



ECONOMICS & STATISTICS DISCUSSION PAPER  
No. 062/11

## **A Simple Panel-CADF Test for Unit Roots**

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# A Simple Panel-CADF Test for Unit Roots <sup>\*</sup>

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November 8, 2011

## Abstract

In this paper we propose a simple extension to the panel case of the covariate-augmented Dickey Fuller (CADF) test for unit roots developed in [Hansen \(1995\)](#). The extension we propose is based on a  $p$  values combination approach that takes into account cross-section dependence. We show that the test is easy to compute, has good size properties and gives power gains with respect to other popular panel approaches. A procedure to compute the asymptotic  $p$  values of [Hansen's](#) CADF test is also a side-contribution of the paper. We also complement [Hansen \(1995\)](#) and [Caporale and Pittis \(1999\)](#) with some new theoretical results. Two empirical applications are carried out for illustration purposes on international data to test the PPP hypothesis and the presence of a unit root in international industrial production indices.

*JEL classification:* C22, C23, F31

*Key words:* Unit root, Panel data, Approximate  $p$  values, Monte Carlo.

## 1 Introduction

It is well known that standard unit root tests suffer from low power (see e.g. [Campbell and Perron, 1991](#); [DeJong et al., 1992](#); [Phillips and Xiao, 1998](#)). Starting from the mid-nineties, it has been suggested that a viable way to increase power in unit root testing is to exploit cross-section variation together with univariate time series dynamics (see

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<sup>\*</sup>This paper is an updated version of [Costantini and Lupi \(2011\)](#) and a substantial revision of [Costantini et al. \(2007\)](#). A very preliminary draft of this article was presented at the *Conference in Honour of David F. Hendry* (University of Oxford, 23-25 August, 2007). We thank Stephan Popp for his contributions in the early stages of this work. Comments from audiences at the University of Oxford, at the Institute for Advanced Studies at Vienna, at the Third Italian Congress of Econometrics and Empirical Economics at Ancona are gratefully acknowledged. We are especially grateful to Roy Cerqueti, Juan Dolado, Luciano Gutierrez, Robert Kunst, Paresh Kumar Narayan, Paolo Paruolo, Martin Wagner, Joakim Westerlund, and Dmitri Zaykin for comments and discussion on the paper or specific parts of it. None of them is responsible for any remaining error. We are very pleased to thank Yoosoon Chang and Wonho Song for having provided their data and GAUSS code ([Chang and Song, 2009](#)).

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Quah, 1994; Levin *et al.*, 2002, among others). Panel unit root tests have become increasingly popular ever since. Of course, potential power gains are not the only reason for using panel tests. A commonly neglected advantage of the panel unit root approach is that it can be useful in avoiding some complications arising from multiple testing. Indeed, if a sequence of individual tests based on single time series were used to investigate the null hypothesis that at least one of the series in the panel were stationary, then inference would result in severe over-rejection (see e.g. Shaffer, 1995): on the contrary, panel testing would provide a correct answer. Furthermore, some specific cross-country macroeconomic analyses may fit naturally in the panel framework, in particular when the focus is on testing for the presence of a unit root as an interesting and economically interpretable common feature in a whole set of time series. However, the power gain motivation has probably been the dominating one in the majority of theoretical and applied papers and it has been questioned only recently (see e.g. Banerjee *et al.*, 2004, 2005).

In order to obtain more powerful unit root tests, Hansen (1995) adopts a different approach to exploit cross-sectional correlation. Rather than using panel data on a single variable, Hansen (1995) suggests using stationary covariates in an otherwise standard Dickey-Fuller framework, in this way proposing his covariate augmented Dickey-Fuller (CADF) test. Indeed, Hansen (1995) and Caporale and Pittis (1999) show that substantial power gains can be achieved using the CADF test, without incurring severe size distortions.

In this paper we couple the two approaches, extending Hansen's CADF test to small panels. Although Hansen (1995) is the seminal paper concerning covariate-augmented unit root tests, other tests might have been considered. In fact, Elliott and Jansson (2003) show that Hansen's CADF test is not the point optimal test in general, and that feasible point optimal tests based on VAR models can be derived. However, we prefer to use the test proposed in Hansen (1995) for three main reasons. First, simulations reported in Elliott and Jansson (2003) show that the feasible point optimal tests can give power gains at the cost of inferior size performances: this is important in our framework, because Hanck (2008) shows that size distortions tend to cumulate in panel tests of the kind proposed here. Second, Hansen's CADF test is based on the familiar ADF framework, so that it can be more appealing to practitioners once the computational burden related to the computation of the test  $p$  values is eased. Finally, we show that under conditions considered as especially relevant for the panel unit root hypothesis, the CADF test is based on the correct conditional model.

The extension we propose is based on a  $p$  value combination approach advocated independently in Maddala and Wu (1999) and Choi (2001). In this paper we refer mainly to Choi's Z-test, that combines the  $p$  values computed from unit root tests applied to each time series in the panel using an inverse-normal formulation. The method is well grounded in the meta-analytic tradition and its choice is supported by several reasons. First, provided that we can compute the  $p$  values of the CADF test, the extension to the panel case is straightforward: the panel test is very easy to compute and intuitive and practitioners can track without difficulty what is going on step-by-step in the analysis,

from the univariate to the panel case. Second, the asymptotics carries through for the temporal size  $T \rightarrow \infty$ , without requiring also the number of cross-section units  $N \rightarrow \infty$  as other approaches instead do: in our view, given that allowing  $N \rightarrow \infty$  in typical macro-panel applications is an implausible hypothesis, this is an extremely important feature of the tests based on [Choi \(2001\)](#). In fact, the test we propose here is especially well suited for small to moderate values of  $N$ . Third, we do not need balanced panel data sets, so that individual time series may come in different lengths and span different sample periods: this can be very useful in practice for example when data from many different countries have to be utilized. However, when data come from a balanced macro panel, quite natural stationary covariates can be used for each equation, as suggested in [Pesaran \(2007\)](#) and [Chang and Song \(2009\)](#). Fourth, the test allows for heterogeneous panels: the stochastic as well as the non stochastic components can be different across individual time series. Last, the alternative hypothesis does not have to be that all the individual time series are stationary: the alternative that considers that some individual time series have a unit root and others do not can be dealt with by using the tests built upon [Choi \(2001\)](#). Indeed, we deliberately deal with the null hypothesis that all of the series in the panel are  $I(1)$  against the alternative that *at least* one of the series is  $I(0)$ . In fact, this hypothesis is common to most tests for a unit root in panels. Some authors consider this as a disadvantage (see [Taylor and Sarno, 1998](#), among others), but we believe that the extent to which this is a real limitation depends on the specific goal of the analysis.

On the other hand, a potentially serious drawback of the methodology advocated in [Choi \(2001\)](#) is that it is based on the hypothesis that the individual time series are cross-sectionally independent. Indeed, this is a common assumption of many papers dealing with panel unit roots and panel cointegration (see [Banerjee, 1999](#); [Baltagi and Kao, 2000](#); [Choi, 2006](#); [Breitung and Pesaran, 2008](#), for comprehensive surveys). However, it is well known (see e.g. [O'Connell, 1998](#); [Maddala and Wu, 1999](#); [Banerjee et al., 2004, 2005](#); [Gengenbach et al., 2006](#); [Lyhagen, 2008](#); [Wagner, 2008](#)) that both short-term and long-run cross-section dependence adversely affects the performance of these panel unit roots tests. Therefore, we extend the approach to cross-sectionally dependent panel units by using the  $p$  value correction method advocated in [Hartung \(1999\)](#) and [Demetrescu et al. \(2006\)](#).<sup>1</sup>

Although developed independently, the results reported in the present paper are related to other recent research. Despite some similarities, even in the name, the panel-CADF ( $p$ CADF) test presented here should not be confused with the cross-sectionally augmented ADF (CADF) test advocated in [Pesaran \(2007\)](#).<sup>2</sup> The CADF-CIPS test developed by [Pesaran](#) is explicitly derived with the aim of addressing directly the problem of cross-sectional dependence. Also [Pesaran's](#) test is related to [Hansen \(1995\)](#), but model augmentation takes place using non-stationary covariates. Furthermore, differently from

<sup>1</sup>[Hartung's](#) correction has been utilized in other recent papers: see, among others, [Hassler and Tarcolea \(2005\)](#) and [Westerlund and Costantini \(2009\)](#).

<sup>2</sup>Notwithstanding the similarity of the names with [Pesaran's](#) test, we think that it is fair to refer to the original [Hansen's](#) test using the original acronym CADF proposed by [Hansen](#) himself. In order to minimize confusion with [Pesaran's](#) test, we label our panel extension as  $p$ CADF.

the  $p$ CADF test we propose here, in [Pesaran \(2007\)](#) the asymptotic results are derived under  $N \rightarrow \infty$ , either with a fixed  $T$  or with  $T \rightarrow \infty$  sequentially or jointly with  $N$ .<sup>3</sup> [Chang and Song \(2009\)](#) also start from the observation that using stationary covariates can greatly improve the power of unit root tests. However, the approach developed in [Chang and Song \(2009\)](#) is rather different from ours. While we use a simple  $p$  value combination approach, [Chang and Song \(2009\)](#) propose a method based on non-linear IV estimation of the autoregressive coefficient, the suggested instruments being non-linear transformations of the lagged levels. This procedure should allow coping with cross-sectional dependencies of unknown form. In fact, [Chang and Song \(2009\)](#) show that the IV-based  $t$ -ratios associated with the autoregressive parameters are asymptotically independent even in the presence of cross-sectionally dependent time series. The test is proposed in three variants based on the average, the min, and the max  $t$ -ratio, depending on the specific null and alternative hypothesis.<sup>4</sup>

The rest of the paper is organized as follows. Section 2 is devoted to a brief discussion of the test proposed in [Hansen \(1995\)](#). We also illustrate the method we use to obtain the necessary  $p$  values. Indeed, this is a subsidiary, but we believe important, contribution of this paper. In fact, while critical values of [Hansen's](#) test are readily available from [Hansen \(1995\)](#), to the best of our knowledge, no procedure has been proposed so far for the numerical computation of the test  $p$  values. Section 3 offers a brief account of the inverse normal combination method and its modifications to deal with dependent time series. In Section 4 an extensive Monte Carlo analysis of the  $p$ CADF test is carried out. The Data Generating Process (DGP) we propose in the paper encompasses other DGPs that are commonly used in the panel unit root literature and it is also related to the DGP used in [Hansen \(1995\)](#). Beside giving us more flexibility in the design of the experiments, our DGP allows us to complement [Hansen \(1995\)](#) and [Caporale and Pittis \(1999\)](#) with new theoretical results and interpretations of the simulations outcomes. The performance of the  $p$ CADF test is compared to that of other important panel unit root tests, namely those advocated in [Chang and Song \(2009\)](#), [Demetrescu et al. \(2006\)](#) and [Moon and Perron \(2004\)](#). All these tests allow for cross-dependence and share the same null and alternative hypothesis. For the purpose of illustration, in Section 5 we apply our  $p$ CADF test to the PPP hypothesis and to international industrial production indices. The last Section concludes. An Appendix describes the algorithm used to compute the  $p$  values of [Hansen's](#) test.

The  $p$ CADF test described in this paper has been implemented in R ([R Development Core Team, 2011](#)). The related procedures are freely available and are part of the ongoing R project **punitroots** ([Kleiber and Lupi, 2011](#)).

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<sup>3</sup>However, [Pesaran \(2007\)](#) shows that satisfactory size and power properties can be obtained even for rather small values of  $N$ .

<sup>4</sup>In fact [Chang and Song \(2009\)](#) consider three different formulations of the unit root hypothesis: (A)  $H_0$  : all of the series are  $I(1)$  against  $H_1$  : all of the series are  $I(0)$ ; (B)  $H_0$  : all of the series are  $I(1)$  against  $H_1$  : at least one of the series is  $I(0)$ ; (C)  $H_0$  : some of the series are  $I(1)$  against  $H_1$  : all of the series are  $I(0)$ .

## 2 The CADF test and the $p$ values approximation

The CADF test proposed in [Hansen \(1995\)](#) starts from the idea that real economic phenomena are not univariate in general. Therefore, using extra information in unit root testing can make test regressions more efficient, allowing more precise inferences.

Formally, [Hansen \(1995\)](#) assumes that the series  $y_t$  to be tested for a unit root can be written as

$$y_t = d_t + s_t \quad (1)$$

$$a(L)\Delta s_t = \delta s_{t-1} + v_t \quad (2)$$

$$v_t = \mathbf{b}(L)'(\Delta \mathbf{x}_t - \boldsymbol{\mu}_x) + e_t \quad (3)$$

where  $d_t$  is a deterministic term (usually a constant or a constant and a linear trend),  $a(L) := (1 - a_1L - a_2L^2 - \dots - a_pL^p)$  is a polynomial in the lag operator  $L$ ,  $\mathbf{x}_t \sim I(1)$  is an  $m$ -vector such that  $\Delta \mathbf{x}_t \sim I(0)$ ,  $\boldsymbol{\mu}_x := E(\Delta \mathbf{x})$ ,  $\mathbf{b}(L) := (\mathbf{b}_{q_2}L^{-q_2} + \dots + \mathbf{b}_{q_1}L^{q_1})$  is a polynomial where both leads and lags are allowed. Furthermore, consider the long-run covariance matrix

$$\boldsymbol{\Omega} := \sum_{k=-\infty}^{\infty} E \left[ \begin{pmatrix} v_t \\ e_t \end{pmatrix} \begin{pmatrix} v_{t-k} & e_{t-k} \end{pmatrix} \right] = \begin{pmatrix} \omega_v^2 & \omega_{ve} \\ \omega_{ve} & \omega_e^2 \end{pmatrix} \quad (4)$$

and define the long-run squared correlation between  $v_t$  and  $e_t$  as

$$\rho^2 := \frac{\omega_{ve}^2}{\omega_v^2 \omega_e^2}. \quad (5)$$

When  $\Delta \mathbf{x}_t$  explains nearly all the zero-frequency variability of  $v_t$ , then  $\rho^2 \approx 0$ . On the contrary, when  $\Delta \mathbf{x}_t$  has no explicative power on the long-run movement of  $v_t$ , then  $\rho^2 \approx 1$ . Furthermore, as emphasized by [Hansen \(1995, p. 1151\)](#), when  $e_t$  is uncorrelated with  $\Delta \mathbf{x}_{t-k} \forall k$ , then  $\rho^2 = \omega_e^2 / \omega_v^2$ . The case  $\rho^2 = 0$  is ruled out ([Hansen, 1995, p. 1151](#)), which implies that  $y_t$  and  $\mathbf{x}_t$  cannot be cointegrated.

Similarly to the conventional ADF test, the CADF test is based on three different models representing the “no-constant”, “with constant”, and “with constant and trend” case, respectively

$$a_0(L)\Delta y_t = \delta_0 y_{t-1} + \mathbf{b}_0(L)' \Delta \mathbf{x}_t + e_{0t} \quad (6)$$

$$a_\mu(L)\Delta y_t = \mu_\mu + \delta_\mu y_{t-1} + \mathbf{b}_\mu(L)' \Delta \mathbf{x}_t + e_{\mu t} \quad (7)$$

$$a_\tau(L)\Delta y_t = \mu_\tau + \theta_\tau t + \delta_\tau y_{t-1} + \mathbf{b}_\tau(L)' \Delta \mathbf{x}_t + e_{\tau t} \quad (8)$$

and is computed as the  $t$ -statistic for  $\delta_m, \widehat{t(\delta_m)}$  (with  $m \in \{0, \mu, \tau\}$ ). [Hansen \(1995, p. 1154\)](#) proves that under the unit-root null, if some mild regularity conditions are satisfied, the

asymptotic distribution of  $\widehat{t(\delta_0)}$  in (6) is

$$\widehat{t(\delta_0)} \xrightarrow{w} \rho \frac{\int_0^1 W dW}{\left(\int_0^1 W^2\right)^{1/2}} + (1 - \rho^2)^{1/2} N(0, 1) \quad (9)$$

where  $W$  is a standard Wiener process and  $N(0, 1)$  is a standard normal independent of  $W$ . Therefore, the asymptotic distribution is a weighted sum of a Dickey-Fuller and a standard normal distribution. As a consequence, if  $\rho^2 \neq 1$ , using conventional ADF critical values would lead to a conservative test.

The asymptotic distribution of the test statistic depends on the nuisance parameter  $\rho^2$  but, provided  $\rho^2$  is given, it can be simulated using standard techniques. The mathematical expression remains unchanged if a model with constant ( $\widehat{t(\delta_\mu)}$ ) or a model with constant and trend ( $\widehat{t(\delta_\tau)}$ ) are considered, except that demeaned and detrended Wiener processes are used instead of the standard Wiener process  $W$ .

In order to extend Hansen's CADF unit root test to the panel case using the approach outlined in Choi (2001), we need to compute the  $p$  values of the CADF unit root distribution.

We derive the quantiles of the asymptotic distribution for different values of  $\rho^2$ . Given that our goal is the computation of  $p$  values, we simulate the distributions for 40 values of  $\rho^2$  ( $\rho^2 = 0.025, 0.05, 0.0725, \dots, 1$ ) using 100,000 replications for each value of  $\rho^2$  and  $T = 5,000$  as far as the Wiener functionals are concerned.<sup>5</sup> From the simulated values we derive 1,005 estimated asymptotic quantiles, (0.00025, 0.00050, 0.00075, 0.001, 0.002, ..., 0.998, 0.999, 0.99925, 0.99950, 0.99975).

Figure 1 reports the estimated asymptotic quantiles for the model with constant, without any smoothing. The surface is extremely regular.<sup>6</sup> Similar considerations carry over for the "no constant" and the "constant plus trend" cases. Therefore we expect that the simulated values can be successfully used to derive asymptotic  $p$  values along lines similar to MacKinnon (1996).

In order to derive  $p$  values from tabulated quantiles of a given distribution, MacKinnon (1996, p. 610) proposes using a local approximation of the kind

$$\Phi^{-1}(p) = \gamma_0 + \gamma_1 \widehat{q(p)} + \gamma_2 \widehat{q(p)}^2 + \gamma_3 \widehat{q(p)}^3 + \nu_p \quad (10)$$

where  $\Phi^{-1}(p)$  is the inverse of the cumulative standard normal distribution function evaluated at  $p$  and  $\widehat{q(p)}$  is the estimated quantile.<sup>7</sup> Equation (10) is not estimated globally (as one would do with a standard response surface). Rather, it is estimated only over a relatively small number of points, in order to obtain a *local* approximation (see MacKinnon, 1996, p. 610, for details).

