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INFERENCE FOR STOCHASTIC VOLATILITY MODELS USING TIME CHANGE TRANSFORMATIONS[1]

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We address the problem of parameter estimation for diffusion driven stochastic volatility models through Markov chain Monte Carlo (MCMC). To avoid degeneracy issues we introduce an innovative reparametrization defined through transformations that operate on the time scale of the diffusion. A novel MCMC scheme which overcomes the inherent difficulties of time change transformations is also presented. The algorithm is fast to implement and applies to models with stochastic volatility. The methodology is tested through simulation based experiments and illustrated on data consisting of US treasury bill rates.

1. Introduction. Diffusion processes provide natural models for continuous time phenomena. They are used extensively in diverse areas such as finance, biology and physics. A diffusion process is defined through a stochastic differential equation (SDE),

$$dX_t = \mu(t, X_t, \theta)\,dt + \sigma(t, X_t, \theta)\,dW_t, \qquad 0 \le t \le T, \tag{1.1}$$

where W is standard Brownian motion. The drift $\mu(\cdot)$ and volatility $\sigma(\cdot)$ reflect the instantaneous mean and standard deviation, respectively. In this paper we assume the existence of a unique weak solution to (1.1) which translates into some regularity conditions (locally Lipschitz with a linear growth bound) on $\mu(\cdot)$ and $\sigma(\cdot)$ (see [31], Chapter 5 for more details).

The task of inference for diffusion processes is particularly challenging and has received remarkable attention in the recent literature (see [32] for an extensive review). The main difficulty is inherent in the nature of diffusions which are infinite-dimensional objects. However, only a finite number of points may be observed and the marginal likelihood of these observations is generally unavailable in closed form. This has stimulated the development of various nonlikelihood approaches which use indirect inference [18], estimating functions [6], or the efficient method of moments [14] (see also [13]).

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Most likelihood-based methods approach the likelihood function through the transition density of (1.1). Denote the observations by Y_k, $k = 0, \ldots, n$, and with t_k their corresponding times. If the dimension of Y_k equals that of X (for each k) we can use the Markov property to write the likelihood, given the initial point Y_0, as

$$\mathcal{L}(Y, \theta | Y_0) = \prod_{k=1}^{n} p_k(Y_k | Y_{k-1}; \theta, \Delta), \qquad \Delta = t_k - t_{k-1}. \tag{1.2}$$

The transition densities $p_k(\cdot)$ are not available in closed form but several approximations are available. They may be analytical (see [1, 2]) or simulation based (see [9, 28]). They usually approximate the likelihood in a way so that the discretization error can become arbitrarily small, although the methodology developed in [4] succeeds exact inference in the sense that it allows only for Monte Carlo error. A potential downside of these methods may be their dependence on the Markov property. In many interesting multidimensional diffusion models, the observation regime is different and some of their components are not observed at all.

A famous such example is provided by stochastic volatility models, used extensively to model financial time series such as equity prices [19, 20, 33] or interest rates [3, 8, 15]. A stochastic volatility model is usually represented by a two-dimensional diffusion,

$$\begin{pmatrix} dX_t \\ d\alpha_t \end{pmatrix} = \begin{pmatrix} \mu_x(X_t, \alpha_t, \theta) \\ \mu_\alpha(\alpha_t, \theta) \end{pmatrix} dt + \begin{pmatrix} \sigma_x(\alpha_t, \theta) & 0 \\ 0 & \sigma_\alpha(\alpha_t, \theta) \end{pmatrix} \begin{pmatrix} dB_t \\ dW_t \end{pmatrix}, \tag{1.3}$$

where X denotes the observed equity (stock) log-price or the short-term interest rate with volatility $\sigma_x(\cdot)$ which is a function of a latent diffusion α. Note that the observed process X in (1.3) is not Markov; the distribution of a future stock price depends (besides the current price) on the current volatility which in turn depends on the entire price history. Nevertheless, since the two-dimensional diffusion is Markov, state space approaches are possible and may be implemented using sequential Monte Carlo techniques [12, 29]. While such approaches allow for online estimation of the volatility, various implications arise regarding inference for the diffusion parameters [25, 34].

An alternative approach to the problem adopts Bayesian inference utilizing Markov chain Monte Carlo (MCMC) methods. Adhering to the Bayesian framework, a prior $p(\theta)$ is first assigned on the parameter vector θ. Then, given the observations Y, the posterior $p(\theta|Y)$ can be explored through data augmentation [35], treating the unobserved paths of X (paths between observations) as missing data. Note that the augmented diffusion satisfies the Markov property irrespectively of the observation regime. Hence data augmentation approaches are more general.

Initial MCMC schemes following this program were introduced by [21] (see also [10, 11] and [22]). However, as noted in the simulation-based experiment of [10] and established theoretically by [30], any such algorithm's convergence properties will degenerate as the number of imputed points increases. The problem

may be overcome with the reparametrization of [30], and this scheme may be applied in all one-dimensional and some multidimensional contexts. However, this framework does not cover general multidimensional diffusion models. Chib, Pitt and Shephard [7] and Kalogeropoulos [23] offer appropriate reparametrizations but only for a class of stochastic volatility models. Alternative reparametrizations were introduced in [17] (see also [16] for a sequential approach).

