

# Itô Conditional Moment Generator and the Estimation of Short-Rate Processes

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## ABSTRACT

This article exploits the Itô's formula to derive the conditional moments vector for the class of interest rate models that allow for nonlinear volatility and flexible jump specifications. Such a characterization of continuous-time processes by the Itô conditional moment generator noticeably enlarges the admissible set beyond the affine jump-diffusion class. A simple generalized method of moments (GMM) estimator can be constructed based on the analytical solution to the lower-order moments, with natural diagnostics of the conditional mean, variance, and kurtosis.

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these features simultaneously for the U.S. interest rate data [Brown and Dybvig (1986)].<sup>1</sup> Rigorous specification tests using historical data tend to reject the square-root model [Aït-Sahalia (1996b), Conley et al. (1997), Gallant and Tauchen (1998)]. Although having an inherent advantage in fitting features 1 and 2, as indicated in the literature, the CIR-type model fails to capture the rich volatility dynamics and the nonlinear non-Gaussian features.

Consequently efforts to modify the square-root model largely concentrate on more flexible specifications of the volatility dynamics. It is clear that the CIR model is just one special case of the so-called linear constant elasticity of volatility (CEV) specification, where the elasticity equals one-half. Recent comparative studies [Chan et al. (1992), Conley et al. (1997), Tauchen (1997), Christoffersen and Diebold (2000)] found that an elasticity around 1.5 is more desirable. Alternatively one can estimate the volatility function nonparametrically [Aït-Sahalia (1996a), Stanton (1997), Jiang and Knight (1997), Jiang (1998), Bandi (2002), Bandi and Phillips (2003)]. The empirical findings along this line suggest that the square-root model fits reasonably well for the medium range of interest rates, but the estimated non-linearity at both the high and low ends is neither accurate nor conclusive. A pertinent approach is to introduce an unobserved stochastic volatility factor into the diffusion function, which finds considerable support in empirical studies [Andersen and Lund (1996, 1997)].<sup>2</sup> The jump-diffusion approach to interest rate modeling (and bond pricing exercise) is of more recent origin [Baz and Das (1996), Das (1998)], and its general equilibrium formulation is explored by Ahn and Thompson (1988).<sup>3</sup>

The innovation of this article is to generate the parametric conditional moments using only the Itô's formula and to construct a computationally efficient generalized method of moments (GMM) estimator. Maximum-likelihood estimation (MLE) is available only for a very restricted class of jump-diffusion models [Lo (1988)]. Our method differs with the infinitesimal generator of Hansen and Scheinkman (1995) (GMM) in that it fully exploits the conditional information, does not rely on simulations as do Duffie and Singleton (1993) [simulated method of moments (SMM)], uses model-dependent moments instead of data-dependent moments [Gallant and Tauchen (1996)] [efficient method of moments (EMM)], generalizes to an arbitrary number of moments rather than only to conditional mean and variance [Fisher and Gilles (1996)] [quasi maximum likelihood (QML)], and has reliable small sample properties in comparison with the nonparametric

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<sup>1</sup> The bivariate extensions of the CIR specification [Chen and Scott (1993), Gibbons and Ramaswamy (1993), Pearson and Sun (1994)] also meet with poor empirical performance. Duffie and Singleton (1997) found favorable evidence for a two-factor CIR model with serially correlated error structure. Dai and Singleton (2000) estimated more flexible three-factor affine specifications similar to Chen (1996) and Balduzzi et al. (1996) for interest rate swap data after 1987.

<sup>2</sup> This article focuses on the maximum flexibility in the univariate setting, and the extension to multivariate or stochastic volatility is deferred to future research.

<sup>3</sup> Recently there is a growing literature on jump

(NP) approach [Aït-Sahalia (1996a)]. As shown below, our method reduces a complicated task of solving a stochastic differential equation (SDE) to a simple matrix solution of an ordinary differential equation (ODE) system. The computational burden is reduced to a minimum of elementary algebra.<sup>4</sup> Another important advantage is that the characterization of short-rate processes by the Itô's approach allows for nonlinear volatility and semiparametric jump specifications. Within the univariate paradigm, nonlinearity is indispensable to the successful modeling of the U.S. interest rate dynamics. In literature, the most closely related method is to identify the stochastic differential equations with an orthogonal series representation [Hansen, Scheinkman, and Touzi (1998)], which is attributed to the generalized eigenvalue-eigenfunction technique [Wong (1964)].

We further justify the aforementioned methodology by a numerical exercise and illustrate by an empirical application. Monte Carlo evidence suggests that the finite sample efficiency of the proposed GMM estimator is comparable to the asymptotically efficient MLE, the sampling  $t$ -statistics of individual parameters are not far away from the normal reference distribution, and the GMM test of overidentifying restrictions has a typical upward bias but with reasonable magnitude. When applied to U.S. short-term interest rates from 1954 to 2002, both the square-root model and the restricted CEV model are rejected outright. Adding jumps shows some improvement, but only the quadratic variance model cannot be rejected at the 1% significance level. U-shaped volatility and nonlinear higher-order moments seem to be the main challenges of fitting the U.S. short-rate dynamics, in addition to the well-known linear mean persistence.

The remainder of this article is organized as follows: Section 1 derives the conditional moments for an admissible class of processes including square-root, restricted CEV, jump-diffusion, and quadratic variance. Section 2 builds an easy-to-implement GMM estimator and provides some finite sample evidence. Section 3 applies the estimating procedure to the four models mentioned above and contrasts the specification differences using the conditional moment profiles. Section 4 concludes.

