Analyzing international business and financial cycles using multi-level factor models∗

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Abstract

This paper compares alternative estimation procedures for multi-level factor models which imply blocks of zero restrictions on the associated matrix of factor loadings. We suggest a sequential least squares algorithm for minimizing the total sum of squared residuals and a two-step approach based on canonical correlations that are much simpler and faster than Bayesian approaches previously employed in the literature. Monte Carlo simulations suggest that the estimators perform well in typical sample sizes encountered in the factor analysis of macroeconomic data sets. We apply the methodologies to study international comovements of business and financial cycles.

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1 Introduction

In recent years (dynamic) factor models have become increasingly popular for macroeconomic analysis and forecasting in a data-rich environment.\(^1\) A serious limitation of the standard approximate factor model is that it assumes the common factors to affect all variables of the system. As argued by Boivin and Ng (2006) the efficiency of the Principal Component (PC) estimator may deteriorate substantially if groups of variables are included that do not provide any information about the factors, that is, the corresponding factor loadings of some subgroups of variables are equal to zero. Similarly, if factors are ignored that affect a subset of variables only, the respective idiosyncratic components may be highly correlated, resulting in poor (PC) estimates of those factors which load on all variables.

There are natural examples for models with factors loading on subgroups of variables only. In an international context, for example, factors may represent regional characteristics, and it may be of independent interest to analyze these “regional factors” in addition to “global factors” linking all variables in the model. Alternatively (or in addition), a block structure may represent economic, cultural or other characteristics. A natural way to deal with such block structures is to extract “regional factors” from various subgroups of data (data associated with specific “regions”) separately. However, if there exist at the same global factors that affect all regions in the sample, a separate analysis of the regions will mix up regional and global factors which hampers identification of the factors and involves a severe loss of efficiency.

A characterizing feature of such model structures is that the loading matrix of the common factors is subject to blocks of zero restrictions and the technical challenge is to take into account such restrictions when estimating the common factors. Estimating the state space representation of the model employing Bayesian methods is most popular Kose, Otrok and Whiteman (2003), Moench, Ng and Potter (2013), Kaufmann and Schumacher (2012) and Francis, Owyang and Savascin (2012).\(^2\) Other recent papers adapt frequency domain PCs (Hallin and Liska (2011)), a two-step quasi maximum likelihood (ML) estimator (Banbura, Giannone and Reichlin (2010), Cicconi (2012)), two-stage PC approaches (e.g. Beck et al. (2009), Beck, Hubrich

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\(^2\)The latter two papers assume that the groups of variables are unknown and are determined endogenously in the model. By contrast, the two former papers as well as the present paper determine a priori which variables are associated with which group.
and Marcellino (2011), Aastveit, Bjoernland and Thorsrud (2011)) or a sequential PC approach (Wang (2010)).

In this paper we make several contributions. First, we provide a comprehensive comparison of existing estimation approaches for multi-level factor models and propose two very simple alternative estimation techniques based on sequential least squares (LS) and canonical correlations. The sequential LS algorithm is equivalent to the (quasi) ML estimator assuming Gaussian i.i.d. errors and treating the common factors as unknown parameters. It is closely related to Wang (2010)'s sequential PC approach and the quasi ML approach of Banbura et al. (2010). The estimator based on a canonical correlation analysis (CCA) avoids any iterations and can be computed in two steps. In particular, we employ this computationally convenient and consistent estimator for initializing the LS algorithm in order to ensure that the procedure starts in the neighborhood of the global minimum.

These estimation techniques provide (point) estimates in less than 0.02 seconds (in typical macroeconomic settings) compared to a Bayesian estimator that requires several hours. Moreover, our Monte Carlo simulations suggest that, in some circumstances, the sequential LS and the CCA estimators tend to outperform alternative estimation methods such as the two-step PC estimator and the quasi ML estimator based on the EM algorithm.

An additional advantage with the LS approach compared to the two-step PC approach is that it requires less stringent assumptions. The two-step PC estimator involves estimating, in the first step, the global factors as the first PCs of the full dataset. In a second step the global factors are purged of all variables and the regional factors are extracted applying regional-specific PC analyses to the residuals. In Section 2.4.1 we argue that for the consistency of this estimator we need to assume that the number of regions tends to infinity, whereas in empirical practice the number of groups is typically small (often less than 10). In such cases, the largest eigenvalues may correspond to dominating regional factors so that identification of the global factors by the largest eigenvalues breaks down.

We also extend the sequential LS estimation approach to a three-level factor model (with, for example, global factors, regional factors and factors specific to types of variables) with overlapping blocks of factors. Such factor structures are challenging as they cannot be estimated one level after another (which is the rationale for Wang (2010)'s sequential PC approach).

3Other studies estimate small-dimensional multi-level factor models (e.g. Gregory and Head (1999)). In our paper we focus, however, on large-dimensional models and, therefore, do not differences between those papers and ours further.
A final contribution are two applications in which we study international comovements of business and financial cycles. The first application use the two-level factor model, while the second application uses the three-level factor model assuming an overlapping factor structure.

In the first application we (basically) replicate the study by Hirata, Kose and Otrok (forthcoming) and apply several estimation methodologies for two-level factor models to an annual real activity dataset of more than 100 countries between 1960 and 2010. We estimate global and regional factors which turn out to be similar across methods. We confirm Hirata et al. (forthcoming)’s main finding that regional (business cycle) factors have become more important and global factors less important over time.

In the second application, we use a large quarterly macro-financial dataset for 24 countries between 1995 and 2011. We estimate a global factor, regional factors, as well as factors specific to types of variables (i.e. macro and financial factors). We find that financial variables strongly comove internationally, to a similar extent as macroeconomic variables. Macroeconomic and financial dynamics share common factors, but financial factors independent from macro factors also matter for financial variables. Finally, the temporal evolution of the estimated financial factors looks plausible.

The remainder of the paper is organized as follows. We first present the two-level factor model in Section 2.1. In Sections 2.2 and 3 we then suggest a sequential LS estimator for the two-level factor model and, as an extension, the three-level factor model. In Section 2.3 we propose a CCA estimator. We show in Section 2.4.1 that the two-stage PC approach which has been used in the literature works well only under specific conditions. In Sections 2.4.2 and 2.4.3 we compare the sequential LS approach with the sequential PC and the quasi ML approaches. In Section 4 we investigate the relative performance of alternative estimators by means of Monte Carlo simulations. For ease of exposition we assume in the methodological sections that we work with a large international dataset. We label factors associated with all variables as ”global factors” and factors associated with specific groups ”regional factors” and/or ”variable type-specific factors”. However, the models are, of course, more general and can be applied to other empirical setups with variables being associated with other groups as well. In Section 5 we present our applications, and we conclude in Section 6.

