

# Composite Likelihood Methods for Large Bayesian VARs with Stochastic Volatility\*

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**Abstract:** Adding multivariate stochastic volatility of a flexible form to large Vector Autoregressions (VARs) involving over a hundred variables has proved challenging due to computational considerations and over-parameterization concerns. The existing literature either works with homoskedastic models or smaller models with restrictive forms for the stochastic volatility. In this paper, we develop composite likelihood methods for large VARs with multivariate stochastic volatility. These involve estimating large numbers of parsimonious sub-models and then taking a weighted average across these sub-models. We discuss various schemes for choosing the weights. In our empirical work involving VARs of up to 196 variables, we show that composite likelihood methods have similar properties to existing alternatives used with small data sets in that they estimate the multivariate stochastic volatility in a flexible and realistic manner and they forecast comparably. In very high dimensional VARs, they are computationally feasible where other approaches involving stochastic volatility are not and produce superior forecasts than natural conjugate prior homoskedastic VARs.

**Keywords:** Bayesian, large VAR, composite likelihood, prediction pools, stochastic volatility

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# 1 Introduction

Large VARs, involving dozens or more dependent variables, are increasingly used in a variety of macroeconomic applications. The literature began with the US macroeconomic application of Banbura, Giannone and Reichlin (2010) but large VARs are now used with similar macroeconomic data sets for other countries (e.g. Bloor and Matheson, 2010). There are also applications where large VARs arise due to the need to build a model involving variables for many countries (e.g. Carriero, Kapetanios and Marcellino, 2010, and Koop and Korobilis, 2016). In addition, large VARs have arisen through having to deal with many related variants of a single variable (e.g. interest rates of different maturities or the different components that make up an inflation index), see Carriero, Kapetanios and Marcellino (2012) or Giannone, Lenza, Momferatou and Onorante (2014). They can also arise through the use of mixed frequency data (e.g. McCracken, Owyang and Sekhposyan, 2016). Large VARs have also been used for structural economic analysis or scenario forecasting in papers such as Bańbura, Giannone and Lenza (2015) and Jarociński and Maćkowiak (2016). In short, large VARs are increasingly used for a plethora of purposes and are promising to become one of the major tools of modern empirical macroeconomics.

Bayesian methods are typically used with large VARs so as to overcome the over-parameterization problems which plague them. For instance, when working with a large VAR with  $N = 100$  variables and a lag length of  $p = 13$  (as might be required with monthly data), the researcher will have over 100,000 VAR coefficients to estimate and 5,050 free parameters in the error covariance matrix. Bayesian prior shrinkage, often using natural conjugate or Minnesota priors, is used to surmount the problems caused by a shortage of data information relative to the number of coefficients being estimated. Even with these priors, which imply that the posterior and one-step ahead predictive densities have analytical forms, the researcher can face a substantial computational burden. The main computational bottleneck is dealing with the huge posterior covariance matrix of the VAR coefficients (even in the absence of deterministic terms it is an  $N^2p \times N^2p$  matrix).<sup>1</sup> Use of the natural conjugate prior in a standard homoskedastic VAR leads to a particular Kronecker product form for the posterior covariance matrix involving separate  $N \times N$  and  $Np \times Np$  matrices which can be manipulated independently of one another (see Chan, 2015 or Carriero, Clark and Marcellino, 2016a). This vastly simplifies computation. The problem is that small departures from the natural conjugate prior VAR destroy the Kronecker structure and, thus, lead to huge increases in the computational burden. With large VARs this makes many sensible alternative approaches untenable. This holds true for alternative approaches using less subjective priors that allow for

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<sup>1</sup>It is worth stressing that the main computational hurdle does not relate to the error covariance matrix but the VAR coefficients. In finance, there are several methods (see, among many others, Creal and Tsay, 2015) for dealing with large-dimensional covariance matrices (e.g. involving asset returns for a huge number of assets) in models where the conditional means of the dependent variables are of low dimension (often zero). These are not relevant for our purposes.

automatic shrinkage of coefficients found to be unimportant (e.g. the variable selection prior of George, Sun and Ni, 2008, Koop, 2013 and Korobilis, 2013, or the Lasso prior of Gefang, 2014). It also holds true for specifications which allow for time-variation in parameters. It is the latter which is the focus of the present paper.

Papers such as Clark (2011) highlight the particular importance in macro-economic applications of allowing for time-variation in the error covariance matrix. Hence, this is what we focus on in this paper (although the econometric methods we develop could also be used with the time-varying parameter VAR). Since the elements of this matrix enter impulse responses and have a large impact on predictive variances, use of mis-specified homoskedastic models can lead to invalid structural inference and poor forecasts. But with large VARs standard approaches (e.g. Primiceri, 2005) which allow for multivariate stochastic volatility are not computationally feasible. This has led to various stochastic volatility specification that can be used with larger VARs (e.g. Chan 2015 and Carriero, Clark and Marcellino, 2016a,b,c). However, these place restrictions on the form of time variation allowed for. And even these have a large computational burden which means they cannot be used for forecasting with the large VARs involving hundreds of dependent variables which are increasingly being used.<sup>2</sup>

In this paper, we use composite likelihood methods to allow us to approximate less restrictive specifications for the time variation in the error covariance matrix in a computationally practical manner. We derive composite likelihood methods for use with large VARs with stochastic volatility (VAR-SV). The basic idea of our methods is to combine inference from smaller sub-models. In our case, these sub-models will be small VAR-SV's. Working with small VAR-SV's has three important advantages. First, the computational burden is vastly reduced. Second, over-parameterization concerns are greatly reduced. Third, the role of prior information becomes less important than in large VARs where the number of parameters is large relative to the number of observations. Thus, prior elicitation is easier.

However, if the ideal model is a large VAR with multivariate stochastic volatility, several questions arise relating to the issue of whether working with composite likelihood methods involving many smaller VAR-SV models will provide a good approximation to the ideal. The first of these is whether there is a theoretically strong justification for use of composite likelihood methods in our context. We discuss relevant econometric theory in the next section of the paper. The second question is: How should the various sub-models that arise with composite likelihood methods be combined? This question we also address in the next section of the paper. In particular, we discuss various methods for doing so, drawing on the literature on opinion pools. The third question is: How

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<sup>2</sup>Perhaps the best of the current approaches is developed in Carriero, Clark and Marcellino (2016b). In this paper, impulse responses are presented using a 125 variable VAR, but when forecasting only a 20 variable VAR is used. Repeatedly forecasting with this model on an expanding window of data with the 196 variables used in this paper would take months or more of computer time on a good PC.

well do these methods work in practice? We answer this in the third section, using a large quarterly US macroeconomic data set involving 196 variables. We find our composite likelihood methods to forecast substantially better than a homoskedastic VAR using a natural conjugate prior. We would like to compare our methods to other approaches which involve multivariate stochastic volatility in this large data set, but cannot do since the computational burden of popular Bayesian alternatives is too large. Instead, we compare our methods to a range of different Bayesian VARs with multivariate stochastic volatility using a small data set involving 7 variables. We find parameter estimates produced by our approach to be very similar to those produced by these alternatives. This offers reassurance that the approximation inherent in the use of composite likelihood methods with VAR-SVs is an accurate one. We also find our (large data set) composite likelihood methods to forecast slightly better than the (small data set) Bayesian VAR-SV alternatives.

## 2 Composite Likelihood Methods for large VARs with Stochastic Volatility

### 2.1 Overview

A traditional likelihood function is based on the p.d.f. of the  $N \times 1$  vector of dependent variables,  $y_t$  for  $t = 1, \dots, T$ . In many empirical cases, particularly if  $N$  is large, computation involving a likelihood function can be difficult or infeasible. In such cases, it may be possible to develop statistical methods for estimating the parameters in the likelihood function or forecasting using the composite likelihood instead of the full likelihood. The composite likelihood is built up as a weighted average of likelihoods for  $y_{i,t}$  for  $i = 1, \dots, M$  which are sub-vectors of  $y_t$  (we will call these the likelihood components or sub-models in this paper). Bayesian methods can then be used by combining a prior with the composite likelihood in the standard way. Thus, if  $y_{i,t}$  is of much lower dimension than  $y_t$ , a computationally difficult problem of working with a large model can be turned into a much simpler one of working with many small sub-models.

There are theoretical and empirical reasons for thinking the composite likelihood function can, in many cases, provide a good approximation to the likelihood function. In addition to computational gains, composite likelihood methods can be useful for reasons of robustness. That is, with high dimensional models, there are more ways to become mis-specified than with low dimensional densities and, thus, working with the latter can be more robust. Composite likelihood methods can also have advantages in terms of parsimony. That is, high dimensional models like large VARs are hugely over-parameterized. The correct specification is likely a highly restricted version of the large VAR. The existing Bayesian large VAR literature tries to overcome this problem through the use of prior shrinkage. Using composite likelihood methods, it may be possible to approximate the correct specification in a much more parsimonious fashion, thus leading to more precise inference. Furthermore, since composite likelihood

methods are much less reliant on prior shrinkage, they may approximate the correct specification more closely than large VARs with prior shrinkage in the case that the large VAR prior chosen is a poor one (e.g. one which reflects prior beliefs which are at odds with the correct specification).

The preceding paragraph provides the basic justifications and insights that underlie the methods we use in this paper and which we elaborate on in this section. Composite likelihood methods have been exploited in several fields. For instance, Pakel, Shephard, Sheppard and Engle (2014) is a financial application involving a large number of stock returns. These methods have also been used in spatial statistics (e.g. Ribatet, Cooley and Davison, 2012). But they have been rarely used in macroeconomics. Two exceptions to this lie in the field of Dynamic Stochastic General Equilibrium (DSGE) modelling: Canova and Matthes (2017) and Qu (2016). To our knowledge, our paper is the first to use them in the large VAR field in order to add flexible and computationally feasible forms of multivariate stochastic volatility to large VARs.

## 2.2 The VAR-SV

We begin by defining the VAR-SV. Specifications identical or similar to this have been used in a huge range of papers, including Primiceri (2005), Koop, Leon-Gonzalez and Strachan (2009), Clark (2011), D'Agostino, Gambetti and Giannone (2013) and Chan and Eisenstat (2016). The VAR-SV model can be written as:

$$A_{0t}y_t = c + A_1y_{t-1} + \dots + A_p y_{t-p} + \epsilon_t,$$

where  $c$  is an  $N \times 1$  vector of intercepts,  $A_1, \dots, A_p$  are  $N \times N$  matrices of VAR coefficients,  $\Sigma_t = \text{diag}(e^{h_{1,t}}, \dots, e^{h_{n,t}})$  and  $A_{0t}$  is a time varying  $N \times N$  lower triangular matrix with ones on the diagonal, to be specific,

$$A_{0t} = \begin{pmatrix} 1 & 0 & \dots & 0 \\ a_{21,t} & 1 & \dots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ a_{n1,t} & a_{n2,t} & \dots & 1 \end{pmatrix}.$$

It is convenient to re-write the VAR-SV as

$$y_t = X_t\beta + W_t a_t + \epsilon_t, \quad \epsilon_t \sim N(0, \Sigma_t), \quad (1)$$

where  $X_t = I_n \otimes (1, y'_{t-1}, \dots, y'_{t-p})$ ,  $a_t$  is an  $\frac{N(N-1)}{2} \times 1$  vector consists of the free elements of  $A_{0t}$  stacked by rows, and  $W_t$  is an  $N \times \frac{N(N-1)}{2}$  matrix,

$$W_t = \begin{pmatrix} 0 & 0 & 0 & \dots & \dots & \dots & 0 \\ -y_{1,t} & 0 & 0 & \dots & \dots & \dots & 0 \\ 0 & -y_{1,t} & -y_{2,t} & \dots & \dots & \dots & 0 \\ \vdots & \vdots & \ddots & \vdots & \dots & \dots & 0 \\ 0 & \dots & \dots & -y_{1,t} & -y_{2,t} & \dots & -y_{N-1,t} \end{pmatrix}.$$

The log-volatilities  $h_t = (h_{1,t}, \dots, h_{N,t})'$  and the time-varying parameters  $a_t$  are assumed to follow random walk processes:

$$h_t = h_{t-1} + \epsilon_t^h, \quad \epsilon_t^h \sim N(0, \Sigma_h), \quad (2)$$

$$a_t = a_{t-1} + \epsilon_t^a, \quad \epsilon_t^a \sim N(0, \Sigma_a), \quad (3)$$

where  $\Sigma_h = \text{diag}(\sigma_{h,1}^2, \dots, \sigma_{h,N}^2)$  and  $\Sigma_a = \text{diag}(\sigma_{a,1}^2, \dots, \sigma_{a, \frac{N(N-1)}{2}}^2)$ .