## 1 ITÔ CONDITIONAL MOMENT GENERATOR

This section outlines a strategy to derive the conditional moments simultaneously for certain continuous-time processes, relying only on the Itô's formula and the specifications of drift, diffusion, and jump functions. The resulting characterization not only nests the popular affine jump-diffusion class, but also features nonlinear quadratic variance and semiparametric flexible jumps.

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<sup>4</sup> Alternatively, an equivalent spectral method of moments is developed by exploiting the closed-form conditional characteristic functions for the affine jump-diffusion model [Chacko and Viceira (1999), Singleton (2001), Jiang and Knight (2002), Carrasco et al. (2002)]. However, the selection of spectral moments remains as a difficult challenge, whereas in the classical method of moments, a natural choice is the lower-order moments. Moreover, a strategy to derive moments using the Itô's formula alone and not relying on the characteristic function or moment-generating function may be more desirable for certain nonstandard processes, for example, the quadratic variance model discussed in this article.

## 1.1 A General Characterization of Admissible Processes

Suppose that the evolution of the state variable (i.e., the short rate) is governed by a reduced-form jump-diffusion process

$$dr_t = \mu_t dt + \sigma_t dW_t + J_t dN(\rho_t t), \quad (1)$$

where  $W_t$  is a standard Brownian motion,  $N(\rho_t t)$  is a Poisson driving process with an intensity function  $\rho_t$ , and  $J_t$  is the jump size with distribution  $\Pi(J_t)$ . Note that both the jump rate and jump size are allowed to be state dependent, but conditionally independent of each other and with respect to the Brownian motion. Equation (1) must satisfy certain regularity conditions, the critical ones being (a) both  $\mu_t$  and  $\sigma_t$  are Lipschitz continuous and (b)  $\rho_t$  and  $\Pi(J_t)$  are  $\mathcal{F}_{t-}$  measurable.

The strategy is to solve all the conditional moments up to the  $K$ th order

For the admissible process under Proposition 1, the  $K$ -vector of its conditional moments  $E_t(R_s) = [E_t(r_s), E_t(r_s^2), \dots, E_t(r_s^K)]'$  is characterized by a linear differential equation system,

$$\frac{dE_t(R_s)}{ds} = A(\beta)E_t(R_s) + g(\beta), \quad (4)$$

where  $A(\cdot)$  is a  $K \times K$  lower-triangular matrix and  $g(\cdot)$  is a  $K \times 1$  vector. Both  $A(\cdot)$  and  $g(\cdot)$  are nonlinear functions of the parameter vector  $\beta = [\kappa, \theta, \sigma_0, \sigma_1, \sigma_2, J_{10}, \dots, J_{KK}]'$ , defined by the underlying jump-diffusion process [Equation (1)]. Since the coefficients of such a nonhomogeneous linear first-order differential equation do not depend on time, one obtains the following closed-form solution,

$$E_t(R_T) = e^{(T-t)A(\beta)}R_t + A^{-1}(\beta)(e^{(T-t)A(\beta)} - I)g(\beta), \quad (5)$$

where  $I$  is the  $K \times K$  identity matrix and  $e^{(\cdot)}$  denotes the matrix exponential.

There are some advantages in using the "Itô transformation" to generate the conditional moments. From the perspective of richer dynamics, although the drift function has to be restricted as linear, the diffusion function can be nonlinear, and the jump function only requires the specification of its moments. More detailed examples are examined in the next subsection to illustrate the enhanced flexibility of such an Itô characterization. From the perspective of easier implementation, the calculation of moments in a typical matrix programming language remains a one-line code as Equation (5), and the computation of each entry of  $A(\cdot)$  and  $g(\cdot)$  in Equation (3) does not require differentiation; whereas using the conditional moment-generating function involves messy high-order derivatives. Once computed, a moment-based estimator (like GMM) is readily available, while a likelihood-based method requires the Fourier inversion of the characteristic function. It is also possible to apply the Itô transformation to processes that lack analytical solution to the moment-generating function. The major disadvantage of relying on a potentially limited set of moments is the possible loss of estimation efficiency relative to MLE. To address this concern, the next section designs a GMM estimator and quantifies its adequate finite sample performance.

## 1.2 Leading Empirical Examples

To illustrate the applicability of the proposed methodology, here we present several specifications that are useful to model the short-term interest rate. Only the solutions to the first four moments are spelled out, as the higher-order moments are trivial extensions.

**1.2.1 Flexible jump-diffusion process** We start with a simple jump-diffusion process,

$$dr_t = \kappa(\theta - r_t)dt + \sigma\sqrt{r_t}dW_t + J_t dN(\rho_t t), \quad (6)$$

where  $\rho_t = \rho$  and  $J_t$  is specified by its four moments. Although the diffusion part of this model is affine, the state variable may not be affine if the jump-size moments are

state dependent, as allowed by Proposition 1. The solution to its first four conditional moments in the form of Equation (5), can be characterized by the matrix  $A(\beta)$ ,

$$\begin{bmatrix} -\kappa + \rho E(J) & 0 & 0 & 0 \\ 2\kappa\theta + \sigma^2 & -2\kappa + \rho \sum_{i=1}^2 \binom{2}{i} E(J^i) & 0 & 0 \\ 0 & 3\kappa\theta + 3\sigma^2 & -3\kappa + \rho \sum_{i=1}^3 \binom{3}{i} E(J^i) & 0 \\ 0 & 0 & 4\kappa\theta + 6\sigma^2 & -4\kappa + \rho \sum_{i=1}^4 \binom{4}{i} E(J^i) \end{bmatrix},$$

and the vector  $g(\beta)$ ,

$$\begin{bmatrix} \kappa\theta \\ 0 \\ 0 \\ 0 \end{bmatrix}.$$

If we specialize to the case of uniform jump-size distribution ( $J_t \sim U[ar_t, br_t]$ ), the moments of the jump size are, respectively,  $E(J) = [(b^2 - a^2)/2(b - a)]r_t$ ,  $E(J^2) = [(b^3 - a^3)/3(b - a)]r_t^2$ ,  $E(J^3) = [(b^4 - a^4)/4(b - a)]r_t^3$ , and  $E(J^4) = [(b^5 - a^5)/5(b - a)]r_t^4$ .

