parameter estimation for SV models is difficult due to the intractable form of the likelihood function. Recently, a variety of frequentist estimation methods have been proposed for the SV model, including generalized method of moments (Melino and Turnbull (1990), Sorensen (2000)), quasi-maximum likelihood (Harvey *et al.*, 1994), efficient method of moments (Gallant *et al.*, 1997), simulated maximum likelihood (Danielsson (1994), Sandmann

and Koopman (1998)), and approximate maximum likelihood (Fridman and Harris, 1998). A Bayesian analysis of the SV model is complicated due to multidimensional integration problems involved in posterior calculations. These difficulties with posterior computations have been overcome, though, with the development of Markov chain Monte Carlo (MCMC) techniques (Gilks *et al.*, 1996) over the last two decades and the ready availability of computing power. MCMC procedures for the SV model have been suggested by Jacquier *et al.* (1994), Shephard and Pitt (1997), and Kim *et al.* (1998).

Among all of these methods, MCMC ranks as one of the best estimation tools. See, for example, Andersen *et al.* (1999) for a comparison of various methods in Monte Carlo studies. However, MCMC procedures are 'computationally demanding and much harder to implement, using non-conventional software that is not widely available among researchers and practitioners in the field' (Fridman and Harris, 1998, p. 285).

The purpose of this paper is to illustrate the ease of implementation of a Bayesian analysis of SV models using BUGS (Bayesian analysis using Gibbs sampling), a recently developed software package (Spiegelhalter *et al.*, 1996), as well as the major drawbacks of fitting SV models with BUGS. BUGS is available free of charge from <http://www.mrc-bsu.cam.ac.uk/bugs/welcome.shtml> for the operating systems UNIX, LINUX, and WINDOWS, among others. It comes with complete documentation and two example volumes. BUGS is not a package specially designed for time series analysis like *SsfPack* (Koopman *et al.*, 1999) but rather an all-purpose Bayesian software that does sampling-based posterior computations for a variety of statistical models such as random effects, generalized linear, proportional hazards, latent variable, and frailty models (Gilks *et al.*, 1994). We will show that state-space models (Harvey, 1989, Ch. 2), in particular the SV model, is amenable to a Bayesian analysis via BUGS. The SV model is simple to implement in BUGS and does not require the programmer to know the precise formulae for any prior density or likelihood. Its main strength lies in the ease with which any changes in the model, such as different autoregressive structures or polynomial state transitions, the choice of different prior distributions for the parameters, and the change from Gaussian to heavy-tailed observation error distributions, are accomplished. This is in contrast to tailored implementations of stochastic volatility models in low-level programming languages such as C, where any such change necessitates major reprogramming usually followed by even more time-consuming debugging. Its major weakness is the extremely slow convergence and inefficiency in terms of simulation due to the single move Gibbs sampling algorithm. Due to high posterior correlations between successive states of the SV model, mixing is generally very slow in single update MCMC algorithms (Kim *et al.*, 1998). Since a SV model contains at least one state per observation, a time series of up to 5000 data points is probably the current limit that BUGS can handle. However, in terms of exploring new models, BUGS is helpful as it is quite general, but more specific code may be needed for more detailed and efficient applications.

This paper is organized as follows: in Section 2 we introduce a stochastic volatility model using a well-studied dataset. Section 3 puts the SV model into the framework of nonlinear state-space methodology and describes the Bayesian approach to parameter estimation using Gibbs sampling. This model is then represented as a DAG in the fourth section. Its implementation in BUGS is illustrated in Section 5 and a timing comparison is made to an implementation of the same model in *SVPack*, a freeware dynamic link library for the Ox programming language (Doornik, 1996) discussed by Kim *et al.* (1998). Section 6 demonstrates that any modification of the model becomes a simple task in BUGS and is implemented rapidly. In particular, we consider a SV model that includes a leverage effect. We highlight the strength of the BUGS approach as well as its current limitations in the Discussion.

## 2. THE STOCHASTIC VOLATILITY MODEL

For illustrative and comparative purposes, we use a dataset that has been previously analysed by Harvey *et al.* (1994) and more recently by Shephard and Pitt (1997) and Kim *et al.* (1998) using Gibbs sampling and by Durbin and Koopman (2000) using a maximum likelihood (ML) as well as a Bayesian approach via importance sampling. The data consist of a time series of daily Pound/Dollar exchange rates  $\{x_t\}$  from 01/10/81 to 28/6/85. The series of interest are the daily mean-corrected returns,  $\{y_t\}$ , given by the transformation  $y_t = \log x_t - \log x_{t-1} - \frac{1}{n} \sum_{i=1}^n (\log x_i - \log x_{i-1})$ ,  $t = 1, \dots, n$ . The SV model used for analysing these data can be written in the form of a nonlinear state-space model (Harvey, 1989). A state-space model specifies the *conditional* distributions of the observations *given* unknown states, here the underlying latent volatilities,  $\theta_t$ , in the observation equations:

$$y_t | \theta_t = \exp\left(\frac{1}{2}\theta_t\right) u_t, \quad u_t \stackrel{i.i.d.}{\sim} N(0, 1), \quad t = 1, \dots, n. \quad (1)$$

The unknown states are assumed to follow a Markovian transition over time (therefore the state-space models are often referred to as ‘hidden Markov models’) given by the state equations:

$$\theta_t | \theta_{t-1}, \mu, \phi, \tau^2 = \mu + \phi(\theta_{t-1} - \mu) + v_t, \quad v_t \stackrel{i.i.d.}{\sim} N(0, \tau^2), \quad t = 1, \dots, n, \quad (2)$$

with  $\theta_0 \sim N(\mu, \tau^2)$ . The state  $\theta_t$  determines the amount of volatility on day  $t$  and the value of  $\phi$ ,  $-1 < \phi < 1$ , measures the autocorrelation present in the logged squared data. Thus  $\phi$  can be interpreted as the persistence in the volatility, the constant scaling factor  $\beta = \exp(\mu/2)$  as the modal volatility, and  $\tau$  as the volatility of log-volatilities (cf. Kim *et al.* (1998)).