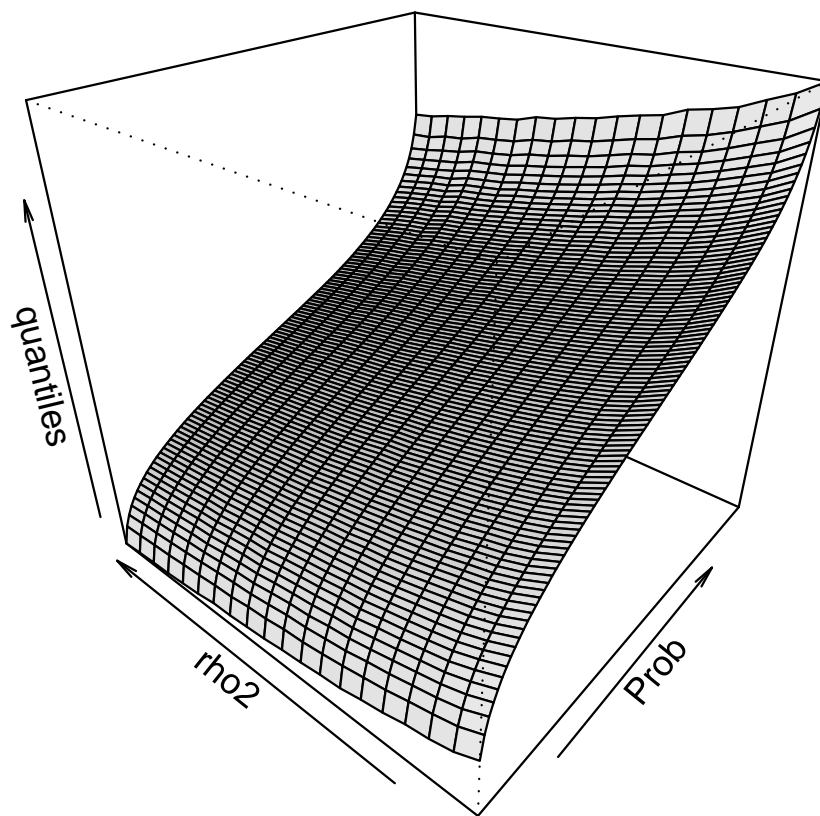
With respect to MacKinnon (1996), we have the extra difficulty that we have to deal

<sup>5</sup>Simulations have been carried out using R (R Development Core Team, 2011).

<sup>6</sup>Figure 1 reports the estimated asymptotic quantiles using a coarser resolution than the one used in the computations.

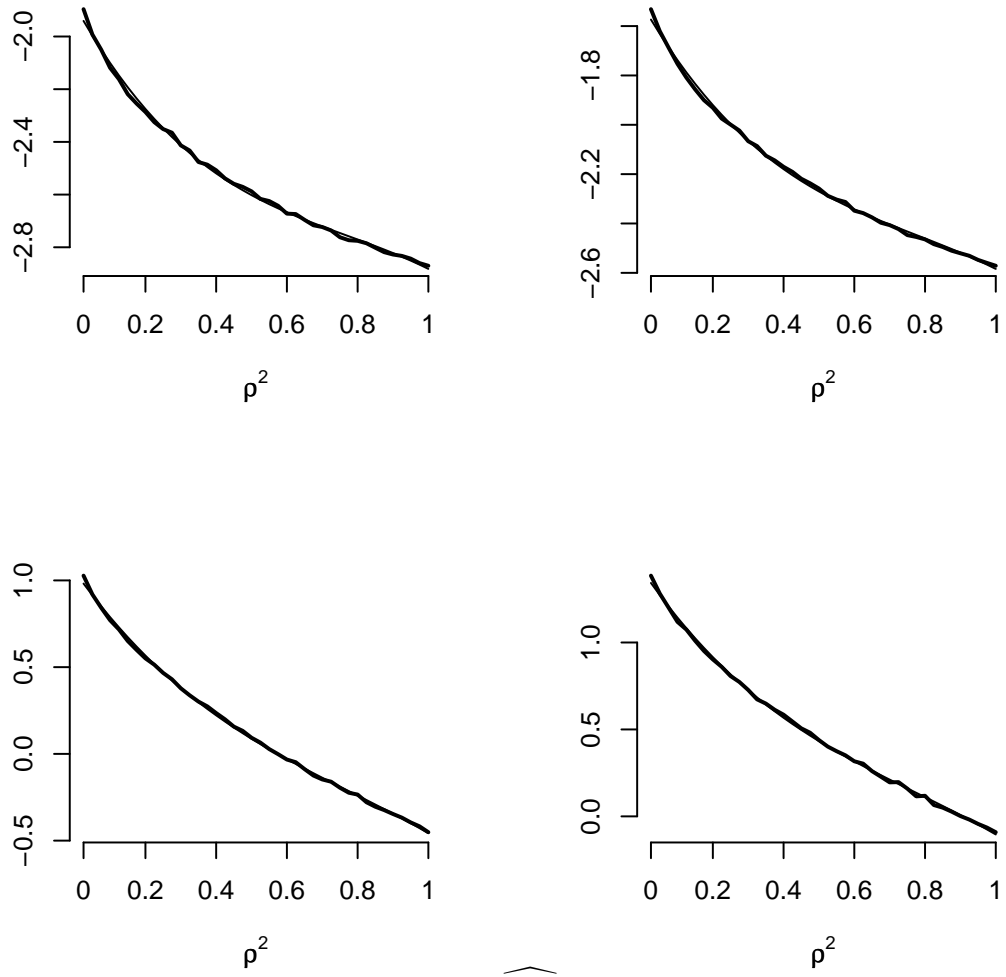
<sup>7</sup>In MacKinnon (1996) approximate finite sample quantiles are used, instead of the asymptotic ones.





**Figure 1** – Estimated asymptotic quantiles of  $\widehat{t(\delta_\mu)}$ .





**Figure 2** – Interpolation of the quantiles  $\widehat{q_\rho(p)}$ . From upper-left clockwise:  $\alpha = 5\%$ ,  $\alpha = 10\%$ ,  $\alpha = 95\%$ ,  $\alpha = 90\%$ . The thick solid lines are the simulated quantiles. The thin lines are the interpolated values.

$\rho^2$	Standard			Demeaned			Detrended		
	1%	5%	10%	1%	5%	10%	1%	5%	10%
0.05	-2.426	-1.740	-1.380	-2.661	-1.987	-1.626	-2.794	-2.125	-1.767
0.10	-2.450	-1.770	-1.410	-2.760	-2.091	-1.733	-2.937	-2.274	-1.921
0.15	-2.470	-1.795	-1.436	-2.847	-2.183	-1.829	-3.063	-2.408	-2.058
0.20	-2.488	-1.818	-1.460	-2.924	-2.266	-1.915	-3.175	-2.527	-2.181
0.25	-2.503	-1.837	-1.481	-2.990	-2.339	-1.991	-3.274	-2.633	-2.291
0.30	-2.515	-1.854	-1.500	-3.049	-2.403	-2.060	-3.360	-2.727	-2.389
0.35	-2.525	-1.868	-1.517	-3.099	-2.460	-2.121	-3.436	-2.810	-2.476
0.40	-2.534	-1.880	-1.531	-3.142	-2.510	-2.174	-3.502	-2.883	-2.553
0.45	-2.540	-1.890	-1.544	-3.179	-2.554	-2.222	-3.560	-2.947	-2.622
0.50	-2.545	-1.898	-1.555	-3.211	-2.593	-2.265	-3.610	-3.005	-2.683
0.55	-2.550	-1.905	-1.565	-3.239	-2.628	-2.303	-3.654	-3.055	-2.738
0.60	-2.553	-1.911	-1.573	-3.264	-2.658	-2.338	-3.693	-3.101	-2.788
0.65	-2.555	-1.916	-1.581	-3.286	-2.686	-2.369	-3.729	-3.143	-2.834
0.70	-2.558	-1.921	-1.587	-3.307	-2.712	-2.399	-3.762	-3.183	-2.877
0.75	-2.560	-1.925	-1.593	-3.327	-2.737	-2.428	-3.794	-3.220	-2.919
0.80	-2.563	-1.929	-1.598	-3.348	-2.762	-2.456	-3.825	-3.258	-2.960
0.85	-2.566	-1.933	-1.603	-3.371	-2.787	-2.484	-3.858	-3.296	-3.002
0.90	-2.569	-1.938	-1.608	-3.395	-2.814	-2.514	-3.893	-3.336	-3.046
0.95	-2.574	-1.944	-1.613	-3.423	-2.843	-2.545	-3.932	-3.379	-3.093
1.00	-2.580	-1.950	-1.618	-3.455	-2.874	-2.580	-3.975	-3.427	-3.144

**Table 1** – Asymptotic critical values of the CADF test.

with the nuisance parameter  $\rho^2$ , so that the local approximation must be obtained along two dimensions. However, given that quantiles change fairly smoothly by varying  $\rho^2$ , we adopt a rather straightforward two-step procedure. In the first step we interpolate the quantiles  $\widehat{q}(p)$  to obtain an approximation for the relevant value of  $\rho^2$ . In practice we use

$$\widehat{q}_\rho(p) = \beta_0 + \beta_1 \rho^2 + \beta_2 \rho^4 + \beta_3 \rho^6 + \varepsilon_\rho \quad (11)$$

where we have used the subscript  $\rho$  in  $\widehat{q}_\rho(p)$  to indicate the dependence of the quantiles on  $\rho^2$ . Interpolation is always very good, as can be gathered from Figure 2.

As a by-product of our analysis, we compute a detailed table of asymptotic critical values of the CADF test using equation (11) (see Table 1). Given that these critical values are based on a larger number of replications and on a response surface approach (see e.g. [Hendry, 1984](#)), we believe that they can be more accurate than those reported in [Hansen \(1995\)](#).

Finally we apply the procedure advocated in [MacKinnon \(1996\)](#) on the interpolated quantiles to obtain the  $p$  values.<sup>8</sup>

### 3 The inverse normal combination test

Once the goal of the computation of the  $p$  values for the distribution (9) is achieved, the extension of [Hansen's](#) test to the panel case is straightforward. Indeed, [Choi \(2001\)](#) shows

<sup>8</sup>A more detailed description of the procedure is reported in Appendix A.

that under some fairly general regularity conditions, if the cross-section units  $i = 1, \dots, N$  are independent, under the null

$$Z := \frac{1}{\sqrt{N}} \sum_{i=1}^N \hat{t}_i \xrightarrow{w} N(0, 1) \quad (12)$$

where the  $\hat{t}_i$ 's are the *probits*  $\hat{t}_i := \Phi^{-1}(\hat{p}_i)$ , with  $\Phi(\cdot)$  the standard normal cumulative distribution function, and  $\hat{p}_i$  the estimated individual  $p$  values for  $i = 1, \dots, N$ . Convergence in (12) takes place as  $T \rightarrow \infty$ , whereas  $N < \infty$  is the number of individual time series.  $T \rightarrow \infty$  is required for the relevant statistics to converge to a proper continuous distribution, under some regularity conditions. The null hypothesis is  $H_0 : \delta = 0 \forall i$ , while the alternative is  $H_1 : \delta < 0$  for at least one  $i$ , with  $i = 1, 2, \dots, N$ . This is a different alternative from  $H_1^* : \delta < 0 \forall i$ , used in other tests (see e.g. [Levin and Lin, 1993](#); [Levin et al., 2002](#); [Quah, 1994](#); [Papell, 2006](#)). In fact, we believe that our formulation of the alternative hypothesis is an advantage, rather than a disadvantage, as some authors claim. The *homogeneous alternative* that all of the series are  $I(0)$  with identical first-order partial autocorrelation is rather restrictive and not very interesting and informative, given that it can be tested only under the maintained hypothesis that the crucial parameter characterising the presence/absence of the unit root is the same across the individual time series in the panel (see e.g. [Levin et al., 2002](#)). Furthermore, the researcher can only conclude that a significant fraction of the series in the panel do not contain a unit root even when the null hypothesis is rejected using a test based on the homogeneous alternative ([Breitung and Pesaran, 2008](#)). In any case, from the economist's point of view there are instances in which it can be more interesting to test for the presence a unit root collectively over a whole panel of time series precisely because the presence of a unit root in *all* the series can be interpreted as a stylized fact that can give stronger support in favour (or against) a particular economic interpretation as compared to the same analysis conducted separately on each single time series. Moreover, because of multiple testing issues, the two approaches are not statistically equivalent.

However, the presence of cross-section dependence among the time series complicates substantially the theoretical framework, and the test statistic is no longer asymptotically (with  $T$ ) standard normal. However, [Hartung \(1999\)](#) suggests that a suitably modified inverse normal combination test can be obtained. The advantage of this solution is that under the null the test statistic has approximately standard normal distribution even in the presence of correlated individual test outcomes. In particular, [Hartung \(1999\)](#) analyses the case where the pairwise correlation across the individual test statistics is constant and equal to  $\varrho$ , say. If  $\varrho$  were known then, given a set  $\lambda_i, \dots, \lambda_N$  of real valued weights such that  $\sum_{i=1}^N \lambda_i \neq 0$ , it would be possible to compute

$$t(\varrho) := \frac{\sum_{i=1}^N \lambda_i \hat{t}_i}{\sqrt{(1 - \varrho) \sum_{i=1}^N \lambda_i^2 + \varrho \left( \sum_{i=1}^N \lambda_i \right)^2}} \quad (13)$$

which under the null would be distributed as  $N(0, 1)$ . When  $\varrho = 0$  (no cross-section

dependence) and  $\lambda_i = 1 \forall i$ , then (13) collapses into (12).

Of course,  $\rho$  is not known, and the feasible test statistic advocated by Hartung (1999, p. 851) is

$$t(\hat{\rho}^*, \kappa) := \frac{\sum_{i=1}^N \lambda_i \hat{t}_i}{\sqrt{\sum_{i=1}^N \lambda_i^2 + \left[ \left( \sum_{i=1}^N \lambda_i \right)^2 - \sum_{i=1}^N \lambda_i^2 \right] \left( \hat{\rho}^* + \kappa \sqrt{\frac{2}{N+1}} (1 - \hat{\rho}^*) \right)}} \quad (14)$$

where  $\hat{\rho}^*$  is a consistent estimator of  $\rho$  such that  $\hat{\rho}^* = \max\{-1/(N-1), \hat{\rho}\}$  with  $\hat{\rho} = 1 - (N-1)^{-1} \sum_{i=1}^N (\hat{t}_i - N^{-1} \sum_{i=1}^N \hat{t}_i)^2$ .  $\kappa > 0$  is a parameter that controls the small sample actual significance level. Hartung (1999) shows that under the null  $t(\hat{\rho}^*, \kappa)$  is approximately distributed as  $N(0, 1)$ . However, the proof offered in Hartung (1999) rests on the assumption that the probits are not only individually  $N(0, 1)$ , but are also jointly multivariate normal.

Demetrescu *et al.* (2006) generalize Hartung's results in two directions. They first show that the pairwise correlation of the individual test statistics need not be constant for Hartung's results to hold (Demetrescu *et al.*, 2006, Proposition 1, p. 651). Furthermore, they wonder under what conditions does the inverse normal method map the original test statistics to a multivariate normal distribution of the probits and they conclude that the necessary and sufficient condition for  $t(\rho)$  to have a standard normal distribution is that the test statistics from which the probits are derived are such to have the copula of a multivariate normal distribution (Demetrescu *et al.*, 2006, Proposition 2, p. 653). Despite the fact that the augmented Dickey-Fuller test does not satisfy the condition stated in their Proposition 2, Demetrescu *et al.* (2006) suggest that correcting for dependence using (14) may still be a good practice because units cross-correlation is likely to have much stronger adverse effects on inference than deviations from normality of the individual test statistics can have. Indeed, they show by simulation that this is in fact the case.

In this paper we follow the approach suggested by Demetrescu *et al.* (2006) to combine the  $p$  values of the individual CADF unit root tests in the presence of cross-section dependence. We argue that, if the correction proposed in Hartung (1999) works quite nicely in the presence of Dickey-Fuller distributions, it should *a fortiori* work at least as nicely in the presence of distributions that are closer to the standard normal. In other words, given that under the null Hansen's distribution is precisely a weighted sum of a Dickey-Fuller and a standard normal distribution, we expect that the correction for cross-section dependence in our case should be at least as effective as it is in the standard Dickey-Fuller case explored by Demetrescu *et al.* (2006).

## 4 Monte Carlo simulations

In this Section we compare the performance of the  $p$ CADF test to that of three unit root tests that are valid under cross-dependence. Specifically, we compare our test with an ADF-based  $p$  values combination test (Demetrescu *et al.*, 2006), with a dynamic factor test (Moon and Perron, 2004) and with a recent IV-based covariate-augmented test (Chang

and Song, 2009). For the latter two tests we consider in particular the  $t_a^*$  statistic (Moon and Perron, 2004, p. 92) and the *minimum-t* version of the test (see Chang and Song, 2009, pp. 905–906), respectively. All these tests share the same null  $H_0$  : “all of the series are  $I(1)$ ” and the same alternative  $H_1$  : “at least one series is  $I(0)$ ”.

We verify the performances of the  $p$ CADF test and of the test proposed in Demetrescu *et al.* (2006) using the versions of the tests with constant and with constant and linear trend.<sup>9</sup> The tests advocated in Chang and Song (2009) and Moon and Perron (2004) are examined in both the demeaned and detrended versions.