In this paper we introduce a novel reparametrization that, unlike previous MCMC approaches, operates on the time scale of the observed diffusion rather than its path. This facilitates the construction of irreducible and efficient MCMC schemes designed appropriately to accommodate the time change of the diffusion path. Being a data augmentation procedure, our approach does note rely on the Markov property and can be applied to a much larger class of diffusions than those considered in [1] and [4]. Moreover, it may be coupled with the approaches of [30] and [7] to handle more general models, that is almost every stochastic volatility model used in practice. The paper is organized as follows: Section 2 elaborates on the need for a transformation of the diffusion to avoid problematic MCMC algorithms. In Section 3 we introduce a class of transformations based on changing the time scale of the diffusion process. Section 4 provides the details for the corresponding nontrivial MCMC implementation. The proposed methodology of the paper is tested and illustrated through numerical experiments in Section 5, and on US treasury bill rates in Section 6. Finally, Section 7 concludes and provides some relevant discussion.

2. The necessity of reparametrization. A Bayesian data augmentation scheme bypasses a problematic sampling from the posterior $\pi(\theta|Y)$ by introducing a latent variable $\mathcal{X}$ that simplifies the likelihood $\mathcal{L}(Y;\mathcal{X},\theta)$. It usually involves the following two steps:

1. Simulate $\mathcal{X}$ conditional on Y and θ.
2. Simulate θ from the augmented conditional posterior which is proportional to $\mathcal{L}(Y;\mathcal{X},\theta)\pi(\theta)$.

It is not hard to adapt our problem to this setting. Y represents the observations of the price process X. The latent variables $\mathcal{X}$ introduced to simplify the likelihood evaluations are discrete skeletons of diffusion paths between observations or entirely unobserved diffusions. In other words, $\mathcal{X}$ is a fine partition of multidimensional diffusion with drift $\mu_X(t,X_t,\theta)$ and diffusion matrix

$$\Sigma_X(t,X_t,\theta)=\sigma(t,X_t,\theta)\times\sigma(t,X_t,\theta)'$$

and the augmented dataset is $\mathcal{X}_{i\delta}, i=0,\dots,T/\delta$, where δ specifies the amount of augmentation. The likelihood can be approximated via the Euler scheme,

$$\mathcal{L}^E(Y;\mathcal{X},\theta)=\prod_{i=1}^{T/\delta} p(\mathcal{X}_{i\delta}|\mathcal{X}_{(i-1)\delta}),$$

$$\mathcal{X}_{i\delta}|\mathcal{X}_{(i-1)\delta}\sim\mathcal{N}\big(\mathcal{X}_{(i-1)\delta}+\delta\mu_{\mathcal{X}}(\cdot),\delta\Sigma_{\mathcal{X}}(\cdot)\big),$$

which is known to converge to the true likelihood $\mathcal{L}(Y; \mathcal{X}, \theta)$ for small δ [28].

Another property of diffusion processes relates $\Sigma_{\mathcal{X}}(\cdot)$ to the quadratic variation process. Specifically we know that

$$\lim_{\delta \to 0} \sum_{i=1}^{T/\delta} (\mathcal{X}_{i\delta} - \mathcal{X}_{(i-1)\delta})(\mathcal{X}_{i\delta} - \mathcal{X}_{(i-1)\delta})^T = \int_0^T \Sigma_{\mathcal{X}}(s, \mathcal{X}_s, \theta)\, ds \qquad \text{a.s.}$$

The solution of the equation above determines the diffusion matrix parameters. Hence, there exists perfect correlation between these parameters and $\mathcal{X}$ as $\delta \to 0$. This has disastrous implications for the mixing and convergence of the MCMC chain as it translates into reducibility for $\delta \to 0$. This issue was first noted by [30] for scalar diffusions and also confirmed by the simulation experiment of [10]. In fact the convergence time is of $O(\frac{1}{\delta})$. This problem is not MCMC specific as it turns out that the convergence of its deterministic analogue, EM algorithm, is also problematic when the amount of information in the augmented data $\mathcal{X}$ strongly exceeds that of the observations. In our case, $\mathcal{X}$ contains an infinite amount of information for $\delta \to 0$.

The problem may be resolved if we apply a transformation so that the algorithm based on the transformed diffusion is no longer reducible as $\delta \to 0$. Roberts and Stramer [30] provide appropriate diffusion transformations for scalar diffusions. In a multivariate context this requires a transformation to a diffusion with unit volatility matrix (see, for instance, [24]). Aït-Sahalia [2] terms such diffusions as reducible and proves the nonreducibility of stochastic volatility models that obey (1.3). The transformations introduced in this paper follow a slightly different route and target the time scale of the diffusion. Since the construction obeys the same principles of [30] the convergence time of the algorithm is independent of augmentation level controlled by δ. Another appealing feature of such a reparametrization is the generalisation to stochastic volatility models.