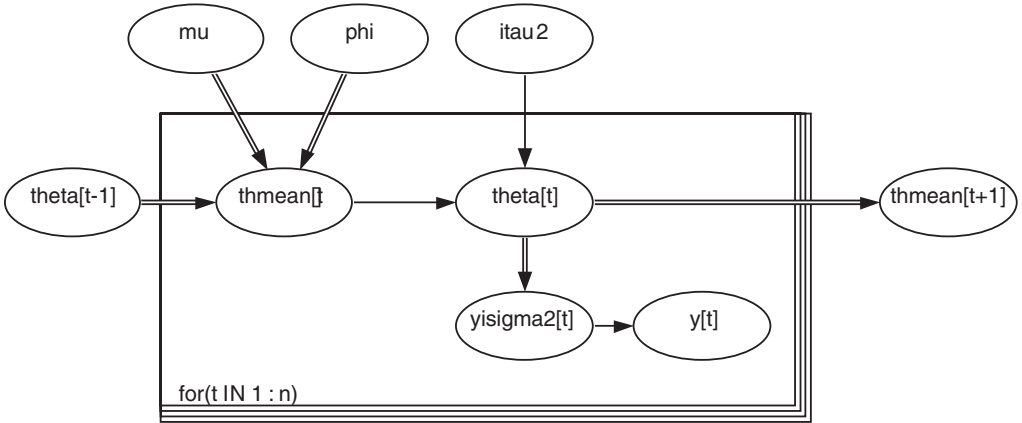
A full Bayesian model consists of the joint prior distribution of all unobservables, here the three parameters,  $\mu$ ,  $\phi$ ,  $\tau^2$ , and the unknown states,  $\theta_0, \theta_1, \dots, \theta_n$ , and the joint distribution of the observables, here the daily returns  $y_1, \dots, y_n$ . Bayesian inference is then based on the posterior distribution of the unobservables given the data. In the following, we will denote the probability density function of a random variable  $\theta$  by  $p(\theta)$ . By successive conditioning, the joint prior density is

$$p(\mu, \phi, \tau^2, \theta_0, \theta_1, \dots, \theta_n) = p(\mu, \phi, \tau^2) p(\theta_0 | \mu, \tau^2) \prod_{t=1}^n p(\theta_t | \theta_{t-1}, \mu, \phi, \tau^2). \quad (3)$$

We assume prior independence of the parameters  $\mu$ ,  $\phi$ , and  $\tau^2$ , and use the same priors as in Kim *et al.* (1998). We employ a slightly informative prior for  $\mu$ ,  $\mu \sim N(0, 10)$ . We set  $\phi = 2\phi^* - 1$  and specify a Beta( $\alpha, \beta$ ) prior for  $\phi^*$  with  $\alpha = 20$  and  $\beta = 1.5$  which gives a prior mean for  $\phi$  of 0.86. A conjugate inverse-gamma prior is chosen for  $\tau^2$ , i.e.  $\tau^2 \sim IG(2.5, 0.025)$  which gives a prior mean of 0.0167 and prior standard deviation of 0.0236.  $p(\theta_t | \theta_{t-1}, \mu, \phi, \tau^2)$  is defined through the state equations (2). The likelihood  $p(y_1, \dots, y_n | \mu, \phi, \tau^2, \theta_0, \dots, \theta_n)$  is specified by the observation equations (1) and the conditional independence assumption:

$$p(y_1, \dots, y_n | \mu, \phi, \tau^2, \theta_0, \dots, \theta_n) = \prod_{t=1}^n p(y_t | \theta_t). \quad (4)$$

Then, by Bayes’ theorem, the joint posterior distribution of the unobservables given the data is



**Figure 1.** Representation of the stochastic volatility model as a directed acyclic graph (DAG).

proportional to the prior times the likelihood, i.e.

$$p(\mu, \phi, \tau^2, \theta_0, \dots, \theta_n | y_1, \dots, y_n) \propto p(\mu) p(\phi) p(\tau^2) p(\theta_0 | \mu, \tau^2) \prod_{t=1}^n p(\theta_t | \theta_{t-1}, \mu, \phi, \tau^2) \times \prod_{t=1}^n p(y_t | \theta_t). \quad (5)$$

### 3. SV MODEL REPRESENTATION AS DAG

A graphical representation of the full Bayesian SV model not only helps to focus on the essential model structure but can be used in the WinBUGS version to implement the model. For any day  $t$ , let us represent all unobservables,  $\mu$ ,  $\phi$ ,  $\tau^2$ ,  $\theta_t$ , and observables,  $y_t$ , as ellipses. A way to express the conditional independence assumptions is by drawing solid arrows between nodes (see Figure 1). Open arrows go to deterministic nodes, which are logical functions of other nodes. The conditional mean of  $\theta_t$ ,  $\text{thmean}[t]$ , is an example of a deterministic node as it is a function of the nodes  $\mu$ ,  $\phi$ , and  $\theta_{t-1}$ .

This renders a model representation as a directed acyclic graph (DAG) as all edges in the graph are directed and there are no cycles because of the conditional independence assumptions. Let  $V$  denote the set of all nodes in the graph. Direct predecessors of a node  $v \in V$  are called ‘parents’, direct offspring the ‘children’. The solid arrows indicate that *given its parent nodes*, each node  $v$  is independent of all other nodes except descendants of  $v$ . For instance, if on day  $t$  we know the volatility on day  $t - 1$  and the values of the parameters  $\mu$ ,  $\phi$ , and  $\tau^2$ , then our belief about the volatility,  $\theta_t$ , on day  $t$  is independent of the volatilities on previous days from 1 to  $t - 2$  and the data of all other days except the current return  $y_t$ .