#### 4.1 Structure of the DGP

In our simulations we consider the following DGP:

$$\Delta \mathbf{y}_t = \boldsymbol{\alpha} + \mathbf{D} \mathbf{y}_{t-1} + \mathbf{u}_t \quad (15)$$

$$\begin{pmatrix} \mathbf{u}_t \\ \zeta_t \end{pmatrix} = \begin{pmatrix} \mathbf{B} & \boldsymbol{\gamma} \\ \mathbf{0}' & \lambda \end{pmatrix} \begin{pmatrix} \mathbf{u}_{t-1} \\ \zeta_{t-1} \end{pmatrix} + \begin{pmatrix} \boldsymbol{\eta}_t \\ \varepsilon_t \end{pmatrix} \quad (16)$$

$$\begin{pmatrix} \boldsymbol{\eta}_t \\ \varepsilon_t \end{pmatrix} \sim \text{N} \left[ \begin{pmatrix} \mathbf{0} \\ 0 \end{pmatrix}, \begin{pmatrix} \boldsymbol{\Sigma}_{11} & \boldsymbol{\sigma}_{12} \\ \boldsymbol{\sigma}_{12}' & \sigma_{22} \end{pmatrix} \right] \quad (17)$$

where  $\Delta$  is the usual difference operator,  $\mathbf{y}_t := (y_{1t}, \dots, y_{Nt})'$ ,  $\mathbf{u}_t := (u_{1t}, \dots, u_{Nt})'$ ,  $\boldsymbol{\alpha} := (\alpha_1, \dots, \alpha_N)'$ ,  $\mathbf{D} := \text{diag}(\delta_1, \dots, \delta_N)$ ,  $\mathbf{B} := \text{diag}(\beta_1, \dots, \beta_N)$ ,  $\boldsymbol{\gamma} := (\gamma_1, \dots, \gamma_N)'$  and  $\boldsymbol{\eta}_t := (\eta_{1t}, \dots, \eta_{Nt})'$ . Note that (16) defines a VAR(1) which is stationary as long as  $|\beta_i| < 1 \forall i$  and  $|\lambda| < 1$ .<sup>10</sup>  $\delta_i = 0 \forall i$  under the null, while under the alternative  $\delta_i < 0$  for some  $i$ .

We believe that the proposed DGP is especially interesting, because it can be viewed as a panel extension of the DGP proposed in Hansen (1995, p. 1161) and at the same time is also a generalization of two DGPs commonly used in the panel unit root literature (see e.g. Chang and Song, 2009; Phillips and Sul, 2003). The two DGPs that are special cases of ours share the same equation (15) for  $\Delta \mathbf{y}_t$  when  $\boldsymbol{\alpha} = \mathbf{0}$ , but differ as far as the simulation of the  $\mathbf{u}_t$ 's is concerned:

$$\text{DGP1: } u_{it} = \beta_i u_{i,t-1} + v_{it} \quad (18)$$

$$\text{DGP2: } u_{it} = \beta_i u_{i,t-1} + \gamma_i \zeta_t + v_{it} \quad (19)$$

where the  $N$ -vector  $\boldsymbol{\nu}_t$  is i.i.d.  $\text{N}(\mathbf{0}, \boldsymbol{\Sigma}_{11})$  with  $\boldsymbol{\Sigma}_{11} \neq \mathbf{I}$  and  $\zeta_t$  is a i.i.d.  $\text{N}(0, 1)$  common factor independent of  $\boldsymbol{\nu}_t$ .

It can be seen that, even when  $\boldsymbol{\alpha} = \mathbf{0}$ , our DGP (15)–(17) is more general than both (18) and (19): in fact, in our DGP the “common factor”  $\zeta_t$  can be autocorrelated and non-zero correlations between the innovations to  $u_{it}$  and the innovations to  $\zeta_t$  can be introduced.

<sup>9</sup>We do not consider the models without deterministic terms that are less relevant in practical applications.

<sup>10</sup>To see this, let's define

$$\boldsymbol{\Phi} := \begin{pmatrix} \mathbf{B} & \boldsymbol{\gamma} \\ \mathbf{0}' & \lambda \end{pmatrix}$$

and note that  $\boldsymbol{\Phi}$  is upper-triangular, so that the eigenvalues of  $\boldsymbol{\Phi}$  are given simply by the diagonal elements of  $\boldsymbol{\Phi}$ ,  $\text{dg}(\boldsymbol{\Phi})$ . Therefore, the VAR(1) is stationary as long as  $|\beta_i| < 1 \forall i$  and  $|\lambda| < 1$ .

As a result, the cross-dependence structure is stronger than in either DGP1 or DGP2. However, DGP2 can be derived as a special case from (15)–(17) when  $\lambda = 0$  and  $\sigma_{12} = \mathbf{0}$ , while DGP1 is retrieved if in addition  $\gamma = \mathbf{0}$ . In both cases, in general  $\Sigma_{11} \neq \mathbf{I}$ .

Using the DGP (15)–(17) we can determine the form of the model that should be used to test for a unit root in each single  $y_{it}$ . For simplicity, assume now  $\alpha = \mathbf{0}$ . Then, denoting the “past” by  $\mathbf{Z}_{t-1}$ , the correct conditional model for  $\Delta y_{i,t}$  is

$$\begin{aligned} E(\Delta y_{i,t} | \xi_t, \mathbf{Z}_{t-1}) &= \delta_i (1 - \beta_i) y_{i,t-1} + (1 + \delta_i) \beta_i \Delta y_{i,t-1} \\ &+ \frac{(\sigma_{12})_i}{\sigma_{22}} \xi_t + \left( \gamma_i - \frac{(\sigma_{12})_i}{\sigma_{22}} \lambda \right) \xi_{t-1}. \end{aligned} \quad (20)$$

with  $(\sigma_{12})_i$  the  $i$ -th element of  $\sigma_{12}$ . Note that (20) has the form of a CADF(1,1,0) model. In fact, unless  $\gamma = 0$  and  $\sigma_{12} = 0$ , the standard approach of using a panel combination ADF test in a context where the DGP is supposed to be of the kind of (15)–(17) (which is a fairly standard situation in the panel unit root literature) is bound to be at least inefficient, because the correct models should include  $\xi_t$  and/or  $\xi_{t-1}$  and the individual tests should be CADF. Even if  $\gamma_i = 0$  (i.e., when  $\xi_t$  does not Granger-cause  $u_t$ ), as far as  $(\sigma_{12})_i \neq 0$  the correct model has the form of a CADF(1,1,0).

Expression (20) is very similar to an expression derived in Caporale and Pittis (1999, p. 586, equation 11) and some special cases can be of interest. Under DGP2 ( $\lambda = 0$  and  $\sigma_{12} = \mathbf{0}$ ) the correct conditional model becomes

$$E(\Delta y_{i,t} | \xi_t, \mathbf{Z}_{t-1}) = \delta_i (1 - \beta_i) y_{i,t-1} + (1 + \delta_i) \beta_i \Delta y_{i,t-1} + \gamma_i \xi_{t-1} \quad (21)$$

and we should expect the  $p$ CADF test to have a better performance than the tests based on the conventional ADF. Of course, the same conditional model (21) holds for the  $i$ -th unit if only  $(\sigma_{12})_i = 0$ , while if  $\lambda = 0$  and  $(\sigma_{12})_i \neq 0$  we have

$$\begin{aligned} E(\Delta y_{i,t} | \xi_t, \mathbf{Z}_{t-1}) &= \delta_i (1 - \beta_i) y_{i,t-1} + (1 + \delta_i) \beta_i \Delta y_{i,t-1} \\ &+ \frac{(\sigma_{12})_i}{\sigma_{22}} \xi_t + \gamma_i \xi_{t-1}. \end{aligned} \quad (22)$$

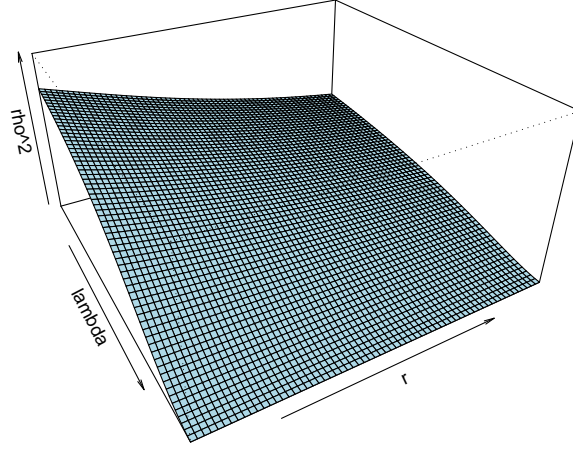
On the other hand, under DGP1 ( $\lambda = 0$ ,  $\sigma_{12} = \mathbf{0}$ ,  $\gamma = \mathbf{0}$ ), the correct conditional model is simply

$$E(\Delta y_{i,t} | \xi_t, \mathbf{Z}_{t-1}) = \delta_i (1 - \beta_i) y_{i,t-1} + (1 + \delta_i) \beta_i \Delta y_{i,t-1} \quad (23)$$

which has the form of an ordinary ADF(1) test equation, so that in this case the  $p$ CADF test has no advantage on  $p$  values combination tests based on the ADF test.

From the discussion in Section 2, we know that the power of the CADF test depends crucially on the nuisance parameter  $\rho^2$ . Therefore, the power of the  $p$ CADF tests will depend on the values of this parameter for each unit in the panel,  $\rho_i^2$ . Using the DGP (15)–(17) we can derive analytically the theoretical value of  $\rho_i^2$  under the DGP.<sup>11</sup> This

<sup>11</sup>Hansen (1995) derives  $\rho^2$  by simulation using different models. None of the models used by Hansen



**Figure 3** – Values of  $\rho^2$  for varying values of  $0 < \lambda < 1$  and  $0 < r_i < 1$ ,  $\gamma_i = 0.5$ ,  $\sigma_{e_i} = \sigma_\varepsilon = 1$ .  $\rho^2$  is plotted on a 0 – 1 scale.

result gives important insights to better investigate the performance of the test in the Monte Carlo experiments.

Consider the residual  $e_{i,t}$  from the correct conditional model (20)

$$\begin{aligned} e_{i,t} &= \Delta y_{i,t} - \delta_i (1 - \beta_i) y_{i,t-1} - (1 + \delta_i) \beta_i \Delta y_{i,t-1} \\ &\quad - \frac{(\sigma_{12})_i}{\sigma_{22}} \xi_t - \left( \gamma_i - \frac{(\sigma_{12})_i}{\sigma_{22}} \lambda \right) \xi_{t-1}. \end{aligned} \quad (24)$$

Given that  $e_{i,t}$  is the residual from the correct conditional model, it must be an innovation uncorrelated with  $\xi_{t-k} \forall k$ . As discussed in Hansen (1995, p. 1151), in this case  $\rho_i^2 = \omega_{e_i}^2 / \omega_{v_i}^2$  with  $\omega_h^2$  the long-run variance of  $h$ , that is the zero-frequency spectral density of  $h$  (where  $h \in \{e_i, v_i\}$ ). Given that  $e_{i,t}$  is an innovation, its long-run variance is just the variance of  $e_{i,t}$ , apart from the normalizing factor  $(2\pi)^{-1}$ .

Now consider

$$v_{i,t} = \frac{(\sigma_{12})_i}{\sigma_{22}} \xi_t + \left( \gamma_i - \frac{(\sigma_{12})_i}{\sigma_{22}} \lambda \right) \xi_{t-1} + e_{i,t}. \quad (25)$$

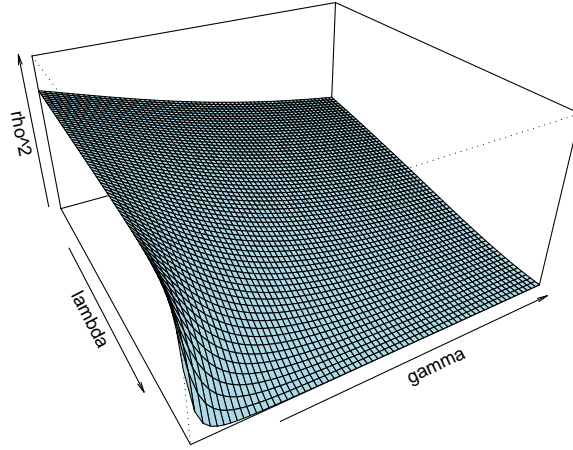
In order to compute the long-run variance of  $v_{i,t}$ ,  $\omega_{v_i}^2$ , from (16) note that  $\xi_t = (1 - \lambda L)^{-1} \varepsilon_t$  and define  $r_i := (\sigma_{12})_i / \sigma_{22}$ . Then, rewrite (25) as

$$\begin{aligned} v_{i,t} &= [r_i + (\gamma_i - r_i \lambda) L] \xi_t + e_{i,t} \\ &= \frac{r_i + (\gamma_i - r_i \lambda) L}{1 - \lambda L} \varepsilon_t + e_{i,t}. \end{aligned} \quad (26)$$

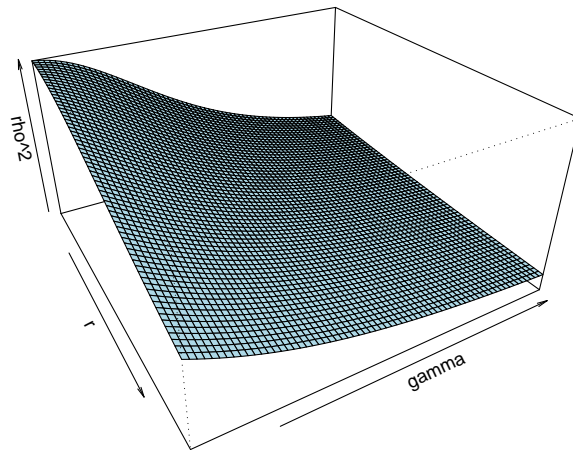
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(1995, Table 3, p. 1162) correspond to the correctly specified CADF(1,1,0), so that all the models are either over- or under-parameterized. Using the theoretical results derived below jointly with Hansen's results, we can show that under-parameterization can result in biased estimates of  $\rho^2$ , with adverse effects on inference. This is particularly evident with respect to Hansen's experiments 11 and 15, where the simulation-based estimates of  $\rho^2$  from the CADF(2,0,1) model are equal to 0.87 and 0.90, respectively, while the true values under the DGP are 0.67 and 0.50.





**Figure 4** – Values of  $\rho^2$  for varying values of  $0 < \lambda < 1$  and  $0 < \gamma_i < 1$ ,  $r = 0.5$ ,  $\sigma_{e_i} = \sigma_\varepsilon = 1$ .  $\rho^2$  is plotted on a 0 – 1 scale.



**Figure 5** – Values of  $\rho^2$  for varying values of  $0 < r < 1$  and  $0 < \gamma_i < 1$ ,  $\lambda = 0.5$ ,  $\sigma_{e_i} = \sigma_\varepsilon = 1$ .  $\rho^2$  is plotted on a 0 – 1 scale.

The spectral density of  $v_{i,t}$  at frequency  $\omega$  is

$$f_{v_i}(\omega) \propto \frac{|r_i + (\gamma_i - r_i\lambda) e^{-i\omega}|^2}{|1 - \lambda e^{-i\omega}|^2} \sigma_\varepsilon^2 + \sigma_{e_i}^2 \quad (27)$$

so that the long-run variance of  $v_{i,t}$ ,  $\omega_{v_i}^2$ , is

$$\omega_{v_i}^2 := f_{v_i}(0) \propto \frac{[\gamma_i + (1 - \lambda) r_i]^2}{(1 - \lambda)^2} \sigma_\varepsilon^2 + \sigma_{e_i}^2. \quad (28)$$

Finally,  $\rho_i^2$  is given by

$$\rho_i^2 = \frac{\omega_{e_i}^2}{\omega_{v_i}^2} = \frac{\sigma_{e_i}^2}{\frac{[\gamma_i + (1 - \lambda) r_i]^2}{(1 - \lambda)^2} \sigma_\varepsilon^2 + \sigma_{e_i}^2}. \quad (29)$$

The value of  $\rho_i^2$  is a nonlinear function of  $(\sigma_{12})_i$ ,  $\sigma_{22}$ ,  $\gamma_i$  and  $\lambda$ . Contrary to what is suggested in Hansen (1995, p. 1161), we find that the value of  $\lambda$  is crucial in determining the value of the nuisance parameter  $\rho^2$ , also when the VAR(1) (16) is stationary. Of course, when  $\lambda \rightarrow 1$ , then  $\omega_{v_i}^2 \rightarrow \infty$  and  $\rho^2 \rightarrow 0$ : this is an expected result, because if  $\lambda = 1$ ,  $\xi_t$  has a unit root and is cointegrated with  $y_{i,t}$ . Conversely, if  $\gamma_i = 0$  and  $r_i = 0$ , then  $\rho_i^2 = 1$ : in this case there would be no advantage in using individual CADF tests instead of standard ADF tests. Under DGP2, given that  $\lambda = 0$  and  $r_i = 0$ ,  $\rho_i^2$  simply varies inversely with  $\gamma_i$ . Under DGP1, where it is also  $\gamma_i = 0 \forall i$ , then  $\rho_i^2 = 1 \forall i$  and the power of the  $p$ CADF test is substantially the same as the power of the test based on Demetrescu *et al.* (2006), consistently with what already pointed out while discussing the conditional model.

In (29) the larger are either  $\lambda$ ,  $\gamma_i$  or  $r_i$ , the smaller is  $\rho_i^2$ . Given that the power of the CADF test is higher the smaller is the value of  $\rho_i^2$ , this in turn defines the regions where the test is expected to perform better. A graphical summary of the relation between  $\rho_i^2$  and the values of  $\lambda$ ,  $\gamma_i$  and  $r_i$  is offered in Figures 3–5.

## 4.2 Parameters setting and experimental design

Some care must be exerted in simulating the DGP (15)–(17), especially as far as the simulation of  $(\eta'_t, \varepsilon_t)'$  is concerned. From (17),  $(\eta'_t, \varepsilon_t)' \sim N(0, \Sigma)$ , with

$$\Sigma = \begin{pmatrix} \Sigma_{11} & \sigma_{12} \\ \sigma'_{12} & \sigma_{22} \end{pmatrix}. \quad (30)$$

We assume  $\text{diag}(\Sigma) := \mathbf{1}$ , with  $\mathbf{1} := (1, \dots, 1)$  so that the generic element of  $\sigma_{12}$ ,  $(\sigma_{12})_i$ , coincides with  $r_i$ . However, we have to distinguish two different settings for  $\Sigma_{11}$ , depending on  $\sigma_{12} = 0$  or  $\sigma_{12} \neq 0$ .