3. Time change transformations. For ease of illustration we first provide the time change transformation and the relevant likelihood function for scalar diffusion models with constant volatility. Nevertheless, one of the main advantages of this technique is the applicability to general stochastic volatility models.

3.1. *Scalar diffusions.* Consider a diffusion X defined through the following SDE:

$$dX_t = \mu(t, X_t, \theta)\, dt + \sigma\, dW_t^X, \qquad 0 < t < 1, \sigma > 0. \tag{3.1}$$

Without loss of generality, we assume a pair of observations $X_0 = y_0$ and $X_1 = y_1$. For more data, note that the same operations are possible for every pair of successive observations, and these pairs are linked together through the Markov property. We introduce the latent "missing" path of X for $0 \le t \le 1$, denoted by X^{mis}, so that $X = (y_0, X^{\text{mis}}, y_1)$. In the spirit of [30], the goal is to write the likelihood for θ, σ

with respect to a parameter-free dominating measure. Using Girsanov's theorem we can get the Radon–Nikodym derivative between the law of the diffusion X, denoted by $\mathbb{P}^X$, and that of the driftless diffusion $dM_t = \sigma\, dW_t^X$ which represents Wiener measure and is denoted by $\mathbb{W}^X$. We write

$$\frac{d\mathbb{P}^X(X)}{d\mathbb{W}^X} = G(t, X, \theta, \sigma) = \exp\left\{\int_0^1 \frac{\mu(t, X_t, \theta)}{\sigma^2}\, dX_t - \frac{1}{2}\int_0^1 \frac{\mu(t, X_t, \theta)^2}{\sigma^2}\, dt\right\}.$$

Consider the factorization,

$$\mathbb{W}^X = \mathbb{W}_y^X \times \mathrm{Leb}(y_1) \times f(y_1|y_0, \sigma^2), \tag{3.2}$$

where y_1 is a Gaussian random variable, $y_1|y_0 \sim \mathcal{N}(y_0, \sigma^2)$, and $\mathrm{Leb}(\cdot)$ denotes Lebesgue measure. This naturally factorizes the measure of X as the Lebesgue density of y_1 under the dominating measure multiplied by the conditional dominating measure $\mathbb{W}_y^X$. We can now write

$$\frac{d\mathbb{P}^X(X^{\mathrm{mis}}, y_0, y_1)}{d\{\mathbb{W}_y^X \times \mathrm{Leb}(y)\}} = G(t, X, \theta, \sigma) f(y_1|y_0, \sigma),$$

where clearly the dominating measure depends on σ since it contains $\mathbb{W}_y^X$ which represents a Brownian bridge with volatility σ.

To remove this dependency on the parameter σ we consider the following time change transformation. Let a new time scale be

$$s = \eta_1(t, \sigma) = \int_0^t \sigma^2\, d\omega = t\sigma^2 \tag{3.3}$$

and then define the new transformed diffusion U as

$$U_s = \begin{cases} X_{\eta_1^{-1}(s,\sigma)}, & 0 \le s \le \sigma^2, \\ M_{\eta_1^{-1}(s,\sigma)}, & s > \sigma^2. \end{cases}$$

The definition for $t > \sigma^2$ is needed to ensure that U is well defined for different values of $\sigma^2 > 0$ which is essential in the context of a MCMC algorithm. Using standard time change properties (see, for example, [26]), the SDE for U is

$$dU_s = \begin{cases} \dfrac{1}{\sigma^2}\mu(s, U_s, \theta)\, dt + dW_s^U, & 0 \le s \le \sigma^2, \\ dW_s^U, & s > \sigma^2, \end{cases}$$

where W^U is another Brownian motion at the time scale s. Applying Girsanov's theorem again, the law of U, denoted by $\mathbb{P}^U$, is given through its Radon–Nikodym derivative with respect to the law $\mathbb{W}^U$ of the Brownian motion W^U at the time

scale s:

$$\begin{aligned}
&\frac{d\mathbb{P}^U(U^{\mathrm{mis}}, y_0, y_1)}{d\mathbb{W}^U} \\
&\quad = G(s, U, \theta, \sigma) \\
&\quad = \exp\left\{\int_0^{+\infty} \frac{\mu(s, U_s, \theta)}{\sigma^2}\, dU_s - \frac{1}{2}\int_0^{+\infty} \frac{\mu(s, U_s, \theta)^2}{\sigma^4}\, ds\right\} \\
&\quad = \exp\left\{\int_0^{\sigma^2} \frac{\mu(s, U_s, \theta)}{\sigma^2}\, dU_s - \frac{1}{2}\int_0^{\sigma^2} \frac{\mu(s, U_s, \theta)^2}{\sigma^4}\, ds\right\}.
\end{aligned} \tag{3.4}$$

By applying the factorization of (3.2) on $\mathbb{W}^U$ at the new time scale s, the likelihood can be written as

$$\frac{d\mathbb{P}^U(U^{\mathrm{mis}}, y_0, y_1)}{d\{\mathbb{W}_y^U \times \mathrm{Leb}(y)\}} = G(s, U, \theta, \sigma) f(y_1|y_0, \sigma).$$