It is then easy to construct the joint probability distribution of all stochastic nodes using the graphical description of the conditional independence assumptions:

$$p(V) = \prod_{v \in V} p\{v | \text{parents}(v)\}. \quad (6)$$

For our specific SV model, (6) is the graph-theoretical version of the right-hand side of (5). In this way, the DAG (Figure 1) assists in constructing the full Bayesian model. For further reading on conditional independence graphs and graphical chain models the interested reader is referred to Wermuth and Lauritzen (1990).

#### 4. BAYESIAN INFERENCE USING BUGS

Let  $V_u$  denote the subset of unobservable nodes, and  $V_o$  the subset of observable nodes. Once  $p(V)$  has been obtained from (6), a general technical difficulty encountered in any application of Bayesian inference is calculating the high-dimensional integral necessary to find the normalization constant in the posterior distribution of the unobservables given the data:

$$p(V_u|V_o) = \frac{p(V_u, V_o)}{p(V_o)} = \frac{p(V)}{\int p(V_u, V_o) dV_u}. \quad (7)$$

In our specific example this would require an  $(N + 4)$ -dimensional integration as we have to integrate over the unobservables  $\mu, \phi, \tau^2, \theta_0, \dots, \theta_n$ . Calculating the marginal posterior distribution of any variable would require a subsequent  $(N + 3)$ -dimensional integration. High-dimensional integration problems can be solved via Markov chain Monte Carlo as reviewed in Gilks *et al.* (1996). The Gibbs sampler, a special MCMC algorithm, generates a sample from the posterior (7) by iteratively sampling from each of the univariate full conditional posterior distributions. These univariate full conditional posterior distributions  $p(v|V \setminus v)$ , for  $v \in V_u$ , can be easily constructed from the joint posterior distribution  $p(V)$  in (6) by picking out those terms that depend on  $v$ :

$$p(v|V \setminus v) \propto p\{v|\text{parents}(v)\} \prod_{w \in \text{parents}(w)} p\{w|\text{parents}(w)\}. \quad (8)$$

This is facilitated by the graphical representation (Figure 1), as the full conditional posterior distribution of any node  $v$  depends only on its parents, children, and co-parents. For instance, if  $v = \theta_t$ , then the full conditional posterior distribution of  $\theta_t$ ,  $p(\theta_t|\mu, \phi, \tau^2, \theta_0, \dots, \theta_{t-1}, \theta_{t+1}, \theta_n, y_1, \dots, y_N)$ , is proportional to

$$p(\theta_t|\theta_{t-1}, \mu, \phi, \tau^2) \times p(\theta_{t+1}|\theta_t, \mu, \phi, \tau^2) \times p(y_t|\theta_t).$$

Here, the dependence of the deterministic nodes `thmean[t]` and `ysigma[t]` as logical functions of  $\theta_{t-1}, \mu, \phi$ , and  $\theta_t$ , respectively, has been resolved. In this way, BUGS exploits the representation of the model as a DAG for constructing these full conditional posterior distributions for all unobservable nodes. Once this is accomplished, it uses certain sophisticated sampling methods to sample from these univariate densities. BUGS contains a small expert system for choosing the best sampling method. The first choice is to identify conjugacy, where the full conditional reduces analytically to a well-known distribution, and to sample accordingly. If the density is not conjugate but turns out to be log-concave, it employs the *adaptive rejection sampling* (ARS) algorithm (Gilks and Wild, (1992)). If the density is not log-concave, BUGS uses a Metropolis–Hastings (MH) step. The MH algorithms differ across the various BUGS versions and platforms. The current UNIX version 0.6 uses the Griddy Gibbs sampler as developed by Ritter and Tanner (1992). More efficient MH implementations currently under development include slice sampling (Neal, 1997) for variables with a restricted range, and adaptive techniques (Gilks *et al.*, 1998) for variables with unrestricted range. A first version has been released under WinBUGS, the BUGS version for the WINDOWS95 operating system.

## 5. MODEL IMPLEMENTATION IN BUGS

For a typical BUGS run using the UNIX version 0.6, four different files have to be specified:

- (i) The data are entered in a file with extension `.dat`, here called `returns.dat`.
- (ii) Initial values for all unobservables needed to start the Gibbs sampler are in a `.in` file, here `sv.in`.
- (iii) The file that contains the model descriptions has the `.bug` extension, here `sv.bug`.
- (iv) The commands for running BUGS that control the number of sampled values, which parameters to monitor and so on, go into the `sv.cmd` file. In WinBUGS, these commands are options in various menus.

These four files are listed in the Appendix.

The data file can be either in rectangular format like `returns.dat` or in SPLUS format as in `returns_S.dat`.

The format of the initial value file follows that of the data file, here for instance `sv.in` in SPLUS format. If initial values for parameters are not given in the initial value file, then values will be generated by forward sampling from the prior distributions specified in the model.

The DAG representation of our model not only serves BUGS-internal purposes but can assist us in specifying our model in the BUGS language. The file containing the model specification, `sv.bug`, consists of two sections: the declarations and the model description. The declaration part specifies the name of the model, which nodes are constants (rectangles) and which are stochastic (ellipses), and gives the name of the files containing the data and initial values. The model description forms a declarative representation of the fully Bayesian model. It is enclosed in curly brackets `{ . . }`. This is a translation of the graphical model into BUGS syntax. Each statement consists of a relation of two kinds:

- $\sim$  which means 'is distributed as' and substitutes the solid arrows,
- $< -$  which means 'is to be replaced by' and substitutes the open arrows.