3
2 The two-level factor model

2.1 The model

Consider the following two-level factor model

\[ y_{r,it} = \gamma'_{r,i} G_t + \lambda'_{r,i} F_{r,t} + u_{r,it}, \quad (1) \]

where \( r = 1, \ldots, R \) indicates the region, the index \( i = 1, \ldots, n_r \) denotes the \( i \)'th variable of region \( r \) and \( t = 1, \ldots, T \) stands for the time period. The vector \( G_t = (g_{1,t}, \ldots, g_{m_0,t})' \) comprises \( m_0 \) global factors and the \( m_r \times 1 \) vector \( F_{r,t} \) collects the \( m_r \) regional factors in region \( r \). The idiosyncratic component is denoted by \( u_{r,it} \), where the usual assumptions of an approximate factor model (e.g. Bai (2003)) apply. In vector notation, the factor model for region \( r \) is written as

\[ y_{r,t} = \Gamma_r G_t + \Lambda_r F_{r,t} + u_{r,t}, \quad (2) \]

\[ = \begin{pmatrix} \Gamma_r & \Lambda_r \end{pmatrix} \begin{pmatrix} G_t \\ F_{r,t} \end{pmatrix} + u_{r,t}, \quad (3) \]

where \( y_{r,t} = (y_{r,1t}, \ldots, y_{r,n_r,t})' \) and \( \Gamma_r, \Lambda_r \) and \( u_{r,t} \) are defined conformably. The entire system representing all \( R \) regions results as

\[ \begin{pmatrix} y_{1,t} \\ \vdots \\ y_{R,t} \end{pmatrix} = \begin{pmatrix} \Gamma_1 & \Lambda_1 & 0 & \cdots & 0 \\ \Gamma_2 & 0 & \Lambda_2 & \cdots & 0 \\ \vdots & \ddots & \ddots & \ddots & \vdots \\ \Gamma_R & 0 & 0 & \cdots & \Lambda_R \end{pmatrix} \begin{pmatrix} G_t \\ F_{1,t} \\ F_{2,t} \\ \vdots \\ F_{R,t} \end{pmatrix} + \begin{pmatrix} u_{1,t} \\ u_{2,t} \\ \vdots \\ u_{R,t} \end{pmatrix}, \quad (4) \]

\[ y_t = \Lambda^* F_t^* + u_t, \quad (5) \]

where \( F_t^* = (G_t^*, F_{1,t}^*, \ldots, F_{R,t}^*)' \). Define the \( T \times N \) matrices \( Y = (y_1, \ldots, y_T)' \) and \( U = (u_1, \ldots, u_T)' \). The \( T \times r \) matrix of factors is given by \( F = (F_1, \ldots, F_T)' \). With this notation we write The full system as

\[ Y = FA^* + U. \quad (6) \]
Assume that the idiosyncratic components are identically and independent normally distributed\(^4\) (i.i.d.) across \(i, t\) and \(r\) with \(E(u^2_{r,i,t}) = \sigma^2\) for all \(r, i, t\). Treating the factors and factor loadings as unknown parameters yields the log-likelihood function

\[
\mathcal{L}(F^*, \Lambda^*, \sigma^2) = \text{const} - \frac{T}{2} \left( \sum_{r=1}^{R} n_r \right) \log(\sigma^2) - \frac{1}{2\sigma^2} tr[(Y - F^*\Lambda^*)(Y - F^*\Lambda^*)'].
\]

(7)

Since the matrix \(F\) is unrestricted, we can concentrate out these parameters with \(\hat{F} = Y\Lambda^*(\Lambda^*\Lambda^*)^{-1}\) yielding the concentrated likelihood function

\[
\mathcal{L}_c(\Lambda^*, \sigma^2) = \text{const} - \frac{T}{2} \left( \sum_{r=1}^{R} n_r \right) \log(\sigma^2) - \frac{1}{2\sigma^2} tr[Y\Lambda^*(\Lambda^*\Lambda^*)^{-1}\Lambda^*Y'].
\]

Obviously the likelihood function is invariant to any restriction preserving transformation of the loading matrix given by \(\Lambda^*Q\) with

\[
Q = \begin{pmatrix}
Q_{00} & 0 & 0 & \cdots & 0 \\
Q_{10} & Q_{11} & 0 & \cdots & 0 \\
\vdots & \ddots & \ddots & \ddots & \ddots \\
Q_{R0} & 0 & 0 & \cdots & Q_{RR}
\end{pmatrix}.
\]

In order to identify the factors we need to choose some nonsingular matrix \(Q\). In what follows we adapt the normalization common in the PC analysis, that is,

(i) \(Q_{00} = \left(T^{-1} \sum_{t=1}^{T} G_t G'_t\right)^{-1/2}\) and \(Q_{rr} = \left(T^{-1} \sum_{t=1}^{T} F_{r,t} F'_{r,t}\right)^{-1/2}\) for \(r = 1, \ldots, R\) yielding orthonormal global and regional factors within each of the \(R + 1\) blocks.

(ii) \(N^{-1}\Gamma'_r\Gamma_r\) and \(N^{-1}\Lambda'_r\Lambda_r\) are diagonal matrices which coincides with the respective assumption of the PC estimator, see e.g. Breitung and Choi (2013).

(iii) The matrices \(Q_{k0}, k = 1, \ldots, R\) are chosen such that the \(R\) blocks of regional factors are uncorrelated with the block of global factors.

Note that we do not need to assume that the regional factors from different regions are uncorrelated. This assumption is often imposed for a Bayesian analysis of the multi-level factor model (e.g. Kose, Otrok and Whiteman (2003)) and it implies an over-identified model structure.

\(^4\)The assumption that the errors are i.i.d. is a simplifying assumption that is used to obtain a simple (quasi) likelihood function. The estimator remains consistent if the errors are heteroskedastic and autocorrelated, cf. Wang (2010).
2.2 The sequential least-squares estimator

The maximization of the likelihood function (7) is equivalent to minimizing the sum of squared residuals (RSS)

\[
S(F^*, \Lambda^*) = \sum_{t=1}^{T} (y_t - \Lambda^* F^*_t)'(y_t - \Lambda^* F^*_t) \\
= \sum_{r=1}^{R} \sum_{i=1}^{n_r} \sum_{t=1}^{T} (y_{r,it} - \gamma_{r,i}' G_t - \lambda_{r,i}' F_{r,t})^2.
\]

Assume that we have available suitable initial estimators of the global and regional factors, denoted by \(\hat{G}(0) = (\hat{G}_1^{(0)}, \ldots, \hat{G}_T^{(0)})'\) and \(\hat{F}(0) = (\hat{F}_{r,1}^{(0)}, \ldots, \hat{F}_{r,T}^{(0)})'\). The associated loading coefficients are estimated from \(\sum_{r=1}^{R} n_r\) time series regressions of the form

\[
y_{r,it} = \gamma_{r,i}' \hat{G}_t^{(0)} + \lambda_{r,i}' \hat{F}_{r,t}^{(0)} + \tilde{u}_{r,it}.
\]

Denote the resulting estimates as \(\hat{\gamma}_{r,i}^{(0)}\), \(\hat{\lambda}_{r,i}^{(0)}\) and the respective matrices as \(\hat{\Gamma}_r^{(0)} = (\hat{\gamma}_{r,1}^{(0)}, \ldots, \hat{\gamma}_{r,n_r}^{(0)})'\) and \(\hat{\Lambda}_r^{(0)} = (\hat{\lambda}_{r,1}^{(0)}, \ldots, \hat{\lambda}_{r,n_r}^{(0)})'\). The loading matrix for the full system is constructed as

\[
\hat{\Lambda}_*^{(0)} = \begin{pmatrix}
\hat{\Gamma}_1^{(0)} & \hat{\Lambda}_1^{(0)} & 0 & \cdots & 0 \\
\hat{\Gamma}_2^{(0)} & 0 & \hat{\Lambda}_2^{(0)} & \cdots & 0 \\
\vdots & \ddots & \ddots & \ddots & \vdots \\
\hat{\Gamma}_R^{(0)} & 0 & 0 & \cdots & \hat{\Lambda}_R^{(0)}
\end{pmatrix}.
\]

An updated estimator for the vector of factors is obtained from the least-squares regression of \(y_t\) on \(\hat{\Lambda}_*^{(0)}\) yielding

\[
\hat{F}_{*,(1)}^{(1)} = \begin{pmatrix}
\hat{G}_t^{(1)} \\
\hat{F}_{1,t}^{(1)} \\
\vdots \\
\hat{F}_{R,t}^{(1)}
\end{pmatrix} = \left(\hat{\Lambda}_*^{(0)} \hat{\Lambda}_*^{(0)' - 1} \hat{\Lambda}_*^{(0)} y_t\right),
\]

where in each step the factors are normalized to have a unit variance by multiplying the vector of factors with the matrix \(T^{-1} \sum_{t=1}^{T} \hat{F}_{*,(1)}^{(1)} \hat{F}_{*,(1)}^{*(1)}\)^{-1/2}.