The dominating measure still depends on σ as it contains $\mathbb{W}_y^U$ which reflects a Brownian bridge with conditioning event $U_{\sigma^2} = y_1$. We therefore introduce a second transformation which applies to both the path and the time scale of the diffusion process U. Consider a new time scale

$$u = \eta_2(s, \sigma) = \frac{s}{\sigma^2(\sigma^2 - s)} \quad \text{or} \quad s = \eta_2^{-1}(u, \sigma) = \frac{u\sigma^4}{1 + u\sigma^2}$$

and define a new diffusion Z through

$$U_s = (\sigma^2 - s) Z_{\eta_2(s,\sigma)} + \left(1 - \frac{s}{\sigma^2}\right) y_0 + \frac{s}{\sigma^2} y_1, \qquad 0 \le t < \sigma^2. \tag{3.5}$$

Note that this transformation is a bijection. In the case of $y_0 = y_1 = 0$ its inverse is given by

$$Z_u = \frac{1 + u\sigma^2}{\sigma^2} U_{\eta_2^{-1}(u,\sigma)}, \qquad 0 \le u < +\infty.$$

Applying Itô's formula and using time change properties we can also obtain the SDE of Z based on another driving Brownian motion W^Z operating at the time scale u:

$$dZ_u = \left\{\frac{\mu_x(t, \nu(Z_u, \sigma), \theta)}{1 + u\sigma^2} + \nu(Z_u, \sigma)\right\} dt + dW_u^Z, \qquad 0 \le u < +\infty, \tag{3.6}$$

where $\nu(Z_u, \sigma) = U_s$. This operation essentially transforms to a diffusion that runs from 0 to $+\infty$ preserving the unit volatility. A third attempt to write the likelihood, now based on Z, again uses the Girsanov theorem and the factorization of (3.2) to condition the dominating measure on y_1. This writes

$$\frac{d\mathbb{P}^Z(Z, y_0, y_1)}{d\{\mathbb{W}_y^Z \times \mathrm{Leb}(y)\}} = G(u, Z, \theta, \sigma) f(y_1|y_0, \sigma), \tag{3.7}$$

where $\mathbb{P}^Z$ denotes the law of Z and $\mathbb{W}_y^Z$ reflects the law of the driftless diffusion Z conditioned on y_1. The integrals in $G(Z,\theta,\sigma)$ run up to $+\infty$); however, the expression is finite being a bijection of the Radon–Nikodym derivative between $\mathbb{P}^U$ and $\mathbb{W}^U$ given by (3.4). Using the following lemma, we can prove that $\mathbb{W}_y^Z$ is the law of the standard Brownian motion and hence the likelihood is written with respect to a dominating measure that does not depend on any parameters.

LEMMA 3.1. *Let W be a standard Brownian motion in $[0,+\infty)$. Consider the process defined for $0 \le t \le T$*

$$B_t = (T-t)W_{t/\{T(T-t)\}} + \left(1-\frac{t}{T}\right)y_0 + \frac{t}{T}y_1, \qquad 0 \le t < T.$$

Then B is a Brownian bridge from y_0 at time 0 to y_1 at time T.

PROOF. See [31], Section IV.40.1, for the case $y_0 = 0$, $T = 1$. The extension for general y_0 and T is trivial. □

COROLLARY 3.1. *The process Z is standard Brownian motion under the dominating measure. In other words $\mathbb{W}_y^Z$ is standard Wiener measure.*

PROOF. Note that $\mathbb{W}_y^U$ reflects a Brownian bridge from y_0 at time 0 to y_1 at time T and we obtained $\mathbb{W}_y^Z$ by using the transformation of Lemma 3.1. Since this transformation is a bijection, U is a Brownian bridge (under the dominating measure) if and only if Z is standard Brownian motion. □

The likelihood, given by (3.7), allows the construction of an irreducible MCMC scheme that alternates between updating the parameters and the diffusion process Z. For the path updates we may use the fact that

$$\frac{d\mathbb{P}_y^Z}{d\mathbb{W}_y^Z}(Z|y_0,y_1) = G(t,Z,\theta,\sigma)\frac{f(y_1|y_0,\sigma)}{f^P(y_1|y_0,\theta,\sigma)} \propto G(t,Z,\theta,\sigma), \tag{3.8}$$

where $\mathbb{P}_y^Z$ is the law of Z conditioned on y_1 and $f^P(\cdot)$ is the density of y_1 under $\mathbb{P}^Z$. Both $\mathbb{P}_y^Z$ and $f^P(\cdot)$ are generally unknown but their calculation may be avoided in a MCMC algorithm which essentially only uses (3.7) and (3.8). Since these expressions only require the evaluation of $f(\cdot)$ and $G(\cdot)$, which are either known or may be approximated using the augmented diffusion path, the task of Bayesian inference is feasible. Details are presented in Section 4.