Quantities on the left of a  $\sim$  are stochastic, those on the left of  $< -$  are deterministic. In general, each quantity should appear once and only once on the left-hand side of a statement. The order of the expressions within a pair of braces is irrelevant.

As mentioned before, WinBUGS has an option `Doodle` that allows the user to specify the model graphically by drawing a DAG. It uses a hyper-diagram approach to add extra information to the graph to give a complete model specification. `DoodleBUGS` then writes the corresponding model in BUGS syntax to a file.

Note that BUGS uses a non-standard parametrization of distributions in terms of the precision (1/variance) instead of the variance. For example, a normal distribution denoted by `dnorm( $v, \psi^2$ )` has density function  $f(x|v, \psi^2) = \frac{\psi}{\sqrt{2\pi}} e^{-\frac{1}{2}(x-v)^2\psi^2}$ . This is the reason for specifying the node `itau2`. BUGS does not permit an expression to be used as a parameter of a distribution, and hence we need the deterministic nodes `thmean[t]` and `yisigma2[t]`.

Finally, the file `sv.cmd` compiles the BUGS commands in `sv.bug`, generates an initial 10 000 iterations (the so-called 'burn-in' period), monitors every specified parameter for the next 100 000 iterations, stores every 20th value, and calculates summary statistics of the sampled values for each specified parameter, based on a final chain length of 5000. To make results comparable to those in Kim *et al.* (1998), we chose to monitor the nodes  $\phi$ ,  $\tau$ , and  $\beta$ . Our preference is to submit these commands as a batch job by using the command

```
backbugs "sv.cmd"
```

with session output automatically directed to the `bugs.log` file. Alternatively, BUGS can be run interactively by using the command `bugs`.

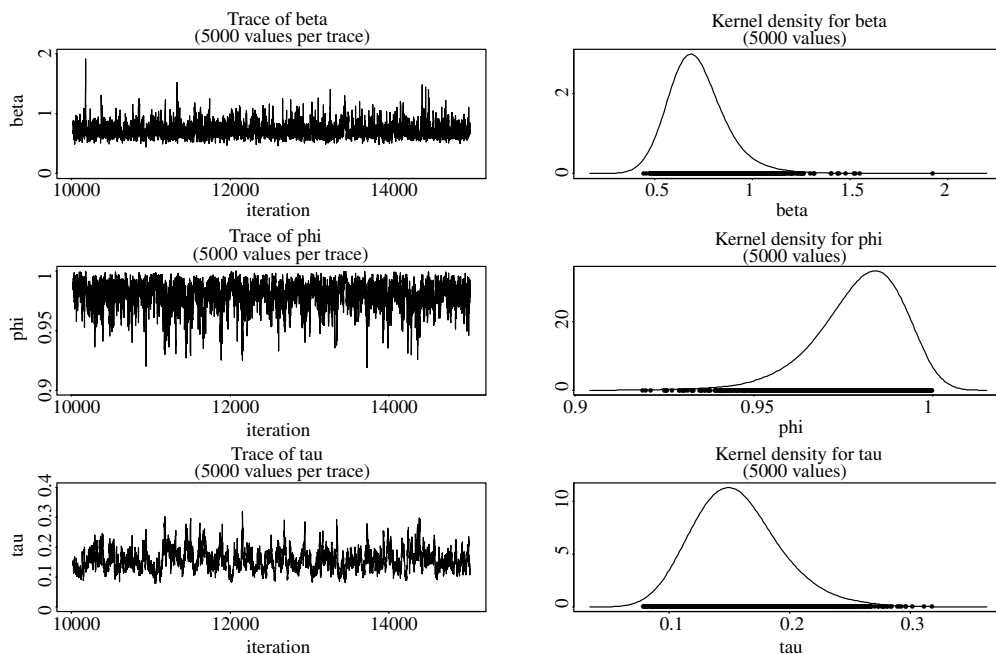
BUGS generates five files after completion:

- (1) The file `bugs.log` contains the BUGS code (`sv.bug`) that was used, any error messages, the running time, and the requested summary statistics of the marginal posterior distribution of each parameter. The posterior summaries from this file are listed in the Appendix.
- (2) The file `bugs.out` contains two columns. The first column gives the iteration number, the second column the corresponding sampled value.
- (3) The file `bugs.ind` tells you which line of the `bugs.out` file corresponds to which monitored variable. Here, lines 1 to 5000 of `bugs.out` are samples from variable  $\phi$ , lines 5001 to 10 000 from variable  $\tau$  and lines 10 001 to 15 000 from variable  $\beta$ .
- (4) The file `bugs1.out` contains the results of the `stats` command in a rectangular format suitable for reading into statistical packages for producing graphs, tables, etc. The 10 columns contain the summary statistics: mean, SD, observed lower percentile being reported (default 2.5%), observed lower percentile, observed upper percentile being reported, observed upper percentile (default 97.5%), median, number of iterations, start iteration, and finish iteration.
- (5) The file `bugs1.ind` contains the node names for the variables listed, and the corresponding row number in the `bugs1.out` file.

A menu-driven collection of SPLUS functions, CODA (Best *et al.*, 1995), is available for analysing the output obtained by BUGS. Besides trace plots and convergence diagnostics based on Cowles and Carlin (1996), CODA calculates statistical summaries of the posterior distributions and kernel density estimates. A version of CODA that runs under the public domain software R can be downloaded from <http://www-fis.iarc.fr/codaversion>. Kernel estimates of the posterior densities of the parameters  $\phi$ ,  $\tau$ , and  $\beta$  are shown in Figure 2. These compare with those given in Figure 2 of Kim *et al.* (1998) and Figure 2 of Shephard and Pitt (1997). Table 1 compares the posterior means, time series standard errors (MC SE), integrated autocorrelation times (IACT), and posterior standard deviations of the parameters  $\phi$ ,  $\tau$ , and  $\beta$  to the estimates obtained using the SVPack implementation of Kim *et al.* (1998). The results from SVPack are based on 100 000 iterations after a burn-in of 10 000, and the same priors, and starting values. The estimates are reasonably close to the ones quoted in Table 1 of Kim *et al.* (1998) based on 1 000 000 iterations.