When  $\sigma_{12} = 0$  (e.g. under DGP1 and DGP2), then we must generate the correlation matrix  $\Sigma_{11}$  in a way that is as flexible and unrestricted as possible. At the same time we want to introduce fairly strong dependence. Therefore, we start by generating a symmetric matrix  $\Sigma^*$  whose diagonal elements are equal to 1 and whose non-diagonal

elements are randomly drawn from  $U_{(0,0.8)}$ . Of course, although symmetric,  $\Sigma^*$  is not in general positive definite. Therefore, we find a positive definite symmetric matrix  $\Sigma^\dagger$  that is “close” to  $\Sigma^*$  by computing  $\Sigma^\dagger = V^* \Lambda^\dagger V^{*'}$  where the matrix  $V^*$  is derived from the singular value decomposition of  $\Sigma^*$  and  $\Lambda^\dagger$  is the diagonal matrix of the eigenvalues of  $\Sigma^*$ , after substituting the negative eigenvalues with very small but positive values. Finally, the positive definite covariance matrix obtained in this way (the diagonal elements are not exactly equal to one) is transformed into the required correlation matrix  $\Sigma_{11}$  by normalization.<sup>12</sup> The resulting symmetric positive definite matrix  $\Sigma_{11}$  is such that most of the simulated correlations are positive, as we probably would expect in many empirical macro panel settings, and the average correlation is larger than the one simulated using the method proposed by Chang (2002) and Chang and Song (2009).<sup>13</sup> Furthermore, the simulated  $\Sigma_{11}$  is likely to satisfy Proposition 1 in Demetrescu *et al.* (2006).

On the other hand, when  $\sigma_{12} \neq \mathbf{0}$  the parameters  $r_i := (\sigma_{12})_i$  enter the expression for  $\rho_i^2$  and are therefore important design parameters that we want to control precisely. In this case we want to simulate a correlation matrix  $\Sigma$  whose last column is a given vector  $(\sigma'_{12}, 1)'$ . Furthermore, given the vector of correlations  $\sigma_{12}$ , it is reasonable to consider  $\Sigma_{11} \neq I$ . However,  $\Sigma_{11}$  in this case must be consistent with the given  $\sigma_{12}$ . Therefore, we introduce a minimal structure in  $\Sigma_{11}$  by assuming that its generic off-diagonal element is  $(\Sigma_{11})_{ij} := (\sigma_{12})_i (\sigma_{12})_j$  (with  $i \neq j$ ) and  $\text{diag}(\Sigma_{11}) := \mathbf{1}$ . This structure essentially states that the more  $\eta_{it}$  is correlated with  $\varepsilon_t$  and  $\eta_{jt}$  is correlated with  $\varepsilon_t$ , the more  $\eta_{it}$  is correlated with  $\eta_{jt}$ , that is what we should expect in the usual case. Simulating such a  $\Sigma$  is very easy: just draw the elements of  $\sigma_{12}$  from a specified distribution,  $U_{(r_{\min}, r_{\max})}$ , say, and compute  $S = \sigma_{12} \sigma'_{12}$ . Set  $\text{diag}(S) := \mathbf{1}$  and call  $\Sigma_{11}$  the resulting matrix. Then, build the correlation matrix  $\Sigma$  as in (30). The matrix  $\Sigma$  simulated in this way is symmetric positive definite.<sup>14</sup>

As already pointed out in the previous subsection, we expect the nuisance parameter  $\rho^2$  to influence the performance of our test. Therefore, rather than embarking in a full factorial design, we concentrate on just a few experiments carefully selected in such a way that they differ in the underlying value of  $\rho^2$  (see Table 2).

<sup>12</sup>The proposed algorithm is essentially equivalent to the procedure advocated in Rebonato and Jäckel (1999, Section 3).

<sup>13</sup>In a pilot simulation carried out using 50,000 replications we found that the average non-diagonal element of a  $20 \times 20$  simulated correlation matrix was about 0.34 with the simulated correlations spanning the interval  $(-0.30, 0.96)$ . We also used the procedure outlined in Demetrescu *et al.* (2006, p. 659). The results are very similar to those reported here and are available from the authors upon request.

<sup>14</sup>To see this, note that  $\Sigma$  is real symmetric by construction. Then there exists a matrix  $P$  such that  $P' \Sigma P = \Lambda$ , with  $\Lambda$  the diagonal matrix of the eigenvalues of  $\Sigma$ .  $P$  and  $\Lambda$  can be found using the Schur canonical form:

$$\begin{aligned} & \begin{pmatrix} I & -\sigma_{12} \\ \mathbf{0}' & 1 \end{pmatrix} \begin{pmatrix} \Sigma_{11} & \sigma_{12} \\ \sigma'_{12} & 1 \end{pmatrix} \begin{pmatrix} I & \mathbf{0} \\ -\sigma'_{12} & 1 \end{pmatrix} = \begin{pmatrix} \Sigma_{11} - \sigma_{12} \sigma'_{12} & \mathbf{0} \\ \mathbf{0}' & 1 \end{pmatrix} \\ & = \begin{pmatrix} 1 - (\sigma_{12})_1^2 & 0 & \dots & 0 & 0 \\ 0 & 1 - (\sigma_{12})_2^2 & \dots & 0 & 0 \\ \vdots & \vdots & \ddots & \vdots & \vdots \\ 0 & 0 & \dots & 1 - (\sigma_{12})_N^2 & 0 \\ 0 & 0 & \dots & 0 & 1 \end{pmatrix} = \Lambda. \end{aligned}$$

Since all the eigenvalues of  $\Sigma$  are positive,  $\Sigma$  is positive definite.

Experiment	$\lambda$	$\gamma$	$r$	$\rho^2$
1	0.0	0.0	0.0	1.000
2	0.0	$U_{(0.7,0.9)}$	0.0	0.610
3	0.2	$U_{(0.7,0.9)}$	$U_{(0.1,0.3)}$	0.410
4	0.5	$U_{(0.1,0.3)}$	$U_{(0.7,0.9)}$	0.410
5	0.2	$U_{(0.7,0.9)}$	$U_{(0.7,0.9)}$	0.236
6	0.5	$U_{(0.7,0.9)}$	$U_{(0.7,0.9)}$	0.148

**Table 2** – Parameters setting. The values of  $\rho^2$  are computed using the means of the Uniform distributions.

The other parameters of the DGP are generated as in [Chang and Song \(2009\)](#): in particular,  $\beta_i \sim U_{(0.2,0.4)}$  and  $\gamma_i \sim U_{(0.5,3)}$  (with  $i = 1, \dots, N$ ). Under the null  $\delta_i = 0 \forall i$ , under the alternative  $\delta_i \sim U_{(-0.2,-0.01)}$  for the stationary units. In order to highlight the power of the tests when only a few series are stationary, the number of stationary units under the alternative is fixed to 2 in all experiments dealing with power.

Given that our DGP allows for a non-zero drift  $\alpha_i$ , we run the experiments first using  $\alpha_i = 0 \forall i$  and then using  $\alpha_i \sim U_{(0.7,0.9)}$ .

Finally, the experiments are carried out using 2,500 replications with  $T \in \{100, 300\}$  and  $N \in \{10, 20\}$  that are fairly typical values in macro-panel applications.

Since the use of the  $p$ CADF test implies a sequence of decisions, we use a pseudo-real setting that aims at replicating the way these decisions might be taken in practice. Therefore, the choice to correct or not to correct for cross-unit dependence is based on a test for the presence of cross-unit correlation ([Pesaran, 2004](#)). When the test rejects the absence of correlation among the cross-section units, the panel test is performed by using the modified weighted inverse normal combination (14), otherwise standard inverse normal combination (12) is utilized. When the modified version (14) is used, consistently with [Hartung \(1999\)](#) and [Demetrescu et al. \(2006\)](#), in our experiments we use  $\lambda_i = 1 \forall i$  and  $\kappa = 0.2$ . Furthermore, the selection of the lags structure for the lagged differences of both the dependent variable and the covariate in the  $p$ CADF test equations (6)-(8) is based on the BIC separately for each equation. The choice of the variable to be used as the stationary covariate in testing the unit root for the  $i$ -th series in the panel is determined using three different criteria. First,  $\zeta_t$  is used as the stationary covariate; second, we consider as the stationary covariate the average of the differenced series  $\Delta y_{jt}$  ( $\forall j \neq i$ ) related to the other units in the panel, as in [Chang and Song \(2009\)](#); third, we use the first difference of the first principal component of the series. A word of caution is in order here. It could be argued that selecting the stationary covariate using the average of the other  $\Delta y_{jt}$  or the differences of the first principal component of the series may overlook the problem that the derived covariate might be non-invertible. In fact, [Hansen \(1995\)](#) shows that over-differencing the covariates raises theoretical problems and can have some adverse effects on the size and power of the test. However, for this to be the case it would be necessary that all the series are  $I(0)$ . In this instance the test would have high power anyway. Furthermore, one could wonder if using a covariate different from  $\zeta_t$  would ensure convergence of the test statistic to the correct asymptotic distribution. In fact, in

Hansen (1995) there is no “true” covariate to be used, and convergence to (9) holds for any stationary covariate satisfying Assumption 1 (Hansen, 1995, p. 1151), which in turn is more likely to be satisfied if models (6)-(8) include appropriate lag polynomials. However, while the choice of the stationary covariate(s) does not influence the size of the test (at least asymptotically), it can nevertheless have a significant impact on its power so that the choice of “good” covariates is essential to reach the potential power gains offered by the CADF and  $p$ CADF tests.

The panel-ADF test is carried out in the version proposed by Demetrescu *et al.* (2006), that exploits the correction for cross-section dependence introduced by Hartung (1999). The number of lags is selected also in this case by using the BIC and, differently from Demetrescu *et al.* (2006), Hartung’s correction is applied after pre-testing for cross-dependence as for the  $p$ CADF test. If no cross-dependence is detected, then the test is applied as in Choi (2001).

The test developed in Moon and Perron (2004) deals directly with cross-unit correlation by using an approximate linear factor model. We set the maximum number of factors to 4 and select the actual number of factors to be used in the test by the BIC<sub>3</sub> criterion, as suggested in Moon and Perron (2004, p. 94).

Finally, as far as the test proposed by Chang and Song (2009) is concerned, the procedure that we use in our Monte Carlo simulations amounts to the selection of the lag order of the lagged differences and of the covariate for each cross-section unit using the BIC and the selection of the appropriate covariate to be used by selecting the one that has the highest correlations with the error process (see, on this, Chang and Song, 2009, footnote 9).

### 4.3 Simulation results

The simulation results are presented using the graphical approach proposed in Davidson and MacKinnon (1993, 1998). Let’s denote by  $\hat{F}(x_i)$  the estimated empirical distribution of the  $p$  values at any point  $x_i \in (0, 1)$ . Under the null, the  $p$  values are uniformly distributed, so that it should be true that  $\hat{F}(x_i) \approx x_i$ . A useful way to investigate the size properties of a test is therefore to plot  $\hat{F}(x_i) - x_i$  against  $x_i$ . This is what Davidson and MacKinnon call a *p value discrepancy plot*. The statistical significance of the discrepancies  $\hat{F}(x_i) - x_i$  can be approximately assessed by using the Kolmogorov-Smirnov distribution.<sup>15</sup> Using the  $p$  value discrepancy plots it is possible to investigate the size properties of the tests not only in correspondence with a couple of selected points, but along all the  $p$  values distribution. However, given that we are mostly interested in the left tail of the distribution, we confine our attention to the nominal size up to 30%.

In order to analyse the power of the tests, we plot the power against the actual size. Davidson and MacKinnon (1998) call these plots *size-power curves*.<sup>16</sup> By plotting the

<sup>15</sup>Other statistics and distributions could in principle be used that give more weight to the left tail of the  $p$  values distribution (see, e.g., Delicado and Placencia, 2001) but the Kolmogorov-Smirnov statistic proposed by Davidson and MacKinnon (1998) fits perfectly in the graphical framework adopted here.

<sup>16</sup>Size-power curves were first introduced by Wilk and Gnanadesikan (1968) as a specialized example of the use of P-P plots.

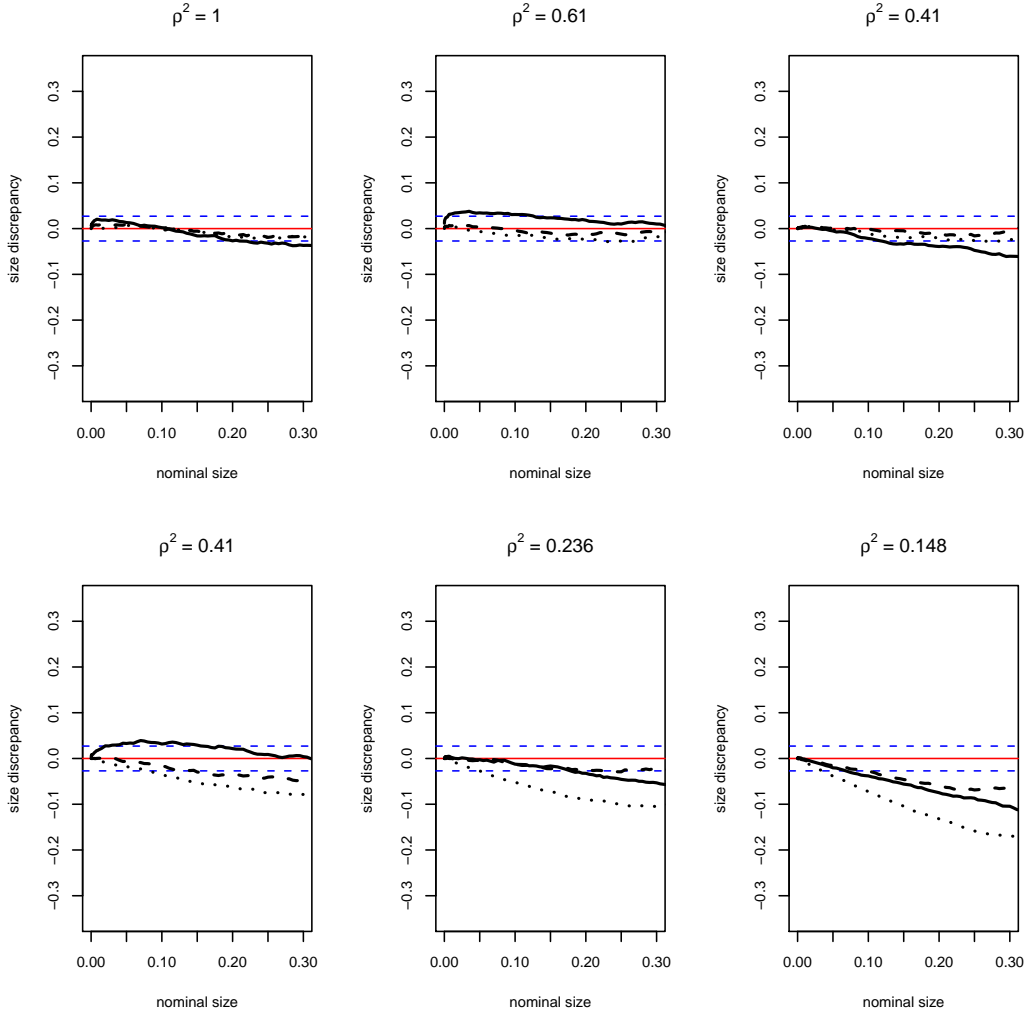
power on the vertical axis and the actual size on the horizontal one, we have a graphical representation of the power for any desired size of the test. A  $45^\circ$  line is also plotted that is equivalent to the size-power curve of a hypothetical test whose power is always equal to the size. Of course, for a test to be of any value, we should expect its size-power curve to lie well above the  $45^\circ$  line. Depending on the size and power properties of each test, the corresponding size-power curves based on the actual size may cross each other (see e.g. [Wilk and Gnanadesikan, 1968](#); [Davidson and MacKinnon, 1998](#), for examples of crossing size-power curves). Size-power curves are also related to the receiver operating characteristic (ROC) curves (see e.g. [Lloyd, 2005](#)). In fact, a plot of the power against the size is the ROC curve of the test. It is worth emphasizing that any point on the estimated ROC (size-power) curve represents the estimated power of the test when the *correct* (as opposed to the *nominal*) critical value for a given test size is utilized. In other words, the ROC curve is a graphical representation of the *intrinsic* (size-adjusted) power of the test ([Lloyd, 2005](#)).

While it is customary to report simulation results only with respect to the percentage of rejections obtained in correspondence with conventional significance levels (5% and 10%, say), we offer for the first time a detailed analysis of the whole empirical distribution function of the  $p$  values of different panel unit root tests under cross-dependence. We can do this because we can compute the  $p$  values of each test and we do not rely only on the critical values. Of course, this greater detail comes at the cost of some extra computational burden.

All the figures presented in this Section are produced using the same scale in order to ease comparison among the tests and across the experiments.