3.2. *Stochastic volatility models*. We will first demonstrate how the case of stochastic volatility models may be brought to a similar and equivalent form to that of the previous section. Consider the general class of stochastic volatility models with SDE given by (1.3) for $0 \le t \le t_1$. Without loss of generality, we may assume

a pair of observations ($X_0 = y_0$, $X_1 = y_1$) due to the Markov property of the two-dimensional diffusion (X, α). The likelihood can then be divided into two parts: the first contains the marginal likelihood of the diffusion α, and the remaining part corresponds to the diffusion X conditioned on the path of α

$$\mathbb{P}_\theta(X, \alpha) = \mathbb{P}_\theta(\alpha)\mathbb{P}_\theta(X|\alpha).$$

Denote the marginal likelihood for α by $\mathcal{L}_\alpha(\alpha, \theta)$. To overcome reducibility issues arising from the paths of α one may use the reparametrizations of [7] or [23]. The relevant transformations of the latter are

$$\beta_t = h_1(\alpha_t, \theta), \qquad \frac{\partial h_1(\alpha_t, \theta)}{\partial \alpha_t} = \{\sigma_\alpha(\alpha_t, \theta)\}^{-1},$$
$$\gamma_t = \beta_t - \beta_0, \qquad \beta_t = h_2(\gamma_t),$$

and the marginal likelihood for the transformed latent diffusion γ becomes

$$\mathcal{L}_\gamma(\gamma, \theta) = \frac{d\mathbb{P}}{d\mathbb{W}}(\gamma) = G_\gamma(t, \gamma, \theta), \tag{3.9}$$

where $\mathbb{W}$ denotes Wiener measure. By letting $\alpha_t = g_t^{\theta,\gamma} = h_1^{-1}(h_2(\gamma_t), \theta)$, the SDE of X conditional on γ becomes

$$dX_t = \mu_x(X_t, g_t^{\theta,\gamma}, \theta)\, dt + \sigma_x(g_t^{\theta,\gamma}, \theta)\, dB_t, \qquad 0 \le t \le 1.$$

Given the paths of the diffusion γ_t, the volatility function $\sigma_x(g_t^{\theta,\gamma}, \theta)$ may be viewed as a deterministic function of time and θ. The situation is similar to that of the previous section. We can now introduce a new time scale

$$s = \eta(t, \gamma, \theta) = \int_0^t \sigma_x^2(g_\omega^{\theta,\gamma}, \theta)\, d\omega.$$

Let T be the transformation of the ending time t_1, $T = \eta(t_1, \gamma, \theta)$. We can then define U on the new time scale s as in (3.3):

$$U_s = \begin{cases} X_{\eta^{-1}(s,\gamma,\theta)}, & 0 \le s \le T, \\ M_{\eta^{-1}(s,\gamma,\theta)}, & s > T. \end{cases} \tag{3.10}$$

The SDE for U now becomes

$$dU_s = \left\{ \frac{\mu_x(U_s, g^{\theta,\gamma}_{\eta^{-1}(s,\gamma,\theta)}, \theta)}{\sigma_x^2(g^{\theta,\gamma}_{\eta^{-1}(s,\gamma,\theta)}, \theta)} \right\} dt + dW_s^U, \qquad 0 \le s \le T.$$

We obtain the Radon–Nikodym derivative between the distribution of U with respect to that of the Brownian motion W^U,

$$\frac{d\mathbb{P}}{d\mathbb{W}^U} = G(s, U, \gamma, \theta)$$

and introduce $\mathbb{W}_y^U$ as before. The density of y_1 under $\mathbb{W}^U$, denoted by $f(y_1|y_0, \gamma, \theta)$, is just

$$f(y_1|y_0, \gamma, \theta) \equiv N(y_0, T).$$

The dominating measure $\mathbb{W}_y^U$ reflects a Brownian motion conditioned to equal y at a parameter depended time $T = \eta(t_1, \gamma, \theta)$. To remove this dependency we introduce another time scale,

$$u = \eta_2(s) = \frac{s}{T(T-s)} \quad \text{or} \quad s = \eta_2^{-1}(u) = \frac{uT^2}{1+uT},$$

which defines a second time change similar to (3.5)

$$U_t = (T-s)Z_{s/\{T(T-s)\}} + \left(1 - \frac{s}{T}\right)y_0 + \frac{s}{T}y_1, \qquad 0 \le s < T. \tag{3.11}$$

The SDE for Z, in the case of $y_0 = y_1 = 0$ is given by

$$dZ_u = \frac{T}{1+uT}\left\{\frac{\mu_x(u, \nu(Z_u), \gamma_{k(u,\gamma,\theta)}, \theta)}{\sigma_x^2(\gamma_{k(u,\gamma,\theta)}, \theta)} + \nu(Z_u)\right\}du + dW_u^Z,$$
$$0 \le u < \infty,$$

where $k(u, \gamma, \theta)$ denotes the initial time scale of X, t, and $\nu(Z_u) = U_s$.