Extensive convergence diagnostics for this chain were calculated using the CODA software of Best *et al.* (1995). All parameters passed the Heidelberger and Welch stationarity and halfwidth tests. Geweke's  $Z$ -scores for  $\phi$ ,  $\tau$ , and  $\beta$  are very reasonable (0.226,  $-0.125$ , and  $-1.72$ , respectively) but the Raftery and Lewis convergence diagnostics (estimating the 2.5th percentile up to an accuracy of 0.02 with probability 0.9) suggest a larger sample size. This is reflected in high posterior autocorrelations as already noted by Kim *et al.* (1998) and Shephard and Pitt (1997). Note that Kim *et al.* (1998) based their results on a chain of length 1 000 000 after a burn-in period of 50 000.

The integrated autocorrelation time, IACT (cf. Sokal (1996)), which is also referred to as 'inefficiency factor' by Kim *et al.* (1998) was calculated using the same window-based estimate with the Parzen kernel with the same bandwidths as given in Kim *et al.* (1998) for comparative purposes. As the estimate of the posterior mean of a parameter  $x$  is the average of  $N$  correlated



**Figure 2.** Trace and kernel density estimates of the marginal posterior distribution of model parameters.

**Table 1.** Comparison of Bayesian estimates obtained from the state-space model using BUGS with Bayesian estimates using SVPack as in Kim *et al.* (1998).

	BUGS				SVPack			
	Mean	MC SE	IACT	SD	Mean	MC SE	IACT	SD
$\phi$	0.9797	0.0004434	150.2	0.01144	0.9774	0.0003338	101.5	0.01048
$\tau$	0.1562	0.001845	336.1	0.03184	0.1604	0.001346	200.4	0.03007
$\beta$	0.7209	0.003537	87.2	0.1198	0.6481	0.0006755	4.54	0.1002
Time (s)	6171				220			

samples from a Markov chain, its variance is a factor of IACT larger than the variance of the sample mean based on the same number of independent samples, i.e.

$$\text{var}(\bar{x}_{\text{MC}}) = \text{IACT} \cdot \frac{\text{var}(x)}{N}.$$

Hence, IACT is the number of correlated samples with the same variance-reducing power as one independent sample. A reasonable estimate of the MC standard error can be obtained by multiplying the estimated standard deviation of  $x$  by the square root of the estimate of IACT and dividing by the square root of the sample size (here,  $N = 100\,000$ ). The interested reader should note the paper by Geyer (1992) who develops improved window estimates for IACT by calculating the ‘optimal’ bandwidth using specific properties of the autocovariances of a Markov



chain. CODA automatically calculates the Monte Carlo standard error by batch means as well as by Geweke's (1992) method, often referred to as 'numerical standard error' or 'time series standard error' which is based on estimating the spectral density.

The computing time to generate 100 iterations is 6.1 seconds using the LINUX version of BUGS on a Pentium III PC. True, this compares dismally with 0.2 seconds per 100 iterations for the SVPack implementation on the same computer. One should keep in mind, however, that the SVPack implementation used optimized C++ code that was dynamically linked to the Ox programming package. The all-purpose package BUGS is not meant to be a serious competitor to a specially tailored package for one particular model. Whereas BUGS uses a 'black-box' simulation technique (ARS) to sample from a full conditional density, the SVPack implementation makes use of bounds for each full conditional density that results in efficient rejection sampling but requires a mathematical analysis of the full conditionals under consideration, as detailed in Kim *et al.* (1998). BUGS main strength, however, lies in its flexibility that allows the practitioner to experiment with different scenarios.

## 6. FLEXIBLE MODELLING

Any implementation of the Gibbs sampler requires the specification of each of the full conditional posterior densities and of a simulation technique to sample from them. Any change in the model such as a different prior distribution or different sampling distribution necessarily entails changes in those full conditional densities. As BUGS alleviates the tedious task of calculating the full conditionals and as it also chooses an effective method to sample from them, one can experiment with different types of models without worrying about major reprogramming. Modifications of the model are straightforward to implement by changing just one or two lines in the code. To illustrate this major strength and flexibility of the BUGS software, we consider the following variations of the basic model implemented in the previous chapter:

- a sensitivity analysis, i.e. a change from the informative prior distributions for the model parameters  $\mu$ ,  $\phi$ , and  $\tau^2$  to non-informative priors to check how sensitive the results are to prior specifications,
- fitting more complex models with additional parameters,
- using heavy-tailed distributions instead of Gaussians for the observation errors,
- and fitting a leverage effect model.

The model with non-informative priors will be referred to as Model 2. Changing the prior distributions of the three model parameters comes down to changing three lines of code. BUGS only allows use of proper prior distributions but the non-informative distribution for a scale parameter like  $\tau^2$ ,  $p(\tau^2) \propto 1/\tau^2$ , is improper. Therefore, in BUGS one would use a gamma(0.001,0.001) prior for the inverse of  $\tau^2$  which is practically equivalent to  $p(\tau^2) \propto \frac{1}{\tau^2}$ . A vague Normal distribution with mean 0 and some low precision like 0.001 is used to substitute the non-informative distribution for a location parameter. The necessary changes in the BUGS code are:

```
mu ~ dnorm(0,0.001);
phistar ~ dunif(0,1);
itau2 ~ dgamma(0.001,0.001);
```

We observed only minor changes in the posterior distributions of the parameters. This indicates that the statistical inference for these data is insensitive to misspecification of priors. Moreover,

using flat priors implies equality of posterior mode and MLE and Bayesian estimates based on the posterior mode should therefore be very close to the ML estimates obtained by Durbin and Koopman (2000). Note that the IACT and MC standard errors quoted in Table 2 are calculated by Geweke's method.