It can be seen that the VAR-SV can have an enormous number of parameters when  $N$  is large. This has led large VAR researchers to work with restricted versions of the stochastic volatility process. An influential recent model is the common drifting volatility specification of Carriero, Clark and Marcellino (2016a) which we denote by VAR-CCM1 and use in our empirical work. This is the same as the VAR-SV except that  $a_t = 0$  and  $\Sigma_t = e^{h_t} \Sigma$ , where the  $\Sigma$  is an  $N \times N$  positive definite matrix and  $h_t$  is a scalar stochastic volatility process:

$$h_t = \rho h_{t-1} + \epsilon_t^h, \quad \epsilon_t^h \sim \mathcal{N}(0, \sigma_h^2).$$

This, much more parsimonious, specification has been successfully used with large VARs. But it does severely restrict the form that the time variation in the error covariance matrix can take. In our empirical work, we compare our new approach to the VAR-CCM1. We also use another specification proposed in Carriero, Clark and Marcellino (2016b) which we label VAR-CCM2. This amounts to the VAR-SV with  $a_t$  restricted to be time-invariant.

## 2.3 The Theory of Composite Likelihood Methods

### 2.3.1 Preliminaries

Assuming serially independent errors, the likelihood function for  $y = (y_1', \dots, y_T')'$  can be written as:

$$L(y; \theta) = \prod_{t=1}^T L(y_t; \theta), \quad (4)$$

where  $L(y_t; \theta) = p(y_t | \theta)$ . The composite likelihood is defined as

$$L^C(y; \theta) = \prod_{t=1}^T \prod_{i=1}^M L^C(y_{i,t}; \theta)^{w_i}, \quad (5)$$

where  $L^C(y_{i,t}; \theta) = p(y_{i,t} | \theta)$  and  $w_i$  is the weight attached to each likelihood component with  $\sum_{i=1}^M w_i = 1$ . The weights will be discussed in sub-section 2.3.3.

The maximum composite likelihood estimator (MCLE) involves taking the maximum of  $L^C(y; \theta)$ . Bayesian estimation proceeds using a posterior based on the composite likelihood (i.e. the Bayesian composite posterior is  $p^C(\theta | y) \propto L^C(y; \theta) p(\theta)$  where  $p(\theta)$  is the prior).

In theory, the likelihood components used to build a composite likelihood can be anything. That is,  $y_{i,t}$  for  $i = 1, \dots, M$  can be any sub-sets of  $y_t$  and, indeed,

$y_{i,t}$  and  $y_{j,t}$  can overlap. For computational purposes, the key issue is that  $y_{i,t}$  and  $M$  should be small enough to lead to fast estimation. For instance, Pakel, Shephard, Sheppard and Engle (2014), in an application involving stock returns for 129 companies, achieve these goals by considering all bivariate distributions involving each distinct pair of assets. Thus, they work with  $M = \frac{N(N-1)}{2} = 8,256$  bivariate Dynamic Conditional Correlation (DCC) models which is much easier than trying to work with a 129 dimensional DCC model.

With large VARs, it is common to have a few core variables of interest either for impulse response analysis (e.g. as in the FAVAR approach of Bernanke, Boivin and Elias, 2005, where the interest rate is isolated in order to identify a monetary policy shock) or forecasting. In this spirit, we propose partitioning  $y_t = \begin{pmatrix} y_t^* \\ z_t \end{pmatrix}$  where  $y_t^*$  is  $N_*$ -dimensional and contains the core variables of interest and  $z_t$  (with elements denoted by  $z_{i,t}$ ) is the  $N_{other} = N - N_*$  vector which contains the remaining variables. Then we can let  $y_{i,t} = \begin{pmatrix} y_t^* \\ z_{i,t} \end{pmatrix}$  for  $i = 1, \dots, N_{other}$  and, thus,  $M = N_{other}$ . Our composite likelihood VAR-SV (VAR-CL-SV) application will involve sub-models which are all  $N_* + 1$  dimensional VAR-SVs. To give the reader a rough guideline of computation time: estimating the VAR-CL-SV with  $N = 100$  and  $N_* = 3$  would involve using MCMC methods with 97 4-variate VAR-SVs which a good PC can run in a few hours.<sup>3</sup>

### 2.3.2 Asymptotic Results

The standard frequentist way of investigating the theoretical properties of composite likelihoods is to assume that  $L(y; \theta)$  is the true data generating process involving a true parameter value  $\theta = \theta^0$  and derive the behavior of the MCLE. Results exist in the literature noting that the MCLE should converge asymptotically to  $\theta^0$  under certain assumptions (see, e.g., Varin, Reid and Firth, 2011 or Ribatet, Cooley and Davison, 2012). But such results are limited and model dependent. In a recent survey, Varin, Reid and Furth (2011, page 34) conclude: “Using the most general definition of composite likelihood, it may be difficult to derive very many specific properties beyond perhaps consistency of the point estimator.” Ribatet, Cooley and Davison (2012, section 2.3.1) derive asymptotic Bayesian results using  $p^C(\theta|y)$  and show that this posterior will also converge to  $\theta^0$  under certain assumptions. We take these results as offering general support for the idea that, in finite samples, the composite likelihood is often a reasonable approximation to  $L(y_t; \theta)$ .

However, it is important to dig a bit deeper into the assumptions that underlie both frequentist and Bayesian asymptotic theories discussed above. In (5), we have written the likelihood components as  $L(y_{i,t}; \theta)$  which all depend upon a common parameter vector  $\theta$ . In the VAR-CL-SV this will not be the case. Some parameters will not appear in any of the likelihood components. For

<sup>3</sup> Allowing  $y_{i,t}^*$  to involve all distinct pairs of variables would involve working with roughly 5,000 5-variate VAR-SVs which would raise the computational burden by more than a factor of 50, but still be feasible in some empirical contexts.

instance, consider the equations for  $z_{i,t}$  and  $z_{j,t}$  for  $i \neq j$ . A large VAR-SV will contain a time-varying error covariance between these two equations. However, this error covariance will not appear in the composite likelihood function and so it will be impossible to obtain consistent estimates of it using  $L^C(y; \theta)$ .

Pakel, Shephard, Sheppard and Engle (2014) set up the composite likelihood function somewhat differently, involving likelihood components  $L(y_{i,t}; \theta, \eta_i)$  where  $\eta_i$  are nuisance parameters specific to sub-model  $i$  and  $\theta$  are the parameters of interest which are common to all models. This set-up is more appropriate for our case since we are interested in the time-varying error covariance matrix corresponding to the upper left-hand  $N_* \times N_*$  block of the error covariance matrix (which is common to all models). In our case, the time-varying error covariances of the other variables are of subsidiary interest. Pakel, Shephard, Sheppard and Engle (2014) show that, under a set of stronger assumptions,<sup>4</sup>  $\theta$  is consistent (although they do not provide a central limit theorem). Under these assumptions they show that the incidental parameter bias present in many related approaches vanishes asymptotically. We rely on this theory to justify including a set of  $y_t^*$  variables in each component of the composite likelihood and using the remaining  $z_t$  variables as only being useful insofar as they improve estimation of the error covariance matrix for the  $y_t^*$  variables.

For the choice of sub-models made in the preceding sub-section, we have been able to prove asymptotic convergence of the composite likelihood to that of a restricted VAR-SV of the following form:

$$\begin{pmatrix} A_{y,t} & 0 & \cdots & 0 \\ -\alpha'_{z,1,t} & 1 & \cdots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ -\alpha'_{z,M,t} & 0 & \cdots & 1 \end{pmatrix} \begin{pmatrix} y_t^* \\ z_{1,t} \\ \vdots \\ z_{M,t} \end{pmatrix} = \begin{pmatrix} c_y \\ c_{z,1} \\ \vdots \\ c_{z,M} \end{pmatrix} + \sum_{j=1}^p \begin{pmatrix} B_{yy,j} & \frac{w_1}{g(M)}\beta_{yz,1,j} & \cdots & \frac{w_M}{g(M)}\beta_{yz,M,j} \\ \beta'_{zy,1,j} & \beta_{zz,1,j} & \cdots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ \beta'_{zy,M,j} & 0 & \cdots & \beta_{zz,M,j} \end{pmatrix} \begin{pmatrix} y_{t-j}^* \\ z_{1,t-j} \\ \vdots \\ z_{M,t-j} \end{pmatrix} + \begin{pmatrix} \epsilon_{y,t} \\ \epsilon_{z,1,t} \\ \vdots \\ \epsilon_{z,M,t} \end{pmatrix},$$

with  $\epsilon_{y,t} \sim N(0, \Sigma_{y,t})$ ,  $\epsilon_{z,i,t} \stackrel{iid}{\sim} N(0, e^{h_{N^*+i,t} - \ln w_i})$  independent of each other and

$$A_{y,t} = \begin{pmatrix} 1 & 0 & \cdots & 0 \\ -\alpha_{21,t} & 1 & \cdots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ -\alpha_{N_*1,t} & -\alpha_{N_*2,t} & \cdots & 1 \end{pmatrix}, \Sigma_{y,t} = \begin{pmatrix} e^{h_{1,t}} & & & \\ & e^{h_{2,t}} & & \\ & & \ddots & \\ & & & e^{h_{N_*,t}} \end{pmatrix}.$$

<sup>4</sup>Standard assumptions relating to asymptotic mixing either involve the dependence between the same variable at different points in time or different variables at the same point in time. They add to these standard assumptions, additional mixing assumptions relating to the dependence between different variables at different points in time.



Observe that this is a VAR-SV of the form

$$\tilde{A}_t y_t = c + \sum_{j=1}^p \tilde{B}_j y_{t-j} + \epsilon_t, \quad (6)$$

with some elements of  $\tilde{A}_t$  and  $\tilde{B}_j$  restricted to zero and some elements of  $\tilde{B}_j$  shrunk towards zero by factors  $\frac{w_1}{g(M)}, \dots, \frac{w_M}{g(M)}$  where  $g(M)$  is a function of  $M$ .

A word of explanation is in order about  $g(M)$ . A sufficient condition for the proof of the following proposition depends  $\frac{\sqrt{M}}{g(M)}$  to be bounded for all  $M$  (e.g. if  $g(M) = \sqrt{M}$  our proof follows standard law of large numbers results). But this condition is exactly what prior shrinkage in VARs usually does. That is, in our approach as  $M$  increases  $N$  also increases and the VAR dimension increases. It is standard for Bayesians working with large VARs to increase prior shrinkage (e.g. using the Minnesota prior) when VAR dimension increases (see, e.g., Table 1 of Banbura Giannone and Reichlin, 2010). Hence, the presence (and interpretation) of  $g(M)$  is justified as being equivalent to the types of prior shrinkage commonly used in large Bayesian VARs. Note too that  $g(M)$  only applies to other lags in the equations for the core variables, so the convergence of the composite likelihood to a restricted VAR-SV only depends on the presence of shrinkage on these coefficients.

It is important to emphasize that  $L^C(y; \theta)$  is not a true likelihood in the sense that it is not a density in the data (conditional on parameters) that integrates to one. To compare it to a conventional likelihood for the restricted VAR-SV given in (6),  $L(y; \theta)$ , we consider the normalized composite likelihood

$$\tilde{L}^C(y; \theta) = \frac{L^C(y; \theta)}{\int_y L^C(y; \theta) dy}.$$

A useful measure of the approximation error associated with using  $L^C(y; \theta)$  instead of  $L(y; \theta)$  is the Kulback-Liebler divergence of  $L(y; \theta)$  from  $\tilde{L}^C(y; \theta)$ , denoted  $D_{KL}(L \parallel \tilde{L}^C)$ , which is summarized in the following proposition.