Two important points are worth noting here. First, the model is not affine, as the conditional variance is not linear but quadratic in the state variable, which is qualitatively similar to the quadratic variance diffusion model discussed next. Second, the particular type of state dependence of the jump size rules out the possibility of negative interest rate, under the mild restriction that  $-1 \leq a < b < +\infty$ , which is easily enforceable during estimation. Negative interest rates are difficult to deal with for certain affine specifications and are conceptually problematic in a nominal economic environment.

**1.2.2 Quadratic variance diffusion model** An important alternative to the affine variance model is the “quadratic variance” process, defined as

$$dr_t = \kappa(\theta - r_t)dt + \sqrt{\sigma_0^2 - \sigma_1^2 r_t + \sigma_2^2 r_t^2} dW_t. \tag{7}$$

No sign restrictions are imposed in the GMM estimation procedure, but are adopted here in line with the actual result to highlight some nice properties – non zero volatility when the rate level approaches zero, high volatility when the rate level is high, and comparable scale of the local variance parameter with that of the square-root model.

For this quadratic variance model, the conditional moments are characterized by Equation (5) in terms of

$$A(\beta) = \begin{bmatrix} -\kappa & 0 & 0 & 0 \\ 2\kappa\theta - \sigma_1^2 & -2\kappa + \sigma_2^2 & 0 & 0 \\ 3\sigma_0^2 & 3\kappa\theta - 3\sigma_1^2 & -3\kappa + 3\sigma_2^2 & 0 \\ 0 & 6\sigma_0^2 & 4\kappa\theta - 6\sigma_1^2 & -4\kappa + 6\sigma_2^2 \end{bmatrix}$$

and

$$g(\beta) = \begin{bmatrix} \kappa\theta \\ \sigma_0^2 \\ 0 \\ 0 \end{bmatrix}.$$

Note that the solution structure is similar for both the jump diffusion and the quadratic variance models, and that the only difference is in each entry. This feature makes the numerical calculation of the moments straightforward and convenient.

The quadratic variance model has several important advantages. First, the model is not affine, hence its moment-generating function or characteristic function may not be easy to derive. Then the Itô conditional moment generator may be the only choice among all the non-simulation-based methods to calculate the moments. Second, there is a great deal of debate about whether the volatility is linear or nonlinear, for example, the 'U'-shaped volatility pattern reported by Aït-Sahalia (1996a). Here we can provide a simple parametric nonlinear alternative and a feasible GMM estimator with conditional moment-based diagnostics. Third, the quadratic variance specification seems to nest several famous short-rate models, namely, log-linear ( $\sigma_0 = \sigma_1 = 0$ ), Ornstein-Uhlenbeck ( $\sigma_1 = \sigma_2 = 0$ ), and square-root ( $\sigma_0 = \sigma_2 = 0$  and reversing the sign of  $\sigma_1^2$ ). Of course, the obvious disadvantage is that the bond pricing solution is not easily obtained except for using Monte Carlo simulation. Nevertheless, the empirical evidence of Section 3 seems to suggest that nonlinear quadratic variance is indispensable in modeling the univariate short-rate dynamics.

**1.2.3 Cubic or transformable CEV model** Some models are not directly solvable by the Itô conditional moment generator, but can be "reduced" to the tractable cases by appropriate transformations. For a detailed discussion on the reducibility technique, see Chapter 4 of Kloeden and Platen (1992). Consider the following nonlinear drift and CEV specification,

$$dr_t = \kappa(\theta r_t^{2\gamma-1} - r_t)dt + \sigma r_t^\gamma dW_t, \quad (8)$$

which has a positive starting value and satisfies  $r_t \in (0, +\infty)$ , under appropriate parameter restrictions. Note that the cross-restriction on parameter  $\gamma$  between drift and diffusion is required for the reducibility, and may prove to be empirically too restrictive relative to the standard linear drift CEV model. Marsh and Rosenfeld (1983) first proposed such a modeling strategy and conducted MLE for distinct values of  $\gamma = 0, 0.5, 1$ . Eom (1997) studied the distributional properties and the optimal GMM instruments for  $\gamma \in [0, 1)$ . Ahn and Gao (1999) examined the term structure implications for the case of  $\gamma = 1.5$  and estimated the model with GMM. The GMM estimators adopted above were based on the time discretization of the diffusion process and relying on the approximate first and second moments.