We fitted a model with one additional parameter using the same priors for the common parameters  $\mu$ ,  $\phi$ , and  $\tau^2$  as for the model in the previous section, now referred to as Model 1. An AR(2) structure for the state transitions is specified in

Model 3:

$$y_t | \theta_t = \exp\left(\frac{1}{2}\theta_t\right) u_t, \quad u_t \stackrel{i.i.d.}{\sim} N(0, 1), \quad t = 1, \dots, n,$$

$$\theta_t | \theta_{t-1}, \mu, \phi, \psi, \tau^2 = \mu + \phi(\theta_{t-1} - \mu) + \psi(\theta_{t-2} - \mu) + v_t, \quad v_t \stackrel{i.i.d.}{\sim} N(0, \tau^2), \quad t = 1, \dots, n.$$

The implementation of Model 3 in BUGS, for instance, requires only adding  $\psi$  and  $\psi^*$  to the parameter list, adding corresponding initial values in the vol.in file, changing the state equation to:

```
thmean[t] <- mu + phi*(theta[t-1]-mu) + psi*(theta[t-2]-mu);
```

and adding a prior for  $\psi$ :

```
psi <-2*psistar-1;
psistar ~ dbeta(20,1.5);
```

In a further extension of Model 3, we consider a central Student  $t$ -distribution with unspecified degrees of freedom,  $k$ , for the observation errors. Observation and state equations for Model 4 are specified by:

Model 4:

$$y_t | \theta_t, k = \exp\left(\frac{1}{2}\theta_t\right) u_t, \quad u_t \stackrel{i.i.d.}{\sim} t_k, \quad t = 1, \dots, n,$$

$$\theta_t | \theta_{t-1}, \mu, \phi, \psi, \tau^2 = \mu + \phi(\theta_{t-1} - \mu) + \psi(\theta_{t-2} - \mu) + v_t, \quad v_t \stackrel{i.i.d.}{\sim} N(0, \tau^2), \quad t = 1, \dots, n.$$

This is coded in BUGS as:

```
y[t] ~ dt(0,yisigma2[t],k);
k ~ dchisq(8)I(2,50);
```

We have to restrict the ranges of those nodes with non-logconcave full conditional distributions (such as  $k$  above) by specifying lower and upper bounds using the `l(lower,upper)` function for BUGS to be able to use the Metropolis–Hastings updating step.

The posterior means, MC standard errors, inefficiency factors, and standard deviations of the parameters for Models 1–4 and the total computing time needed for 100 000 iterations after a burn-in of 10 000 are given in Table 2. The integrated autocorrelation times for the parameters in the AR(2) model are considerably higher than in the basic Models 1 and 2 and the computation time increased. The Metropolis–Hastings updating slows down the Gibbs sampler for Model 4. Interestingly, the parameter  $\psi$  is estimated to be positive and quite large with its upper interval bigger than zero and the posterior mean of  $k$  in Model 4 suggests that the observation errors are indeed non-Gaussian.

**Table 2.** Comparison of Bayesian estimates obtained using BUGS for parameter estimation in Models 1–4.

	Model 1				Model 2			
	Mean	MC SE	IACT	SD	Mean	MC SE	IACT	SD
$\phi$	0.9797	0.000402	124.3	0.01144	0.9760	0.000551	144.4	0.01450
$\tau$	0.1562	0.001490	219.5	0.03184	0.1750	0.001880	219.8	0.04010
$\beta$	0.7209	0.003180	70.5	0.1198	0.7080	0.002990	61.1	0.12100
Time (s)	6171				6477			

	Model 3				Model 4			
	Mean	MC SE	IACT	SD	Mean	MC SE	IACT	SD
$\phi$	0.539	0.01020	300.7	0.186	0.588	0.0106	339.2	0.182
$\psi$	0.441	0.01010	298.1	0.185	0.398	0.0106	343.0	0.181
$\tau$	0.200	0.00222	213.9	0.048	0.159	0.00189	254.0	0.0375
$\beta$	0.759	0.00342	52.7	0.149	0.729	0.00365	68.0	0.140
$k$					13.3	0.230	368.3	3.79
Time (s)	9387				26 115			

The basic SV model does not address the so-called *leverage effect* that relates the changes in volatility to the sign and magnitude of price changes in an asymmetric way (see e.g. Black (1976), Glosten *et al.* (1993), and Harvey and Shephard (1996)), modelled by introducing correlation between the error distributions of the returns and the log-volatilities,  $u_t$  and  $v_{t+1}$ , respectively. A negative correlation would infer that a negative return is likely to be associated with a positive variance shock  $v_{t+1}$ . The leverage model is particularly important for stock returns, but the leverage effect is expected to be much lower for exchange rates (Harvey and Shephard, 1996). In the following, we demonstrate Bayesian parameter estimation in a leverage model via MCMC with BUGS using the same time series as above.