**Proposition 1** *Assume  $\max\{w_i\}$  is decreasing in  $M$  and  $\frac{\sqrt{M}}{g(M)} < \infty$  for all  $M \geq 1$ . Then*

$$\lim_{M \rightarrow \infty} D_{KL}(L \parallel \tilde{L}^C) = 0.$$

The proof of this proposition is in the Technical Appendix. The assumption that  $\max\{w_i\}$  is decreasing in  $M$  is innocuous as it implies only that when we add a new sub-model it has non-zero weight which will leave less weight for the other models, including the model with maximum weight. Thus, our composite likelihood using small VAR-SV sub-models asymptotically converges to a particular large VAR-SV under sensible assumptions.

Of course, given the way we have defined our sub-models, it is not possible to asymptotically converge to an unrestricted large VAR-SV since (as noted previously) some of the unrestricted model's parameters appear in none of our

sub-models. If interest lies in using composite likelihood methods to provide estimates of all the parameters in a large VAR-SV, then other sub-models should be chosen to build a composite likelihood function (e.g. building a set of sub-models involving all possible bivariate or tri-variate combinations of the variables). Our choice of sub-models is based on our choice of empirical problem. We are interested in forecasting a small number of variables, using the other variables only to improve these forecasts. For this, our choice of sub-models is a sensible one.

### 2.3.3 Composite Likelihoods as Opinion Pools

An alternative way of theorizing about composite likelihoods, popular among Bayesians (see, e.g., Roche, 2016) is to begin by assuming there is some feature of interest,  $\theta$  (in our case, the error covariance matrix relating to the core variables). There are many “agents” each of which uses a (possibly agent-specific) information set to produce an “opinion” (i.e. a posterior) about  $\theta$ . The opinions going into the pool can be obtained from any source. The question arises as to how to pool these opinions? There is a literature on such opinion or prediction pools. Geweke and Amisano (2011) is an influential approach in econometrics. Genest, Weerahandi, Zidek (1984) and Genest, McConway and Schervish (1986) are influential early references which establish or review many theoretical properties of opinion pools.

If, in our case, we interpret each likelihood component,  $L^C(y_{i,t}; \theta)$ , as arising from an agent, we can draw on this literature to obtain a theoretical justification for our approach. In sub-section 2.2.1, we defined the Bayesian composite posterior  $p^C(\theta|y)$  based on the composite likelihood (5). Papers such Roche (2016) shows that Bayesian inference using the composite likelihood can be interpreted as arising from a generalized logarithmic opinion pool. This offers strong theoretical justification for our approach. Genest et al (1984) show that such opinion pools have attractive properties including external Bayesianity. External Bayesianity implies that, if all agents agree on the same prior, then it does not matter whether the prior is added before or after the opinions are pooled. Generalized logarithmic opinion pools are the only class of opinion pools that have this property.

An alternative approach is to use linear opinion pools (e.g. Hall and Mitchell, 2007, and Geweke and Amisano, 2011). The use of linear opinion pools means this approach does not satisfy external Bayesianity nor lead to Bayesian inference based on  $p^C(\theta|y)$ . However, as discussed in Geweke and Amisano (2011), linear pools also have attractive properties and often give results that are different from logarithmic opinion pools. Hence, even though they are not a composite likelihood approach, they are closely related and we include them in our set of empirical results.

The advantage of drawing on the opinion pool literature is that it offers insights into how the weights,  $w_i$  for  $i = 1, \dots, M$ , can be chosen. In our empirical work, we consider a range of approaches. Setting the weights to be equal ( $w_i = \frac{1}{M}$ ) is simple and commonly done. However, this often leads to a problem

known as “information overload”. Adding more and more agents can lead to less precise inference as the agents with good opinions will find their signal swamped. An advantage of the linear opinion pool formulation is that it derives a set of weights which are optimal for the linear pool and provides a method for calculating them.

In the logarithmic opinion pool formulation, a logical thing to do (see Canova and Matthes, 2017) is to base the weights based on some measure of the fit of each sub-model. In our application, where each component used in the composite likelihood is a VAR-SV involving a set of core variables ( $y_t^*$ ) and one other variable, it makes sense to use the marginal likelihood or an approximation to it to calculate the weights. Hence, we consider weighting schemes based on the Bayesian information criterion (BIC), the Deviance Information criterion (DIC) and the marginal likelihood. Letting  $\text{BIC}_i$  be the BIC for sub-model  $i$ , we have

$$\text{BIC}_i = -2 \log L(y^*; \hat{\theta}_i) + d \log(T),$$

where  $\hat{\theta}$  is the maximum likelihood estimate using sub-model  $i$ ,  $y^* = (y_1^*, \dots, y_T^*)'$  and  $d$  is the number of free parameters. We stress that, in each sub-model, we are only using the core variables (which are common to all sub-models) to define the BIC. The maximum likelihood estimate is computed using the integrated likelihood as in Chan and Eisenstat (2016). The weight for each sub-model is computed as

$$w_i^{\text{BIC}} = \frac{e^{-\frac{1}{2}\text{BIC}_i}}{\sum_{j=1}^M e^{-\frac{1}{2}\text{BIC}_j}}, \quad \text{for } i = 1, \dots, M.$$

Our second set of weights follows the same strategy, but using DIC instead of BIC. DIC is calculated based on the integrated likelihood for the core variables of interest (see Chan and Grant, 2016, for details).

The third weighting scheme is based on the marginal likelihood. We use the following marginal likelihood for sub-model  $i$ :

$$\text{ML}_i = \int p_i(y^*|\theta)p(\theta)d\theta,$$

where  $p_i(y|\theta) = \prod_{t=1}^T L^C(y_{i,t}; \theta)$  and  $p_i(y^*|\theta)$  implies evaluating the marginal likelihood only using the core variables. The weight for each sub-model is computed as

$$w_i^{\text{ML}} = \frac{\text{ML}_i}{\sum_{j=1}^M \text{ML}_j}.$$

We use the abbreviations, VAR-CL-BIC, VAR-CL-DIC and VAR-CL-ML for composite likelihood methods involving these three different weights.

In the linear opinion pool approach calculating the optimal weights involves the following steps. Let  $p_i(y_t^*|y_{1:t-1})$  be the one-step-ahead predictive density

for the core variables for the  $i^{th}$  sub-model and  $w = (w_1, w_2, \dots, w_M)'$ . The predictive log score function is given by

$$f(w) = \sum_{t=1}^T \log \left( \sum_{i=1}^M w_i p_i(y_t^* | y_{1:t-1}) \right).$$

The optimal weight is obtained by solving the optimization problem  $\hat{w} = \operatorname{argmax}_w f(w)$ . We use VAR-LIN as the abbreviation for this approach. Even though these weights are calculated to be optimal in the linear opinion pool case, we can use them as weights in the composite likelihood. We refer to such an approach as VAR-CL-LIN.

### 3 Bayesian Analysis Using the Composite Posterior

#### 3.1 Sub-model Posterior Distributions

Our goal is to carry out Bayesian analysis on the composite posterior using MCMC draws from each of the sub-models. This section develops an algorithm for doing so. We first extend our earlier notation to define the sub-models. Remember that each of these is a VAR-SV that combines core variables of interest,  $y_t^*$ , with an additional variable,  $z_{i,t}$ . Thus, sub-model  $i$  (for  $i = 1, \dots, M$ ) can be expressed in the form:

$$A_{y,t} y_t^* = X_{y,t} \beta_y + X_{z,t} \beta_{yz} + \epsilon_{y,t}, \quad \epsilon_{y,t} \sim N(0, \Sigma_{y,t}), \quad (7)$$

$$z_{i,t} = y_t^* \alpha_{z,t} + X_t \beta_z + \epsilon_{z,t}, \quad \epsilon_{z,t} \sim N(0, e^{h_{N_*+i,t}}), \quad (8)$$

$$A_{y,t} = \begin{pmatrix} 1 & 0 & \dots & 0 \\ \alpha_{21,t} & 1 & \dots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ \alpha_{N_*1,t} & \alpha_{N_*2,t} & \dots & 1 \end{pmatrix}, \quad \Sigma_{y,t} = \begin{pmatrix} e^{h_{1,t}} & & & \\ & e^{h_{2,t}} & & \\ & & \ddots & \\ & & & e^{h_{N_*t}} \end{pmatrix}.$$

In (7), the matrix  $X_{y,t}$  contains lags of  $y_t^*$ , and the matrix  $X_{z,t}$  contains lags of  $z_{i,t}$ .

Let  $\theta = \{\beta_y, A_{y,1}, \dots, A_{y,T}, \Sigma_{y,1}, \dots, \Sigma_{y,T}\}$  be the set of parameters that are common in all sub-models, and denote by  $\eta_i = \{\beta_{yz}, \beta_z, \alpha_{z,1}, \dots, \alpha_{z,T}, h_{N_*+i,0}, \dots, h_{N_*+i,T}\}$  the parameters that appear only in sub-model  $i$ . Each sub-model  $i$  is characterized by the posterior

$$p_i(\theta, \eta_i | y^*, z_i) = p(\theta, \eta_i) p(y^*, z_i | \theta, \eta_i) / p(y^*, z_i)$$

where  $z_i = (z_{i,1}, \dots, z_{i,T})'$ .

A key feature of our set-up is that the likelihood of each sub-model can be

conveniently decomposed as:

$$\begin{aligned}
p(y^*, z_i | \theta, \eta_i) &= \prod_{t=1}^T p(y_t^* | y_{t-1}^*, \dots, y_{t-p}^*, z_{i,t-1}, \dots, z_{i,t-p}, \beta_y, \beta_{yz}, A_{y,t}, \Sigma_{y,t}) \\
&\quad \times p(z_{i,t} | y_t^*, y_{t-1}^*, \dots, y_{t-p}^*, z_{i,t-1}, \dots, z_{i,t-p}, \beta_z, \alpha_{z,t}, h_{N_*+i,t}), \\
&= \left( \prod_{t=1}^T p(y_t^* | \cdot) \right) \left( \prod_{t=1}^T p(z_{i,t} | y_t^*, \cdot) \right), \\
&= p(y^* | \tilde{z}_i, \theta, \beta_{yz}) p(z_i | y^*, \tilde{\eta}_i),
\end{aligned}$$

where  $\tilde{z}_i = \{z_{i,1}, \dots, z_{i,T-1}\}$  and  $\tilde{\eta}_i = \{\beta_z, \alpha_{z,1}, \dots, \alpha_{z,T}, h_{N_*+i,0}, \dots, h_{N_*+i,T}\}$ .

In this decomposition,  $p(y^* | \tilde{z}_i, \theta, \beta_{yz})$  is the density of a multivariate normal distribution that can be regarded as the likelihood for the model in (7), with  $z_{i,1}, \dots, z_{i,T-1}$  treated as exogenous regressors. Moreover, this density can be integrated analytically with respect to a prior on  $\beta_{yz}$  to obtain a density that only contains common parameters  $\theta$ , i.e.  $p(y^* | \tilde{z}_i, \theta) = \int_{\beta_{yz}} p(\beta_{yz}) p(y^* | \tilde{z}_i, \theta, \beta_{yz}) d\beta_{yz}$ . Similarly,  $p(z_i | y^*, \tilde{\eta}_i)$  can be viewed as the multivariate normal likelihood for a time-varying parameter autoregressive distributed lag model (TVP-ARDL) with exogenous  $y_t^*$  defined by (8), with the important feature that it contains only nuisance parameters.