Using the transformation  $x_t = r_t^\alpha$ , which is a *state-preserving* transformation when  $r_t \in (0, +\infty)$  and  $\gamma \in [0, 1)$  or  $\gamma \in (1, +\infty)$ , one arrives at the familiar square-root model,<sup>6</sup>

$$dx_t = a(b - x_t)dt + c\sqrt{x_t}dW_t. \tag{9}$$

The above transformation can be characterized by the following proposition

**Proposition 2 (transformation)** *The mappings between the CEV process of Equation (8) and the square-root model of Equation (9) are*

$$\begin{aligned} \alpha &= 2(1 - \gamma) \\ a &= 2(1 - \gamma)\kappa \\ b &= \theta + \frac{(1 - 2\gamma)\sigma^2}{2\kappa} \\ c &= 2(1 - \gamma)\sigma. \end{aligned} \tag{10}$$

The proof is a straightforward application of the Itô’s lemma, and is available from the author upon request. The solution to conditional moment of the transformed process  $x_t$  is a special case of the jump-diffusion process of Equation (6) without jumps (letting  $\rho_t = 0$  would be sufficient). The fourth parameter  $\gamma$  in the nonlinear-drift CEV model of Equation (8) is identified through the nonlinear but monotonic transformation  $x_t = r_t^\alpha$ , given that  $r_t \in (0, +\infty)$ .

## 2 ESTIMATION STRATEGY AND MONTE CARLO EVIDENCE

Deriving the conditional moment restriction [Equation (5)] only achieves half of the task for estimating the underlying continuous-time model. The other half rests on designing an appropriate estimator with desirable large and small sample properties. The purpose of this section is to outline an easy-to-implement GMM estimator based on the moment condition solution of Equation (5), and to assure the readers that the estimator performs reasonably well for the benchmark square-root model under some empirically plausible scenarios.

### 2.1 The GMM Estimator

The conditional moments solution [Equation (5)] can be spelled out as a vector autoregressive (VAR) formula,

$$E_t[h_{t+1}(\beta)] = \begin{bmatrix} E_t(r_{t+1}) \\ E_t(r_{t+1}^2) \\ E_t(r_{t+1}^3) \\ E_t(r_{t+1}^4) \end{bmatrix} - \begin{bmatrix} \mathcal{A}_{11} & 0 & 0 & 0 \\ \mathcal{A}_{21} & \mathcal{A}_{22} & 0 & 0 \\ \mathcal{A}_{31} & \mathcal{A}_{32} & \mathcal{A}_{33} & 0 \\ \mathcal{A}_{41} & \mathcal{A}_{42} & \mathcal{A}_{43} & \mathcal{A}_{44} \end{bmatrix} \begin{bmatrix} r_t \\ r_t^2 \\ r_t^3 \\ r_t^4 \end{bmatrix} - \begin{bmatrix} \mathcal{A}_{01} \\ \mathcal{A}_{02} \\ \mathcal{A}_{03} \\ \mathcal{A}_{04} \end{bmatrix} = 0, \tag{11}$$

<sup>6</sup> When  $\gamma = 1$ , the nonlinear CEV process of Equation (8) is reduced to the log-normal process  $dx_t = \kappa(\theta - 1)r_t dt + \sigma r_t dW_t$ , and the parameters  $\kappa$  and  $\theta$  are not separately identifiable.



which is a recursive simultaneous equation system, and its unrestricted version can be estimated by the OLS. To form a GMM estimator, a natural choice of instruments is the constant one and the lagged variables, hence the moment condition vector (with a total of 14 equations).

$$f_t(\beta) \equiv \begin{bmatrix} (E(r_{t+1}) - r_{t+1})(1, r_t)' \\ (E(r_{t+1}^2) - r_{t+1}^2)(1, r_t, r_t^2)' \\ (E(r_{t+1}^3) - r_{t+1}^3)(1, r_t, r_t^2, r_t^3)' \\ (E(r_{t+1}^4) - r_{t+1}^4)(1, r_t, r_t^2, r_t^3, r_t^4)' \end{bmatrix}. \quad (12)$$

By construction  $E[f_t(\beta_0)] = 0$ , and the corresponding GMM or minimum chi-square estimator is defined by  $\hat{\beta}_T = \arg \min g_T(\beta)' W g_T(\beta)$ , where  $g_T(\beta)$  refers to the sample mean of the moment conditions,  $g_T(\beta) \equiv 1/T \sum_{t=1}^{T-1} f_t(\beta)$ , and  $W$  denotes the asymptotic covariance matrix of  $g_T(\beta_0)$  [Hansen (1982)]. An iterative estimator of  $W$  is adopted here; and since the error is not serially correlated, only the heteroscedasticity needs to be accounted for. Under standard regularity conditions, the minimized value of the objective function (normalized by the sample size) is asymptotically distributed as a chi-square random variable, which allows for an omnibus test of the overidentifying restrictions. Moreover, inference regarding individual parameters is readily available from the standard formula of the asymptotic variance-covariance matrix,  $(\partial f_t(\beta) / \partial \beta)' W \partial f_t(\beta) / \partial \beta / T$ .

## 2.2 Considerations for Identification and Efficiency

Identification, or global identification, is equivalent to the assumption that the GMM estimator achieves a unique minimum at some  $\beta_0 \in \mathcal{B}$ , where  $\mathcal{B}$  is a compact set. In the unrestricted recursive VAR model [Equation (11)], the total number of identifiable parameters is 14, which can be easily verified by the standard *order* and *rank* conditions. Since the underlying jump-diffusion model is nonlinear, the identification issue becomes more complicated – on the one hand, the restricted nonlinear dynamics may not be able to identify as many as 14 parameters; on the other hand, a nonlinear structure usually helps to identify more parameters than a linear structure. There is not much theoretical guidance in literature on how to verify the identification condition for a nonlinear model