Next, the updated factors can be used to obtain the associated loading coefficients from the least-squares regression (8), yielding the updated estimator \(\hat{\Lambda}_*^{(1)}\).
which in turn yields the updated factors \( \hat{F}_{t,(2)}^* \). It is easy to see that

\[
S(\hat{F}_{(0)}^*, \hat{\Lambda}_{(0)}^*) \geq S(\hat{F}_{(1)}^*, \hat{\Lambda}_{(0)}^*) \geq S(\hat{F}_{(1)}^*, \hat{\Lambda}_{(1)}^*) \geq \cdots
\]

since in each step the previous estimators are contained in the parameter space of the subsequent least-squares estimators. Hence the next estimation step cannot yield a larger RSS and, therefore the sequence of least-squares regressions eventually converges to a minimum.

To check whether the fixed point of the iterative algorithm is indeed a minimum, the first order conditions of the ML estimator can be verified by computing the matrix

\[
\hat{\Upsilon} = \hat{U}'\hat{F}^* (\hat{F}^*\hat{F}^*)^{-1},
\]

where \( \hat{F}^* \) and \( \hat{\Lambda}^* \) denote the final estimates and \( \hat{U} = Y - \hat{F}^*\hat{\Lambda}^* \). If the fixed point corresponds to a minimum, then the matrix of regression coefficients \( \hat{\Upsilon} \) is zero. Accordingly, the first order conditions implies that \( tr(\hat{\Upsilon}'\hat{\Upsilon}) \) is close to zero.

To ensure that the iterative algorithm converges quickly to the global minimum, we initialize the algorithm with suitable starting values for the factors. In our Monte Carlo experiments and in the empirical applications we employ the CCA estimator, which is considered in Section 2.3.

So far we have assumed that the idiosyncratic variances are identical for all variables and regions. Although the resulting LS estimator is consistent in the case of heteroskedastic errors (since the LS estimators are robust against heteroskedastic errors), the asymptotic efficiency may be improved by using a generalized least-squares (GLS) approach (cf. Breitung and Tenhofen (2011)).

It is important to notice that the proposed algorithm does not impose a particular normalization. Therefore, although the vector of common components \( \xi_t = \Lambda^* F_t^* \) is identified and consistently estimated, whereas the factors and loading matrices are estimated consistently up to some arbitrary rotation. In order to impose the normalization proposed in Section 2.1 we first regress the final estimators of the regional factors \( \hat{F}_{r,t} \) \( (r = 1, \ldots, R) \) on \( \hat{G}_t \). The residuals from these regressions yield the orthogonalized regional factor. In order to adopt the same normalization as in the PC analysis, the normalized global factors can be obtained as the \( r_g \) PCs of the estimated common components resulting from the nonzero eigenvalues and the
associated eigenvectors of the matrix
\[
\hat{\Gamma} \left( \frac{1}{T} \sum_{t=1}^{T} \hat{G}_t \hat{G}_t' \right) \hat{\Gamma}'.
\]

The PC normalization of the regional factors can be imposed in a similar manner by using the covariance matrix of the respective common components.

Confidence intervals of the factors (or factor loadings) can be obtained from a simple bootstrap procedure. The artificial data are generated according to the estimated analog of model (4)
\[
y_t^* = \hat{\Lambda}^* \hat{F}_t^* + u_t^*,
\]
where the errors are drawn from the empirical distribution of the idiosyncratic residuals. In order to account for the serial correlation of the errors, a block bootstrap scheme may be employed.

### 2.3 The CCA estimator

We start with estimating the \( m = m_0 + m_r \) global and regional factors in each region separately by a PC analysis yielding the vector of factors \( \hat{F}_{r,t}^+ \) which is a consistent estimator for the factor space of the \( m \times 1 \) vector of factors \( (G_t', F_{r,t}')' \). Since the PCs of two different regions share a common component (the global factor), we apply a CCA to determine the linear combination \( \hat{G}_{r,t} = \tau_r^* \hat{F}_{r,t}^+ \) that is most correlated with the linear combination \( \hat{G}_{s,t} = \tau_s^* \hat{F}_{s,t}^+ \) of some other region \( s \). This problem is equivalent to solving the generalized eigenvalue problem
\[
\begin{vmatrix}
\mu \sum_{t=1}^{T} \hat{F}_{r,t}^+ \hat{F}_{r,t}' - \sum_{t=1}^{T} \hat{F}_{r,t}^+ \hat{F}_{s,t}' \left( \sum_{t=1}^{T} \hat{F}_{s,t}^+ \hat{F}_{s,t}' \right)^{-1} \sum_{t=1}^{T} \hat{F}_{s,t}^+ \hat{F}_{r,t}'
\end{vmatrix} = 0.
\]

The eigenvectors associated with the \( m_0 \) largest eigenvalues provide the weights of the linear combination \( \hat{G}_{r,t} = \tau_r^* \hat{F}_{r,t}^+ \) which serves as an estimator of the global factors \( G_t \). As in the appendix of Breitung and Pigorsch (2013) it can be shown that as \( N \to \infty \) and \( T \to \infty \) the linear combination \( \hat{G}_{r,t} \) (or \( \hat{G}_{s,t} \)) converges in probability to \( HG_t \), where \( H \) is some regular \( m_0 \times m_0 \) matrix. Hence, \( \hat{G}_{r,t} \) yields a consistent estimator of the space spanned by \( G_t \).

Obviously, there are \( R^2(R-1)/2 \) possible pairs \( (\hat{F}_{r,t}^+, \hat{F}_{s,t}^+) \) that can be employed for a CCA. We suggest to choose the linear combination with the largest canonical
correlation (resp. eigenvalue) as the preferred estimate of $G_t$. In the next step the estimated global factors are purged of all variables and from $R$ region-specific PC analyses the regional factors are extracted.

2.4 Relation to existing (non Bayesian) approaches

2.4.1 Two-step PC estimators

Since the set of regional factors $\{F_{1,t},\ldots,F_{R,t}\}$ is assumed to be uncorrelated with the vector of global factors $G_t$, the regional factors may be treated as idiosyncratic components yielding the reduced factor model

$$y_{r,it} = \gamma'_{r,i}G_t + e_{r,it}$$

where $e_{r,it} = \lambda'_{r,i}F_{r,t} + u_{r,it}$. Accordingly, the global factors may be estimated by the first $m_0$ PCs of the matrix $T^{-1}Y'Y$, where $Y = (Y_1,\ldots,Y_R)$ and $Y_r = (y_{r,it})$ is the $T \times n_r$ data matrix of region $r$. In a second step, the regional factors may be estimated again with PCs from the covariance matrix of the resulting idiosyncratic components associated with a specific region. We refer to this estimator as the “top-down PC estimator” as this estimator starts from a PC analysis of the entire system. In empirical studies this top-down PC estimator is employed by Beck et al. (2011), Beck et al. (2009), Aastveit et al. (2011) and Thorsrud (2013). A problem with this estimator is that the regional factors give rise to a strong correlation among the regional clusters of idiosyncratic components. Let $\tau_{r,ij} = \max_t E(|e_{r,it}e_{r,jt}|)$. Since the errors possess a factor structure it follows that $\sum_{i=1}^{n_r} \sum_{j=1}^{n_r} \tau_{r,ij} = O(n_r^2)$ and, therefore,

$$\sum_{r=1}^{R} \sum_{i=1}^{n_r} \sum_{j=1}^{n_r} \tau_{r,ij} = O\left(\sum_{r=1}^{R} n_r^2\right).$$

As shown by Bai (2003) consistent estimation of the factors requires that

$$1/\left(\sum_{r=1}^{R} n_r\right) \sum_{r=1}^{R} \sum_{i=1}^{n_r} \sum_{j=1}^{n_r} \tau_{r,ij} \leq M < \infty$$

and, thus, $\sum_{r=1}^{R} n_r^2/\sum_{r=1}^{R} n_r$ needs to be bounded. Obviously, this condition is fulfilled if $n_r$ is fixed and $R \to \infty$. In empirical practice, however, $n_r$ is large relative to $R$ so that an asymptotic framework assuming $n_r/R \to 0$ is inappropriate in typical empirical applications.