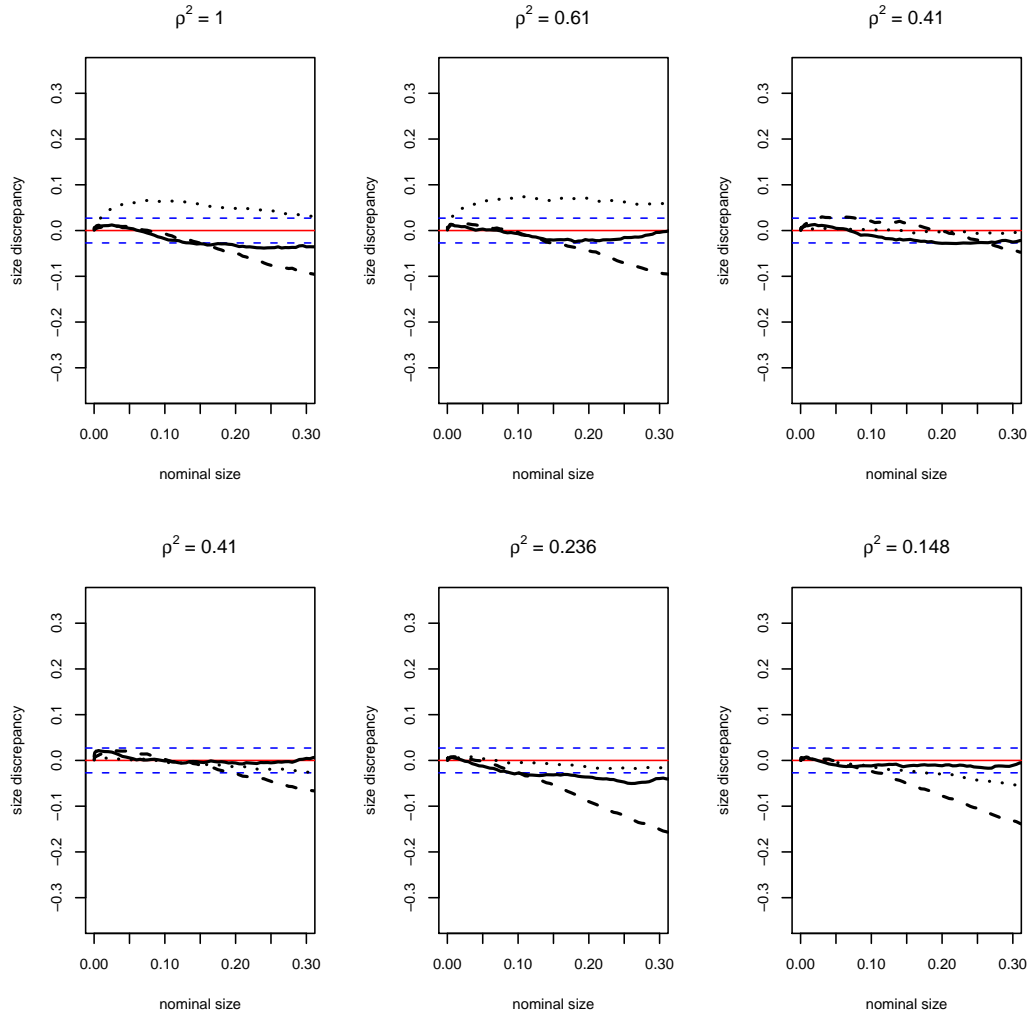
We start the analysis by considering experiments 1–6 of Table 2 with  $\alpha = 0$  in the DGP and no trend in the model. The size discrepancies of the tests are reported in Figures 6 and 7. The test proposed by [Demetrescu et al. \(2006\)](#) has the best overall size properties across experiments. However, the  $p$ CADF test performs quite well, with no large size discrepancies in correspondence with the usual size levels. However, it tends to be slightly conservative in experiment 6, especially when the first principal component is used to derive the stationary covariate. On the contrary, the test advocated by [Moon and Perron \(2004\)](#) tends to over-reject in experiments 1 and 2, where the factor structure is weaker. In all the other experiments it performs remarkably well in terms of size. Finally, the test developed by [Chang and Song \(2009\)](#) does not display significant discrepancies in correspondence with the usual size levels, but shows a general tendency towards under-rejection, especially in experiments 5 and 6.

The size-power curves for the same experiments are reported in Figures 8 and 9. In particular, Figure 8 shows that the power of the  $p$ CADF test increases significantly with decreasing values of  $\rho^2$ , as expected. Indeed, when  $\rho^2 < 0.5$ , the  $p$ CADF correctly rejects the null more often than the other tests when  $\zeta_t$  is used as the stationary covariate and, for somewhat smaller values of  $\rho^2$  also when the other covariates are used as well. The covariate-augmented test proposed by [Chang and Song \(2009\)](#) shows a rather stable rejection rate across experiments (Figure 9), with only a fairly small increase for low values



**Figure 6** – Size discrepancy plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 100$ ,  $N = 10$ . Solid line,  $\zeta_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate. The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.





**Figure 7** – Size discrepancy plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 100$ ,  $N = 10$ . Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#). The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.

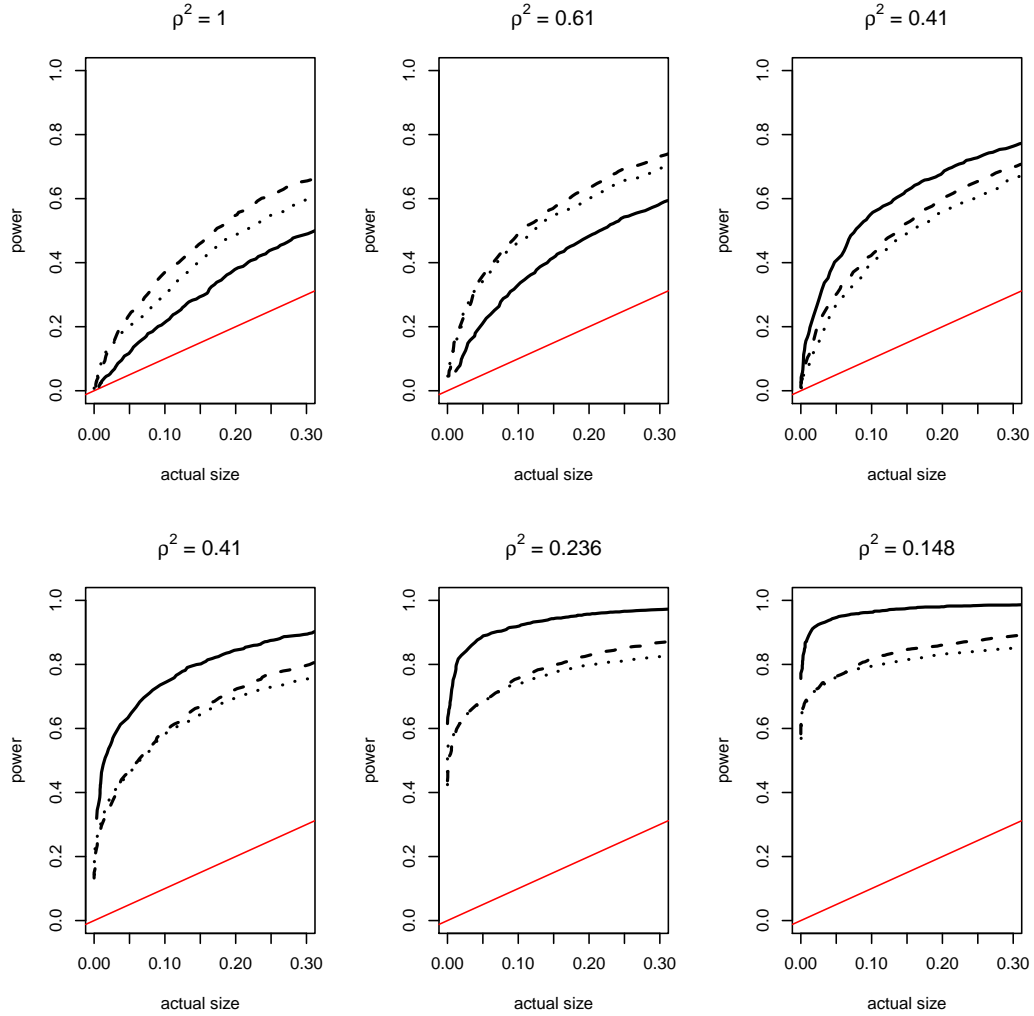
of  $\rho^2$ . A direct comparison with the  $p$ CADF test is offered in Figure 10 that shows that the test proposed by Chang and Song (2009) performs better than the  $p$ CADF only for relatively high values of  $\rho^2$ . However, it should be reminded that the  $p$ CADF is equivalent to the panel ADF test when  $\rho^2 = 1$  while, when  $\rho^2 < 1$ , the power gain obtained by using stationary covariates can be substantial. In fact, the power of Chang and Song's test is still higher than the power of the  $p$ CADF test for  $\rho^2 = 0.61$ . This is due to the fact that, although the power of the  $p$ CADF test increases as  $\rho^2$  decreases, nevertheless the relation between the power and  $\rho^2$  is not linear, and larger power gains are expected for fixed decrements of  $\rho^2$  when the value of  $\rho^2$  is small. In fact, simulation results are consistent with the behaviour of the asymptotic power envelope of the (ordinary) CADF test (see Hansen, 1995, p. 1153). Therefore, it is reasonable that the  $p$ CADF test becomes more powerful than Chang and Song's only for values of  $\rho^2$  that are below some threshold. Finally, inspection of Figure 9 suggests that the power of Moon and Perron's test is instead rather disappointing, being virtually identical to the size in most experiments.

When size of the tests with trend ( $p$ CADF and Demetrescu *et al.*'s) or detrended (Chang and Song's and Moon and Perron's) over the same DGP as above is considered (Figures 11 and 12), Demetrescu *et al.*'s ADF-based test ranks first, as in the previous case. The  $p$ CADF test has approximately correct size in the usual size ranges. It is again slightly conservative in experiment 6, especially when the difference of the first principal component is used as the stationary covariate, while Chang and Song's test is now very conservative across all the experiments. On the other hand, Moon and Perron's test tends to over-reject substantially. Furthermore, the presence of the trend in the model tends to reduce the power of all the tests (see Figures 13 and 14). As far as the ADF test is concerned, this is a well known result. Despite the observed moderate power reduction, the  $p$ CADF test continues to behave quite well, even if rejections do not increase monotonically when  $\rho^2$  decreases. In fact, the same kind of behaviour is mirrored, on a different scale, by Demetrescu *et al.*'s test. However, comparison with the latter test shows that the power gain deriving from using the stationary covariates is again substantial. Chang and Song's test has good intrinsic power and the rejections remain fairly stable across experiments, as in the no-trend case. The  $p$ CADF test still compares well with Chang and Song's, above all when the correct covariate is considered. Finally, Moon and Perron's test has virtually no power at all.

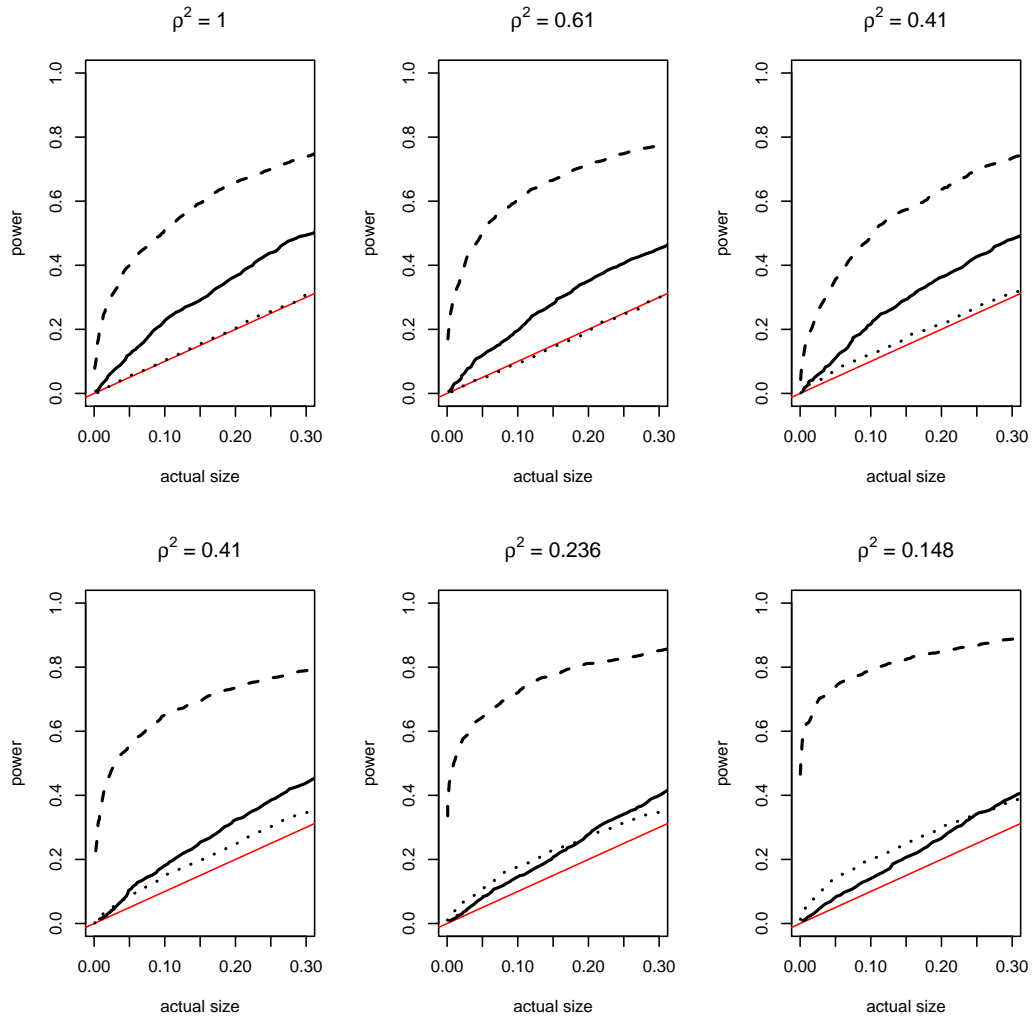
We now extend our analysis also to cover the case where the DGP includes a drift term  $\alpha \neq 0$ . In particular, in our simulations we consider  $\alpha_i \sim U_{(0.7,0.9)}$  (with  $i = 1, \dots, N$ ). Given the presence of a drift, in this case we only consider the tests based on models including the deterministic trend (or the detrended versions of the tests).

When we allow for a non-zero drift in the DGP, the behaviour of the  $p$ CADF test and of Demetrescu *et al.*'s test remains substantially unchanged and fairly good in terms of size (Figures 15 and 16). On the contrary, Chang and Song's detrended test is so conservative that it never rejects even in correspondence with quite high nominal size levels, while Moon and Perron's test rejects much too often (Figure 16).

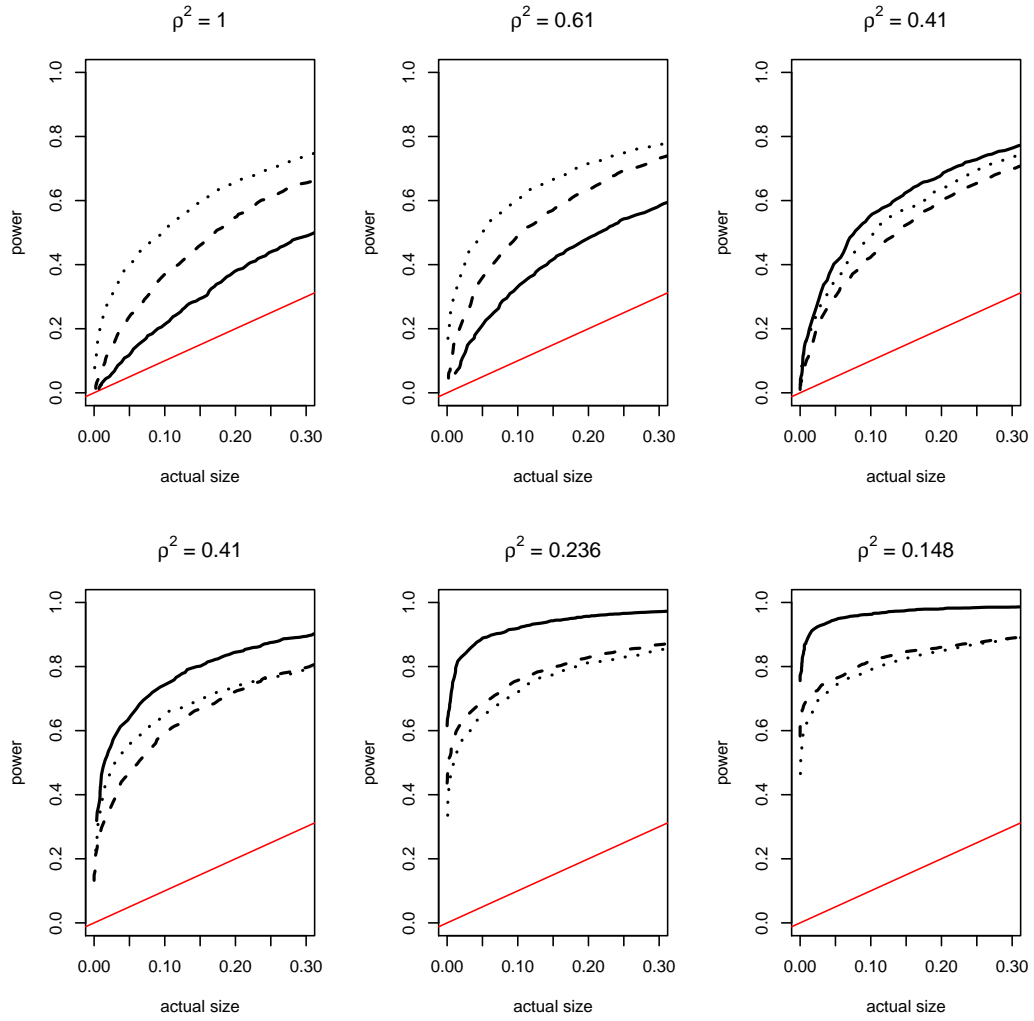
The power of the  $p$ CADF test (Figure 17) improves somewhat with respect to the



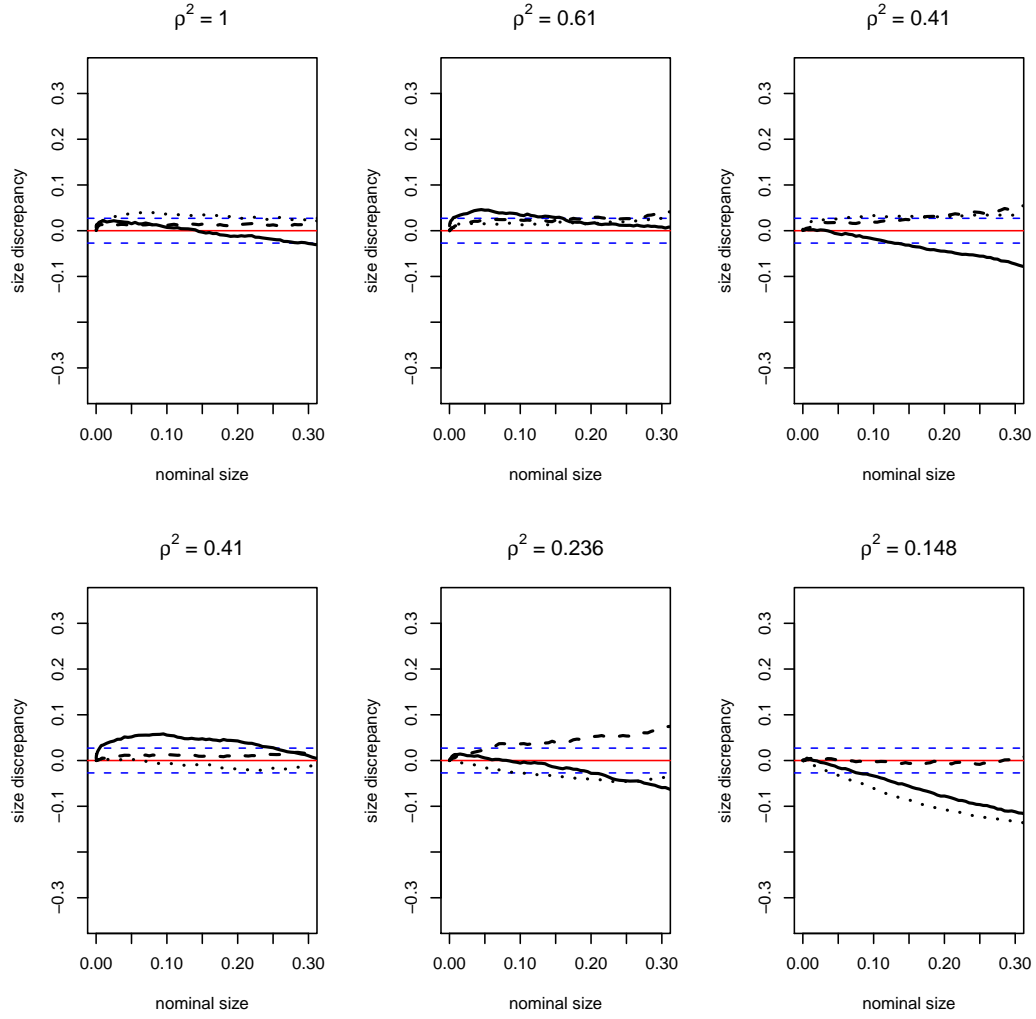
**Figure 8** – Size-power plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line,  $\xi_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate.