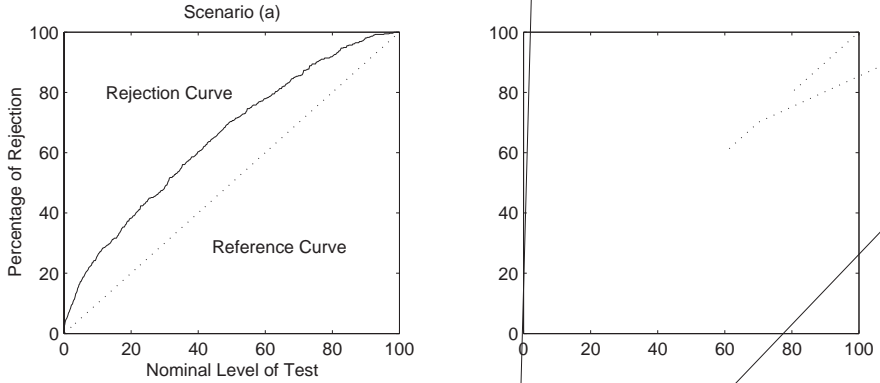
favor the natural choice of Equation (12). First, the optimal instruments involve an unknown true distribution parameter  $\beta_0$ , which has to be approximated in the GMM estimation procedure. Second, to calculate the optimal instruments one needs to solve for eight lower-order moments if one uses only four lower-order moments for Furber (1997) and three for the other two studies.

**Table 1** Monte Carlo experiment.<sup>a</sup>

True value	MLE mean bias	GMM mean bias	MLE root-MSE	GMM root-MSE
Scenario (a), $\Delta = 1/12$ , $\mathcal{J}f = 5.33$				
$\kappa = 0.50$	0.0489	0.0828	0.1344	0.1473
$\theta = 0.06$	0.0006	-0.0027	0.0080	0.0086
$\sigma = 0.15$	0.0002	-0.0028	0.0034	0.0046
Scenario (b), $\Delta = 1/12$ , $\mathcal{J}f = 2.48$				
$\kappa = 0.50$	0.0597	0.1036	0.1413	0.1697
$\theta = 0.06$	-0.0003	-0.0052	0.0114	0.0118
$\sigma = 0.22$	0.0001	-0.0045	0.0054	0.0075
Scenario (c), $\Delta = 1/12$ , $\mathcal{J}f = 133.33$				
$\kappa = 0.50$	0.0438	-0.0042	0.1299	0.1221
$\theta = 0.06$	0.0001	-0.0000	0.0016	0.0017
$\sigma = 0.03$	0.0002	-0.0003	0.0007	0.0008
Scenario (d), $\Delta = 1/12$ , $\mathcal{J}f = 4.27$				
$\kappa = 0.40$	0.0458	0.0892	0.1210	0.1446
$\theta = 0.06$	0.0008	-0.0046	0.0102	0.0102
$\sigma = 0.15$	0.0001	-0.0029	0.0035	0.0048
Scenario (e), $\Delta = 1/12$ , $\mathcal{J}f = 53.33$				
$\kappa = 5.00$	0.0151	0.0169	0.4630	0.4580
$\theta = 0.06$	0.0001	-0.0002	0.0008	0.0009
$\sigma = 0.15$	0.0000	-0.0040	0.0043	0.0059
Scenario (f), $\Delta = 2$ , $\mathcal{J}f = 53.33$				
$\kappa = 0.50$	0.0013	0.0283	0.0430	0.0483
$\theta = 0.06$	0.0004	-0.0022	0.0018	0.0029
$\sigma = 0.15$	0.0004	-0.0041	0.0056	0.0066

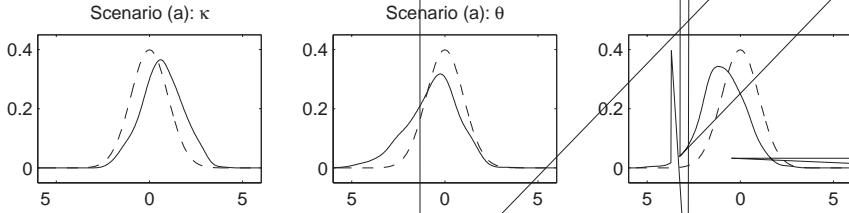
<sup>a</sup>This table compares the finite sample performance of the GMM estimator proposed in this article with that of the MLE estimator provided by Durham and Gallant (2002).  $\Delta$  stands for the discrete sampling interval and  $\mathcal{J}f$  for the degree of freedom of the implied noncentral chi-square distribution. The random sample size is chosen as 1000 and the number of Monte Carlo replicates is 512. Here we report the mean bias and root mean squared error.

has a sizable upward bias when the persistence level is high (scenarios a, b, and d)—about 10% of the parameter value for MLE and about 20% for GMM; while for the less-persistent scenarios (c, e, and f), the bias is noticeably reduced. This is a classical case of finite sample bias in estimating the AR(1) coefficient for the near-unit-root processes. For the long-run mean parameter  $\theta$  and the local variance parameter  $\sigma$ , MLE has negligible positive bias and GMM has negligible negative biases. In terms of relative efficiency, the proposed GMM estimator is remarkably close to the asymptotically efficient MLE. The root mean squared error of GMM is at most 10% higher than that of MLE for most parameters in the persistent cases (scenarios a, b, and d), and is practically indistinguishable for most parameters in the less-persistent cases (scenarios c, e, and f). Figure 1 reports



