

## Serial Correlation (Very Brief Overview)

[NOTE: These notes draw very, very heavily from Pindyck and Rubinfeld.]

**Introduction.** I've never had much reason to worry about serial correlation in my work. But, if you are working with data that are collected repeatedly across time (something which I suspect is much more common in Economics than in Sociology) this may be a concern for you; or, you may read other work in which serial correlation is an issue. I'll therefore briefly discuss the problem, and you can turn to Pindyck and Rubinfeld or other sources if you need to know more.

**What Serial Correlation is.** When error terms from different (usually adjacent) time periods (or cross-section observations) are correlated, we say that the error term is *serially correlated*. Serial correlation occurs in time-series studies when the errors associated with a given time period carry over into future time periods. For example, if we are predicting the growth of stock dividends, an overestimate in one year is likely to lead to overestimates in succeeding years.

There are different types of serial correlation. With *first-order serial correlation*, errors in one time period are correlated directly with errors in the ensuing time period. (Errors might also be lagged, e.g. if data are collected quarterly, the errors in Fall of one year might be correlated with the errors of Fall in the next year.) With *positive serial correlation*, errors in one time period are positively correlated with errors in the next time period.

**Consequences of Serial Correlation.** Serial correlation will not affect the unbiasedness or consistency of OLS estimators, but it does affect their efficiency. With positive serial correlation, the OLS estimates of the standard errors will be *smaller* than the true standard errors. This will lead to the conclusion that the parameter estimates are more precise than they really are. There will be a tendency to reject the null hypothesis when it should not be rejected. This is illustrated by the following graphs:

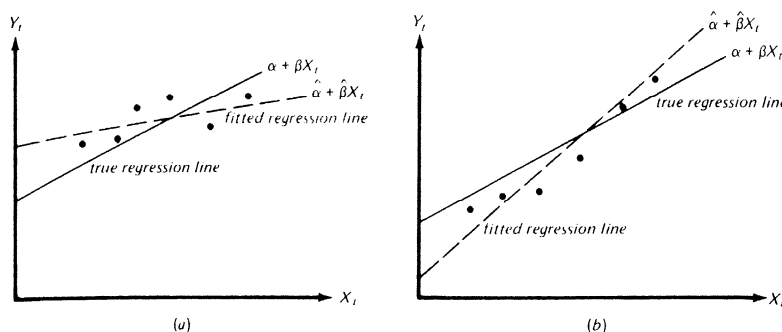


FIGURE 6.1  
Positive serial correlation.

In figure 6.1a, the error term associated with the first error term happens to be positive. The first 4 error terms are then positive, followed by two negative errors. In figure 6.1b, just the opposite

occurs: the first 4 errors are negative and the last two are positive. Each of these are equally likely to occur, so OLS estimates will be unbiased. But, in both cases, the OLS line fits the observed cases more closely than the true regression line does; this leads to an  $R^2$  that is too large and an error variance that is smaller than the true variance.

**Tests for Serial Correlation.** By far the most popular test for serial correlation is the Durbin-Watson statistic:

$$DW = \frac{\sum_{t=2}^T (\hat{\varepsilon}_t - \hat{\varepsilon}_{t-1})^2}{\sum_{t=1}^T \hat{\varepsilon}_t^2}$$

$T$  = the number of time periods. Note that the numerator cannot include a difference for the first observation in the sample since no earlier observation is available. When successive values of  $\hat{\varepsilon}_t$  are close to each other, the DW statistic will be low, indicating the presence of positive serial correlation.

The DW statistic will lie in the 0-4 range, with a value near two indicating no first-order serial correlation. Positive serial correlation is associated with DW values below 2 and negative serial correlation with DW values above 2. As Pindyck and Rubinfeld explain, exact interpretation of the DW statistic can be difficult.

**Corrections for Serial Correlation.** Pindyck and Rubinfeld describe various procedures for dealing with serial correlation. These include generalized differencing, the Cochrane-Orcutt Procedure, and the Hildreth-Lu procedure.