Conditional on γ, the likelihood can be written in a similar manner as in (3.7)

$$\frac{d\mathbb{P}}{d\{\mathbb{W}_y^Z \times \mathrm{Leb}(y)\}}(Z|y_0, y_1, \gamma) = G(u, Z, \gamma, \theta) f(y_1|y_0, \gamma, \theta). \tag{3.12}$$

By using the exact same arguments of Section 3.1, we can show that $\mathbb{W}_y^Z$ reflects a standard Wiener measure and therefore the dominating measure is independent of parameters. To obtain the full likelihood we need to multiply the two parts given by (3.9) and (3.12).

3.3. *Incorporating leverage effect.* In the previous section we made the assumption that the increments of X and γ are independent, in other words we assumed no leverage effect. This assumption can be relaxed in the following way: in the presence of a leverage effect ρ, the SDE of X conditional on γ can be written as

$$dX_t = \mu_x(X_t, g_t^{\gamma,\theta}, \theta)\,dt + \rho\sigma_x(g_t^{\gamma,\theta}, \theta)\,dW_t$$
$$+ \sqrt{1-\rho^2}\sigma_x(g_t^{\gamma,\theta}, \theta)\,dB_t, \qquad 0 \le t \le t_1,$$

where W is the driving Brownian motion of γ. Note that given γ, W can be regarded as a function of γ and its parameters θ. Therefore, the term $\rho\sigma_x(g_t^{\gamma,\theta}, \theta)\,dW_t$ can be viewed as a deterministic function of time, and it can be treated as part of the drift of X_t. However, this operation introduces additional

problems as the assumptions ensuring a weakly unique solution to the SDE of X are violated. To avoid this issue we introduce the infinitesimal transformation

$$X_t = \mathcal{H}(H_t, \rho, \gamma, \theta) = H_t + \int_0^t \rho\sigma_x(g_\omega^{\gamma,\theta}, \theta)\, dW_\omega,$$

which leads us to the following SDE for H:

$$dH_t = \mu_x\{\mathcal{H}(X_t, \rho, \gamma, \theta), g_t^{\gamma,\theta}, \theta\}\, dt + \sqrt{1-\rho^2}\sigma_x(g_t^{\gamma,\theta}, \theta)\, dB_t, \qquad 0 \le t \le t_1.$$

We can now proceed as before, defining U and Z based on the SDE of H in a similar manner as in (3.10) and (3.11), respectively.

3.4. *State dependent volatility.* Consider the family of state dependent stochastic volatility models where conditional on γ, the SDE of X may be written as

$$dX_t = \mu_x(X_t, g_t^{\gamma,\theta}, \theta)\, dt + \sigma_1(g_t^{\gamma,\theta}, \theta)\sigma_2(X_t, \theta)\, dB_t, \qquad 0 \le t \le t_1.$$

This class contains, among others, the models of [3, 8, 11, 15]. In order to apply the time change transformations of Section 3.2, we should first transform X to $\dot{X}_t$, through $\dot{X}_t = l(X_t, \theta)$ so that it takes the form of (1.3). Such a transformation, which may be viewed as the first transformation in [30], should satisfy the following differential equation:

$$\frac{\partial l(X_t, \theta)}{\partial X_t} = \frac{1}{\sigma_2(X_t, \theta)}.$$

The time change transformations for U and Z may then be defined on the basis of $\dot{X}$ that will now have volatility $\sigma_1(g_t^{\gamma,\theta}, \theta)$. The transformation $l(\cdot)$ also applies to the observations $\dot{y}_0 = l(X_0, \theta)$ and $\dot{y}_1 = l(X_1, \theta)$ which may now be functions of the parameters in $\sigma_2(\cdot)$. These parameters enter the reparametrized likelihood in two ways: through the density $f(y_1|\gamma, \theta)$ which now should include the relevant Jacobian term, and through the function $\nu(Z_u)$ in the drift of Z which according to (3.11) would depend on the transformed endpoints.

3.5. *Multivariate stochastic volatility models.* We may use the techniques of Section 3.3 to define time change transformations for multidimensional diffusions. Consider a d-dimensional version of the SDE in (3.1) where σ now is a 2×2 matrix ($[\sigma]_{ij} = \sigma_{ij}$). As noted in [24], the mapping between σ and the volatility matrix $\sigma\sigma^T$ should be 1–1 in order to ensure identifiability of the σ parameters. A way to achieve this is by allowing σ to be the lower triangular matrix that produces the Cholesky decomposition of $\sigma\sigma^T$. For $d = 2$, the SDE of such a diffusion is given by

$$\begin{aligned} dX_t^{\{1\}} &= \mu\big(X_t^{\{1\}}, X_t^{\{2\}}, \theta\big)\, dt + \sigma_{11}\, dB_t, \\ dX_t^{\{2\}} &= \mu\big(X_t^{\{1\}}, X_t^{\{2\}}, \theta\big)\, dt + \sigma_{21}\, dB_t + \sigma_{22}\, dW_t. \end{aligned}$$

The time change transformations for $X^{\{1\}}$ will be exactly as in Section 3.1. For $X^{\{2\}}$ note that given $X^{\{1\}}$ the term $\sigma_{21}\,dB_t$ is now a deterministic function of time and may be treated as part of the drift. Thus, we may proceed following the route of the Section 3.3.

