Wold Decomposition

Christopher A. Sims
Princeton University
sims@princeton.edu

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Preliminaries

If we have a set (possibly countably infinite) of random variables $\{X_i\}$, the set of all finite linear combinations of them forms a linear space.

We can define an inner product, and thus a norm on that space as $\langle X, Y \rangle = \mathrm{Cov}(X, Y)$. Then defining the distance between X and Y as $\|(\| X - Y)$, our space is a metric space. We can **complete** the metric space by extending it to include all limits of Cauchy sequences. That is, if $\{Z_i, i = 1, \ldots, \infty\}$ has the property that $\|Z_m - Z_n\| \to \infty$ as $m, n \to \infty$, then $Z_\infty = \lim_{i\to\infty} Z_i$ is in the space.

Projections

Suppose G is a complete linear subspace of H, with a Hilbert space (i.e., innerproduct and norm defined) structure. We can define the operator $\mathcal{E}$ by

$$\mathcal{E}[X \mid H] = Z \in H \text{ that minimizes } \|X - Z\| \ .$$

It is not hard to prove that such a Z must always exist and is unique.

If G_1 and G_2 are two subspaces of H such that $\langle X, Y \rangle = 0$ whenever $X \in G_1$ and $Y \in G_2$, we say that G_1 and G_2 are **orthogonal**, or $G_1 \perp G_2$. In that case it is not hard to show that $\mathcal{E}[X \mid G_1, G_2] = \mathcal{E}[X \mid G_1] + \mathcal{E}[X \mid G_2]$.

It is always true that $X - \mathcal{E}[X \mid G] \perp G$.

A finite variance stochastic process and its predictive projections

Now let $Y_t, t = -\infty, \ldots, \infty$ be a vector valued stochastic process. That is, each Y_t is an n-dimensional random vector, and the probability law of the stochastic process specifies mutually consistent joint distributions for any finite collection of the $\{Y_t\}$ variables.

Let H_t be the complete metric space generated by $\{Y_s, s \leq t\}$.

We can always project Y_t on H_{t-1} and express the gap between the two as $\varepsilon_t = Y_t - \mathcal{E}[Y_t \mid H_{t-1}$.

ε_t is the **innovation** in Y_t.

Recursive projections, Wold representation

H_t for any t is the same as the space spanned by ε_t, H_{t-1}. (This is obvious if you think about the definitions.) Therefore we can write

$$y_t = \varepsilon_t + \mathcal{E}[y_t \mid \varepsilon_{t-1}] + \mathcal{E}[y_t \mid H_{t-2}] = \varepsilon_t + A_1\varepsilon_{t-1} + \mathcal{E}[y_t \mid H_{t-2}]\,.$$

The A_1 is a square matrix of coefficients. Since ε_t is of dimension n the space it spans is just the space of linear combinations of elements of the ε_t vector, so each element of the $\mathcal{E}[Y_t \mid \varepsilon_{t-1}]$ vector is a linear combination of elements of ε_{t-1}, given by a row of A_1.

Repeating this T times, we get

$$y_t = \sum_{s=0}^{T-1} A_s \varepsilon_{t-s} + \mathcal{E}[Y_t \mid H_{t-T}] = \tilde{y}_t^T + \bar{y}_t^T \ .$$

Taking limits

$\text{Var}(\tilde{y}_t^T)$ is increasing in T and is bounded above by $\text{Var}(y_t)$.. (These are matrices, so we mean by "increasing" that their differences are positive semi-definite, which implies their diagonal elements are non-negative.) It is therefore a Cauchy sequence and has a limit we call simply $\tilde{y}_t$. This is the **linearly regular** piece of y_t.

$\text{Var}(\bar{y}_t^T)$ is decreasing in T and bounded below by zero, so it too is Cauchy and has a limit, which we call $\bar{y}_t$.

Note that $\bar{y}_t$ is in H_{t-T} for every T, so $\mathcal{E}[\bar{y}_t \mid H_{t-T}] = \bar{y}_t$, for every T. In other words, $\bar{y}_t$ can be forecast arbitrarily well from data on y_s before time $t-T$, no matter how far back in the past these data are. So we call this part the **linearly deterministic** part.

Stationarity

If the y process is stationary, meaning the joint distribution of $\{X_1, \ldots, X_m\}$ is the same as that of $\{X_{s+1}, \ldots, X_{s+m}\}$ for any s, no matter what m we start with, then our decomposition above produces the same A_s sequence, no matter what t we pick for y_t. Furthermore $\tilde{y}_t$, $\bar{y}_t$, and ε_t will then also be stationary.

A stationary process is called linearly regular if its linearly deterministic component is zero. It is called linearly deterministic if its linearly regular component is zero. (For a non-stationary process, we can do the same decomposition at any t, but the component processes could have variance zero for some dates and not for others.)

Examples of LR stationary processes: i.i.d. $N(0, I)$; stationary AR(1) ($\mathcal{E}[y_t \mid H_{t-1}] = \rho y_{t-1}], \mathrm{Var}\, \varepsilon_t$ constant)

Examples of LD stationary processes: $y_t = \sin(t + \theta)$, $\theta \sim U(0, 2\pi)$; $y_t \sim N(0, 1), y_t \equiv y_{t-1}$; $y_t = \sum_s e^{-(t-s)^2} \nu_{t-s}$, ν i.i.d. $N(0, 1)$.