**Figure 1** GMM specification test of overidentifying restrictions.

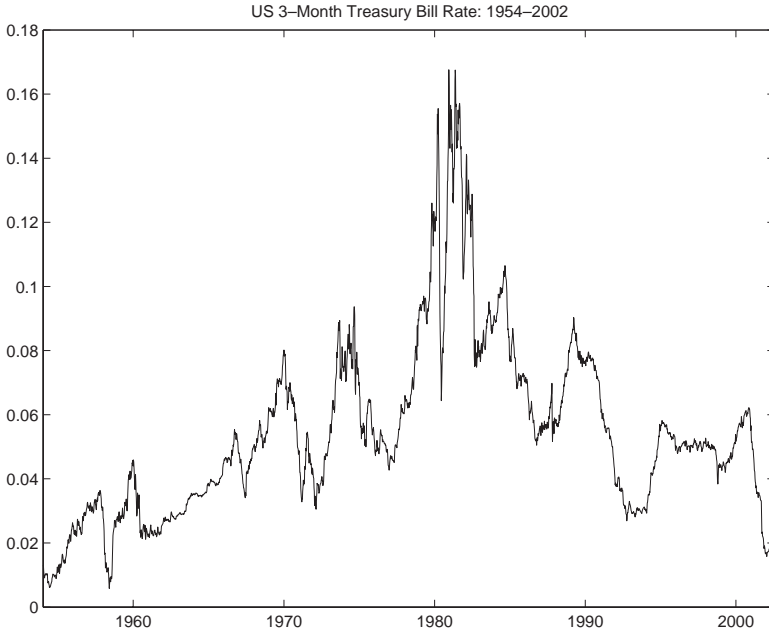
the GMM test of the overidentifying restrictions, which exhibits a typical overrejection bias, but with a reasonable size comparing with the reference level. The sampling distribution of the  $t$ -test statistics is graphed in Figure 2, indicating that the finite sample distortion is rather small compared with the reference standard normal distribution.



**Figure 2** “- -” normal (0, 1) reference density; “—”  $t$ -test statistics.

### 3 EMPIRICAL APPLICATION

In this section, the Itô moment generator and the related GMM estimator are applied to the empirical U.S. interest rate data. The weekly 3-month Treasury bill rate from January 1954 to July 2002, totaling 2504 observations, is obtained



**Figure 3** Time series plot of the short-term interest rate.

from the Federal Reserve Bank of St. Louis public website. The time-series plot is given in Figure 3 and the summary statistics are reported in Table 2. The short rate exhibits the typical features found in literature — high persistence (autoregressive coefficients close to one), high volatility (standard deviation 277 basis points), moderately high skewness (1.14), and kurtosis (4.87). I will focus on the estimation result of the four empirical examples — including the benchmark CIR model — presented in Section 2, and illustrate how to use the conditional moment functions to further compare different model specifications.

### 3.1 Estimation Result

The GMM estimator designed in Section 2 is applied to the four candidate models discussed in Section 2: square-root, restricted CEV, jump diffusion, and quadratic variance.<sup>7</sup> The results are summarized in Table 3.

<sup>7</sup> As pointed out by a referee, one could estimate a comprehensive model nesting both time-varying jumps and quadratic variance. I found out that such a specification is not empirically identifiable by the GMM estimator. My intuition is that the particular jump and diffusion specifications adopted here produce the similar quadratic conditional variance. Therefore they are substituting for each other, instead of being complementary. This can be easily seen from the diagnostic conditional moment graphs in the next subsection.

**Table 2** Summary statistics of three-month Treasury bill rates.<sup>a</sup>

Moments and quantiles		j <sup>th</sup> Order	autocorrelations
Mean	0.0542	$\rho_0$	1.0000
Std. Dev.	0.0277	$\rho_1$	0.9964
Skewness	1.1414	$\rho_2$	0.9912
Kurtosis	4.8728	$\rho_3$	0.9856
Minimum	0.0058	$\rho_4$	0.9798
5%-qntl.	0.0171	$\rho_5$	0.9734
25%-qntl.	0.0347	$\rho_6$	0.9667
Medium	0.0504	$\rho_7$	0.9600
75%-qntl.	0.0689	$\rho_8$	0.9537
95%-qntl.	0.1045	$\rho_9$	0.9477
Maximum	0.1676	$\rho_{10}$	0.9418

<sup>a</sup>The table summarizes the weekly U.S. 3-month Treasury bill rates from January 1954 to July 2002 with a total of 2504 observations. The data are obtained from the public website of the Federal Reserve Bank of St. Louis.

**Table 3** Empirical estimation results.<sup>a</sup>

	Square root	Nonlinear CEV	Jump-diffusion	Quadratic variance
$\kappa =$	0.0020 (0.0013)	0.0017 (0.0010)	0.0005 (0.0001)	0.0010 (0.0002)
$\theta =$	0.0497 (0.0131)	0.0458 (0.0128)	0.0995 (0.0186)	0.0669 (0.0016)
$\sigma =$	0.0062 (0.0002)	0.0059 (0.0002)	0.0031 (0.0012)	
$\gamma =$		0.4825 (0.0028)		
$\rho =$			0.0381 (0.0025)	
$a =$			0.2196 (0.0265)	
$\sigma_0 =$				0.0015 (0.0002)
$\sigma_1 =$				0.0097 (0.0005)
$\sigma_2 =$				0.0412 (0.0006)
$\chi^2 =$	49.3617	48.5714	31.6703	21.1222
df =	11	10	9	9
p value =	0.0000	0.0000	0.0002	0.0121

<sup>a</sup>This table presents the main empirical results of the four model specifications discussed in Section 2 and estimated by the GMM estimator outlined in Section 3.

The standard square-root model is strongly rejected by the GMM specification test, with a chi-square ( $df = 11$ ) of 49.36. The long-run mean parameter (0.0497) is about 50 basis points lower than the sample average (0.0542), the mean-reversion parameter is very low (0.0020) and imprecisely estimated with standard error 0.0013, and the local variance parameter is also lower — 0.0062 implies an unconditional standard deviation of 0.0219 versus the sample standard deviation of 0.0277.