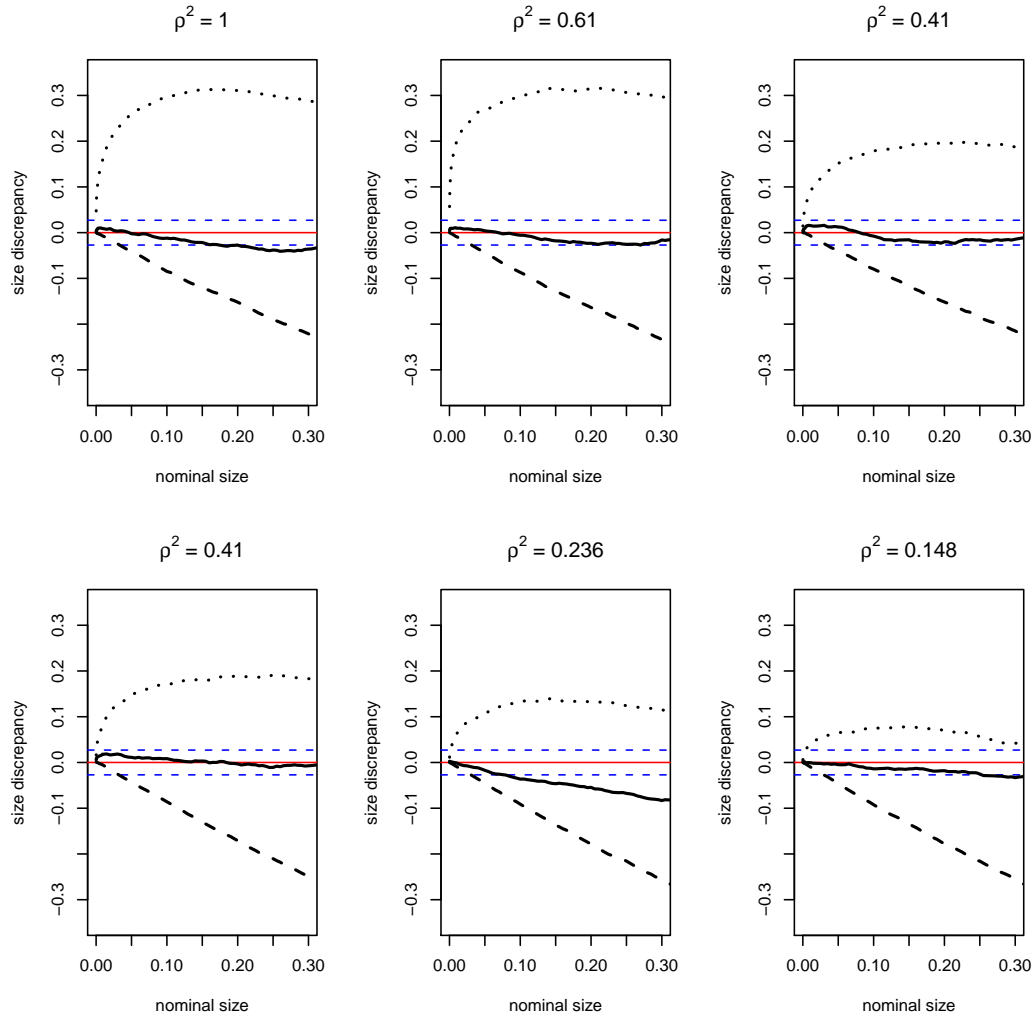
**Figure 9** – Size-power plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#).



**Figure 10** – Size-power plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line,  $p$ CADF with  $\zeta_t$  as the stationary covariate; dashed,  $p$ CADF with average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, [Chang and Song \(2009\)](#).

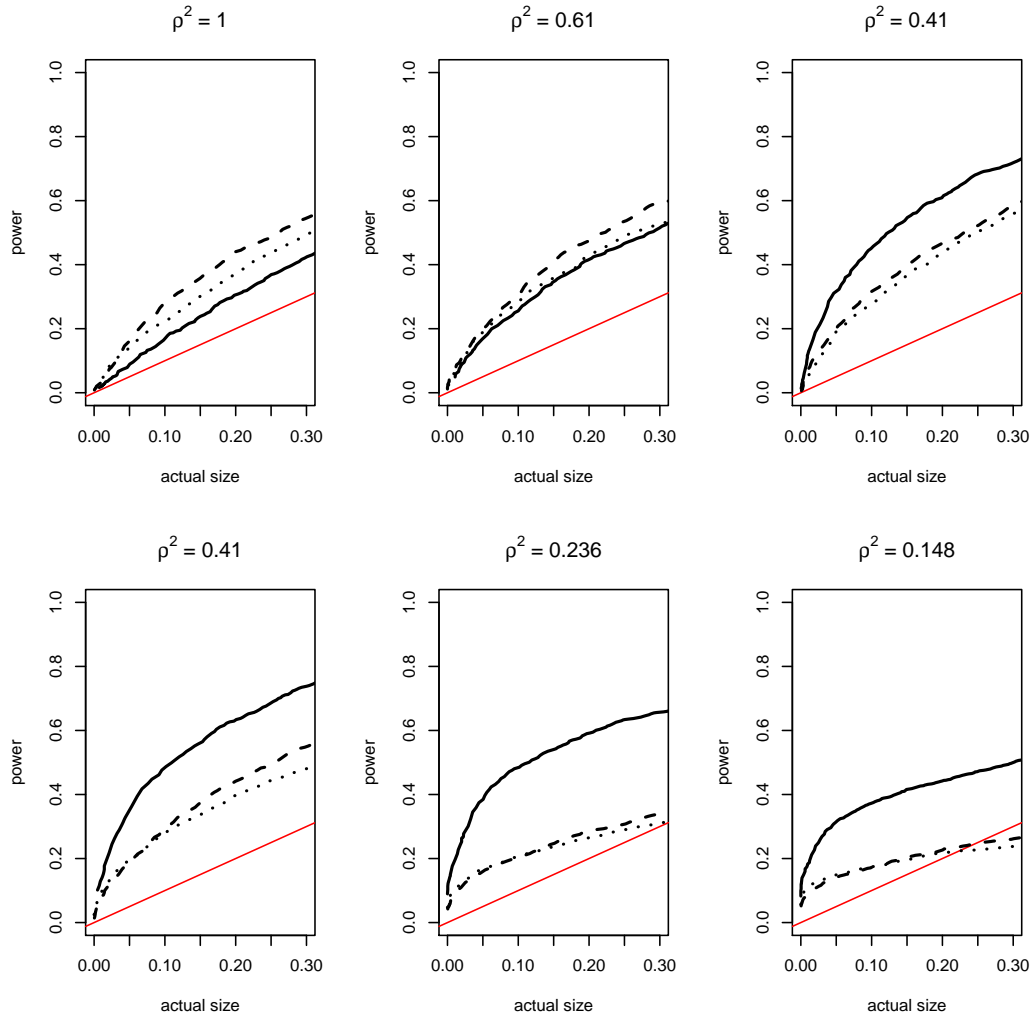


**Figure 11** – Size discrepancy plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with trend.  $T = 100$ ,  $N = 10$ . Solid line,  $\zeta_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate. The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.

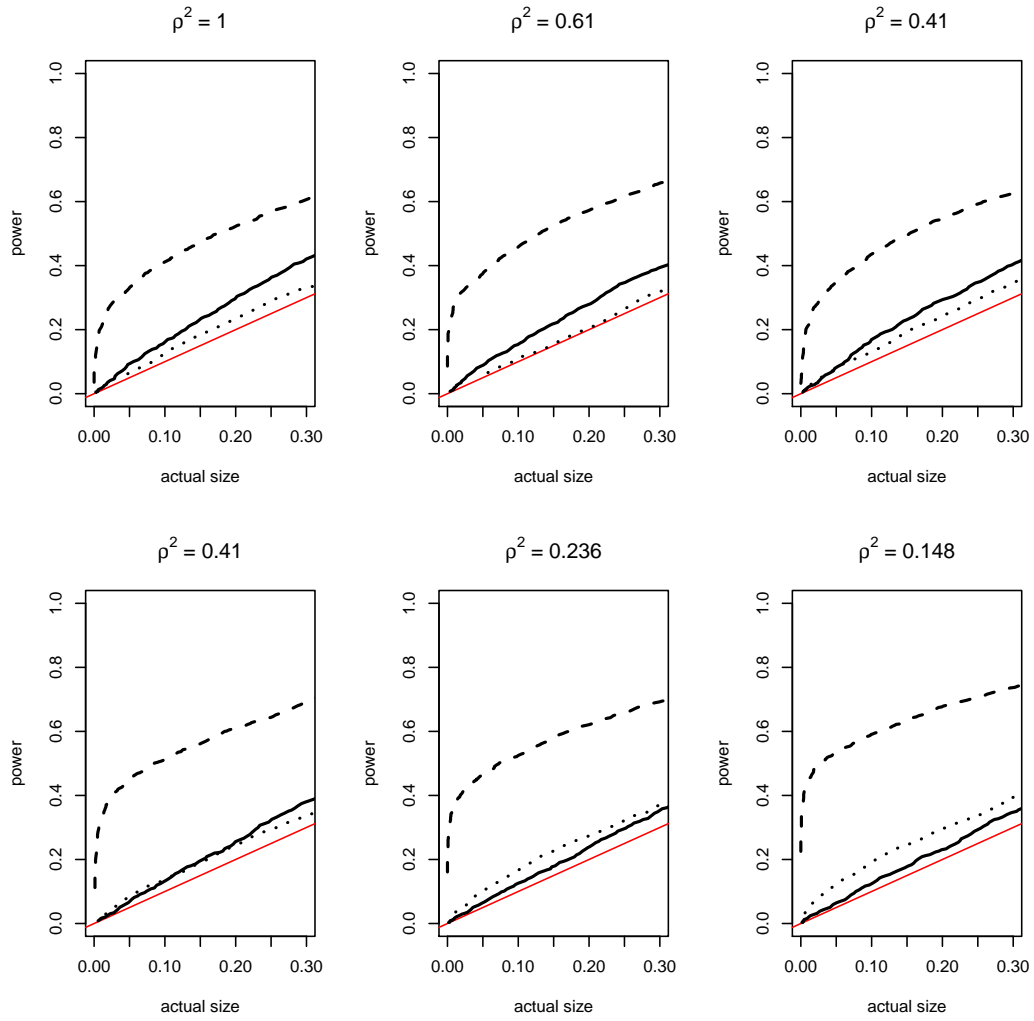


**Figure 12** – Size discrepancy plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with trend.  $T = 100$ ,  $N = 10$ . Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#). The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.

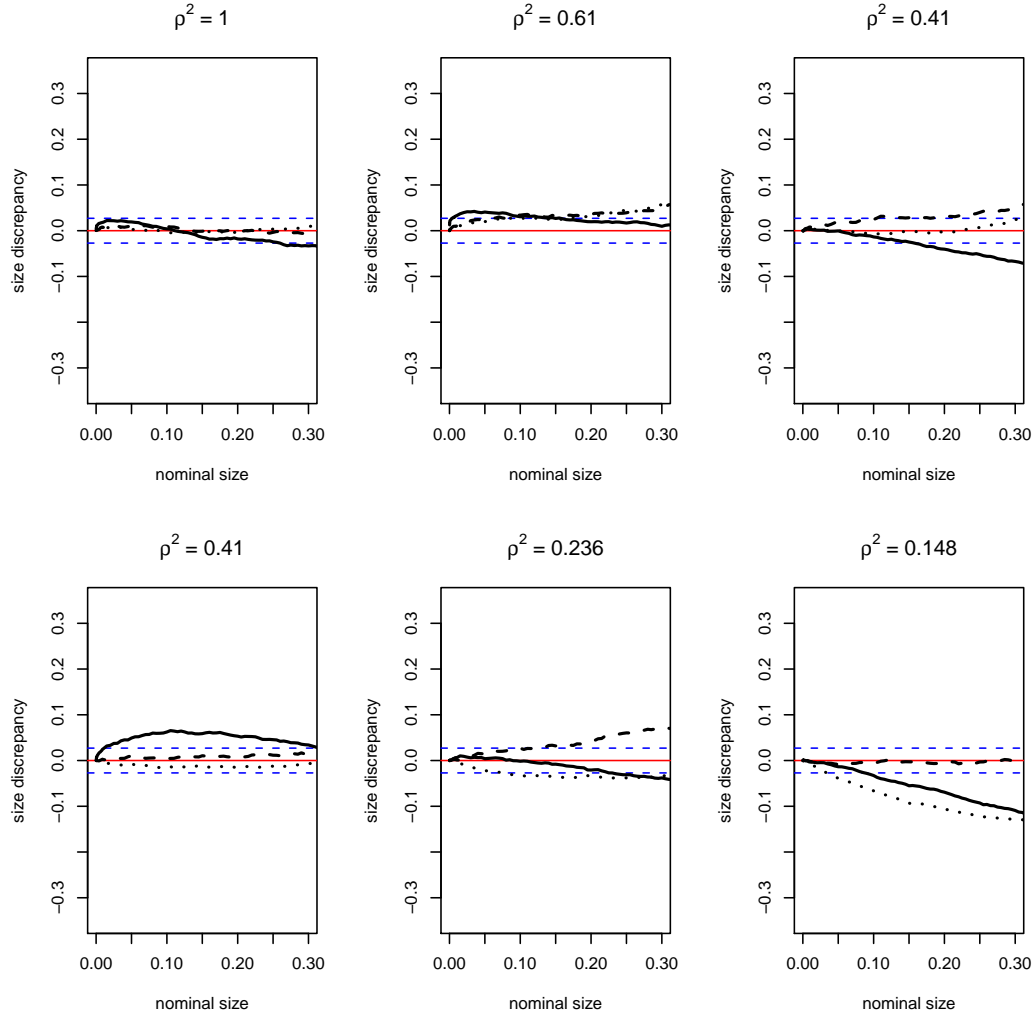




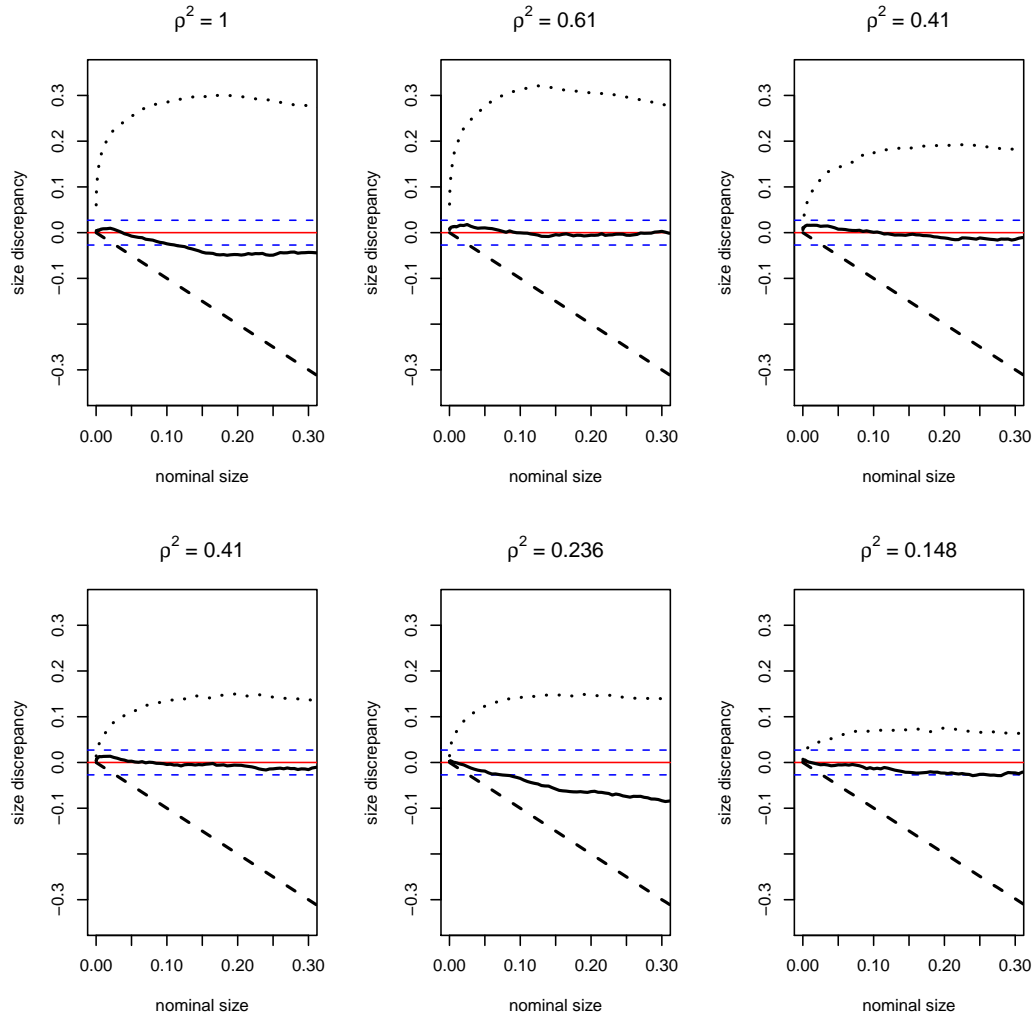
**Figure 13** – Size-power plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line,  $\xi_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate.