Compared to Model 1, the leverage Model 5 has one additional parameter, the correlation  $\rho$ :  
 Model 5:

$$y_t | \theta_t, \rho = \exp\left(\frac{1}{2}\theta_t\right) u_t, \quad t = 1, \dots, n,$$

$$\theta_{t+1} | \theta_t, \mu, \phi, \tau^2, \rho = \mu + \phi(\theta_t - \mu) + \tau v_t, \quad t = 1, \dots, n - 1$$

with

$$\begin{pmatrix} u_t \\ v_{t+1} \end{pmatrix} \overset{i.i.d.}{\sim} \mathcal{N} \left\{ \begin{pmatrix} 0 \\ 0 \end{pmatrix}, \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix} \right\}.$$

This implies a bivariate Normal distribution for  $y_t | \theta_t, \rho$  and  $\theta_{t+1} | \theta_t, \mu, \phi, \tau^2, \rho$ . By writing this bivariate Normal density as the product of the density of  $\theta_{t+1} | \theta_t, \mu, \phi, \tau^2$  and the conditional density of  $y_t | \theta_{t+1}, \theta_t, \mu, \phi, \tau^2, \rho$ , it is easily seen that Model 5 can alternatively be specified by

$$\theta_{t+1} | \theta_t, \mu, \phi, \tau^2 \sim N\{\mu + \phi(\theta_t - \mu), \tau^2\},$$

$$y_t | \theta_{t+1}, \theta_t, \mu, \phi, \tau^2, \rho \sim N \left[ \frac{\rho}{\tau} \exp(\theta_t/2) \{\theta_{t+1} - \mu - \phi(\theta_t - \mu)\}, \exp(\theta_t)(1 - \rho^2) \right].$$

**Table 3.** Bayesian estimates of parameters in the leverage effect Model 5 using BUGS.

Model 5				
	Mean	MC SE	IACT	SD
$\phi$	0.988	0.000227	60.1	0.00926
$\tau$	0.197	0.0000428	17.5	0.00323
$\beta$	1.05	0.00712	69.5	0.270
$\rho$	-0.214	0.00128	40.0	0.0640
Time (s)	18 667			

These two conditional distributions specify the state and observation equations in the leverage model. They are easily coded in BUGS:

```

theta0 ~ dnorm(mu, itau2);
thetamean[1] <- mu + phi*(theta0-mu);
theta[1] ~ dnorm(thetamean[1], itau2)I(-5,5);

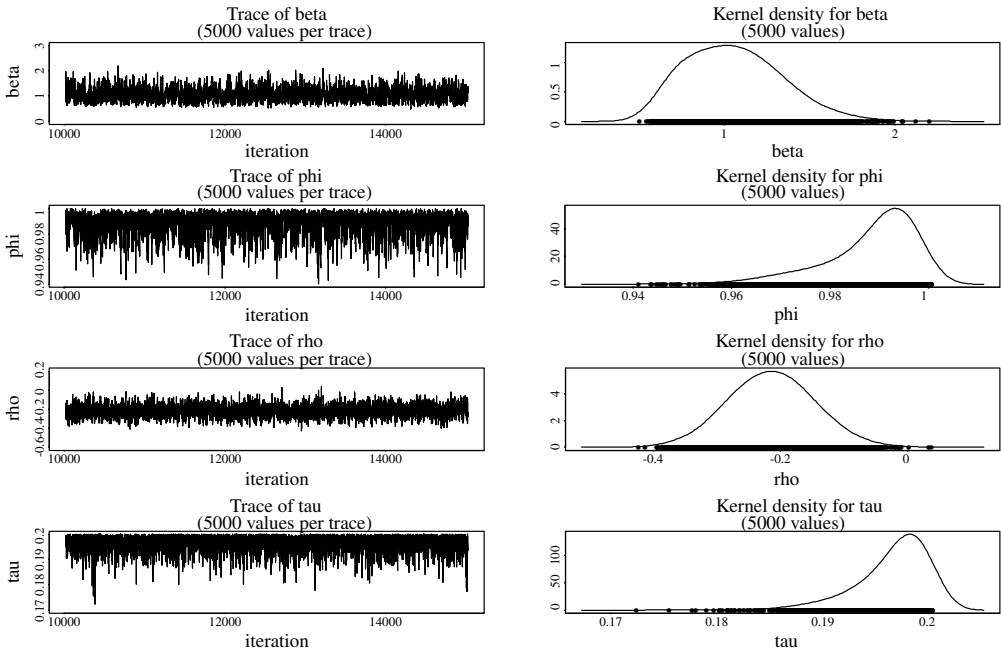
for (t in 2:n) {
  thetamean[t] <- mu + phi*(theta[t-1]-mu);
  theta[t] ~ dnorm(thetamean[t], itau2)I(-4,4);
}

for (t in 1:(n-1)) {
  Ymean[t] <- rho/tau*exp(0.5*theta[t])*(theta[t+1]-mu
  - phi*(theta[t]-mu)); Yisigma2[t] <- 1/(exp(theta[t])*(1-rho*rho));
  Y[t] ~ dnorm(Ymean[t], Yisigma2[t]);
}

Ymean[n] <- mu-phi*(theta[n]-mu);
Yisigma2[n] <- 1/(exp(theta[n]));
Y[n] ~ dnorm(Ymean[n], Yisigma2[n]);

```

We need the indicator function to give  $\theta_t$  a finite support since its full conditional distribution is no longer log-concave and a MH updating step is needed. This slows the program down tremendously as there are close to 1000 of these variables. However, the mixing is not affected. On the contrary, the integrated autocorrelation times are smaller than for the basic SV model. The posterior correlation between the parameters are lower than in the basic SV model without leverage effect. A reduction in posterior correlation and thereby better mixing in the Gibbs sampling is a phenomenon that is quite often observed after suitable reparametrization (Gilks and Roberts, 1996). The parameter estimates for the leverage model based on 100 000 iterations after a burn-in of 10 000 are given in Table 3. The posterior correlations between parameters in the basic SV Model 1 are contrasted to those in the leverage effect Model 5 in Table 4. The chain passed all CODA convergence diagnostics. The trace plots and kernel density estimates of the parameters are given in Figure 3.