An identical estimator would be obtained by an alternative two-stage PC esti-
mator. Let \( \hat{F}_{r,t}^+ \) denote the vector of the first \( m_0 + m_r \) PCs of the region-specific covariance matrix \( T^{-1}Y_r'Y_r \). The global factor is estimated by a second PC analysis of the covariance matrix of the estimated factors \( T^{-1}\sum_{i=1}^{T} \tilde{F}_i \tilde{F}_t \) where \( \tilde{F}_t = (\hat{F}_{1,t}^+, \ldots, \hat{F}_{R,t}^+) \)'. This estimator may be referred to as the “bottom-up PC estimator”. A problem with the last PC step is that the number of regions is often too small in practice, violating the conditions established by Bai (2003) and Bai and Ng (2002) for consistent estimation of the (global) factors.

For illustration, consider the model with a single global factor \( G_t \). The equivalence to the bottom-up and top-down PC estimators results from the fact that for the eigenvalue problem we have

\[
\max_v \frac{v'Y'Yv}{v'v} = \max_v \frac{\sum_{r=1}^{R} v_r'Y_r'Y_r v_r}{\sum_{r=1}^{R} v_r'v_r} = \max_{a_1, \ldots, a_R} \max_{v_r} \frac{v_r'X_r'X_r v_r}{v_r'v_r} \text{ subject to } \sum_{r=1}^{R} a_r = 1
\]

where \( v = (v_1', \ldots, v_R')' \) and \( a_r = v_r'v_r / \sum_{r=1}^{R} v_r'v_r \). Accordingly, the first PC of the full sample results as a linear combination of the \( R \) region-specific PCs and the maximum is obtained as the largest eigenvalue of the sample covariance matrix of the vector \( (\hat{F}_{1,t}^+, \ldots, \hat{F}_{R,t}^+) \)' . It follows that the bottom-up and the top-down PC estimators are equivalent.

### 2.4.2 The sequential PC approach

Wang (2010) proposes a sequential PC estimator for maximizing the log-likelihood estimator which is also based on the minimization of the RSS of the two-level factor model.

\[
S(F^*, \Lambda^*) = \sum_{r=1}^{R} \sum_{i=1}^{n_r} \sum_{t=1}^{T} (y_{it} - \Lambda^*F_t^*)'(y_{it} - \Lambda^*F_t^*)
\]

with respect to \( F^* = (F_1^*, \ldots, F_T^*)' \) and \( \Lambda^* \).

Assume that we have a suitable initial estimator of the global factors, denoted by \( \hat{G}^{(0)} = (\hat{G}_{1}^{(0)}, \ldots, \hat{G}_{T}^{(0)})' \). Conditional on these initial estimates it is straightforward to obtain initial estimators of the regional factors in region \( r \). All variables are purged of the global factor by running regressions of the variables on the estimated global factor. Then regional factors are estimated as the first \( m_r \) PCs of the sample
covariance matrix
\[
\hat{\Sigma}_r^{(0)} = \frac{1}{T} \sum_{t=1}^{T} Y_t' M_{\hat{G}^{(0)}} Y_r ,
\] (11)

where \( Y_r = (y_{r,it}) \) is the \( T \times n_r \) matrix of observations from region \( r \) and \( M_{\hat{G}^{(0)}} = I_T - \hat{G}^{(0)}(\hat{G}^{(0)'}\hat{G}^{(0)})^{-1}\hat{G}^{(0)'} \). Let \( T \times m_r \) matrix of the resulting PCs be \( \hat{F}_r^{(0)} \). To eliminate the regional factors from the sample the following \( R \) regressions are performed

\[
Y_r = \hat{F}_r^{(0)} B_r + W_r \quad \text{for } r = 1, 2, \ldots, R. \] (12)

Note that at this stage the assumption is imposed that the regional factors are orthogonal to the global factor (that enters the residual of this regression). Let \( \hat{W} = (\hat{W}_1, \ldots, \hat{W}_R) \) denote the \( T \times (\sum_{r=1}^{R} n_r) \) matrix of residuals from the \( R \) regressions (12). The updated estimates of the global factors \( \hat{G}_t^{(1)} \) are obtained as the first \( m_0 \) PCs obtained from the sample covariance matrix

\[
\hat{\Omega}^{(1)} = \frac{1}{T} \hat{W}'\hat{W}.
\]

With the updated estimate of the global factors the matrix \( \hat{\Sigma}_r^{(0)} \) can be computed as in (11) but using \( M_{\hat{G}^{(1)}} \) instead of \( M_{\hat{G}^{(0)}} \) in order to obtain the updated estimate \( \hat{F}_r^{(1)} \). These steps are repeated until convergence.

Wang (2010) initializes the algorithm either with global factors obtained with the top-down PC approach considered in the Section 2.4.1 or, alternatively, with a confirmatory factor analysis given the set of admissible rotations of the regional PCs.

Since both sequential LS and PC approaches minimize the sum of squared errors, the fix point is identical, and the approaches should yield the same estimates. The main advantage of the LS estimator is that it can be straightforwardly generalized to more than two factor levels with overlapping factor structures (as we will show in Section 3), whereas the sequential PC estimator is confined to hierarchical factor models. Second, the LS estimator is computationally less demanding and tends to be faster. Third, in models with heteroskedastic or autocorrelated errors, the sequential LS technique can be used to compute the implied ML estimator that is equivalent to minimizing the weighted sum of squared residuals (cf. Breitung and Tenhofen (2011)), which is equivalent to the (pseudo) ML estimator. It is unclear how this could be achieved with the sequential PC approach.
2.4.3 The quasi ML approach

A related estimation procedure based on quasi ML is employed in Banbura et al. (2010). The conceptual difference to the sequential LS approach is that their approach assumes that the factors are normally distributed random variables yielding a log-likelihood function which includes – besides our RSS – an additional expression that is due to the distribution of the vector of factors. To maximize the likelihood function an EM algorithm is adapted that was originally proposed for the standard factor model without block structures. This approach gives rise to a shrinkage estimator for the vector of factors given by

\[ \hat{F}_t^{(1)} = (\hat{\Lambda}_0^*\hat{\Lambda}_0^* + \tilde{\sigma}_0^2 I_n)^{-1}\hat{\Lambda}_0^* y_t, \]  

(13)

where \( \tilde{\sigma}_0^2 = (NT)^{-1}S(\hat{F}_{(0)}^*, \hat{\Lambda}_{(0)}^*). \) As \( N \to \infty \) we have \( \Lambda'\Lambda/N + (\sigma^2/N)I_m \to \lim_{N \to \infty} \Lambda'\Lambda/N \) and, therefore, the estimators (9) and (13) are asymptotically equivalent.