The nonlinear-drift CEV model is also strongly rejected with a chi-square ( $df = 10$ ) of 48.57. Although most parameters are accurately estimated, the model also has a difficulty in nailing down the mean-reversion parameter  $\kappa$  (0.0017 with standard error 0.0010). The restricted CEV model accurately estimates the elasticity parameter as 0.4825 with standard error 0.0028, which confirms the empirical finding by Eom (1997). All other parameter estimates are close to and/or slightly lower than their square-root counterparts.<sup>8</sup>

The jump-diffusion model is implemented here with a constant jump rate  $\rho$  and a uniform jump size  $[-ar_t, ar_t]$ . The symmetry restriction on jump sizes is required to ensure identification. The result predicts roughly two jumps per year; with a state-dependent jump size of  $\pm 119$  basis points at the sample average (0.0542),  $\pm 13$  basis points at sample minimum (0.0058), and  $\pm 368$  basis points at sample maximum (0.1676). Such a jump pattern is more realistic than the constant jump-size distribution, and can rule out the negative interest rates, which can be quite troublesome in a nominal economic environment. Nevertheless, the model is rejected at a  $p$ -value of 0.0002, and the parameter  $\theta$  is unconvincingly large (0.0995).

The quadratic variance model has the best performance and is not rejected at the 1% significance level ( $p = .0121$ ). All the parameter estimates are highly significant. The estimates of the drift parameters fall between the square-root model (similar to the CEV model) and the jump-diffusion model. The parameter estimates of the diffusion function guarantee that (a) instant variance does not admit negative value, (b) minimum volatility is achieved at a positive short-rate level, and (c) volatility increases more when the short-rate level is high and increases less when the short-rate level is low (see the conditional moment graphs below). Such a result from a parametric perspective seems to confirm that by Ait-Sahalia (1996a) from a nonparametric perspective.

### 3.2 Conditional Moment Graphs

The conditional moment vector of Equation (11) not only serves as the basis for constructing a GMM estimator, but also provides intuitive diagnostics as conditional mean, volatility, skewness, and kurtosis. The conditional mean and conditional variance in discrete sampling intervals are equivalent to the drift and

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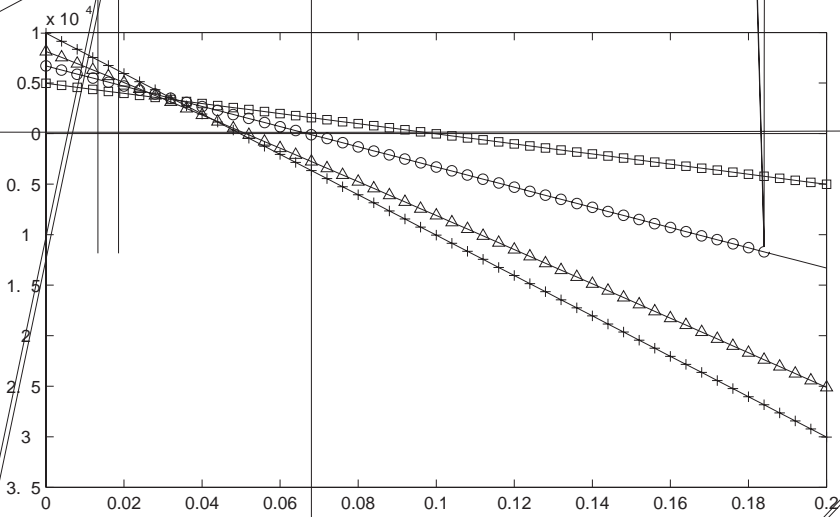
<sup>8</sup> This result differs from the typical empirical finding for the linear-drift CEV model, in that the elasticity coefficient is mostly found to be in the range of 1.0–1.5 [Chan et al. (1992), Conley et al. (1997), Tauchen (1997), Christoffersen and Diebold (2000)], possibly because the nonlinear-drift CEV model imposes an unrealistic restriction across the drift and diffusion functions.



volatility functions in instant times for the pure diffusion processes, but more general in covering the jump-diffusion processes. The conditional skewness and kurtosis provide natural assessment on how much the implied transitional density deviates from the conditional normality. Higher-order conditional moments are especially informative about the jump impact when the time horizon is longer than zero, but the instantaneous higher-order moments cannot provide any new information than the instantaneous drift and volatility.

Figure 4 plots the conditional mean (top panel) and the conditional variance (bottom panel). It is clear that the square-root model has the least persistence in level. Although the restricted CEV model has a potential nonlinear drift, the estimated mean function is mostly linear and close to the square-root model. Of interest is that the jump-diffusion model is the most persistent case, suggesting an observational equivalence between occasional jumps and the near unit root. Our preferred quadratic variance model has a linear mean function with a moderate persistence among the four models. Turning to the conditional variance, both the square-root model and the restricted CEV model produce nearly identical linear volatility profiles, underpinning the clear rejection by the GMM specification tests. The jump-diffusion process provides a slightly nonlinear quadratic variance function, due to the state-dependent jump-size specification ( $J_t \sim U[-ar_t, ar_t]$ ) which differs from the standard affine jump-diffusion models. Of course the most dramatic result comes from the U-shaped quadratic variance model, which partially confirms the nonparametric finding of nonlinear volatility by Aït-Sahalia (1996a) and the parametric finding of a CEV elasticity between 1.0 and 1.5 [Chan et al. (1992), Conley et al. (1997), Tauchen (1997), Christoffersen and Diebold, (2000)]. The postwar U.S. history suggests that the interest rate volatility is certainly high when the short-rate level is high, but the volatility is also elevated when the rate is close to zero. Therefore a nonlinear dependence of short-rate volatility on its level may be better captured by a quadratic variance model than by a standard affine model.