In consequence, if  $\theta$  and  $\tilde{\eta}_i$  are independent in the prior (as we assume in this paper), then they are also independent in the  $i$ th sub-model posterior. Moreover, this independence carries over to the composite posterior defined as

$$\begin{aligned}
p^C(\theta, \tilde{\eta}_1, \dots, \tilde{\eta}_M | y^*, z_1, \dots, z_M) &\propto p(\theta) \prod_{i=1}^M p(\tilde{\eta}_i) p(y^*, z_i | \theta, \tilde{\eta}_i)^{w_i}, \\
&= p^C(\theta | y^*, \tilde{z}_1, \dots, \tilde{z}_M) \prod_{i=1}^M p^C(\tilde{\eta}_i | y^*, z_i), \\
p^C(\theta | y^*, \tilde{z}_1, \dots, \tilde{z}_M) &\propto p(\theta) \prod_{i=1}^M p(y^* | \tilde{z}_i, \theta)^{w_i}, \\
p^C(\tilde{\eta}_i | y^*, z_i) &\propto p(\tilde{\eta}_i) p(z_i | y^*, \tilde{\eta}_i)^{w_i},
\end{aligned}$$

and we have used the identity

$$\begin{aligned}
p(y^*, z_i | \theta, \tilde{\eta}_i) &= \int_{\beta_{yz}} p(\beta_{yz}) p(y^*, z_i | \theta, \eta_i) d\beta_{yz} \\
&= \int_{\beta_{yz}} p(\beta_{yz}) p(y^* | \tilde{z}_i, \theta, \beta_{yz}) p(z_i | y^*, \tilde{\eta}_i) d\beta_{yz} \\
&= p(y^* | \tilde{z}_i, \theta) p(z_i | y^*, \tilde{\eta}_i)
\end{aligned}$$

to construct the composite likelihood in the definition of the posterior.

### 3.2 Simulation from the Composite Posterior

Our computational algorithm involves taking draws from each sub-model  $i$  and then use these draws to analyze the composite posterior  $p^C(\theta, \tilde{\eta}_1, \dots, \tilde{\eta}_M | y^*, z_1, \dots, z_M)$ . The key advantage of this approach is that sampling from each sub-model can be done in parallel and using standard MCMC methods for small VAR-SV models. This allows us to work with hundreds of variables where other approaches which involve use of MCMC methods with large VAR-SV are not feasible.

The decomposition of the composite posterior in the previous sub-section suggests that once draws of  $\theta$  and  $\tilde{\eta}_i$  are obtained from each of the sub-models, we can proceed using these to generate samples from  $p^C(\theta | y^*, \tilde{z}_1, \dots, \tilde{z}_M)$ ,  $p^C(\tilde{\eta}_1 | y^*, z_1), \dots, p^C(\tilde{\eta}_M | y^*, z_M)$  independently.

We begin by considering simulation from  $p^C(\theta | y^*, \tilde{z}_1, \dots, \tilde{z}_M)$  by appropriately pooling draws of  $\theta$  from each of the sub-models. Consider a proposal density  $q(\theta)$  that is a mixture of sub-model posteriors, i.e.

$$q(\theta) = \sum_{i=1}^M w_i p_i(\theta | y^*, z_i) = p(\theta) \sum_{i=1}^M w_i p(y^* | \tilde{z}_i, \theta) / p(y^* | \tilde{z}_i),$$

where  $p(y^* | \tilde{z}_i) = \int_{\theta} p(\theta) p(y^* | \tilde{z}_i, \theta) d\theta$  can be regarded as the marginal likelihood of the VAR-SV with exogenous variables defined in (7).

Note that given a set of weights  $w_i$  for  $i = 1, \dots, M$ , which can be any of those described in section 2.3.3, and draws from  $p_i(\theta | y^*, z_i)$  for  $i = 1, \dots, M$  it is trivial to obtain a set of draws from  $q(\theta)$ . Moreover,  $q(\theta)$  can be easily evaluated because  $p(y^* | \tilde{z}_i)$  can be computed using the algorithm of Chan and Eisenstat (2015) that we use to obtain the marginal likelihood in a VAR-SV (see Section 2.3.3). Finally,  $p(y^* | \tilde{z}_i, \theta)$  is a multivariate normal density given by

$$(y^* | z_i, \theta) \sim N \left( W_y \alpha_y + X_y \beta_y + X_z \beta_{yz}, X_z V_{\beta,z} X_z' + \Sigma_y \right),$$

assuming  $\beta_{yz} \sim N(\beta_{yz}, V_{\beta,z})$  is the prior. In the preceding equation,  $X_y$  and  $X_z$  stack  $X_{y,t}$  and  $X_{z,t}$  which were defined in (7).  $W_{y,t}$  and  $\alpha_{y,t}$  are defined analogously to  $W_t$  and  $a_t$  in (1), but only apply to the core variables.  $W_y$  and  $\alpha_y$  stack  $W_{y,t}$  and  $\alpha_{y,t}$  into matrices and  $\Sigma_y$  is a block diagonal matrix with diagonal blocks  $\Sigma_{y,t}$ .

Observe further that

$$r(\theta) = \frac{\prod_{i=1}^M [p(y^* | \tilde{z}_i, \theta) / p(y^* | \tilde{z}_i)]^{w_i}}{\sum_{i=1}^M w_i p(y^* | \tilde{z}_i, \theta) / p(y^* | \tilde{z}_i)} \leq 1.$$

This follows from the fact that a geometric average is always less than or equal to the arithmetic average. Since we can express

$$p^C(\theta | y^*, \tilde{z}_1, \dots, \tilde{z}_M) \propto p(\theta) \prod_{i=1}^M [p(y^* | \tilde{z}_i, \theta) / p(y^* | \tilde{z}_i)]^{w_i},$$

this suggests a rejection sampling approach to pool draws of common parameters obtained from individual sub-models. Specifically:

1. obtain a candidate draw  $\tilde{\theta} \sim q(\theta)$ ;
2. accept  $\tilde{\theta}$  with probability  $r(\tilde{\theta})$ .

Next, consider obtaining draws from  $p^C(\tilde{\eta}_i | y^*, z_i)$  for each  $i$ . Here we focus on the TVP-ARDL model defined by (8) and observe that sampling from  $p^C(\tilde{\eta}_i | y^*, z_i)$  is equivalent to sampling from the TVP-ARDL posterior of sub-model  $i$  when  $w_i = 1$ . For the more general case with  $w_i < 1$ , it turns out that the standard MCMC method needs only minor modifications.

Specifically, the Gibbs steps needed to obtain draws of the parameters  $\sigma_{h,i}^2$ ,  $\Sigma_\alpha$ ,  $\alpha_{z,0}$  and  $h_{N_*+i,0}$ , conditional on draws of  $\alpha_{z,1}, \dots, \alpha_{z,T}$  and  $h_{N_*+i,1}, \dots, h_{N_*+i,T}$  are identical to the standard case. The Gibbs steps to sample  $\alpha_{z,1}, \dots, \alpha_{z,T}$  and  $\beta_z$  are also very similar, with the only modification being that  $h_{N_*+i,t}$  is replaced by  $\tilde{h}_{N_*+i,t} = h_{N_*+i,t} - \ln w_i$  for all  $t = 1, \dots, T$  and  $i = 1, \dots, M$  in the conditional distributions.

The most substantial adjustment is required in sampling  $h_{N_*+i,1}, \dots, h_{N_*+i,T}$ . To implement this, consider the state-space model defined by

$$\begin{aligned} z_{i,t} &= y_t^{*'} \alpha_{z,t} + x_t' \beta_z + \epsilon_{z,t}, & \epsilon_{z,t} &\sim \mathcal{N}\left(0, e^{\tilde{h}_{N_*+i,t}}\right), \\ \tilde{h}_{N_*+i,t} &= \frac{T-t+1}{2}(1-w_i)\sigma_{h,N_*+i}^2 + \tilde{h}_{N_*+i,t-1} + \epsilon_{N_*+i,t}^h, & \epsilon_{N_*+i,t}^h &\sim \mathcal{N}\left(0, \sigma_{h,N_*+i}^2\right). \end{aligned}$$

Clearly, we can sample  $\tilde{h}_{N_*+i,1}, \dots, \tilde{h}_{N_*+i,T}$  using standard methods for stochastic volatility models. It can be shown that proceeding this way and setting  $h_{N_*+i,t} = \tilde{h}_{N_*+i,t} + \ln w_i$  yields draws from

$$\begin{aligned} &p(h_{N_*+i,1}, \dots, h_{N_*+i,T} | h_{N_*+i,0}, \sigma_{h,N_*+i}^2, \alpha_{z,0}, \alpha_{z,1}, \dots, \alpha_{z,T}, \beta_z, z_i, y^*) \\ &\propto p(h_{N_*+i,1}, \dots, h_{N_*+i,T} | h_{N_*+i,0}, \sigma_{h,N_*+i}^2) \\ &\quad p(z_i | y^*, h_{N_*+i,1}, \dots, h_{N_*+i,T}, \alpha_{z,1}, \dots, \alpha_{z,T}, \beta_z)^{w_i} \end{aligned}$$

as desired.

In summary, our algorithm proceeds by running a standard MCMC algorithm for each of the sub-models, producing candidate draws of  $\theta$  and  $\tilde{\eta}_i$  for  $i = 1, \dots, M$ . These draws are then used in a second re-sampling stage. For  $\theta$ , a simple rejection algorithm is used at this stage. For  $\tilde{\eta}_i$  the re-sampling stage requires some simple Gibbs steps.<sup>5</sup> However, it is worth pointing out that, for the equal weights case (i.e., if we set  $w_i = 1/M$  for  $i = 1, \dots, M$  and, thus,  $\ln w_i$  is the same for all sub-models), then there is no need for  $\tilde{\eta}_i$  to be re-sampled.

## 4 Forecasting

We forecast the core variables at horizon  $h$  using the predictive density  $p^C(y_{T+h}^* | y^*, z_1, \dots, z_M)$  that is obtained from the composite likelihood as follows. The composite pre-

<sup>5</sup>Note that the draws of  $\tilde{\eta}_i$  are only needed to compute MLs, DICs, and BICs, which are only used to compute the weights  $\{w_i\}$ . If the weights are known (e.g. as in the equal weights case), then the algorithm can be simplified slightly and there is no need for  $\tilde{\eta}_i$  to be re-sampled.

dictive density, conditional on the parameters, is given by

$$p^C(y_t^*, z_{1,t}, \dots, z_{M,t} \mid y_{t-1:t-p}, z_{t-1:t-p}, \theta, \tilde{\eta}_1, \dots, \tilde{\eta}_M) = p^C(y_t^* \mid y_{t-1:t-p}^*, z_{t-1:t-p}, \theta) \prod_{i=1}^M p^C(z_{i,t} \mid y_{t:t-p}^*, z_{i,t-1:t-p}, \tilde{\eta}_i),$$

where

$$p^C(y_t^* \mid y_{t-1:t-p}^*, z_{t-1:t-p}, \theta) \propto \prod_{i=1}^M p(y_t^* \mid y_{t-1:t-p}^*, z_{i,t-1:t-p}, \theta)^{w_i},$$

$$p^C(z_{i,t} \mid y_{t:t-p}^*, z_{i,t-1:t-p}, \tilde{\eta}_i) \propto p(z_{i,t} \mid y_{t:t-p}^*, z_{i,t-1:t-p}, \tilde{\eta}_i)^{w_i},$$

and  $z_{t-1:t-p}$  denotes the set of non-core variables and their lags:  $\{z_{1,t-1:t-p}, \dots, z_{M,t-1:t-p}\}$ .