Similar transformations can be applied for diffusions that have, or may be transformed to have, volatility functions independent of their paths. For example, we may assume two correlated price processes with correlation ρ_x:

$$[\sigma]_{11} = \sigma_x^{\{1\}}(g_t^{\gamma,\theta}, \theta),$$
$$[\sigma]_{21} = \rho_x \sigma_x^{\{2\}}(g_t^{\gamma,\theta}, \theta),$$
$$[\sigma]_{22} = \sqrt{1-\rho_x^2}\,\sigma_x^{\{2\}}(g_t^{\gamma,\theta}, \theta).$$

We may proceed in a similar manner for multivariate stochastic volatility models of general dimension d.

4. MCMC implementation. The construction of an appropriate data augmentation algorithm involves several issues. We focus on describing how to update the latent diffusion paths and the parameters that drive the time change transformations. The updates of the remaining parameters include standard MCMC steps and are thus omitted. The change in the time scale introduces three interesting features: the presence of three time scales; the need to update diffusion paths that run from 0 to $+\infty$; and the fact that time scales depend on parameters. In this section we present the details of a MCMC scheme that addresses the above. For ease of illustration, we start with the simple case of a univariate diffusion with constant volatility

$$dX_t = \mu(t, X_t, \theta)\,dt + \sigma\,dB_t^X, \qquad 0 \le t \le 1, X_0 = y_0, X_1 = y_1,$$

and build up to the case of stochastic volatility models (1.3). Note that such extensions are not hard to implement since the time change transformations need only be applied to the paths of the observed diffusion process X. The updates of the transformed diffusion process γ, which drives the volatility, may be carried out using an overlapping scheme as in [23].

4.1. *Three time scales.* We introduce m intermediate points of X at equidistant times between 0 and 1, to give $X = \{X_{i/(m+1)}, i = 0, 1, \ldots, m+1\}$. In addition, we make the assumption that m is large enough for accurate likelihood approximations and any error induced by the time discretization is negligible for the purposes of our analysis. This assumption introduces no implications as the value of m may be set to an arbitrarily large value prior to the analysis.

Given a value of the time scale parameter σ, we can get the U-time points by applying (3.3) to each one of the existing points X so that

$$U_{\sigma^2 i/(m+1)} = X_{i/(m+1)}, \qquad i = 0, 1, \ldots, m+1.$$

Note that it is only the times that change, the values of the diffusion remain intact. In a stochastic volatility model we would use the quantities

$$\int_{i/(m+1)}^{(i+1)/(m+1)} \sigma_x^2(\cdot)\, ds$$

for each pair of consecutive imputed points.

The points of Z are multiplied by a time factor which corrects the deviations from unit volatility. The times of the diffusion Z may be obtained by

$$t_i^Z = \frac{\sigma^2 i/(m+1)}{\sigma^2(\sigma^2 - \sigma^2 i/(m+1))}, \qquad i = 0, 1, \ldots, m.$$

Clearly this does not apply to the last point which occurs at time $+\infty$. The paths of X or U are thus more convenient for likelihood evaluations as they only contain finite time points. They may be used instead exploiting the fact that the relevant transformations are bijections. However, the component of the relevant Gibbs sampling scheme should be the diffusion process Z.

4.2. *Updating the paths of Z.* The paths of Z may be updated using an independence sampler with the reference measure as a proposal. Here $\mathbb{W}_y^Z$ reflects a Brownian motion at the Z-time scale u which is fixed given the current values of the time-scale parameters and the paths of γ in the case of stochastic volatility models. An appropriate algorithm is given by the following steps:

- Step 1: Propose a Brownian motion on the Z-time, say Z^*. The value at the endpoint (time $+\infty$) is not needed.
- Step 2: Transform back to X^* using (3.5).
- Step 3: Accept with probability $\min\{1, \frac{G(X^*,\theta,\sigma)}{G(X,\theta,\sigma)}\}$.

4.3. *Updating time scale parameters.* The updates of parameters that define the time scale, such as σ, are of particular interest. In almost all cases, their conditional posterior density is not available in closed form, and Metropolis steps are inevitable. However, every proposed value of these parameters will imply a different Z-time scale u. In other words, for each potential proposed value for σ there exists a different set of Z-points needed for accurate approximations of the likelihood the Metropolis accept–reject probabilities. In theory, this would pose no issues had we been able to store an infinitely thin partition of Z, but of course this is not possible.

