Complements on classical linear model *

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1. Formulas for partitioned regression

$$\begin{aligned} y &= X\beta + \varepsilon \\ &= (X_1,\, X_2)\begin{pmatrix}\beta_1\\ \beta_2\end{pmatrix} + \varepsilon \\ &= X_1\beta_1 + X_2\beta_2 + \varepsilon \end{aligned} \tag{1.1}$$

$$\hat{\beta} = (X'X)^{-1}X'y = \begin{pmatrix}\hat{\beta}_1\\ \hat{\beta}_2\end{pmatrix} \tag{1.2}$$

where

$$\begin{aligned} X &: T\times k\ ,\ X_1 : T\times k_1\ ,\ X_2 : T\times k_2\ , \\ \beta_1 &: k_1\times 1\ ,\ \beta_2 : k_2\times 1\ ,\ k = k_1 + k_2\,. \end{aligned}$$

$$\begin{aligned} \hat{\beta}_1 &= (X_1'X_1)^{-1}X_1'y - (X_1'X_1)^{-1}X_1'X_2D^{-1}X_2'M_1y \\ &= b_1 - (X_1'X_1)^{-1}X_1'X_2D^{-1}X_2'M_1y \end{aligned} \tag{1.3}$$

where

$$b_1 = (X_1'X_1)^{-1}X_1'y\,, \tag{1.4}$$

$$M_1 = I_T - X_1(X_1'X_1)^{-1}X_1'\,, \tag{1.5}$$

$$D = X_2'M_1X_2\,; \tag{1.6}$$

$$\hat{\beta}_2 = D^{-1}X_2'M_1y = (X_2'M_1X_2)^{-1}X_2'M_1y\,; \tag{1.7}$$

$$\hat{\beta}_1 = (X_1'M_2X_1)^{-1}X_1'M_2y \tag{1.8}$$

where

$$M_2 = I_T - X_2(X_2'X_2)^{-1}X_2'\,. \tag{1.9}$$

For further discussion, the reader may con consult Schmidt (1976) and Seber

(1977).

2. Updating formulas for linear regressions

$$y_t = x_t'\beta + \varepsilon_t \quad , \quad t = 1, \ldots, T \tag{2.1}$$

where

$$x_t : k \times 1\,, \tag{2.2}$$

$$Y_r = \begin{pmatrix} y_1 \\ y_2 \\ \vdots \\ y_r \end{pmatrix} \quad , \quad X_r = \begin{bmatrix} x_1' \\ x_2' \\ \vdots \\ x_r' \end{bmatrix} \quad , \quad r = k, k+1, \ldots, T\,. \tag{2.3}$$

$$b_r = (X_r'X_r)^{-1}X_r'Y_r \tag{2.4}$$

is the estimator of β based on the first r observations. Then the following updating formulas hold [see Brown, Durbin and Evans (1975)] :

$$b_r = b_{r-1} + (X_r'X_r)^{-1}x_r\left(y_r - x_r'b_{r-1}\right)\,,\; k+1 \leq r \leq T\,, \tag{2.5}$$

$$(X_r'X_r)^{-1} = (X_{r-1}'X_{r-1})^{-1} - \frac{\left(X_{r-1}'X_{r-1}\right)^{-1}x_rx_r'\left(X_{r-1}'X_{r-1}\right)^{-1}}{1 + x_r'\left(X_{r-1}'X_{r-1}\right)^{-1}x_r}\,. \tag{2.6}$$

Further,

$$\begin{aligned} V(b_r) - V(b_{r-1}) &= \sigma^2(X_r'X_r)^{-1} - \sigma^2(X_{r-1}'X_{r-1})^{-1} \\ &= -\sigma^2\frac{\left(X_{r-1}'X_{r-1}\right)^{-1}x_rx_r'\left(X_{r-1}'X_{r-1}\right)^{-1}}{1 + x_r'\left(X_{r-1}'X_{r-1}\right)^{-1}x_r} \end{aligned} \tag{2.7}$$

is a negative semidefinite matrix.

3. Orthogonal decompositions of least squares estimators

Consider $\hat{\beta}$ and $\hat{\beta}_0$, respectively the unrestricted estimator of β and the restricted estimator of β under the constraint $R\beta = r$:

$$\hat{\beta} = (X'X)^{-1} X'y\,, \tag{3.1}$$

$$\hat{\beta}_0 = \hat{\beta} + Q_R\big[r - R\hat{\beta}\big] \tag{3.2}$$

where

$$Q_R = (X'X)^{-1} R' \big[R\,(X'X)^{-1} R'\big]^{-1}. \tag{3.3}$$

Then, we see easily that

$$\begin{aligned} R\hat{\beta} - r &= R\big[\beta + (X'X)^{-1} X'\varepsilon\big] - r & (3.4)\\ &= (R\beta - r) + R_X\varepsilon & (3.5) \end{aligned}$$