3 The three-level factor model

The factor model can be extended to include further (overlapping) levels. Assume an international macro-financial panel, where the variables are clustered according to some additional criteria. For example, the variables may be grouped into output-related variables (e.g. production indices, employment), price variables (e.g. consumer prices, producer prices, wages) and financial variables (e.g. interest rates, stock returns). Accordingly, an additional index \( k = 1, \ldots, K \) is introduced and the factor model is written as

\[ y_{rk,it} = \gamma_{rk,i}^r G_t + \lambda_{rk,i}^r F_{r,t} + \theta_{rk,i}^r H_{k,t} + u_{rk,it}, \]  

(14)
where $H_{k,t}$ is a $m_k \times 1$ vector of additional factors. The system can be casted (period-wise) as

$$
\begin{pmatrix}
y_{11,t} \\
y_{R1,t} \\
y_{12,t} \\
y_{R2,t} \\
y_{1K,t} \\
y_{RK,t}
y
\end{pmatrix}
= 
\begin{pmatrix}
\Gamma_{11} & \Lambda_{11} & 0 & \ldots & 0 & \Theta_{11} & 0 & \ldots & 0 \\
\Gamma_{21} & \Lambda_{21} & 0 & \ldots & 0 & \Theta_{21} & 0 & \ldots & 0 \\
\vdots & \vdots & \ddots & \vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
\Gamma_{R1} & 0 & 0 & \ldots & \Lambda_{R1} & \Theta_{R1} & 0 & \ldots & 0 \\
\Gamma_{12} & \Lambda_{12} & 0 & \ldots & 0 & 0 & \Theta_{12} & \ldots & 0 \\
\Gamma_{22} & \Lambda_{22} & 0 & \ldots & 0 & 0 & \Theta_{22} & \ldots & 0 \\
\vdots & \vdots & \ddots & \vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
\Gamma_{R2} & 0 & 0 & \ldots & \Lambda_{R2} & 0 & \Theta_{R2} & \ldots & 0 \\
\vdots & \vdots & \ddots & \vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
\Gamma_{1K} & \Lambda_{1K} & 0 & \ldots & 0 & 0 & 0 & \ldots & \Theta_{1K} \\
\Gamma_{2K} & \Lambda_{2K} & 0 & \ldots & 0 & 0 & 0 & \ldots & \Theta_{2K} \\
\vdots & \vdots & \ddots & \vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\
\Gamma_{RK} & 0 & 0 & \ldots & \Lambda_{RK} & 0 & 0 & \ldots & \Theta_{RK}
\end{pmatrix}
\begin{pmatrix}
G_t \\
F_{1,t} \\
\vdots \\
F_{R,t} \\
H_{1,t} \\
\vdots \\
H_{K,t}
\end{pmatrix}
+ 
\begin{pmatrix}
\uparrow_{11,t} \\
\uparrow_{R1,t} \\
\uparrow_{12,t} \\
\uparrow_{R2,t} \\
\uparrow_{1K,t} \\
\uparrow_{RK,t}
\end{pmatrix}
$$

$$y_t = \Lambda^{**} F^{**}_t + u_t . \quad (15)$$

To identify the parameters we assume that $\mathbb{E}(H_{k,t} H_{k,t}^t) = I_{m_k}$ as well as $\mathbb{E}(H_{k,t} G_t^t) = 0$ and $\mathbb{E}(H_{k,t} F_{r,t}^t) = 0$. The least-squares principle can be applied to estimate the factors and factor loadings, where the iteration adopts a sequential estimation of the factors $G_t, F_{1,t}, \ldots, F_{R,t}$, and $H_{1,t}, \ldots, H_{K,t}$. In what follows we focus on the sequential LS procedure which is convenient to implement. Consistent starting values can be obtained from a CCA of the relevant subfactors (see below). Let $\hat{G}_{t}^{(0)}, \hat{F}_{1,t}^{(0)}, \ldots, \hat{F}_{R,t}^{(0)}$, and $\hat{H}_{1,t}^{(0)}, \ldots, \hat{H}_{K,t}^{(0)}$ denote the initial estimators. The elements of the loading matrices can be estimated by running regressions of $y_{rk,it}$ on the initial factor estimates $\hat{G}_{t}^{(0)}, \hat{F}_{1,t}^{(0)}, \ldots, \hat{F}_{R,t}^{(0)}$, and $\hat{H}_{1,t}^{(0)}, \ldots, \hat{H}_{K,t}^{(0)}$. The resulting least-squares estimators for the loading coefficients are organized as in the matrix $\hat{\Lambda}^{**}$, yielding the estimator $\hat{\Lambda}^{**}$. An update of the factor estimates is obtained by running a regression of $y_t$ on $\hat{\Lambda}^{**}$ yielding the updated vector of factors, $\hat{G}_{t}^{(1)}, \hat{F}_{1,t}^{(1)}, \ldots, \hat{F}_{R,t}^{(1)}$, and $\hat{H}_{1,t}^{(1)}, \ldots, \hat{H}_{K,t}^{(1)}$. With this updated estimates of the factors we are able to obtain improved estimates of the loading coefficients by running again regressions of $y_{rk,it}$ on the estimated factors. This sequential LS estimation procedure continues until convergence.

The last step involves orthogonalizing the two vectors of factors $\left(\hat{F}_{1,t}, \ldots, \hat{F}_{R,t}\right)$.
and \((\hat{H}_{1,t}, \ldots, \hat{H}_{K,t})\). Although this orthogonalization step is not necessary for identification of the factors, it enables us to perform a variance decomposition of individual variables with respect to the factors. Orthogonalizing the factors can be achieved by regressing \((\hat{F}_{1,t}', \ldots, \hat{F}_{R,t}')\) on \((\hat{H}_{1,t}', \ldots, \hat{H}_{K,t}')\) (or vice versa) and taking the residuals as new estimates of \((F_{1,t}', \ldots, F_{R,t}')\) (or of \((H_{1,t}', \ldots, H_{K,t}')\)). We note that the results may depend on whether we regress \((\hat{F}_{1,t}', \ldots, \hat{F}_{R,t}')\) on \((\hat{H}_{1,t}', \ldots, \hat{H}_{K,t}')\) or \((\hat{H}_{1,t}', \ldots, \hat{H}_{K,t}')\) on \((\hat{F}_{1,t}', \ldots, \hat{F}_{R,t}')\).

The initialization for the three-level factor model works as follows. We first estimate the global factor as the first \(m_0\) PCs and the global factors are eliminated from the variables by running least-squares regressions of the variables on the estimated global factors.\(^5\) In the next step the CCA is employed to extract the common component among the \(m_r + m_k\) estimated factors from region \(r\), group \(k\) and the estimated vectors from the same region \(r\) but different group \(k'\). This common component is the estimated regional factor. Similarly, the estimated factor \(H_{k,t}\) is obtained from a CCA of the factor of region \(r\), group \(k\) and a different region \(r'\) but the same group. These initial estimates are used to start the sequential LS procedure.

The overall estimation procedure outlined for the three-level factor model with an overlapping factor structure can be generalized straightforwardly to allow for further levels of factors (provided that the number of units in each group is sufficiently large). Furthermore, the levels may be specified as a hierarchical structure (e.g. Moench et al. (2013)), that is, the second level of factors (e.g. regions) is divided into a third level of factors (e.g. countries) such that each third level group is uniquely assigned to one second level group. For such hierarchical structures the CCA can be adapted to yield a consistent initial estimator for a sequential estimation procedure that switches between estimating the factors and (restricted) loadings.