The density  $p^C(y_t^* \mid y_{t-1:t-p}^*, z_{t-1:t-p}, \theta)$  is multivariate normal and has the form

$$(y_t^* \mid y_{t-1:t-p}^*, z_{t-1:t-p}, \theta) \sim N(\hat{y}_t, V_{y,t}),$$

$$\hat{y}_t = W_{y,t} \alpha_{y,t} + X_{y,t} \beta_y + V_{y,t} \left( \sum_{i=1}^M w_i V_{y,i,t}^{-1} X_{z,yz} \beta_{yz} \right),$$

$$V_{y,t} = \left( \sum_{i=1}^M w_i V_{y,i,t}^{-1} \right)^{-1},$$

$$V_{y,i,t} = X_{z,t} V_{\beta,z} X'_{z,t} + \Sigma_{y,t}.$$

The density  $p^C(z_{i,t} \mid y_{t:t-p}^*, z_{i,t-1:t-p}, \tilde{\eta}_i)$  is also normal and has the form

$$(z_{i,t} \mid y_{t:t-p}^*, z_{i,t-1:t-p}, \tilde{\eta}_i) \sim N(y_t^* \alpha_{z,t} + X_t \beta_z, e^{h_{N^*+i,t} - \ln w_i}).$$

Accordingly, the one-step ahead predictive density is given by

$$p^C(y_{T+1}^* \mid y^*, z_1, \dots, z_M) = \int_{\theta} p^C(y_{T+1}^* \mid y_{T:T-p+1}^*, z_{T:T-p+1}, \theta) p^C(\theta \mid y^*, \tilde{z}_1, \dots, \tilde{z}_M) d\theta,$$

and posterior simulator output of  $\theta$  along with the normal density for  $p^C(y_{T+1}^* \mid y_{T:T-p+1}^*, z_{T:T-p+1}, \theta)$  can be used to do one-step ahead forecasting.

The two-steps ahead predictive density is given by

$$p^C(y_{T+2}^* \mid y^*, z_1, \dots, z_M) = \int_{\theta} \int_{y_{T+1}} \int_{z_{1,T+1}} \dots \int_{z_{M,T+1}} p^C(y_{T+2}^* \mid y_{T+1:T-p+2}^*, z_{i,T+1:T-p+2}, \theta) \prod_{i=1}^M \int_{\tilde{\eta}_i} p^C(z_{i,T+1} \mid y_{T+1:T-p+1}^*, z_{i,T:T-p+1}, \tilde{\eta}_i) p^C(\tilde{\eta}_i \mid y^*, z_i) d\tilde{\eta}_i dz_{i,T+1} p^C(y_{T+1}^* \mid y_{T:T-p+1}^*, z_{i,T:T-p+1}, \theta) dy_{T+1}^* p^C(\theta \mid y^*, \tilde{z}_1, \dots, \tilde{z}_M) d\theta,$$



and similarly for longer forecasting horizons.

Observe that sampling from the one-step-ahead predictive density  $p^C(y_{T+1}^* | y^*, z_1, \dots, z_M)$  does not require draws of  $\tilde{\eta}_i$ , and therefore, the extra steps involved in sampling  $\tilde{\eta}_i$  can be omitted if the researcher is interested only in one-step ahead forecasting or uses the direct method of forecasting. The empirical results in the following section use the direct method of forecasting.

## 5 Empirical Results

### 5.1 Overview

We carry out an empirical investigation of our composite likelihood methods using a small data set of quarterly US data for 7 variables and a large quarterly data set involving 196 variables. The data is taken from the Federal Reserve Bank of St. Louis' FRED-QD data set and runs from 1959Q1- 2015Q3.<sup>6</sup> All data are transformed to stationarity following the recommendations in the FRED-QD data base and then standardized to have mean zero and standard deviation one. We focus on empirical results relating to three core variables: CPI inflation, GDP growth and the Federal Funds rate. The 4 other variables in the small data set are the Civilian Unemployment Rate, Industrial Production Index, Real M2 Money Stock and S&P's Common Stock Price Index. A lag length of four is used for all models.

We include the small data set since it is computationally feasible to estimate a wide range of VARs with stochastic volatility for models of this dimension. The VAR-SV is the most flexible model we consider and, with 7 variables should not be over-parameterized. Thus, it should provide us reasonable benchmark estimates to compare the alternative approaches to. Accordingly, we classify any alternative approach as performing well if it yields estimates which are close to those of the VAR-SV. We also estimate the VAR-CCM1 and VAR-CCM2 using these 7 variables (see sub-section 2.2 for a definition of these models). We also present results from a homoskedastic VAR using the small data set (labelled VAR-HM in the tables).

When working with the large data set, we wish to have an alternative approach to compare our composite likelihood methods to. However, it is not possible to estimate the VAR-SV with the large data set. The only approach (other than our composite likelihood approach) that is computationally feasible using the large data set is a homoskedastic natural-conjugate prior VAR. Accordingly, this is the model we use in our forecast comparison. It is labelled Large VAR in the tables.

Further details about the specification of all models, including prior choice, are given in the Technical Appendix. For the VAR coefficients in all models we make standard Minnesota prior choices. Where possible, we make identical

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<sup>6</sup>The data is available through <https://research.stlouisfed.org/econ/mccracken/fred-databases/>. See also McCracken and Ng (2015). Complete details of all the variables in the data set are provided there.

specification and prior hyperparameter choices across models. It is worth stressing that, in conventional large VAR approaches where the number of parameters being estimated exceeds the number of observations, prior elicitation is crucial. Priors must be very informative and results can be sensitive to prior choice. An advantage of composite likelihood approaches is that, since all sub-models used are small, prior elicitation is a less important issue. It is possible to use less informative priors and prior sensitivity concerns are mitigated.

A summary of all the models used in the paper, including their acronyms, is given in Table 1.

VAR-HM	7-variable Homoskedastic VAR
VAR-SV	7-variable VAR with stochastic volatility
VAR-CCM1	7-variable model of CCM (2016a)
VAR-CCM2	7-variable model of CCM (2016b)
Large VAR	Large Homoskedastic VAR
VAR-CL-BIC	VAR-CL-SV with BIC based weights
VAR-CL-DIC	VAR-CL-SV with DIC based weights
VAR-CL-EQ	VAR-CL-SV with equal weights
VAR-CL-ML	VAR-SV with ML weights
VAR-CL-LIN	VAR-CL-SV with linear pool weights
VAR-LIN	VAR-SV with linear pool weights

We discuss the empirical performance of each model in terms of their forecasting performance and the reasonableness of the estimates of features of interest they produce. Our features of interest focus on the error variances and covariances involving the three core variables.

To evaluate forecast performance, we use two point forecast metrics and two density forecast metrics for the core variables. Let  $y_t^* = (y_{t,1}^*, y_{t,2}^*, y_{t,3}^*)'$  denote the random variables being forecast and  $y_t^R = (y_{t,1}^R, y_{t,2}^R, y_{t,3}^R)'$  be their realizations. For the point forecast, we report the root mean squared forecast error (RMSFE) and the mean absolute forecast error (MAFE),

$$\text{RMSFE}_i = \sqrt{\frac{\sum_{t=t_0}^{T-h} (y_{t+h,i}^R - E(y_{t+h,i}^* | y_{1:t}^R))^2}{T-h-t_0+1}}.$$

$$\text{MAFE}_i = \frac{\sum_{t=t_0}^{T-h} |y_{t+h,i}^R - \hat{y}_{t+h,i}^M|}{T-h-t_0+1},$$

for  $i = 1, 2, 3$  where  $E(y_{t+h} | y_{1:t}^R)$  is the mean of the predictive density and  $\hat{y}_{t+h}^M$  is the median of the predictive density. For the density forecasts, we report the average log-predictive likelihoods (ALPL) and the average continuous rank probability score (ACRPS),

$$\text{ALPL}_i = \frac{\sum_{t=t_0}^{T-h} \log p_{t+h}(y_{t+h,i}^* = y_{t+h,i}^R | y_{1:t}^R)}{T-h-t_0+1},$$

$$\text{ACRPS}_i = \frac{1}{T - h - t_0 + 1} \sum_{t=t_0}^{T-h} \text{CRPS}_{t,i},$$

for  $i = 1, 2, 3$  where  $\text{CRPS}_{t,i} = \int_{-\infty}^{\infty} (F_{t+h}(z) - 1(y_{t+h}^R < z))^2 dz = E_{p_{t+h}} |y_{t+h,i}^* - y_{t+h,i}^R| - 0.5 E_{p_{t+h}} |y_{t+h,i}^* - y_{t+h,i}^R|$  and  $F_{t+h}(\bullet)$  is the c.d.f. of the predictive density. A small value of the  $\text{ACRPS}_i$  indicates a better forecasting performance.

We also present a joint ALPL for the three core variables of interest:

$$\text{ALPL} = \frac{\sum_{t=t_0}^{T-h} \log p_{t+h}(y_{t+h}^* = y_{t+h}^R | y_{1:t}^R)}{T - h - t_0 + 1},$$

## 5.2 Estimating Variances and Covariances

Let  $\sigma_{ijt}$  denote the  $(i, j)^{th}$  element of the error covariance matrix at time  $t$ . In this sub-section we present posterior means and, in some figures, credible intervals covering the 16<sup>th</sup> to 84<sup>th</sup> percentiles of  $\sigma_{ijt}$  for  $i, j = 1, 2, 3$  (i.e. the three variances and three covariances corresponding to the core variables). For the sake of brevity, the figures only presents results for a few main approaches.

Figure 1 provides point estimates from two of the main composite likelihood approaches as well as VAR-SV and VAR-CCM2 (as we shall see below, VAR-CCM2 is in many cases the best alternative approach). It can be seen that all of the approaches track the VAR-SV fairly well, although VAR-CCM2 tracks it slightly more closely than our composite likelihood approaches for  $\sigma_{31t}$  and  $\sigma_{32t}$ .

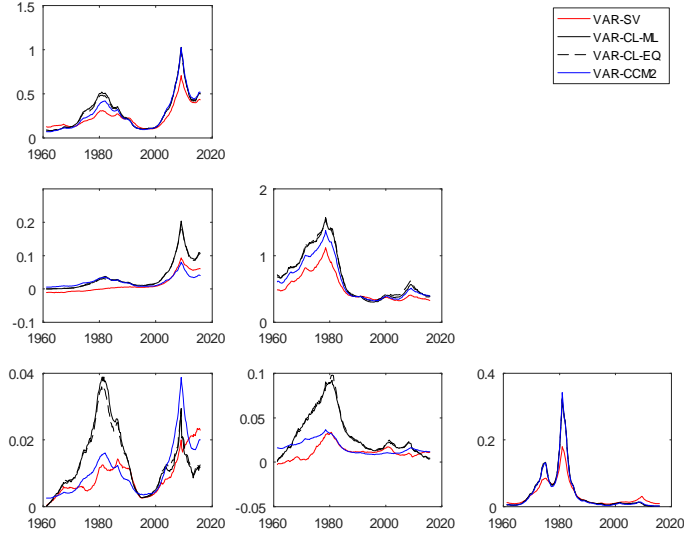


Figure 1: Point estimates of  $\sigma_{ij,t}$  for  $i, j = 1, 2, 3$

Figure 2 offers a more detailed comparison of one of our major composite likelihood approaches (VAR-CL-ML) to the unrestricted VAR-SV (the other composite likelihood and linear pooling approaches reveal similar patterns). It can be seen that, even for  $\sigma_{31t}$  and  $\sigma_{32t}$ , where the point estimates differ somewhat, the credible intervals always overlap. We take this as evidence that our composite likelihood approaches are doing a good job of matching the VAR-SV. The VAR-CCM2 produces similarly accurate estimates. However, it is worth noting that the VAR-CCM1 and VAR-HM do not. This is revealed in Figures 3 and 4 which present detailed results for these two models. From the former, we can see that the common drifting volatility assumption in VAR-CCM1 is too restrictive, with high volatility in  $\sigma_{11,t}$  spilling over inappropriately into some of the other variances and covariances. From Figure 4 we can see the homoskedastic model is failing to pick up changes in volatility that are clearly present in the data.

