



## On the interpretation of panel unit root tests<sup>☆</sup>

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### ABSTRACT

Applications of panel unit root tests have become commonplace in empirical economics, yet there are ambiguities as how best to interpret the test results. This note clarifies that rejection of the panel unit root hypothesis should be interpreted as evidence that a statistically significant proportion of the units are stationary. Accordingly, in the event of a rejection, and in applications where the time dimension of the panel is relatively large, it recommends the test outcome to be augmented with an estimate of the proportion of the cross-section units for which the individual unit root tests are rejected. The economic importance of the rejection can be measured by the magnitude of this proportion.

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Over the last decade, considerable work has been carried on unit root testing in panel data models. See, for example, [Breitung and Pesaran \(2008\)](#) for a recent survey of the literature. Most panel unit root tests are designed to test the null hypothesis of a unit root for each individual series in a panel. The formulation of the alternative hypothesis is however a controversial issue that critically depends on which assumptions one makes about the nature of the homogeneity/heterogeneity of the panel. A number of panel unit root tests proposed in the literature use the following articulation of the alternative hypothesis:

$H_1^a$ : each of the series is stationary as a panel,

while other tests use

$H_1^b$ : at least one of the series in

the panel is generated by a stationary process.

The above two formulations of the alternative hypothesis are not satisfactory for carrying inference on the non-stationarity properties of panel data models. To see why this is so, consider the following simple dynamic heterogeneous panel on  $N$  cross-sections observed over  $T$  time periods:

$$y_{it} = (1 - \phi_i) \mu_i + \phi_i y_{i,t-1} + \varepsilon_{it},$$

$$i = 1, 2, \dots, N; t = 1, 2, \dots, T, \quad (1)$$

where initial values,  $y_{i0}$ , are assumed to be given. (1) can be expressed as

$$\Delta y_{it} = c_i + \beta_i y_{i,t-1} + \varepsilon_{it}, \quad (2)$$

where  $c_i = (1 - \phi_i) \mu_i$ ,  $\beta_i = -(1 - \phi_i)$  and  $\Delta y_{it} = y_{it} - y_{i,t-1}$ . The null hypothesis of unit roots can then be written as

$$H_0: \beta_i = 0 \quad \text{for all } i. \quad (3)$$

Under a homogeneous alternative we have  $\beta_i = \beta \neq 0$  for all  $i$ , and

$$H_1^a: \beta < 0,$$

is meaningful. Testing for unit roots within homogeneous dynamic panels is considered, for example, by [Harris and Tzavalis \(1999\)](#) and [Levin et al. \(2002\)](#). One drawback of tests based on such alternative hypotheses is that they usually have power also if not all units are stationary; and hence a rejection is not convincing evidence that all series are indeed stationary. In particular, [Westerlund and Breitung \(2012\)](#) show that the local power of the [Levin et al. \(2002\)](#) test is greater than that of the [Im et al. \(2003\)](#) test, based on a less restrictive alternative, also when not all individual series are stationary. A further drawback in using  $H_1^a$  is that this is likely to be unduly restrictive, particularly for cross-country studies involving differing short-run dynamics. For example, such a homogeneous alternative seems particularly inappropriate in the case of the purchasing power parity (PPP) hypothesis, where  $y_{it}$  is taken to be the real exchange rate. There are no theoretical grounds for the imposition of the homogeneity

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hypothesis,  $\beta_i = \beta$ , under PPP. The alternative hypothesis  $H_1^b$  stands at the other extreme and in terms of the above notation states that

$$H_1^b : \beta_i < 0, \quad \text{for one or more } i.$$

Such an alternative hypothesis lies at the heart of panel unit root tests proposed by Chang (2002, 2004). We observe that  $H_1^b$  is only appropriate when  $N$  is finite, namely within the multivariate model with a fixed number of variables analyzed in the time series literature. In contrast, in the case of large  $N$  and  $T$ , panel unit root tests will lack power if the alternative,  $H_1^b$ , is adopted. For large  $N$  and  $T$  panels it is reasonable to entertain alternatives that lie somewhere between the two extremes of  $H_1^a$  and  $H_1^b$ . In this context, a more appropriate alternative is given by

$$\begin{aligned} H_1^c : \beta_i < 0, \quad i = 1, 2, \dots, M, \\ \beta_i = 0, \quad i = M + 1, M + 2, \dots, N, \end{aligned} \quad (4)$$

where  $M$  is an increasing function of  $N$ , say  $M(N)$ .