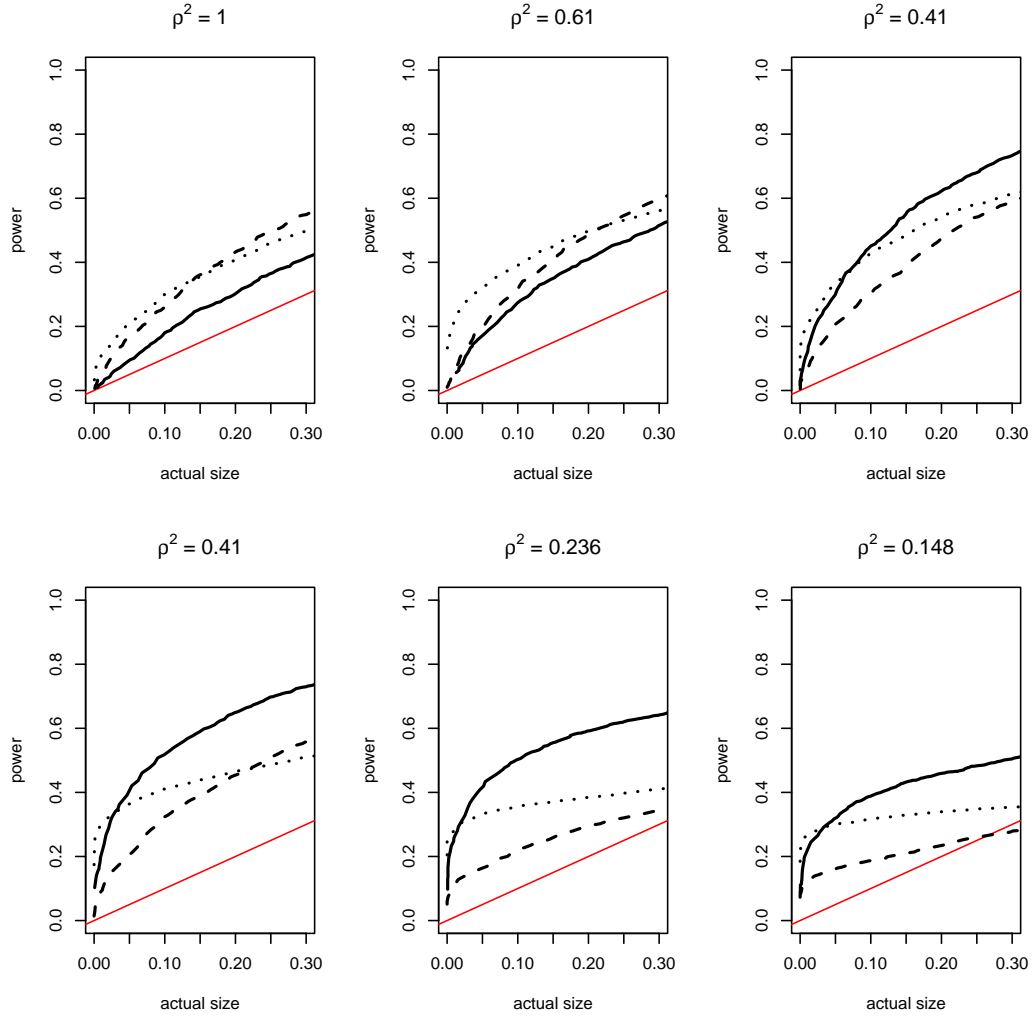
**Figure 14** – Size-power plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#).



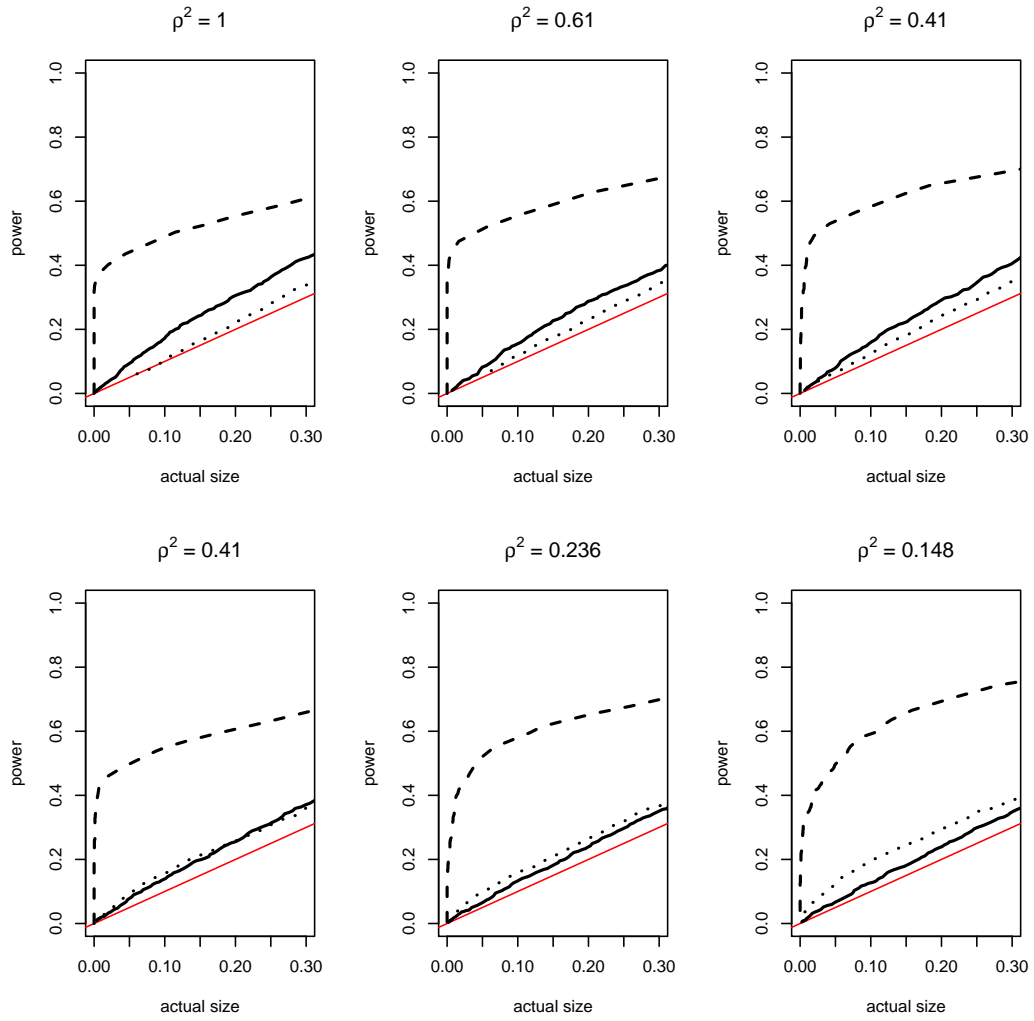
**Figure 15** – Size discrepancy plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with non-zero drift, model with trend.  $T = 100$ ,  $N = 10$ . Solid line,  $\xi_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate. The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.



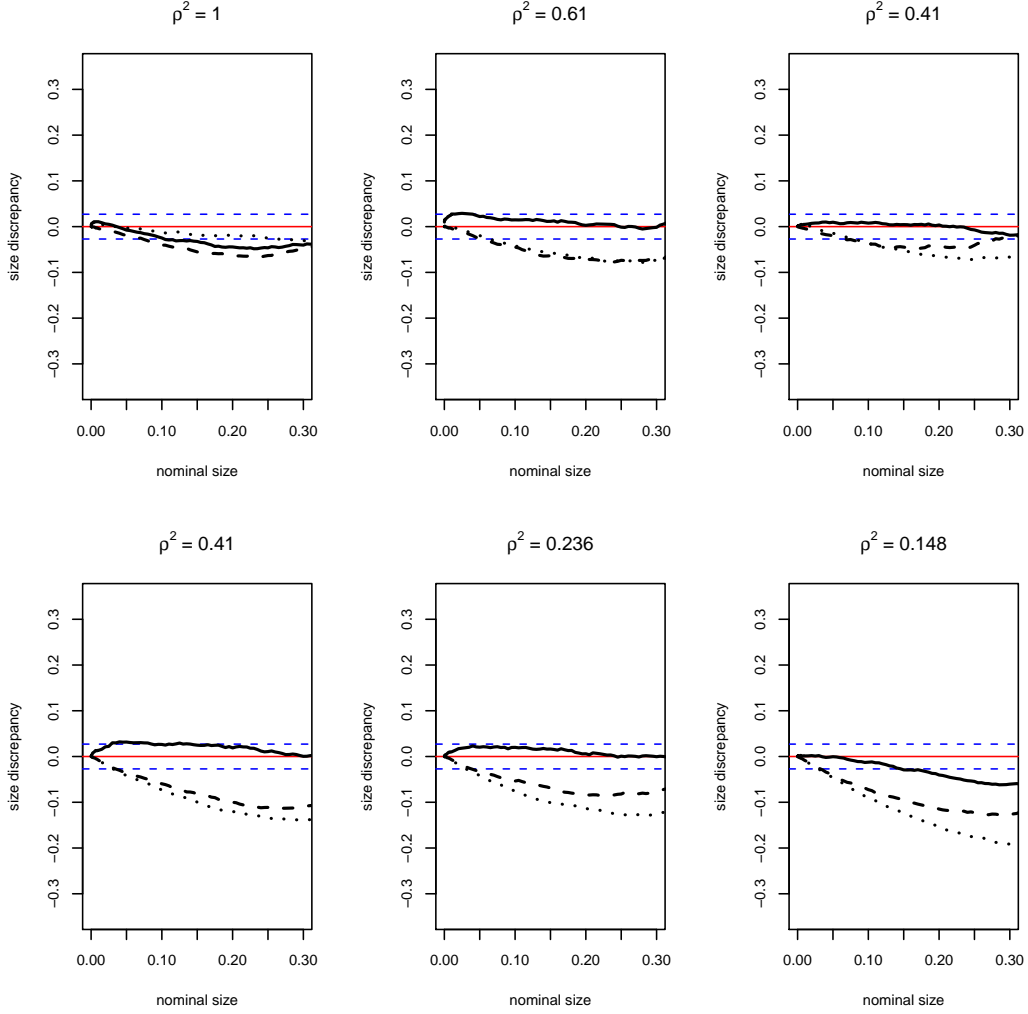
**Figure 16** – Size discrepancy plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with non-zero drift, model with trend.  $T = 100$ ,  $N = 10$ . Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#). The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.



**Figure 17** – Size-power plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with non-zero drift, model with trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line,  $\xi_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate.



**Figure 18** – Size-power plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with non-zero drift, model with trend.  $T = 100$ ,  $N = 10$ , 2 series are stationary. Solid line, Demetrescu *et al.* (2006); dashed, Chang and Song (2009); dotted, Moon and Perron (2004).



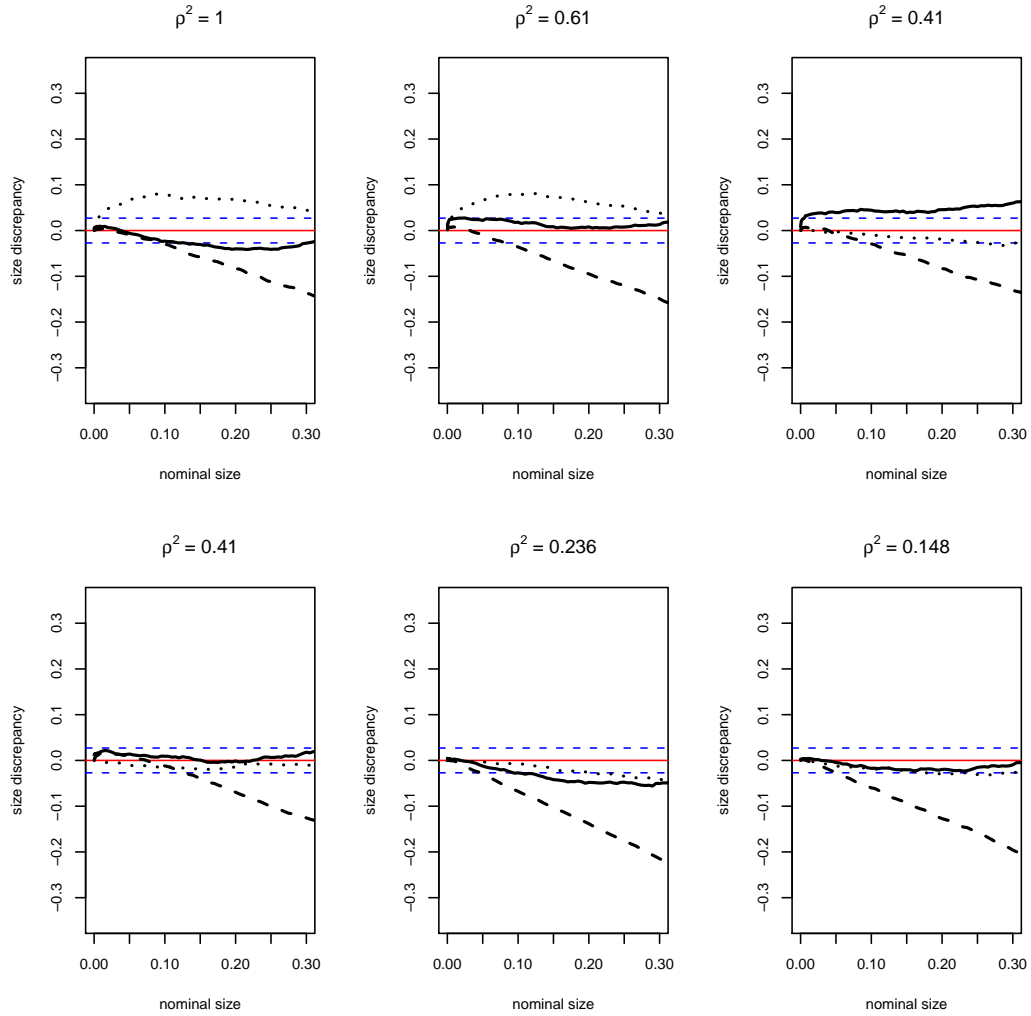
**Figure 19** – Size discrepancy plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 300$ ,  $N = 20$ . Solid line,  $\tilde{\zeta}_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate. The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.

trend case without drift and is very good, compared to [Demetrescu et al.](#)'s and [Moon and Perron](#)'s tests, whose power is very similar to the case without drift (Figure 18). [Chang and Song](#)'s test maintains good intrinsic power, but it should be emphasised that the correct critical values that ensure that the test has correct size are very different from the theoretical ones so that it is difficult to imagine that the test can be really useful in practice under these circumstances.<sup>17</sup>

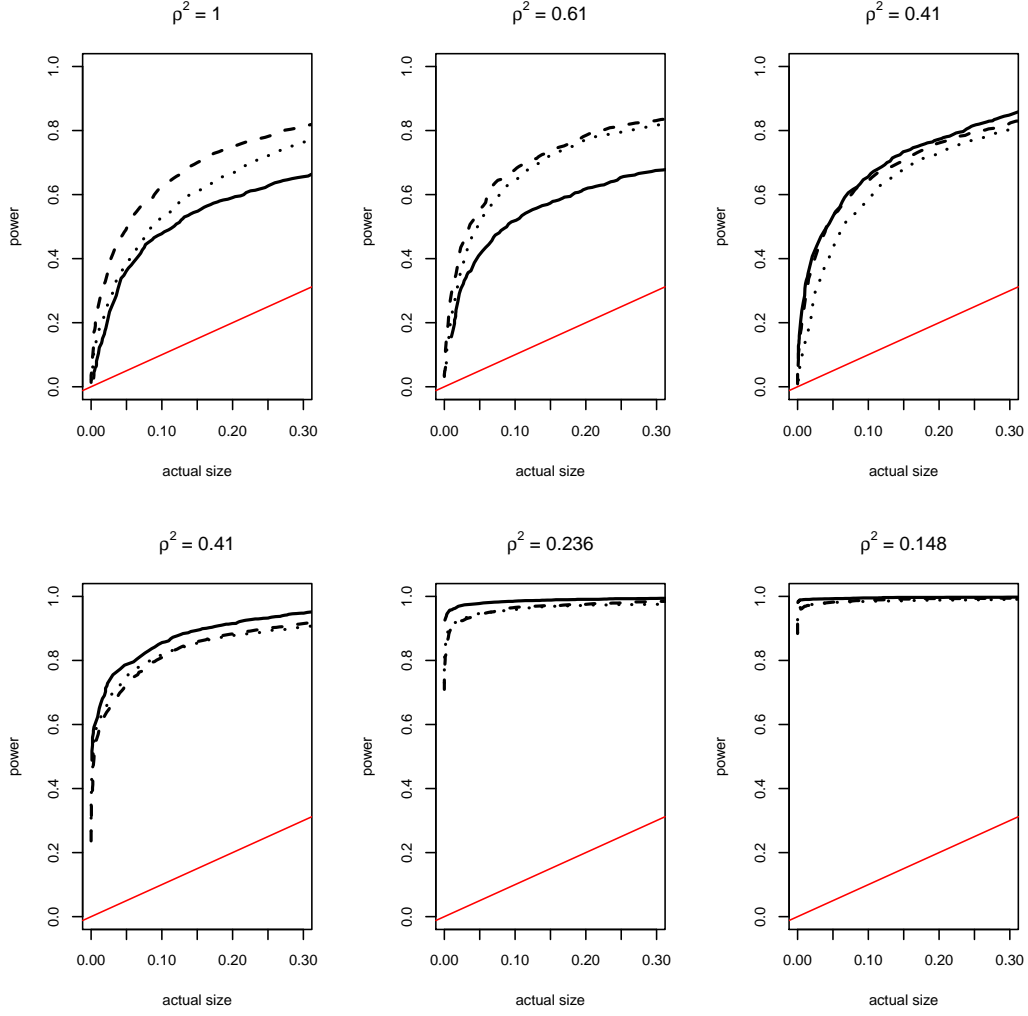
In order to check the performance of the tests for larger values of  $T$  and  $N$ , we repeat the experiments of Table 2 with  $T = 300$  and  $N = 20$ . Power is investigated again using only 2 stationary series. The results essentially confirm the tendencies already highlighted using  $T = 100$  and  $N = 10$ ; to save space we report only the results for

<sup>17</sup>If power is plotted against *nominal size*, it becomes apparent that under this DGP [Chang and Song](#)'s detrended test is heavily biased, with the empirical rejections being well below the nominal size.