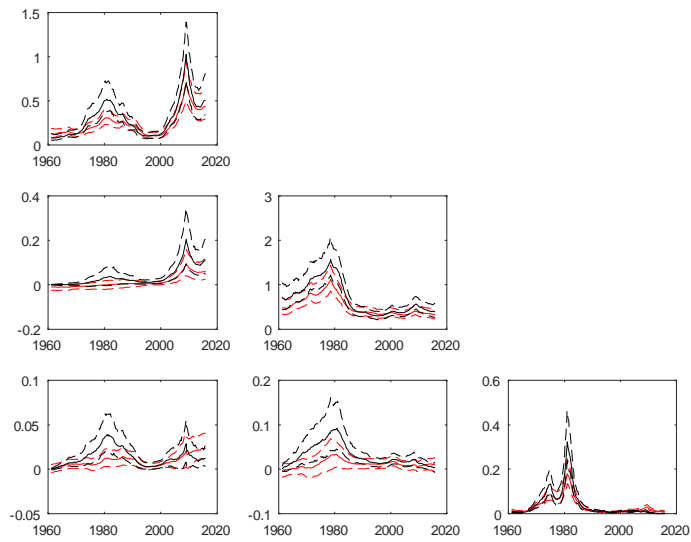


Figure 2: Comparison of VAR-CL-ML to VAR-SV (Point estimates of  $\sigma_{ij,t}$  with 16%-84th percentiles, VAR-SV in red)

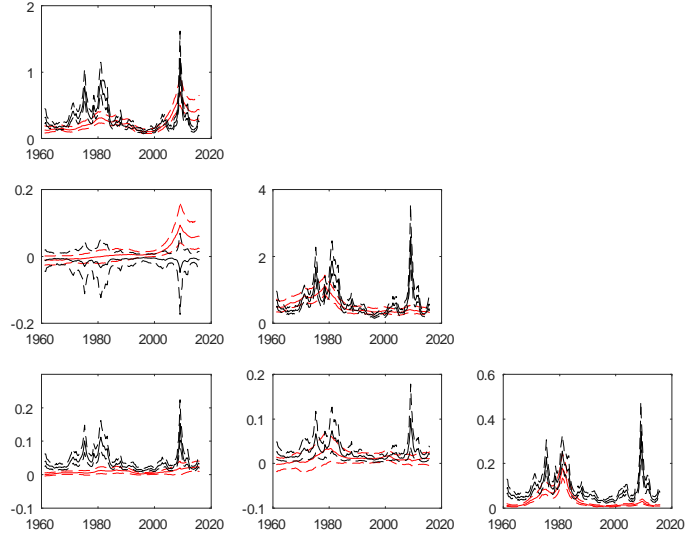


Figure 3: Comparison of VAR-CCM1 to VAR-SV (Point estimates of  $\sigma_{ij,t}$  with 16%-84th percentiles, VAR-SV in red)

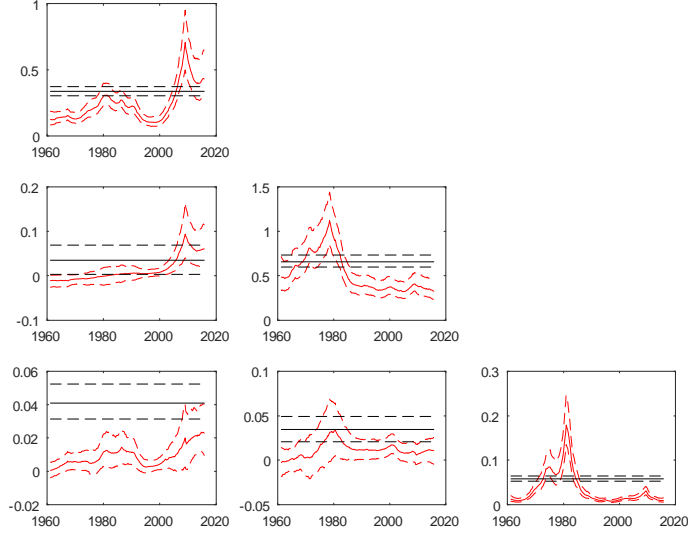


Figure 4: Comparison of VAR-HM to VAR-SV (Point estimates of  $\sigma_{ij,t}$  with 16%-84th percentiles, VAR-SV in red)

In this sub-section, we have compared our composite likelihood approaches to a range of alternatives using a small data set where such a comparison is feasible. Of course, with such a small data set, the researcher would probably want to work with a VAR-SV (or similar model) since it is the more flexible approach and, thus, more able to capture empirically-relevant features of the data. But it is re-assuring to see that even with the small data set, composite likelihood methods are producing results which are very similar to the VAR-SV.

### 5.3 Forecasting

In this sub-section, we investigate how well composite likelihood methods forecast using the large data set involving 196 variables. We remind the reader that, with this many variables, the only other feasible Bayesian VAR approach is the one with acronym Large VAR which is homoskedastic and uses a natural conjugate prior. We also include all the models of the preceding sub-section, but for these other models we are using the small data set to produce forecasts. We present results for a long forecast evaluation period (beginning in 1970) and a short forecast evaluation period that begins in 2008Q1 so as to take in the financial crisis and subsequent period. In both cases the forecast evaluation period runs to the end of the sample. We provide forecasts of quarterly variables ( $h = 1$ ) and quarterly variables one year in the future ( $h = 4$ ). To aid in interpretation, note that all variables are standardized to have zero mean and unit

standard deviation and that our forecast metrics are not benchmarked against any model. We carry out the sign test of equal predictive accuracy of Diebold and Mariano (1995) using the homoskedastic large VAR as the benchmark. In the tables, \*\*\*, \*\* and \* denote rejection of the null hypothesis of equal predictive accuracy of a model and the benchmark at the 1%, 5% and 10% level of significance, respectively.

The best overall summary of forecast performance involves the entire joint predictive density for the three core variables. This is presented in Table 2 for  $h = 1$  and  $h = 4$ . The most important comparison is between the Large VAR and the methods which pool results from many small models, since these are the only feasible approaches with large data sets. In this comparison, it can be seen that the composite likelihood approaches are clearly winning for both forecast horizons, particularly for the forecast evaluation period which begins in 2008Q1. For the longer forecast evaluation period with  $h = 1$ , the linear pooling method actually forecasts slightly better than logarithmic pooling used with the composite likelihood approaches. In general, any method which involves homoskedasticity or highly restrictive forms for the error covariance matrix (i.e. VAR-CCM1) forecast poorly when evaluated using the ALPL for the 3 core variables. The less restrictive VAR-CCM2 forecasts well over the longer forecast evaluation period but is beaten by composite likelihood methods for the shorter evaluation period. These statements hold true for both  $h = 1$  and  $h = 4$ . The forecast improvements relative to the Large VAR are statistically significant in almost every case. The only exceptions are for  $h = 4$  for the forecast evaluation period which begins in 2008Q1.

Horizon	$h = 1$		$h = 4$	
	1970Q1	2008Q1	1970Q1	2008Q1
VAR-HM	0.33***	-0.58***	-1.04***	-1.60
VAR-SV	0.65***	0.44***	-1.04***	-1.61
VAR-CCM1	0.06***	-0.51**	-0.98***	-1.85
VAR-CCM2	0.90***	0.52***	-0.84***	-1.58
Large VAR	-0.47	-1.69	-1.41	-2.02
VAR-CL-ML	0.90***	1.27***	-0.99***	-1.49
VAR-CL-DIC	0.85***	0.67***	-0.72***	-0.92***
VAR-CL-BIC	0.90***	1.15***	-0.88***	-1.51
VAR-CL-EQ	0.88***	0.89***	-0.71***	-0.84***
VAR-CL-LIN	0.89***	0.92***	-0.71***	-0.79***
VAR-LIN	0.91***	1.01***	-0.75***	-0.83***

The following tables present detailed results for the individual variables using the full range of forecast metrics. The good forecast performance of composite likelihood methods and relatively poor forecasting performance of the large homoskedastic VAR noted in Table 2 are also found in these tables, but there are some differences across variables and forecast metrics worth noting.

The general pattern is that composite likelihood and linear pooling methods forecast particularly well for inflation and the interest rate, for the post-2008



period and using metrics that involve the entire predictive density (i.e. ACRPS and ALPL). The last point is not that surprising in that incorporation of stochastic volatility is usually found to be more important in getting the shape of the entire predictive density correct as opposed to just getting a reasonable point forecast. For example, for inflation over the longer forecast evaluation period with  $h = 1$ , the homoskedastic VAR-HM model is actually forecasting quite well if we look at RMSFE and MAE. However its ALPL is not as high as other methods for this case. It is worth noting that this pattern does not hold for  $h = 4$ . Also, for the interest rate, the small homoskedastic model produces poor point forecasts, especially after 2008. And the homoskedastic large VAR often produces high RMSFEs. So the reader should not take away the message that, if point forecasts are all that matter, then working with homoskedastic models is adequate.

For GDP growth, Tables 7 and 8 indicate that the small VAR-SV forecasts best for  $h = 1$  and, in general, small models such as VAR-CCM2 tend to forecast well. But even here, the forecast performance of composite likelihood methods is only slightly worse than these models. For  $h = 4$ , composite likelihood methods tend to produce superior forecasts.

In general, of the alternative models, the VAR-CCM2 tends to forecast almost as well as our methods (and forecasts much better than VAR-CCM1). However, we stress that VAR-CCM2 is not computationally feasible in the really large VARs macroeconomists are increasingly interested in.

These tables also reinforce the finding that, among the various composite likelihood approaches, the alternative ways of doing the weighting typically do not make a great deal of difference for forecasting. There is no consistent pattern where one weighting method dominates and it is always possible to find case where a particular set of weights forecasts best. There are also cases where a linear pool of sub-models forecasts best. Indeed, even using equal weights produces forecasts which are only slightly inferior to other methods which estimate weights in a data-based fashion.

Table 3: Evaluation of Inflation Forecasts Beginning in 1970

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	0.66	0.45	0.36***	-0.15***	0.88	0.64	0.50***	-0.53
VAR-SV	0.67	0.46	0.36***	-0.06***	0.88**	0.65**	0.51***	-0.49**
VAR-CCM1	0.71	0.51	0.39***	-0.12	0.90	0.65	0.50***	-0.43***
VAR-CCM2	0.67	0.46	0.36***	-0.00***	0.87***	0.64***	0.50***	-0.39***
Large VAR	0.73	0.52	0.56	-0.14	1.03	0.79	0.82	-0.64***
VAR-CL-ML	0.69	0.47	0.36***	-0.01**	0.68***	0.48***	0.48***	-0.39***
VAR-CL-DIC	0.68	0.47	0.36***	-0.01	0.67***	0.47***	0.49***	-0.36***
VAR-CL-BIC	0.69	0.46	0.36***	-0.01**	0.66***	0.47***	0.48***	-0.38***
VAR-CL-EQ	0.68	0.47	0.36***	-0.01	0.66***	0.47***	0.48***	-0.35***
VAR-CL-LIN	0.68	0.47	0.36***	0.00	0.66***	0.47***	0.48***	-0.34***
VAR-LIN	0.68	0.47	0.38***	-0.00	0.67***	0.48***	0.50***	-0.36***

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	1.04	0.66	0.52***	-1.16	1.13	0.79	0.61***	-0.94
VAR-SV	1.06	0.68	0.54***	-0.68	1.11	0.75	0.60***	-0.80
VAR-CCM1	1.04	0.66	0.52***	-0.71	1.06	0.71	0.56***	-0.78
VAR-CCM2	1.05	0.68	0.53***	-0.57	1.08	0.72	0.58***	-0.65
Large VAR	1.03	0.65	0.69	-0.71	1.25	0.88	0.94	-1.00
VAR-CL-ML	1.04	0.65	0.51***	-0.54	0.97	0.60	0.54***	-0.59
VAR-CL-DIC	1.04	0.66	0.52**	-0.57	0.95	0.59	0.54***	-0.57***
VAR-CL-BIC	1.02	0.63	0.50***	-0.50	0.97	0.60	0.54***	-0.60
VAR-CL-EQ	1.04	0.66	0.52***	-0.57	0.96	0.61	0.54***	-0.57***
VAR-CL-LIN	1.04	0.66	0.52**	-0.50	0.95	0.58	0.54***	-0.55***
VAR-LIN	1.03	0.66	0.54**	-0.48	0.96	0.61	0.54***	-0.55***