\section{Monte Carlo simulations}

\subsection{Two-level factor model}

In this section we first examine the small sample properties of the LS estimation procedure for the two-level factor model (Section 2.2). We compare them to those of

\footnote{Alternatively, a CCA between (i) the variables in region \(r\) and group \(k\) and (ii) the variables in group \(r'\) and \(k'\) with \(r \neq r'\) and \(k \neq k'\) may be employed to extract the common factors. In our experience the two-step top-down estimator used in our simulation performs similarly and has the advantage that the starting values are invariant with respect to a reorganization of the levels (that is interchanging regions and groups).}
the simple CCA approach (which provides us with starting values for the sequential LS approach), the two-step PC estimation procedure considered in Section 2.4.1 and the quasi ML approach. An advantage of all these approaches is that they do not take long. By contrast, the Bayesian method requires many hours for a single estimation. Therefore, we are not able to include Bayesian methods in our Monte Carlo study, but we will compare the sequential LS estimation and the other procedures to the Bayesian approach in the first empirical application in Section 5.1.

The Monte Carlo setup is as follows. The factors are generated (independently) by a first order autoregressive process, where the autoregressive coefficient is 0.5. The idiosyncratic components are also generated independently and follow an AR(1) process with an autoregressive parameter of 0.1. The innovations of the global factor(s) and the idiosyncratic errors are independently standard normally distributed. The innovations of the regional factors are also independently normally distributed; the standard deviations are set to $\text{stdfacreg} \in \{0.5, 1, 2\}$ in order to study the effect of the importance of the regional factors (relative to the global factor(s)). All factor loadings are generated as $N(1, 1)$, following Boivin and Ng (2006). We finally multiply the idiosyncratic components by a scalar which yields idiosyncratic and common components, which are about equally important. We note that all results improve as the idiosyncratic component gets less important relative to the common component. However, the relative performances of the different methodologies remain unchanged.

We consider $R \in \{2, 4\}$ regions with $n_r \in \{20, 50, 80\}$ variables in each region, and one global and one regional factor in each region. The time dimension is $T \in \{50, 200\}$. For each of the experiments we determine the $R^2$ (or trace $R^2$) of a regression of the actual on the estimated factors based on 1000 replications of the model.

From the Monte Carlo experiments presented in Table 1 it turns out that the performance of the two-step PC estimator crucially depends on the relative importance of the global and regional factors. Only if the variance of the global factor is large relative to the variance of the regional factors ($\text{stdregfac} = 0.5$), the two-

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6We have shown in Section 2.4.1 equivalence of the top-down and the bottom-up PC approaches and therefore, only show Monte Carlo results for one of them.

7We are grateful to Domenico Giannone for providing us with his Matlab codes.

8Note that (apart from the two-step PC estimator which requires the additional assumption that $R \to \infty$) all estimators are consistent if the factors and idiosyncratic components are weakly autocorrelated and heteroscedastic.
The CCA estimator for the global factor is less sensitive to the relative importance of the global and regional factors and performs reasonably well for all values of stdfacreg. This is due to the fact that if the regional factors are more important than the global factor, the largest eigenvalue may correspond to a regional factor instead of the global factor and the two-step PC estimator may confound global with regional factors. In contrast, our two-step estimator identifies the global factors by CCA of the (standardized) factors, which does not depend on the relative importance of the factors.

While the simple CCA approach performs already well, iterations tend to lead to small improvements on average. The sequential LS estimator (which uses CCA-based starting values) produces even more reliable estimates of the global factor in sample sizes typically encountered in macroeconomic datasets. The quasi ML approach, finally, also delivers reliable global factor estimates. The average correlation between true and estimated global factors is never smaller than 0.79 and in general larger than 0.9.

In small samples, the regional factors are less precisely estimated by all methods when they are less important than the global factors. Those estimates tend to improve substantially as the sample size increases. However, as the standard deviation of the regional factors relative to the global factor increases and as the sample size grows, the regional factors are less precisely estimated with the quasi ML approach.

For nr = 50, T = 200 and R = 2, we also compare the estimated density functions of the R^2 (resp. trace R^2) of the global and regional factors as well as the computing time across methods (on average over the simulations). Figure 1 shows that not only the correspondence between the factors obtained with the two-step PC approach tends to be smaller than the one obtained with the other methods, but also the variance is larger. The sequential procedures yield better factor estimates, but in few cases (for stdfacreg = 2), the quasi ML approach delivers rather inaccurate solutions.

We have also looked at the average (trace) R^2 (means and distributions) of the sequential PC approach suggested by Wang (2010) and of the sequential LS approach, where we employ the two-step PC approach to generate the starting values for the factor estimates. As expected, we obtain virtually the same results as for the sequential LS approach with CCA-based starting values and, hence, do not show them here.
Among the two methods with no iteration, the two-step PC approach is slightly faster than the CCA approach. It takes, on average over all iterations, between 0.006 and 0.007 seconds (depending on stdfacreg) compared to 0.008—0.009 seconds with the CCA. Notwithstanding, the sequential LS approach with CCA starting values tends to be faster (between 0.016 and 0.021 seconds) than the sequential LS approach starting with the two-step PC approach (between 0.019 and 0.027 seconds). This suggests that, although the starting values do not seem to matter for the precision of the factor estimates, using improved (CCA-based) starting values leads to faster convergence of the algorithm. The sequential PC approach takes longer than both sequential LS approaches, especially as the regional factors become more important (between 0.04 and 0.12 seconds). The quasi ML approach is slower than the other methods. It takes between 0.30 and 1.08 seconds.

4.2 Three-level factor model

We next carry out simulations for the three-level factor model using the sequential LS approach. Third-level factors (e.g. factors specific to certain types of variables) are generated just like the regional factors. We consider \( \text{stdfacreg} \in \{0.5, 1, 2\} \) and \( \text{stdfacvar} \in \{0.5, 1, 2\} \) to study the importance of the regional factors and the factors specific to certain types of variables relative to the global factors, respectively. We further assume that each variable is driven by \( m_0 = 1 \) global factor, \( m_r = 1 \) regional factor and \( m_k = 1 \) variable type-specific factor. We consider \( R = 2 \) regions with \( n_r \in \{20, 50, 80\} \) variables in each region and \( N/2 \) variables in each of the \( K = 2 \) groups. The time dimensions are \( T \in \{50, 200\} \). Again, we multiply the idiosyncratic components by a scalar so that common components are about equally important.

Overall, our simulation results suggest that in reasonably large samples the LS approach yields very precise estimators of the factors. In small samples, global factors are also quite precisely estimated, whereas the precision of regional and variable type-specific factor estimates depends on the importance of those factors.

5 Applications

In this section, we provide two applications of our methodology to study international business and financial comovements. The first application serves to compare the methods for estimating a two-level factor model presented in Section 2 with
the Bayesian approach. The second application makes use of the three-level factor model with an overlapping factor structure as outlined in Section 3.

5.1 Comovement of international business cycle

There is an interest reaching far back in describing and understanding the international synchronization of business cycles. Examples for key questions that have been addressed in the literature are: Does increased trade and financial integration lead to more or less synchronization of business cycles (something which is theoretically unclear)?\textsuperscript{9} Has there been a decoupling of emerging economies from advanced economies in recent years, for instance due to regional or bilateral integration agreements or similar policies within regions and, hence, emergence of regional cycles?\textsuperscript{10}

We basically replicate the analysis conducted by Hirata et al. (forthcoming) using the sequential LS and CCA methodologies, in comparison to their Bayesian approach (and to the two-step PC and the quasi ML approaches). From their dataset of annual consumption, investment and GDP growth for 106 countries\textsuperscript{11}, we estimate global and regional factors for the entire period 1960-2010 and separately for 1960-1984 and 1985-2010. We initially follow Hirata et al. (forthcoming) and estimate one global factor and one factor for each of seven regions (North America, Europe, Oceania, Latin America and the Carribean, Asia, Sub-Saharan Africa, Middle East and North Africa). Hirata et al. (forthcoming) also estimate country factors. We use a simplified model with no country factors given the small number of series available for each country. Nevertheless, the assumptions on the idiosyncratic components in our model are fairly flexible to account for weak correlation across variables (also within a country).