It is easily established that the panel unit root tests have power if

$$\lim_{N \rightarrow \infty} \frac{M(N)}{N} = \delta, \quad 0 < \delta \leq 1. \quad (5)$$

Using the above specification the null hypothesis is  $H_0 : \delta = 0$ , while the alternative hypotheses  $H_1^c$  can be written as

$$H_1^c : \delta > 0.$$

In other words, rejection of the unit root null hypothesis can be interpreted as providing evidence in favor of rejecting the unit root hypothesis for a non-zero fraction of panel members as  $N \rightarrow \infty$ . In cases where  $T$  is sufficiently large,  $\delta$  can be estimated by application of univariate unit root tests to all the individual time series in the panel. With  $N$  and  $T$  sufficiently large, a consistent estimate of  $\delta$  will then be given by the proportion of the cross-section units for which the individual unit root tests are rejected. In applications where  $N$  and  $T$  are not sufficiently large,  $\delta$  cannot be estimated consistently, although the panel unit root test outcome could still be valid, in the sense that it has the correct size under the null hypothesis,  $H_0$ .

A number of recent papers have considered the problem of estimating the proportion of stationary units,  $\delta$ . In the context of testing for output and growth convergence, Pesaran (2007) suggests using the proportion of unit root tests applied to pairs of log per-capita output gaps across  $N$  economies, for which the null hypothesis of non-stationarity is rejected at a given significance level,  $\alpha$ . The author proves that, although the underlying individual unit root tests are not cross-sectionally independent, under the null hypothesis of non-stationarity such an average rejection statistic converges to  $\alpha$ , as  $N$  and  $T$  jointly tend to infinity. Ng (2008) shows that, if a fraction,  $\delta$ , of the panel is made of stationary units, with the remaining series having unit roots, the cross-sectional variance of the panel will have a linear trend that increases exactly at rate  $1 - \delta$ . Hence, she suggests a statistic for the proportion of non-stationary units ( $1 - \delta$ ) based on the time average of the sample cross-sectional variance.

While these procedures deliver an estimate of the fraction of (non-)stationary units, they are not designed to identify which units are stationary. After rejection of the null hypothesis of unit roots for each individual series in a panel, it is often of interest to identify which series can be considered stationary and which can be deemed non-stationary. Kapetanios (2003) and Chortareas and Kapetanios (2009) propose a sequential panel selection method that consists of applying the Im et al. (2003)'s panel unit root test sequentially on progressively smaller fractions of the original data set, where the reduction is carried out by dropping series for which there is evidence of stationarity, signaled by low individual

$t$ -statistics. A similar approach is taken by Smeeks (2010), who proposes testing on user-defined fractions of the panel, using panel unit root tests based on order statistics and computing the corresponding critical values by using the block bootstrap. Hanck (2009) and Moon and Perron (2010) apply methods from the literature on multiple testing to classify the individual series into stationary and non-stationary sets. In particular, Moon and Perron (2010) suggest the use of the so-called false discovery rate (FDR), given by the expected fraction of series classified as  $I(0)$  that are in fact  $I(1)$ , as a useful diagnostic on the aggregate decision. In the computation of the FDR, the authors estimate the fraction of true null hypotheses by applying Ng (2008)'s approach described above.

The heterogeneity of panel data models used in cross-country analysis introduces a new kind of asymmetry in the way in which the null and the alternative hypotheses are treated, which is not usually present in the univariate time series (or cross-section) models. This is because the same null hypothesis is imposed across all  $i$  but the specification of the alternative hypothesis is allowed to vary with  $i$ . This asymmetry is assumed away in homogeneous panels. However, as demonstrated in Pesaran and Smith (1995), neglected heterogeneity (even if purely random) can lead to spurious results in dynamic panels. Therefore, in cross-country analysis where slope heterogeneity is a norm, the asymmetry of the null and the alternative hypotheses has to be taken into account. The appropriate response critically depends on the relative size of  $N$  and  $T$ . In large  $N$  heterogeneous panel data models with  $T$  small (say around 15), it is only possible to devise sufficiently powerful unit root tests which are informative in some average sense, namely indicating whether the null of a unit root can be rejected in the case of a significant fraction of the countries in the panel.<sup>1</sup> To identify the exact proportion of the sample for which the null hypothesis is rejected, one requires country-specific data sets with  $T$  sufficiently large. But if  $T$  is large enough for reliable country-specific inferences to be made, then there seems little justification for pooling countries into a panel.

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<sup>1</sup> Some of these difficulties can be circumvented if slope heterogeneity can be modeled in a sensible and parsimonious manner.