**Figure 20** – Size discrepancy plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 300$ ,  $N = 20$ . Solid line, [Demetrescu et al. \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#). The horizontal dashed lines represent 5% Kolmogorov-Smirnov critical values.

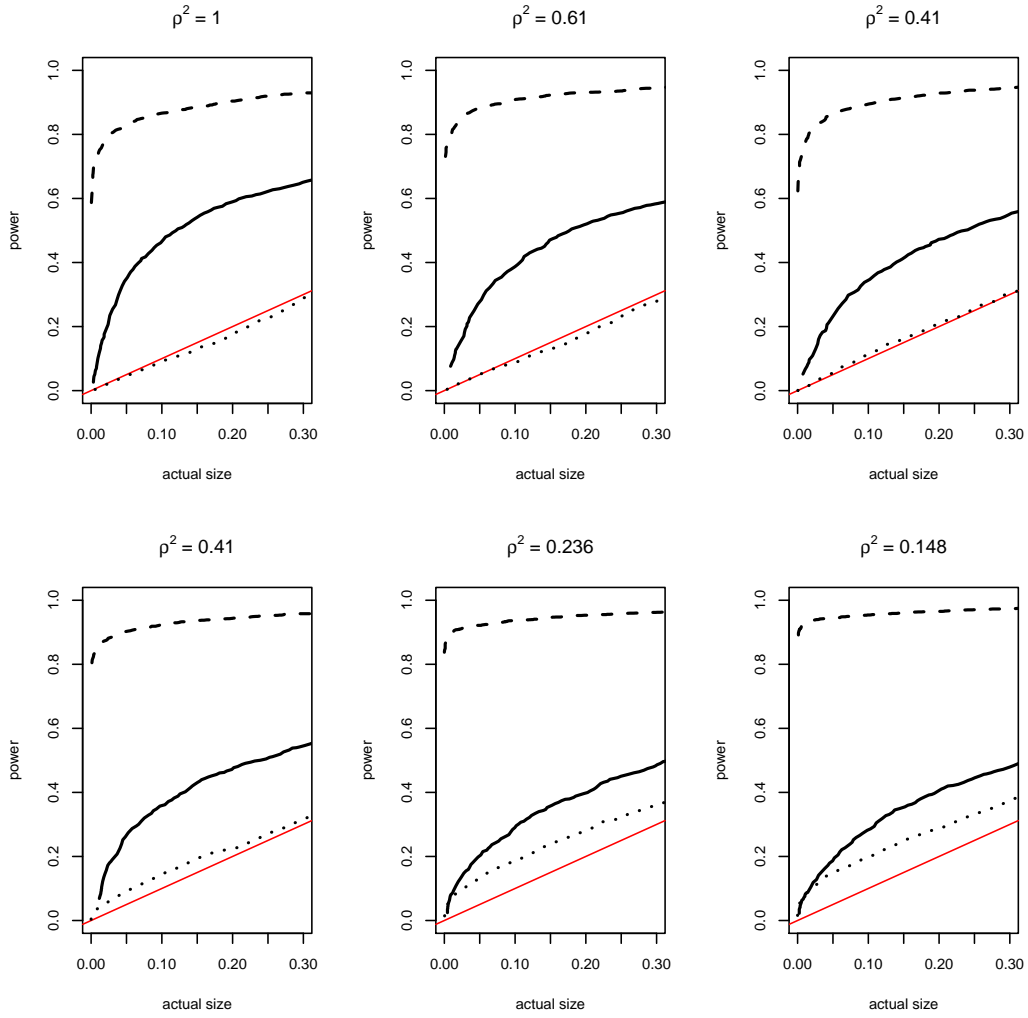


**Figure 21** – Size-power plots of the  $p$ CADF test. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 300$ ,  $N = 20$ , 2 series are stationary. Solid line,  $\zeta_t$  as the stationary covariate; dashed, average  $\Delta y_{jt}$  ( $j \neq i$ ) as the stationary covariate; dotted, first difference of the first principal component as the stationary covariate.

the models with constant (or demeaned data). Similar conclusions carry over for the other cases.

When the size of the tests is examined, the  $p$ CADF test has approximately the same behaviour as in the  $T = 100$  and  $N = 10$  case, being slightly conservative especially for low values of  $\rho^2$  (Figure 19). The ADF-based test proposed by Demetrescu *et al.* (2006) has again good size. The performance of Moon and Perron’s test is also very similar to the corresponding DGP with  $T = 100$  and  $N = 10$  and tends to over-reject in the presence of a weak factor structure. Quite on the contrary, the tendency towards under-rejection of the test advocated by Chang and Song (2009) is now more pronounced than in the  $T = 100$ ,  $N = 10$  case (Figure 20).

As far as power is concerned, the size-power curves plotted in Figure 21 show that power of the  $p$ CADF increases with decreasing values of  $\rho^2$  and the test virtually always reject when  $\rho^2$  is small, despite being in the presence of only 2 out of 20 stationary series.



**Figure 22** – Size-power plots. The first row refers to experiments 1 to 3, the second to experiments 4 to 6. DGP with no drift, model with no trend.  $T = 300$ ,  $N = 20$ , 2 series are stationary. Solid line, [Demetrescu \*et al.\* \(2006\)](#); dashed, [Chang and Song \(2009\)](#); dotted, [Moon and Perron \(2004\)](#).

In other words, even if the fraction of series under the alternative is smaller than in the previous experiments conducted with  $T = 100$  and  $N = 10$  (where it was 2 out of 10), nevertheless the  $p$ CADF test is now substantially more powerful (see again Figure 8 for a comparison). Furthermore, using either the average of the differenced series or the differenced first principal component gives in this case excellent results, very close to those that can be obtained using  $\xi_t$  as the stationary covariate. The comparison with the performance of the test proposed by Demetrescu *et al.* (2006) (see Figure 22) gives a measure of the gain that can be obtained by using the stationary covariates within the panel test. Moon and Perron's test has again virtually no intrinsic power at all. On the contrary, the test advocated by Chang and Song (2009) has the best performance for high values of  $\rho^2$ , while its power is slightly worse than the  $p$ CADF's for small values of the nuisance parameter.

## 5 Applications

For the sake of illustration, in this Section we offer two different applications developed using macro-panel data. We first consider the PPP hypothesis. This is a well-known example used in many papers dealing with panel unit roots. Then we consider the issue of the existence of a unit root in international industrial production indices. In this paper we are using these topics merely as illustrative examples of application of the  $p$ CADF test. Conclusive answers on the validity of the underlying economic theories would require more structured empirical analyses and are out of the scope of the present work.

In all applications we use exactly the same procedure adopted in the Monte Carlo analysis, with automatic model selection and correction for cross-dependence based upon the outcome of the test proposed in Pesaran (2004). Furthermore, we apply all the tests considered in the Monte Carlo to the actual data. In addition, in carrying out the  $p$ CADF tests we use stationary covariates chosen on theoretical grounds.

### 5.1 Testing the PPP hypothesis

It is well known that a necessary condition for the PPP to hold is that the real exchange rate must be *mean-reverting* (for a recent survey see Taylor and Taylor, 2004). This of course excludes the possibility that the real exchange rate can have a trending behaviour or a unit root. For this reason, a number of influential papers on panel unit root testing, including Choi (2001) and Chang and Song (2009), consider the same empirical application. Other papers employ instead covariate-augmented tests in the time series framework. In particular, Amara and Papell (2006) use the tests developed in both Hansen (1995) and Elliott and Jansson (2003), Elliott and Pesavento (2006) employ Elliott and Jansson's feasible point optimal test and Lee and Tsong (2011) utilize Hansen's CADF test with a stationary factor-based covariate selection.

It should be noticed that we are deliberately *not* dealing with the (alternative) hypothesis that the PPP is valid in all the countries. In fact, here we are interested in testing

Test	test statistic	p-value
<a href="#">Demetrescu et al. (2006)</a>	-0.383	0.351
<a href="#">Moon and Perron (2004)</a>	-1.134	0.128
<a href="#">Chang and Song (2009)</a>	-0.634	0.998
$p$ CADF (principal component)	-0.672	0.251
$p$ CADF (nominal exchange rate)	-4.210	0.000

**Table 3** – Panel tests of the PPP hypothesis ( $T = 103$ ,  $N = 20$ ).

the null that the PPP is *not* valid in all the countries. If the null is rejected, there is an indication that the data are consistent with the PPP hypothesis in *at least one* country.

For greater comparability, we use quarterly data from [Chang and Song \(2009\)](#) covering the period 1973q1–1998q4.<sup>18</sup> Data for the same countries over the same period have been used also in other papers (see e.g. [Amara and Papell, 2006](#); [Papell, 2006](#)). Given that under the PPP hypothesis the real exchange rate should not exhibit trends of any kind, in developing our application of the  $p$ CADF test, we focus specifically on the test without deterministic trends, as in e.g. [Choi \(2001\)](#), [Amara and Papell \(2006\)](#), [Papell \(2006\)](#) and [Chang and Song \(2009\)](#). Consistently with [Elliott and Pesavento \(2006, pp. 1412–1413\)](#), we apply the  $p$ CADF test also using the first difference of the nominal exchange rate as the stationary covariate. Since the covariate should not cointegrate with the dependent variable, in order to verify that the nominal exchange rate is not cointegrated with the variable of interest, we apply the group mean cointegration tests proposed in [Westerlund \(2007\)](#). The null hypothesis of these tests is no cointegration for all the panel units, while the alternative is that cointegration is present in at least a panel unit. The  $p$  values of [Westerlund's](#)  $G_\tau$  and  $G_\alpha$  tests are equal to 0.325 and 0.757, respectively, supporting the validity of the nominal exchange rate as a potential covariate.

The empirical results are summarized in Table 3. Here we also replicate [Chang and Song \(2009\)](#), so our results are identical to theirs.

While the other panel tests in Table 3 do not reject the  $I(1)$  null, when the differenced nominal exchange rate is used as the stationary covariate, the  $p$ CADF test strongly rejects the unit root null consistently with [Elliott and Pesavento \(2006\)](#) that reject the null for most countries when the same covariate is used in the testing procedure proposed by [Elliott and Jansson \(2003\)](#).<sup>19</sup> This result is also broadly consistent with other papers investigating the same data set: in particular, [Amara and Papell \(2006\)](#) find evidence in favour of the PPP hypothesis in many countries again using the time series approach proposed in [Elliott and Jansson \(2003\)](#), while [Papell \(2006\)](#) reaches the same conclusion using a panel-ADF test based on the homogeneous alternative and parametric bootstrap. Strictly speaking, the outcomes of these papers are not directly comparable because they refer to different null and alternative hypotheses; however, they all point in the same

<sup>18</sup>We warmly thank Yoosoon Chang and Wonho Song for having provided their data. The original sources are the International Monetary Fund's International Financial Statistics and cover 20 countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom).

<sup>19</sup>The fact that the choice of the covariate can influence the outcome of the test is well known and documented in other papers (see, e.g. [Elliott and Pesavento, 2006](#); [Lee and Tsong, 2011](#)).

Test	test statistic	p-value
<a href="#">Demetrescu <i>et al.</i> (2006)</a>	1.309	0.905
<a href="#">Moon and Perron (2004)</a>	1.234	0.891
<a href="#">Chang and Song (2009)</a>	-0.089	0.996
$p$ CADF (principal component)	2.128	0.983
$p$ CADF (real GDP)	-2.839	0.002

**Table 4** – Panel unit root tests for industrial production ( $T = 103$ ,  $N = 9$ ).

direction.

## 5.2 Unit roots in international industrial production indices

We offer a second application that deals with checking for the presence of a unit root in industrial production indices in 9 OECD countries. As before, the  $p$ CADF test is performed using the differenced first principal component as the stationary covariate. In addition, we use the differences of real GDPs as stationary covariates. In this context we may interpret real GDP as a measure of demand. The variable of interest is quarterly seasonally adjusted industrial production index (total industry, 2005 = 100) over the period 1983q1–2008q3. The covariate is quarterly seasonally adjusted real GDP (chained volume estimates). Both industrial production and GDP are log-transformed.<sup>20</sup> We consider here the versions of the tests that include a constant and a deterministic trend, or the equivalent versions of the tests on detrended series. In order to avoid using a covariate whose levels are cointegrated with the variable of interest, we test again the null of lack of cointegration among industrial production in all countries against the alternative that there is cointegration in at least one country using the group mean tests proposed in [Westerlund \(2007\)](#). Indeed, there are theoretical reasons that induce to anticipate the absence of cointegration between industrial production and real GDP and in fact the empirical results are strongly supportive of the null (the  $p$  values of the  $G_\alpha$  and  $G_\tau$  tests are 1.000 and 0.993, respectively).

The results reported in Table 4 indicate that the  $p$ CADF test is again the only one rejecting the null.

## 6 Concluding remarks

A simple covariate augmented Dickey-Fuller (CADF) test for unbalanced heterogeneous panels is proposed. The test, that we label panel-CADF ( $p$ CADF, for short), is a generalization of the CADF test proposed in [Hansen \(1995\)](#) and is developed along the lines suggested in [Choi \(2001\)](#). This allows us to be very general in the specification of the individual unit root tests. Thanks to the application of a correction originally due to [Har-](#)

<sup>20</sup>The considered countries are: Australia, Canada, France, Italy, Japan, Norway, Switzerland, United Kingdom, United States. Industrial production is from the OECD Main Economic Indicators data base. Real GDP is from the OECD Quarterly National Accounts data base. The data sample is truncated to 2008q3 to avoid potential complications arising from the deep fall of industrial activity after the international financial crisis. The choice of the countries was somewhat forced by the availability of the data.

tung (1999), the proposed test can be used in the presence of cross-dependent time series and, given that the asymptotics used in Choi (2001) does not require  $N \rightarrow \infty$ , it is especially well suited to deal with macroeconomic panels where the cross-section dimension is typically rather small.

Given that the  $p$ CADF test is based on a modified inverse normal  $p$  value combination, the  $p$  values of the individual CADF tests have to be obtained. For this reason, a procedure to compute the asymptotic  $p$  values of Hansen's CADF test is also proposed.

The size and power properties of the  $p$ CADF test are investigated using an extensive Monte Carlo with cross-dependent DGPs. Simulation results are reported using the graphical approach suggested in Davidson and MacKinnon (1998) that allows us to obtain detailed and readily interpretable results. The performance of the  $p$ CADF test is compared with that of the panel unit-roots tests proposed in Moon and Perron (2004), Demetrescu *et al.* (2006) and Chang and Song (2009). It is shown that the  $p$ CADF test in general does not suffer from important size distortions and can offer significant power gains. In particular, it is shown that the power of the  $p$ CADF test is inversely related to the nuisance parameter  $\rho^2$  and that, when  $\rho^2$  is small, the test can be more powerful than the covariate augmented test proposed by Chang and Song (2009). In all the experiments analysed in the paper, the power of the  $p$ CADF test is significantly higher than the power of the tests advocated by Moon and Perron (2004) and Demetrescu *et al.* (2006). When a drift is present in the DGP, the  $p$ CADF test has the best performance in terms of power, among all the examined tests.

In order to show that the test is viable, we consider two empirical applications dealing with the PPP hypothesis and with international industrial production indices, respectively.

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## Appendix A:

### The algorithm to compute the $p$ values of the CADF test

This paper proposes a way to compute the  $p$  values of the covariate augmented Dickey-Fuller (CADF) test developed in [Hansen \(1995\)](#). The procedure is based on a response surface approach (see e.g. [Hendry, 1984](#)). We believe that this is a side, but important, contribution of the paper. The R ([R Development Core Team, 2011](#)) package **CADFtest** ([Lupi, 2009](#)) that computes [Hansen's](#) test and its  $p$  values can be freely downloaded from the Comprehensive R Archive Network at [www.cran.r-project.org](http://www.cran.r-project.org) or can be installed directly from within R by typing `install.packages("CADFtest")`. In this Appendix we give a detailed account of the algorithm briefly described in Section 2.

In order to set up from scratch a procedure that computes the  $p$  values of [Hansen's](#) distribution (9), the following steps can be followed:

1. Simulate the asymptotic distribution (9) over a grid of values for  $\rho^2 \in (0, 1]$ . In the paper we use 40 distinct values. Once  $\rho^2$  is fixed, the asymptotic distribution can be simulated using standard techniques (see e.g. [Hatanaka, 1996](#)). In this paper we use 100,000 replications and  $T = 5,000$  for the simulation of the Wiener functionals. The asymptotic distribution must be simulated separately for the “no constant”, “constant” and “constant plus trend” case.
2. Derive the simulated quantiles of (9) over a grid of desired probabilities. We use a strict grid of 1,005 probability values ranging from 0.00025 to 0.99975. Save the results in a table. In our case we have a  $1,005 \times 40$  table.
3. For each probability value  $p$  considered in the table (i.e., for each row of the table) estimate

$$q_\rho(p) = \beta_0 + \beta_1 \rho^2 + \beta_2 (\rho^2)^2 + \beta_3 (\rho^2)^3 + \varepsilon_\rho$$

and save the estimated parameters in a table. In our case we have a  $1,005 \times 4$  table of estimated parameters.

4. Use the estimated parameters to derive fitted values  $\widehat{q_{\rho_0}(p)}$  ( $\forall p$ ) of the quantiles for any value of  $\rho_0^2$  you are interested in.  $\widehat{q_{\rho_0}(p)}$  is a vector.
5. Plug  $\widehat{q_{\rho_0}(p)}$  in (10) following the procedure proposed in [MacKinnon \(1994, p. 172\)](#) and [MacKinnon \(1996, p.610\)](#), that is:
  - Find the fitted quantile that is closest to the sample statistic;
  - Interpolate locally (we use 11 observations) by means of (10);
  - Derive the fitted  $p$  value.

Note that it is not necessary to repeat steps 1-3 each time you want to compute a  $p$  value. Once the  $\beta$ 's have been estimated and saved in the relevant tables (for the three cases “no constant”, “constant” and “constant plus trend”), the task is reduced to solving steps 4 and 5 above.