To apply the LS approach we do not need to make assumptions on the processes for the factors and idiosyncratic components nor do we need to choose priors for the parameters. When adopting the Bayesian approach we specify our model as in Hirata et al. (forthcoming) and refer to their study for details. The regional factors are normalized to be positively correlated with GDP growth in a large country in each region (here: US, Germany, Australia, Brazil, Japan, South Africa and Morocco), and the global factor is normalized to be positively correlated with US GDP growth.

\textsuperscript{9}See, e.g., Kose, Otrok and Whiteman (2003), Kose, Otrok and Prasad (2008), Kose, Prasad and Terrones (2003), Kose, Prasad and Terrones (2007).

\textsuperscript{10}See, e.g., Hirata et al. (forthcoming), Kose et al. (2008).

\textsuperscript{11}We are grateful to Ayhan Kose for kindly sharing his dataset with us.
Figure 2 shows the global and regional factors estimated over the entire period 1960-2010 obtained using the different methodologies. Overall, the sets of factor estimates are similar. The LS approach suggests a somewhat less severe global recession at the end of the sample than the other approaches. All approaches attribute some of the Great Recession to the global factor, but for all regions but Africa and the Middle East another important part is attributed to the regional factors. There are also some minor differences between the levels of the African factors estimated using the Bayesian and the other methodologies over parts of the sample period.

Table 2 reveals that the regional factors estimated based on the LS approach are notably correlated across regions. The highest correlations of above 0.4 in absolute terms are found for the pairs North America with Europe and with Oceania and Africa with Latin America. Most correlations are positive, some are negative, but rather small.\footnote{We have also verified correlations between regional factors estimated with the Bayesian approach. Those are correlated to a similar extent (which is not surprising given that factor estimates are similar), although uncorrelated factors are assumed in the underlying model. The explanation is that the Bayesian approach involves overidentifying assumptions (namely that the regional factors are uncorrelated across regions), which are generally not satisfied by the estimated factors.}

Table 3 shows the variance decomposition of GDP growth estimated based on the sequential LS method on average over all countries in each region for the entire sample period and the two subsamples. We find that the regional factors have become more important over time in almost all regions, and in the second subsample, they are more important than the global factor. Moreover, the importance of the global factor has declined over time in most regions except for the Middle East and Africa. In the latter two regions the shares accounted for by the global factor have broadly doubled (from low shares though).

The shares explained by the common global and regional factors tend to be larger than those estimated by Hirata et al. (forthcoming). A reason might be that Hirata et al. (forthcoming) also estimate country factors while comovements among variables within a country in our approach are only implicitly accounted for by cross-correlated idiosyncratic components.

As a robustness check, we also estimated the model using the sequential LS method by allowing for two global and two regional factors. The overall commonality rises by 15 percentage points compared to the model with one global factor and one regional factor in both subsamples. A comparison between the two subsamples confirms the main result from the model with one global factor and one regional factor, i.e. that higher business cycle synchronization is due to a greater
variance share explained by regional factors.\textsuperscript{13} Hence, overall we confirm Hirata et al. (forthcoming)’s main results that the increased business cycle synchronization we have observed in the last decades is due to ”regionalization” rather than to ”globalization”.

\subsection*{5.2 International financial linkages}

In the second application, we broadly extend the previous analysis to financial cycles at the global level. We address the following main questions. (i) How strongly do financial variables in different countries comove? (ii) Are macroeconomic and financial dynamics at the global level driven by the same common factor(s)? Or are there (global) financial factors independent of macroeconomic factors? (iii) Is there something like a ”financial cycle”, i.e. do different groups of financial variables share a common factor, or are there factors specific to individual groups of financial variables? (iv) Are financial factors associated with financial developments in advanced or rather emerging economies or both?

It is far from clear what answers we should expect. While the global financial crisis affected financial markets and economic growth worldwide, other financial crises (such as the Asian crisis in 1997 or the Argentinian crisis in 1999-2002) only mainly affected the neighbouring emerging countries. Financial variables do not only move together during financial busts, but also in boom periods. For example, prior to the latest crisis, many countries experienced simultaneously housing and credit booms. The strong international comovement among financial variables can be explained with financial globalization having led to capital flows, an equalization of asset prices through arbitrage and confidence effects, and cross-border lending and global banks. Moreover, monetary policy has become increasingly similar, at least in advanced countries.\textsuperscript{14}

We broadly use the dataset built by Eickmeier, Gambacorta and Hofmann (2014). It comprises overall 348 quarterly series from 11 advanced and 13 emerging market economies over 1995-2011. 207 series are financial and 141 macroeconomic series. The macroeconomic block includes, for each country (if available for a sufficiently

\textsuperscript{13}One global factor looks almost identical to the one estimated before. The other one seems to match oil price movements fairly well. It has its largest trough around the first oil price shock in 1973/74 and another deep trough around the second oil price shock in 1979/80 (there are no major troughs around the Gulf war and the war with Iraq 1991 and 2003, respectively). Factor plots and variance shares are available upon request.

\textsuperscript{14}There has been a general change in the strategy towards inflation targeting. Central banks now tend to react to output growth and inflation which comove internationally. And recently, monetary policy was coordinated explicitly or implicitly to fight the crisis.
long time span) price series (consumer prices, producer prices, GDP deflator) and output series (GDP, consumption, investment). The financial block contains stock and house prices, domestic and cross-border credit, interest rates (money market rates, long-term government bond yields), monetary aggregates M0 and M2 as well as implied stock market volatility. All series enter in year-on-year growth rates, except for interest rates and implied stock market volatility which enter in levels. Also, each series is demeaned, and its variance is normalized to one.\footnote{The dataset used originally by Eickmeier et al. (2014) also comprises lots of - less standard - US financial series as well as overnight rates and lending rates for different countries, which are not included here. Overnight and lending rates are not included in order not to give interest rates in our dataset a too large weight. Asset prices are included here, but not in the baseline model of Eickmeier et al. (2014). For more details on the dataset and transformations we refer to their analysis.}

We now apply our three-level factor model to the dataset. We estimate a ”global factor” $G_t$, which is common to all variables in our dataset. Moreover, we estimate regional factors $F_t$, i.e. a factor specific to all variables in advanced countries (”advanced economies’ factor”) and one specific to all variables in emerging economies (”emerging economies’ factor”).\footnote{Those factors are normalized to be positively correlated with US GDP (global and advanced economies’ factors) and GDP of Hong Kong (emerging economies’ factor).} We consider only two regions because we have less countries in our sample than in the previous application.\footnote{Our application is an extension of Eickmeier et al. (2014) who extract factors common to all financial variables and identify them as a global monetary policy factor, a global credit supply factor and a global credit demand factor, but do not consider regional factors.} Finally, we estimate variable type-specific factors $H_t$. It is unclear a priori how to divide the variables. Hence, we consider several (variable-wise) splits of the data leading to different models\footnote{The variables can certainly be split also in other ways. We leave systematic assessment of the best split to future research.}:

- real activity series; price series; financial series (all other variables) (model 1)
- real activity series; price series; financial price series (comprising house and stock prices and implied volatility); financial quantities (comprising money and credit aggregates) (model 2)
- real activity series; price series; interest rates; stock prices; house prices; credit; monetary aggregates; implied stock market volatility.\footnote{The factors were normalized to be positively correlated with US GDP (macro factor and real activity factor), the US GDP deflator (price factor), US stock prices (stock price factor), US house prices (house price factor), US domestic credit (credit factor), US M2 (money factor) and Chinese GDP (emerging factor), US money market rate (interest rate factor), US implied stock market volatility (implied stock market volatility factor).} (model 3)
The orthogonalization of variable type-specific and regional factors is achieved by regressing the regional factors on the variable type-specific factors.