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	0.29***	0.18***	0.15***	0.81***	0.62**	0.47**	0.36***	-0.06***
VAR-SV	0.28***	0.17***	0.14***	1.03***	0.59**	0.45**	0.35***	-0.01***
VAR-CCM1	0.51***	0.33***	0.25***	0.53***	0.68	0.51	0.39***	-0.10**
VAR-CCM2	0.28***	0.17***	0.14***	1.19***	0.59***	0.44***	0.34***	0.02***
Large VAR	0.56	0.42	0.44	0.17	0.75***	0.55***	0.60	-0.15
VAR-CL-ML	0.28***	0.17***	0.13***	1.18***	0.46***	0.34***	0.38***	-0.20
VAR-CL-DIC	0.28***	0.16***	0.13***	1.17***	0.36***	0.26***	0.34***	0.04***
VAR-CL-BIC	0.28***	0.17***	0.13***	1.20***	0.41***	0.32***	0.36***	-0.10
VAR-CL-EQ	0.27***	0.16***	0.13***	1.19***	0.37***	0.26***	0.34***	0.02***
VAR-CL-LIN	0.27***	0.16***	0.13***	1.20***	0.36***	0.26***	0.34***	0.01***
VAR-LIN	0.27***	0.16***	0.13***	1.21***	0.37***	0.26***	0.35***	-0.01***

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	0.25***	0.18***	0.14***	0.97***	0.65	0.56	0.39***	-0.12
VAR-SV	0.18***	0.12***	0.10***	1.50***	0.62	0.56	0.39***	-0.16
VAR-CCM1	0.36***	0.30***	0.20***	0.66***	0.74	0.70	0.48***	-0.49
VAR-CCM2	0.20***	0.12***	0.10***	1.45***	0.64	0.57	0.40***	-0.15
Large VAR	0.51	0.45	0.46	0.09	0.72	0.62	0.62	-0.21
VAR-CL-ML	0.13***	0.07***	0.06***	2.00***	0.46**	0.43	0.39***	-0.32
VAR-CL-DIC	0.13***	0.08***	0.07***	1.67***	0.27***	0.25***	0.26***	0.27***
VAR-CL-BIC	0.13***	0.07***	0.06***	1.88***	0.48	0.45	0.39***	-0.28
VAR-CL-EQ	0.12***	0.08***	0.07***	1.79***	0.28***	0.26***	0.26***	0.27***
VAR-CL-LIN	0.12***	0.08***	0.07***	1.78***	0.29***	0.26***	0.27***	0.24***
VAR-LIN	0.12***	0.08***	0.07***	1.83***	0.29***	0.26***	0.30***	0.25***

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	0.89	0.68	0.51***	-0.38	1.01**	0.76**	0.58***	-0.51**
VAR-SV	0.86	0.65	0.50***	-0.32**	1.00***	0.74***	0.57***	-0.51***
VAR-CCM1	0.87	0.67	0.51***	-0.36	1.00**	0.76**	0.58***	-0.52***
VAR-CCM2	0.86	0.66	0.50***	-0.31**	1.00***	0.74***	0.58***	-0.50***
Large VAR	0.93	0.70	0.77	-0.39	1.14	0.89	0.98	-0.62
VAR-CL-ML	0.92	0.67	0.51***	-0.35	0.98**	0.72***	0.56***	-0.49***
VAR-CL-DIC	0.91	0.67	0.51***	-0.36	0.97**	0.72**	0.56***	-0.48***
VAR-CL-BIC	0.93	0.68	0.52***	-0.35***	0.99**	0.73**	0.57***	-0.49***
VAR-CL-EQ	0.92	0.68	0.51***	-0.35	0.97**	0.71**	0.56***	-0.47***
VAR-CL-LIN	0.92	0.68	0.51***	-0.35	0.97**	0.71**	0.55***	-0.47***
VAR-LIN	0.92	0.68	0.54***	-0.36	0.98**	0.72**	0.57***	-0.47***

	$h = 1$				$h = 4$			
	RMSFE	MAE	ACRPS	ALPL	RMSFE	MAE	ACRPS	ALPL
VAR-HM	0.96	0.72	0.56***	-0.48	1.14	0.85	0.64***	-0.70
VAR-SV	0.86	0.63	0.50***	-0.42	1.07	0.77	0.62***	-0.83
VAR-CCM1	0.94	0.73	0.57***	-0.57	1.16	0.87	0.67***	-0.88
VAR-CCM2	0.88	0.65	0.52***	-0.46	1.11	0.82	0.65***	-0.85
Large VAR	0.96	0.77	0.80	-0.47	1.14	0.87	0.99	-0.69
VAR-CL-ML	0.95	0.65	0.52***	-0.46	1.20	0.81	0.63***	-0.83
VAR-CL-DIC	0.95	0.66	0.53***	-0.50	1.11	0.76	0.61***	-0.79
VAR-CL-BIC	0.96	0.67	0.52***	-0.47	1.20	0.83	0.65***	-0.86
VAR-CL-EQ	0.95	0.66	0.52***	-0.47	1.11	0.75	0.60***	-0.76
VAR-CL-LIN	0.95	0.66	0.52***	-0.45	1.10	0.75	0.60***	-0.77
VAR-LIN	0.96	0.68	0.56**	-0.46	1.12	0.76	0.62***	-0.77

## 6 Summary and Conclusions

Large VARs are emerging as a popular tool in modern macroeconomics. Adding multivariate stochastic volatility to them has emerged as one of the unresolved challenges in the field. It arises since it is not computationally practical to carry out Bayesian estimation in large VARs with multivariate stochastic volatility. Even if computation were possible, conventional approaches can be over-parameterized when working with large data sets leading to problems with over-fitting, imprecise estimation and the need for strong prior information. In this paper, we propose the use of composite likelihood methods for meeting this challenge. These involve averaging over many smaller sub-models. In our context, we use many small VAR-SV models thus enabling computation to be feasible even in data sets involving hundreds of variables. By working with smaller models, concerns over over-parameterization and the need for careful prior elicitation are lessened. We explore these themes in the paper. In addition, we discuss the

econometric theory of composite likelihood methods drawing on conventional asymptotic results as well as the literature on prediction pools. All in all, there are strong theoretical reasons for thinking composite likelihood methods may be an attractive way of adding stochastic volatility to large VARs.

The issue of how well composite likelihood methods work in practice is explored in our empirical work. Working with a large US quarterly macroeconomic data set involving 196 variables, we find encouraging results. When we use all 196 variables and compare the forecast performance of our composite likelihood methods against the only practical alternative (a large homoskedastic VAR with natural conjugate prior), we find strong evidence of the superiority of our methods. Clearly, stochastic volatility is an important feature of this data set and our VAR-CL-SV methods allow for this.

When we compare our methods to a range of existing methods which include stochastic volatility we must restrict ourselves to smaller data sets. Using these, we find our composite likelihood methods are producing parameter estimates which are similar to those produced by state-of-the-art approaches. We also find that composite likelihood methods using the large data set forecast well relative to these other methods which use the small data set. Overall, we conclude that the strategy of combining forecasts from many small models is computationally feasible even with large VARs and leads to forecast performance that is as good or better than other computationally feasible approaches.

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# Technical Appendix

## Priors and Specification Choices

For the VAR-SV model, we assume normal priors for the initial condition  $a_0 \sim N(0, V_a)$  and  $h_0 \sim N(0, V_h)$ . Moreover, we assume an independent prior for parameters in  $\Sigma_h$  and  $\Sigma_a$  which are distributed as

$$\sigma_{h,i}^2 \sim IG(\nu_{h,i}, S_{h,i}), \quad \sigma_{a,j}^2 \sim IG(\nu_{a,j}, S_{a,2}),$$

for  $i = 1, \dots, N$  and  $j = 1, \dots, \frac{N(N-1)}{2}$ . We set  $\nu_{h,i} = 10$ ,  $S_{h,i} = 0.1^2(\nu_{h,i} - 1)$ ,  $\nu_{a,j} = 10$  and  $S_{h,j} = 0.01^2(\nu_{h,j} - 1)$ . For the initial states, we set  $V_h = 10 \times I_N$  and  $V_a = 10 \times I_{\frac{N(N-1)}{2}}$ .

For the VAR coefficients  $\beta = \text{vec}((c, A_1, \dots, A_p)')$ , we use a Minnesota prior and assume  $\beta \sim N(\beta_0, V_\beta)$ . For the prior mean, we set  $\beta_0 = 0$ . The prior covariance matrix  $V_\beta$  is set to be diagonal and its corresponding values are set as follows:

$$\begin{aligned} \text{Var}(c) &= 10 \times I_N, \\ \text{Var}(A_l^{ij}) &= \begin{cases} \frac{\lambda_1^2 \lambda_2}{l \lambda_3} \frac{\sigma_i}{\sigma_j} & \text{for } l = 1, \dots, p \text{ and } i \neq j, \\ \frac{\lambda_1^2}{l \lambda_3} & \text{for } l = 1, \dots, p \text{ and } i = j. \end{cases} \end{aligned}$$

where  $A_l^{ij}$  denotes the  $(i, j)$  th element of the matrix  $A_l$  and  $\sigma_r$  is set equal to the standard deviation of the residual from an AR( $p$ ) model for the variable  $r$ . For the hyperparameters, we set  $\lambda_1 = 0.2$ ,  $\lambda_2 = 0.5$ ,  $\lambda_3 = 2$ ,  $p = 4$ .

The VAR-CCM2 is the same as the VAR-SV except that the  $a_t$  is restricted to be time-invariant, i.e.  $a_t = a$ . We assume a normal prior  $a \sim N(0, \Omega_a)$  with  $\Omega_a = 10 \times I_{\frac{N(N-1)}{2}}$ . The priors for other parameters are set the same as those in the VAR-SV.

For the VAR-HM

$$y + X\beta + \epsilon, \quad \epsilon_t \sim N(0, I_N \otimes \Sigma),$$

we assume an independent prior for the model parameters. The prior for the VAR coefficients is set equal to that in the VAR-SV. For the covariance matrix, we set  $\Sigma \sim IW(\Sigma_0, \nu_0)$  with  $\nu_0 = N + 2$  and  $\Sigma_0 = (\nu_0 - N - 1)I_N$ , where  $IW(\cdot, \cdot)$  denotes the inverse Wishart distribution. This implies that the prior mean  $E(\Sigma) = I_N$ . We also include a natural conjugate prior version of the homoskedastic VAR for use with the large data set. For this we choose the same prior with the exception that the prior covariance matrix for  $\beta$  is the same as for VAR-CCM1 (see below).

For the VAR-CCM1, we first let  $x'_t = (1, y'_{t-1}, \dots, y'_{t-p})$ . It is convenient to specify the model as

$$Y = XA + U, \quad \text{vec}(U) \sim N(0, \Sigma \otimes \Omega)$$

where  $Y = (y_1, \dots, y_T)'$ ,  $X = (x_1, \dots, x_T)'$ ,  $A = (c, A_1, \dots, A_p)'$  and  $\Omega = \text{diag}(e^{h_1}, \dots, e^{h_T})$ . Recall that the log volatility follow an AR(1) process

$$h_t = \rho h_{t-1} + \epsilon_t^h, \quad \rho \sim \mathcal{N}(0, \sigma_h^2),$$

with  $|\rho| < 1$ . A standard normal-inverse-Wishart prior are set for model parameters  $(A, \Sigma)$  as

$$\Sigma \sim IW(\Sigma_0, \nu_0), \quad \text{vec}(A)|\Sigma \sim N(\text{vec}(A_0), \Sigma \otimes V_{\mathbf{A}}).$$

The hyperparameters  $\Sigma_0$  and  $\nu_0$  are set equal to those in VAR-HM. We set  $A_0 = 0$  for the prior mean of the VAR coefficients. For the covariance matrix, we assume it to be  $V_{\mathbf{A}} = \text{diag}(v_1, \dots, v_k)$  and set  $v_i = \frac{\lambda_i^2 \sigma_r}{l \lambda_3}$  for coefficients associated to lag  $l$  of variable  $r$  for  $i = 2, \dots, k$  and  $v_1 = 10$ . The other hyperparameters are set equal to those in VAR-SV. For the AR coefficient and the variance of the log volatility process, we assume

$$\rho \sim \mathcal{N}(\rho_0, V_\rho) \text{ for } |\rho| < 1, \quad \sigma_h^2 \sim \mathcal{N}(\nu_h, S_h)$$

with  $\rho_0 = 0.9$ ,  $V_\rho = 0.2^2$ ,  $\nu_h = 10$  and  $S_h = 0.1^2(\nu_h - 1)$ .