**Figure 3.** Trace and kernel density estimates of the marginal posterior distribution of leverage model parameters.

**Table 4.** Posterior correlations of parameters in SV Model 1 and leverage effect Model 5.

	Model 1			Model 5			
	$\phi$	$\tau$	$\beta$	$\phi$	$\tau$	$\beta$	$\rho$
$\phi$	1			1			
$\tau$	-0.695	1		-0.0640	1		
$\beta$	0.506	-0.282	1	0.7070	-0.0239	1	
$\rho$			-0.3390		0.0506	-0.2230	1

With a posterior mean of  $-0.215$  and 95% posterior credibility interval for  $\rho$  of  $[-0.341, -0.097]$ , the Bayesian estimate of the correlation between the observation errors of the returns and the subsequent log-volatilities indicates the presence of a significant leverage effect in this time series of exchange rates. However, the leverage effect is not as strong as the ones observed in time series of stock returns (Harvey and Shephard, 1996).

### 7. DISCUSSION

There is only a very moderate learning curve to ascend before one can write a first BUGS

program. However, anyone who is comfortable with model formulae and has an intuitive grasp of fundamental statistical concepts should be capable of understanding, using, and modifying BUGS code that has already been written for a particular SV model. For a Bayesian analysis, the required statistical knowledge includes familiarity with the Bayesian paradigm and an appreciation for the numerically intensive methods used for posterior computations.

We noted a strong dependency of the mixing behaviour of the chains on the specification of bounds for each parameter with non-logconcave full conditional posterior. The tighter those bounds the faster the convergence due to the Griddy Gibbs sampler used in the implementation of the MH step that is necessary to sample from non-logconcave full conditional posteriors, as e.g. from the full conditional of  $k$ . As demonstrated by Carter and Kohn (1994) and Shephard and Pitt (1997), a multi-move sampler, i.e. a Gibbs sampler that updates the whole state vector at once instead of one state at a time, can be more efficient. However, the multi-move and block samplers are more difficult to implement, requiring specialized code in a low-level programming language such as C++ (Shephard and Pitt, 1997). Writing and debugging might take anything from several days to a few weeks. A subsequent modification of the program, perhaps an extension of the model, choice of different priors, or an application to a different dataset, might well take several hours. The gain in efficiency is therefore largely outweighed by the ease of implementation in BUGS and the feasibility of running large chains, nowadays, on fast computers. The possibility of implementing multi-move or block samplers in BUGS still needs to be investigated.

As typical for the ‘standard’ SV models, with Gaussian errors and linear state transition, the full conditional distributions of all states  $\theta_0, \theta_1, \dots, \theta_n$  are lognormal and therefore sampling from these full conditionals can be very fast using adaptive rejection sampling. However, including a leverage effect or any nonlinearity in the state equations such as a polynomial for instance, i.e.  $\theta_t = \phi_0 + \phi_1\theta_{t-1} + \phi_2\theta_{t-1}^2$ , will result in non-logconcave full conditionals for *all* states, thereby requiring ‘Metropolis–Hastings–within–Gibbs’ sampling. This makes the Gibbs sampler almost prohibitively slow for typical financial time series of about 1000 time points. With more efficient MH algorithms such as those based on slice sampling and adaptive techniques that are currently being developed and implemented (Lunn *et al.*, 2000), this might only be a transient curb and overcome with future enhancements of the BUGS software.

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## APPENDIX

### returns.dat

```
-0.320221363079782
1.46071929942995
-0.408629619810947
1.06096027386685
1.71288920763163
0.404314365893326
-0.905699012715806
-1.01657225575983
.
.
.
2.22371628398118
```

### returns\_S.dat

```
list(y = c(-0.320221363079782, 1.46071929942995, ..., 2.22371628398118))
```

### sv.in



0.975  
0  
50

### sv.cmd

```
compile("sv.bug")
update(10000)
monitor(phi,20)
monitor(tau,20)
monitor(beta,20)
update(100000)
stats(phi)
stats(tau)
stats(beta)
q()
```

### sv.bug:

```
model volatility;
const n=945;

var y[n], yisigma2[n], theta0, theta[n], thmean[n],
    mu, beta, phi, phistar, tau, itau2;

data y in "returns.dat";
inits phistar, mu, itau2 in "sv.in";

{
# likelihood: joint distribution of ys

for (t in 1:n) { yisigma2[t] <- 1/exp(theta[t]);
                y[t] ~ dnorm(0,yisigma2[t]);
                }

# prior distributions

mu ~ dnorm(0,0.1);
phistar ~ dbeta(20,1.5);
itau2 ~ dgamma(2.5,0.025);
beta <- exp(mu/2);
phi <- 2*phistar-1;
tau <- sqrt(1/itau2);

theta0 ~ dnorm(mu,itau2);
thmean[1] <- mu + phi*(theta0-mu);
theta[1] ~ dnorm(thmean[1],itau2);
for (t in 2:n) { thmean[t] <- mu + phi*(theta[t-1]-mu);
                theta[t] ~ dnorm(thmean[t],itau2);
                }
}
```

bugs.log

Bugs&gt;stats(phi)

mean	sd	2.5% :	97.5% CI	median	sample
9.797E-1	1.144E-2	9.524E-1	9.963E-1	9.815E-1	5000

Bugs&gt;stats(tau)

mean	sd	2.5% :	97.5% CI	median	sample
1.562E-1	3.184E-2	1.011E-1	2.282E-1	1.537E-1	5000

Bugs&gt;stats(beta)

mean	sd	2.5% :	97.5% CI	median	sample
7.209E-1	1.198E-1	5.596E-1	1.018E+0	6.955E-1	5000