One advantage of a finer level of disaggregation is that factors are more easily interpretable. Figure 3, hence, shows the financial factor estimates from model 3 (which are estimates conditional on the global and regional factors). The temporal evolution looks broadly plausible. The financial boom in the mid-2000s is characterized by below average interest rate and implied volatility factors and an above average stock price factor early in the boom, as well as above average credit, money and - to a less clearer extent - house price factors later in the boom. This is consistent with various explanations for the boom and subsequent crisis, including loose monetary policy (in the US and worldwide) (Taylor (2009), Hofmann and Bogdanova (2012)), the "global saving glut" (Bernanke (2005)) (which may have led to lower bond yields), strong credit growth due to deregulation on financial markets (Eickmeier et al. (2014)) and major changes in the housing sector. It is interesting that the housing boom is indeed reflected somewhat in the global housing factor, even though the increase in house prices was not shared by some major emerging and advanced countries (e.g. Thailand, Malaysia, Germany, Japan and Korea) (Andr (2010), Ferrero (2012)). During the global financial crisis, the implied stock market volatility factor shows the greatest peak, and stock and house price factors display the deepest troughs. At the end of the sample period, we observe that the interest rate factor is still far below average, suggesting a very loose monetary policy stance. The evolution of all factors indicate sharp reversals towards improvements in financial markets, but only conditions in global stock markets seem to have fully recovered after the global financial crisis (at least temporarily).

We are now ready to answer the questions raised at the beginning of this section.

(i) Financial variables worldwide strongly comove, with variance shares explained by common factors of more than 40 percent on average over all financial variables (Table 4). The degree of synchronization among financial variables worldwide is similar to the degree of synchronization among macroeconomic variables. There is, however, a lot of heterogeneity across variables. The commonality is particularly high for fast-moving financial variables such as stock prices and interest rates and considerably lower for monetary and credit aggregates as well as house prices. The finding for house prices is not surprising given that houses are not tradable and that regulation and financing in housing markets differ across countries. Interestingly, the commonality is relatively low for stock price volatility. One possible explanation is that the high observed degree of worldwide comovement of financial stress or general
uncertainty, which should be reflected in the volatility series, is already captured by
other common (global or regional) factors.

(ii) Macroeconomic and financial dynamics are driven by the same (global and
regional) factors, which explain together more than 20 percent and roughly 30 per-
cent of the variation in macro and financial variables, respectively. This is in line
with Claessens, Kose and Terrones (2012) who illustrate strong linkages between
different phases of macro and financial cycles. We find, however, that financial fac-
tors independent from macro factors also matter for financial variables, explaining
between 10 and 24 percent, depending on the model. Global factors tend to be more
important for financial variables than regional factors.

(iii) The overall commonality in the data (all data, but also only financial data)
(i.e. the data fit) remains remarkably similar if financial variables are explained by
factors specific to individual types of financial variables rather than by one single
common financial factor. This is remarkable, given that we would have expected
more disaggregated factors to be more highly correlated with individual series and,
hence, the explained part to increase with a higher level of disaggregation. (The dis-
aggregated financial factors in model 3 explain indeed a larger share of fluctuations
in interest rates and asset prices compared to model 2, but the overall commonality
does not increase (because the shares explained by the regional factors are lower in
model 3 compared to model 2).) That this is not the case might suggest that it is
sufficient to split the data into real activity, prices and financial variables (model 1)
or real activity, prices, financial quantities and prices (model 2) (or, put differently,
it might suggest existence of a ”financial cycle” or a ”financial quantity cycle” and
a ”financial price cycle”) and that a finer split may not be necessary. This is useful
information for modellers who study the international synchronization of financial
variables.

(iv) We also find that the financial factors load highly on variables from many
advanced and emerging countries simultaneously with no clear regional pattern (re-
sults are not shown, but available upon request). This underlines the global nature
of financial market developments.

Our main results are broadly robust once we let the sample end before the global
financial crisis and once we alter the last estimation step and orthogonalize regional
and variable type-specific factors by regressing variable type-specific on regional
factors rather than regressing regional on variable type-specific factors, as before.
6 Concluding remarks

In this paper we have compared alternative estimation procedures for multi-level factor models which impose blocks of zero restrictions on the associated matrix of factor loadings. For the two-level factor model we have suggested an estimator based on CCA and a simple sequential LS algorithm that minimizes the total sum of squared residuals. The latter estimator is related to Wang (2010)’s sequential PC estimator and to Banbura et al. (2010)’s quasi ML approach, and it is much simpler and faster than Bayesian approaches previously employed in the literature. The sequential LS and CCA estimation approaches can be applied to block structures of two or higher levels of factors (with either overlapping or hierarchical factor structures). Monte Carlo simulations suggest that the estimators perform well (in terms of precision of factor estimates and computing time) in typical sample sizes encountered in the factor analysis of macroeconomic data sets.

We have applied the methodologies to study international comovements of business and financial cycles. We first basically replicate the study by Hirata et al. (forthcoming) and also find that regional cycles have become more important and global cycles less important over time. Our factor estimates (based on sequential LS or CCA) and their (Bayesian) factor estimates are similar. We then move on to analyze the comovement of financial variables at the global level. We find that the estimated financial factors plausibly evolve over time. The international synchronization of financial variables is comparable to the comovement of macro variables. Both types of variables share common factors, but independent financial factors also seem to play an important role.
References


Bai, J. and Ng, S. (2002), ‘Determining the number of factors in approximate factor models’, *Econometrica 70*(1), 191–221.


Wang, P. (2010), ‘Large dimensional factor models with a multi-level factor structure’, *Mimeo, Hong Kong University of Science and Technology*.
Table 1: Monte Carlo simulation results: $R^2$ (or trace $R^2$) of a regression of actual on estimates factors (based on 1000 replications)

(a) Two-level factor model

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Table 1: Monte Carlo simulation results (based on 1000 replications) cont.

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Notes: For details on the simulation design, see the text. G: global factor, F: regional factor, H: variable-specific factor.
### Table 2: Correlation between regional factors 1961-2010 (sequential LS methodology) (application 1)

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### Table 3: Variance shares of GDP growth explained by global and regional factors in percent (1 global factor and 1 regional factor, sequential LS methodology) (application 1)

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Table 4: Variance shares explained by the common factors on average over all and over groups of variables in percent for 1995-2011 (sequential LS methodology) (application 2)

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Figure 1: Smoothed distributions of $R^2$ (or trace $R^2$) of a regression of true on estimated factors (or trace $R^2$) (for $T = 200$, $n_g = 50$, $R = 2$) (1000 replications)
Figure 2: Estimates for global and regional factors of international business cycles (black: sequential LS, magenta dashed: CCA, red dotted: Bayesian (posterior mean), blue dashed: quasi ML, green dotted dashed: two-step PC) (model with 1 global factor and 1 regional factor for each country) (application 1)

(a) Global factor

(b) Regional factors

Notes: The Bayesian approach is based on 1,000 burnins and 10,000 draws (to be increased).
Figure 3: Variable-specific factor estimates from model 3 (sequential LS methodology, application 2)

Notes: The factors are normalized as described in the main text.