Figure 5 depicts the conditional skewness and kurtosis functions and offers some assessment of the departures from the conditional normality. From the top panel we can see that both the square-root and the nonlinear CEV model give the virtually same hyperbolic skewness function — shooting up at the lower end and approaching zero at the higher end. The jump-diffusion process has a similar profile, but a uniformly higher skewness once the short-rate level reaches greater than 2%. The quadratic volatility model is unique in presenting a nonlinear increasing skewness function that approaches  $-0.1$  at the low end and  $+0.1$  at the high end. Turning to the bottom panel, again, both the square-root and the nonlinear CEV models give virtually the same hyperbolic kurtosis function — shooting up at the lower end and approaching three at the higher end. Note that the jump-diffusion model gives an extraordinarily high kurtosis, ranging from 9 at the lower end to 44 at the higher end (outside and above the picture range). Usually introducing jumps helps to increase the model skewness and kurtosis, but an unusually high kurtosis of 9–44 must be caused by the restrictive jump specification (constant jump rate  $\rho_t = \rho$  and uniform jump size  $J_t \sim U[-ar_t, ar_t]$ ),



**Figure 4** Conditional mean and variance.

which is imposed to ensure the parameter identification. The preferred quadratic variance model has a nonlinear V-shaped kurtosis function for the short-rate level between 0 and 8% and then mostly a constant above 3.02. In short, the quadratic variance model produces unique nonlinear conditional skewness and kurtosis, which are dramatically different from all other candidate models.

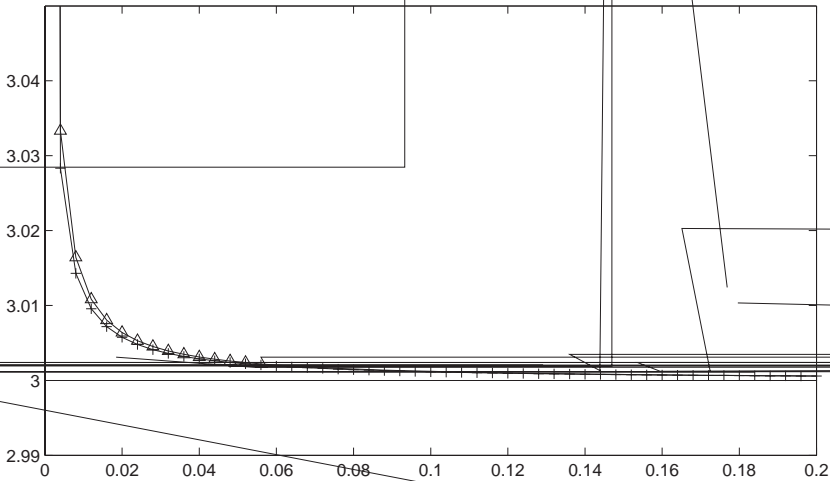
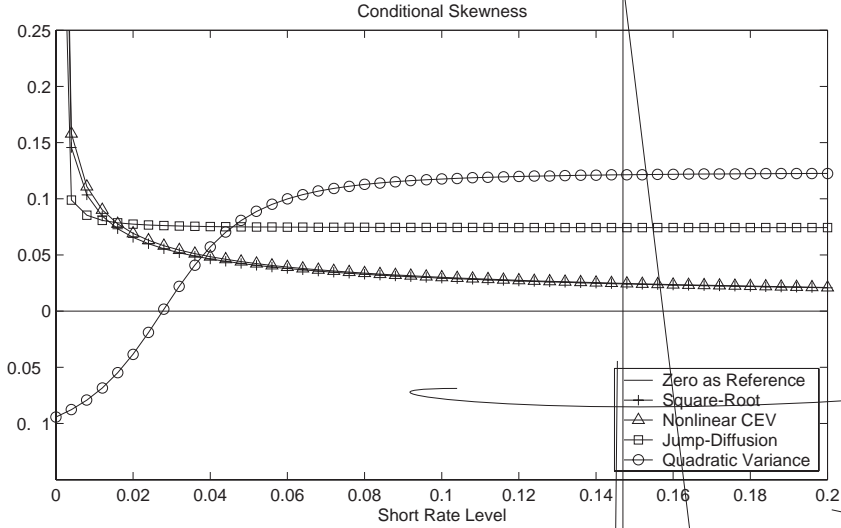


Figure 5 Conditional skewness and kurtosis.

### 4 CONCLUSION

This article proposes an Itô's approach to generating the conditional moments for continuous-time Markov processes and gives a characterization of the class of admissible models. The resulting conditional moment vector forms the basis of a natural GMM estimator. Monte Carlo evidence suggests that such a moment

generator and the related estimator behave reasonably well for a benchmark square-root model. When applied to the empirical U.S. short-rate data, the procedure singles out the quadratic variance model as the only unrejected specification at the 1% level. The benchmark square-root model, the state-dependent jump-diffusion process, and the nonlinear-drift CEV model all fail in the GMM tests of overidentifying restrictions. Further diagnostics suggest that the U-shaped conditional variance and nontrivial conditional skewness and kurtosis are important in modeling the short-rate dynamics in the univariate setting. One important extension is to estimate a multivariate asset return model with possible quadratic volatility components.

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