where

$$R_X = R\,(X'X)^{-1} X'\,, \tag{3.6}$$

$$\begin{aligned} \hat{\beta} - \hat{\beta}_0 &= Q_R\big[R\hat{\beta} - r\big] \\ &= Q_R\big[\,(R\beta - r) + R_X\varepsilon\big] \\ &= Q_R\,(R\beta - r) + Q_R R_X\varepsilon \\ &= Q_R\,(R\beta - r) + Q\varepsilon & (3.7) \end{aligned}$$

and

$$\begin{aligned} \hat{\beta}_0 &= \hat{\beta} + (\hat{\beta}_0 - \hat{\beta}) \\ &= \beta + (X'X)^{-1} X'\varepsilon - Q_R\,(R\beta - r) - Q\varepsilon \\ &= \beta + Q_R\,(r - R\beta) + [(X'X)^{-1} X' - Q]\varepsilon & (3.8) \end{aligned}$$

where

$$Q = Q_R R_X = Q_R R\,(X'X)^{-1} X'\,. \tag{3.9}$$

Since

$$R_X X\left(X'X\right)^{-1} = R\left(X'X\right)^{-1} X'X\left(X'X\right)^{-1} = R\left(X'X\right)^{-1}, \tag{3.10}$$

$$R_X R_X' = R\left(X'X\right)^{-1} X'X\left(X'X\right)^{-1} R' = R\left(X'X\right)^{-1} R' \tag{3.11}$$

and

$$\begin{aligned} R_X Q' &= R_X R_X' Q_R' \\ &= R\left(X'X\right)^{-1} R'\left[R\left(X'X\right)^{-1} R'\right]^{-1} R\left(X'X\right)^{-1} \qquad (3.12) \\ &= R\left(X'X\right)^{-1}, \qquad (3.13) \end{aligned}$$

it follows that

$$\begin{aligned} \mathsf{C}(R\hat{\beta} - r,\ \hat{\beta}_0) &= \mathsf{C}\left(R_X\varepsilon, [(X'X)^{-1}X' - Q]\varepsilon\right) \\ &= \mathsf{E}\left[R_X\varepsilon\varepsilon'[(X'X)^{-1}X' - Q]'\right] \\ &= \sigma^2 R_X[(X'X)^{-1}X' - Q]' \\ &= \sigma^2 R_X[X\left(X'X\right)^{-1} - Q'] \\ &= \sigma^2[R\left(X'X\right)^{-1} - R\left(X'X\right)^{-1}] = 0\,. \qquad (3.14) \end{aligned}$$

and

$$\begin{aligned} \mathsf{C}\left(\hat{\beta} - \hat{\beta}_0,\ \hat{\beta}_0\right) &= \mathsf{C}\left(Q_R\left[R\hat{\beta} - r\right], \hat{\beta}_0\right) \\ &= Q_R\mathsf{C}\left(R\hat{\beta} - r, \hat{\beta}_0\right) = 0\,. \end{aligned}$$

Thus $\hat{\beta}_0$ and $R\hat{\beta} - r$ are uncorrelated under the assumptions of the classical linear model, and similarly for $\hat{\beta}_0$ and $\hat{\beta} - \hat{\beta}_0$. This holds even if the normality assumption or the restriction $R\beta = r$ do not hold. Consequently, the identity

$$\hat{\beta} = \hat{\beta}_0 + \left(\hat{\beta} - \hat{\beta}_0\right) \tag{3.15}$$

provides a decomposition of $\hat{\beta}$ as the sum of two uncorrelated random vectors, so that

$$\mathsf{V}\left(\hat{\beta}\right) = \mathsf{V}\left(\hat{\beta}_0\right) + \mathsf{V}\left(\hat{\beta} - \hat{\beta}_0\right). \tag{3.16}$$

More explicitly, we have

$$\hat{\beta} = \hat{\beta}_0 + Q_R(r - R\beta) - Q\varepsilon \tag{3.17}$$

where

$$\mathsf{C}\left[\hat{\beta}_0, Qy\right] = \mathsf{C}\left[\hat{\beta}_0, Q\varepsilon\right] = 0\,. \tag{3.18}$$

An interesting special case of the latter results is the one where

$$y = X_1\beta_1 + X_2\beta_2 + \varepsilon \tag{3.19}$$

and the restrictions take the form

$$\beta_2 = 0\,, \tag{3.20}$$

with

$$R = \left[0, I_{k_2}\right], r = 0\,. \tag{3.21}$$

Then

$$\hat{\beta} = \begin{pmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{pmatrix}, \quad \hat{\beta}_0 = \begin{pmatrix} \hat{\beta}_{10} \\ \hat{\beta}_{20} \end{pmatrix} = \begin{pmatrix} (X_1'X_1)^{-1}X_1'y \\ 0 \end{pmatrix} \tag{3.22}$$

and

$$\hat{\beta}_1 = \hat{\beta}_{10} - Q_{20}R\hat{\beta} = \hat{\beta}_{10} - Q_{20}\hat{\beta}_2 \tag{3.23}$$

where

$$\hat{\beta}_2 = (X_2'M_1X_2)^{-1}X_2'M_1y \tag{3.24}$$

and $\hat{\beta}_2$ is independent of $\hat{\beta}_{10}$.[1]

[1] See Magnus and Durbin (1999) and Danilov and Magnus (2001) for further discussion.

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