Proof of Proposition 1

**Proof.** Defining  $\tilde{y}_t^* = A_{y,t}y_t^* - c_y - \sum_{j=1}^p B_{yy,j}y_{t-j}^*$  it is straightforward to show the form of the restricted VAR-SV implies:

$$\begin{aligned}
p(y_t | \cdot) &\propto \exp \left\{ -\frac{1}{2} \left( \tilde{y}_t^* - \sum_{i=1}^M w_i \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right)' \Sigma_{y,t}^{-1} \left( \tilde{y}_t^* - \sum_{i=1}^M w_i \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right) \right\} \\
&\quad \times \prod_{i=1}^M \exp \left\{ -\frac{1}{2} [h_{N^*+i,t} - \ln w_i \right. \\
&\quad \quad \left. + e^{-h_{N^*+i,t} + \ln w_i} \left( z_{i,t} - \alpha'_{z,i,t} y_t^* - c_{z,i} - \sum_{j=1}^p \beta'_{zy,i,j} y_{t-j}^* - \sum_{j=1}^p \beta_{zz,i,j} z_{i,t-j} \right)^2 \right\} \\
&\propto \exp \left\{ \sum_{i=1}^M -\frac{w_i}{2} \left( \tilde{y}_t^* - \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right)' \Sigma_{y,t}^{-1} \left( \tilde{y}_t^* - \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right) \right\} \\
&\quad \times \exp \left\{ -\frac{1}{2g(M)^2} \left( \sum_{i=1}^M w_i \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right)' \Sigma_{y,t}^{-1} \left( \sum_{i=1}^M w_i \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right) \right\} \\
&\quad \times \exp \left\{ \sum_{i=1}^M \frac{w_i}{2g(M)^2} \left( \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right)' \Sigma_{y,t}^{-1} \left( \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right) \right\} \\
&\quad \times \prod_{i=1}^M \exp \left\{ -\frac{1}{2} [h_{N^*+i,t} - \ln w_i \right. \\
&\quad \quad \left. + e^{-h_{N^*+i,t} + \ln w_i} \left( z_{i,t} - \alpha'_{z,i,t} y_t^* - c_{z,i} - \sum_{j=1}^p \beta'_{zy,i,j} y_{t-j}^* - \sum_{j=1}^p \beta_{zz,i,j} z_{i,t-j} \right)^2 \right\},
\end{aligned}$$

where we used the fact that  $(y_t^*)' \Sigma_{y,t}^{-1} (y_t^*) = \sum_{i=1}^M w_i (y_t^*)' \Sigma_{y,t}^{-1} (y_t^*)$ . The likelihood of the restricted VAR-SV is

$$L(y; \theta) = \prod_{t=1}^T p(y_t | \cdot). \quad (9)$$

Now, suppose that our composite likelihood is constructed from sub-models:

$$A_{y,t}y_t = c_y + \sum_{j=1}^p B_{yy,j}y_{t-j}^* + \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} + \epsilon_{y,t}, \quad \epsilon_{y,t} \sim N(0, \Sigma_{y,t}), \quad (10)$$

$$z_{i,t} - \alpha'_{z,i,t} y_t^* = c_{z,i} + \sum_{j=1}^p \beta'_{zy,j} y_{t-j}^* + \sum_{j=1}^p \beta'_{zz,i,j} z_{i,t-j} + \epsilon_{z,i,t}, \quad \epsilon_{z,i,t} \sim N(0, e^{h_{N^*+i,t}}), \quad (11)$$

which leads to

$$p^C(y_t | \cdot) \propto \exp \left\{ \sum_{i=1}^M -\frac{w_i}{2} \left( \mathbf{y}_t^* - \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right)' \Sigma_{y,t}^{-1} \left( \mathbf{y}_t^* - \sum_{j=1}^p \frac{\beta_{yz,i,j} z_{i,t-j}}{g(M)} \right) \right\} \\ \times \prod_{i=1}^M \exp \left\{ -\frac{1}{2} [w_i h_{N^*+i,t} \right. \\ \left. + e^{-h_{N^*+i,t} + \ln w_i} \left( z_{i,t} - \alpha'_{z,i,t} y_t^* - c_{z,i} - \sum_{j=1}^p \beta'_{zy,i,j} y_{t-j}^* - \sum_{j=1}^p \beta_{zz,i,j} z_{i,t-j} \right)^2 \right] \right\}$$

and the composite likelihood  $L^C(y; \theta) = \prod_{t=1}^T p^C(y_t | \cdot)$ .

Observe that

$$L^C(y; \theta) \propto L(y; \theta) \\ \times \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \left[ \sum_{i=1}^M w_i \left( \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right)' \Sigma_{y,t}^{-1} \left( \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right) \right. \right. \\ \left. \left. - \left( \sum_{i=1}^M w_i \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right)' \Sigma_{y,t}^{-1} \left( \sum_{i=1}^M w_i \sum_{j=1}^p \beta_{yz,i,j} z_{i,t-j} \right) \right] \right\} \\ \propto L(y; \theta) \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\},$$

where  $\tilde{z}_t = (z_{1,t-1}, \dots, z_{1,t-p}, \dots, z_{M,t-1}, \dots, z_{M,t-p})'$ ,  $B_i = (\beta_{yz,i,1}, \dots, \beta_{yz,i,p})$ , and  $\Xi_t$  is a  $Mp \times Mp$  positive semi-definite matrix with the  $(i, k)$  block given by

$$\Xi_{ik,t} = \begin{cases} w_i(1-w_i)B'_i \Sigma_{y,t}^{-1} B_i & \text{if } i = k, \\ -w_i w_k B'_i \Sigma_{y,t}^{-1} B_k & \text{if } i \neq k. \end{cases}$$

Let  $\tilde{z}_i = (z_{i,1}, \dots, z_{i,T-1})'$ ,  $\tilde{z} = (z'_1, \dots, z'_M)'$ ,  $z_T = (z_{1,T}, \dots, z_{M,T})'$  and  $y^* = ((y_1^*)', \dots, (y_T^*)')'$ . Then, we may write the likelihood  $L(y; \theta)$  as the density  $L(y; \theta) = p(y^*, z_T, \tilde{z} | \theta)$ . Consequently,

$$\tilde{L}^C(y; \theta) = \frac{p(y^*, z_T, \tilde{z} | \theta) \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\}}{\int_{\tilde{z}} \int_{y^*, z_T} p(y^*, z_T, \tilde{z} | \theta) d(y^*, z_T) \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\} d\tilde{z}} \\ = \frac{p(y^*, z_T, \tilde{z} | \theta) \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\}}{\mathbb{E}_{\tilde{z}} \left( \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\} \right)},$$

and

$$D_{\text{KL}}(L \| \tilde{L}^C) = \ln \mathbb{E}_{\tilde{z}} \left( \exp \left\{ -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right\} \right) - \mathbb{E}_{\tilde{z}} \left( -\frac{1}{2g(M)^2} \sum_{t=1}^T \tilde{z}'_t \Xi_t \tilde{z}_t \right).$$

To prove that  $D_{\text{KL}}(L\|\tilde{L}^C) \rightarrow 0$  as  $M \rightarrow \infty$ , note that  $\Xi_t$  can be represented by the Hadamard product  $\tilde{\Xi}_t \odot (W \otimes \iota_p \iota_p')$ , with the  $M \times M$  matrix  $W$  defined by elements

$$W_{ik} = \begin{cases} w_i(1 - w_i) & \text{if } i = k \\ -w_i w_k & \text{if } i \neq k \end{cases},$$

and  $\iota_p = (1, \dots, 1)'$  being the  $p \times 1$  vector of ones. In particular,  $W$  is positive semi-definite and contains information regarding the weights, while  $\tilde{\Xi}_{ik,t} = B_i' \Sigma_{y,t}^{-1} B_k$ , for all  $i$  and  $k$ , depends only on the parameters.

Accordingly,

$$\frac{\tilde{z}_t' \tilde{\Xi}_t \tilde{z}_t}{g(M)^2} = \frac{\tilde{z}_t' \tilde{z}_t}{g(M)^2} \times \frac{\tilde{z}_t' \tilde{\Xi}_t \tilde{z}_t}{\tilde{z}_t' \tilde{z}_t} \leq \frac{\tilde{z}_t' \tilde{z}_t}{g(M)^2} \|\Xi_t\|,$$

where  $\|\cdot\|$  denotes the spectral norm. Since  $\tilde{\Xi}_t$  and  $W \otimes \iota_p \iota_p'$  are positive semi-definite, Schur's inequality (Horn and Johnson, 1991, Theorem 5.5.1) implies  $\|\Xi_t\| \leq p \|\tilde{\Xi}_t\| \|W\|$ . Moreover, there exists a unit vector  $u$  (satisfying  $u'u = 1$ ) such that

$$\|W\| = u'Wu = \sum_{i=1}^M w_i u_i^2 - \left( \sum_{i=1}^M u_i w_i \right)^2.$$

Since  $\sum_{i=1}^M w_i u_i^2 \leq \max\{w_i\} \sum_{i=1}^M u_i^2 = \max\{w_i\}$  and  $\left( \sum_{i=1}^M u_i w_i \right)^2 \geq 0$ , we obtain  $\|W\| \leq \max\{w_i\}$ . Consequently,  $\max\{w_i\} \rightarrow 0$  implies  $\|W\| \rightarrow 0$  and  $\|\Xi_t\| \rightarrow 0$  follows from the fact that  $\|\tilde{\Xi}_t\|$  is constant with respect to  $M$ .

It remains to show that  $\frac{\tilde{z}_t' \tilde{z}_t}{g(M)^2} = \sum_{j=1}^p \frac{\sum_{i=1}^M z_{i,t-j}^2}{g(M)^2}$  does not diverge for fixed  $T$  and  $M \rightarrow \infty$ . Since  $z_{i,t-j}$  is normally distributed conditional on  $y^*$ , with conditional expectation  $\mu_i(y^*) \equiv E(z_{i,t-j} | y^*)$  and variance  $v_i^2$ , the quantity  $\zeta_i = \frac{z_{i,t-j} - \mu_i(y^*)}{g(M)}$  is conditionally independently (though not identically) distributed, and has the following properties:

1.  $E(\zeta_i | y^*) = 0$ ,
2.  $E(\zeta_i^2 | y^*) = \frac{v_i^2}{g(M)^2}$ ,
3.  $\sum_{i=1}^M \text{Var}(\zeta_i | y^*) = \bar{v} \frac{M}{g(M)^2} < \infty$ , where  $\bar{v} = \frac{1}{M} \sum_{i=1}^M v_i^2$ ,
4.  $\sum_{i=1}^M \text{Var}(\zeta_i^2 | y^*) \leq 3\tilde{v} \frac{M}{g(M)^4} < \infty$ , where  $\tilde{v} = \frac{1}{M} \sum_{i=1}^M v_i^4$ .

Hence  $\sum_{i=1}^M \zeta_i$  and  $\sum_{i=1}^M \zeta_i^2 - \bar{v} \frac{M}{g(M)^2}$  both converge in  $\mathbb{R}$  almost surely (Durrett, 2010, Theorem 2.5.3), which implies  $\frac{\sum_{i=1}^M z_{i,t-j}^2}{g(M)^2}$  converges in  $\mathbb{R}$  almost surely. In this case, the product  $\frac{\tilde{z}_t' \tilde{z}_t}{g(M)^2} \|\Xi_t\| \rightarrow 0$  and  $D_{\text{KL}}(L\|\tilde{L}^C)$  vanishes in the limit. ■