We use retrospective sampling ideas (see [27] and [5] for applications in different contexts). Under the assumption of a sufficiently fine partition of the time scale of Z, all the nonrecorded intermediate points contribute nothing to the likelihood and they are irrelevant in that respect. The set of recorded points is sufficient for likelihood approximation purposes. In other words, their distribution is given by the likelihood dominating measure $\mathbb{W}_y^Z$ which reflects a Brownian motion. Hence,

they can be drawn after the proposal of the candidate value of the time scale parameter. To ensure compatibility with the recorded partition of Z, it suffices to condition on their neighboring points. This is easily done using standard Brownian bridge properties. Suppose that we want to simulate the value of Z at time t_b which falls between the recorded values at times t_a and t_c, so that $t_a \le t_b \le t_c$. Denote by Z_{t_a} and Z_{t_c} the corresponding Z values. Under the assumption that Z is distributed according to $\mathbb{W}_y^Z$ between t_a and t_c we have that

$$Z_{t_b} | Z_{t_a}, Z_{t_c} \sim N\left\{ \frac{(t_b - t_a) Z_{t_c} + (t_c - t_b) Z_{t_a}}{t_c - t_a}, \frac{(t_b - t_a)(t_c - t_b)}{t_c - t_a} \right\}. \tag{4.1}$$

We describe the algorithm for the case of more than two observations; denote by $X_0 = y_0$, $X_{t_1} = y_1, \ldots, X_{t_n} = y_n$. The time change transformations should be applied to each pair of successive observations thus giving n separate Z diffusion processes. As mentioned earlier, the diffusion processes X and U are bijections of this collection of Z diffusion processes and may be used instead in a MCMC scheme. Our proposed algorithm for the σ-updates may be summarized through the following steps:

- Step 1: Propose a candidate value for σ, say σ^*.
- Step 2: Repeat for each pair of successive points:
  - Use (3.3) and (3.5) to get the new times associated with it.
  - Draw the values of Z retrospectively at the new times using (4.1).
  - Transform back to X^* (which corresponds to the time between the pair of successive points), using (3.5).
- Step 3: Form the entire path X^* by appropriately joining the bits between successive observations.
- Step 4: Accept with probability

$$\min\left\{ 1, \frac{G(t, X^*, \theta, \sigma^*) \prod_{i=1}^n f(y_i | y_{i-1}, \sigma^*)}{G(t, X, \theta, \sigma) \prod_{i=1}^n f(y_i | y_{i-1}, \sigma)} \right\}.$$

In a stochastic volatility model the updates of the paths of the transformed diffusion γ may be implemented using overlapping blocks. Note that these paths drive the time u, of the diffusion process Z, and therefore a similar algorithm as above should be embedded in their updates. For simplicity consider blocks of γ paths that correspond to times between nonsuccessive observations. Each block is then further split into sub-blocks containing intervals between successive observations, thus providing a number of separate Z diffusion processes. Details are presented below:

- Step 1: Propose γ^* between the times of two nonsuccessive observations, y_A and y_B, by a Brownian bridge connecting the relevant endpoints of γ.
- Step 2: Repeat for each pair of successive points between (and including) y_A and y_B:

  - Use (3.10) and (3.11) to get the new times associated with it.
  - Draw the values of Z retrospectively at the new times using (4.1).
  - Transform back to X^* (which corresponds to the time between the pair of successive points), using (3.11).
- Step 3: Join the bits of X^* to form its path between y_A and y_B.
- Step 4: Accept with probability,

$$\min\left\{1, \frac{G_\gamma(t,\gamma^*,\theta)G(t,X^*,\gamma^*,\theta)\prod_{i=1}^n f(y_i|y_{i-1},\gamma^*,\theta)}{G_\gamma(t,\gamma,\theta)G(t,X,\gamma,\theta)\prod_{i=1}^n f(y_i|y_{i-1},\gamma,\theta)}\right\}.$$

5. Simulations. As discussed in Section 2, appropriate reparametrizations are necessary to avoid issues regarding the mixing and convergence of the MCMC algorithm. In fact, the chain becomes reducible as the level of augmentation increases. This is also verified by the numerical examples performed in [23] even in very simple stochastic volatility models. In this section we present a simulation based experiment to check the immunity of MCMC schemes to increasing levels of augmentation, as well as the ability of our estimation procedure to retrieve the correct values of the diffusion parameters despite the fact that the series is partially observed and only at a finite number of points. We simulated data from the following stochastic volatility model:

$$\begin{aligned} dX_t &= \kappa_x(\mu_x - X_t)\,dt + \rho\exp(\alpha_t/2)\,dW_t + \sqrt{1-\rho^2}\exp(\alpha_t/2)\,dB_t,\\ d\alpha_t &= \kappa_\alpha(\mu_\alpha - \alpha_t)\,dt + \sigma\,dW_t, \end{aligned}$$

where B and W represent independent Brownian motions, and ρ reflects the correlation between the increments of X and α (also termed as leverage effect). A high-frequency Euler approximating scheme with a step of 0.001 was used for the simulation of the diffusion paths. Specifically, 500,001 points were drawn and one value of X for every 1000 was recorded, thus forming a dataset of 501 observations of X at $0 \le t \le 500$. The parameter values were set to $\rho = -0.5$, $\sigma = 0.4$, $\kappa_x = 0.2$, $\mu_x = 0.1$, $\kappa_\alpha = 0.3$ and $\mu_\alpha = -0.2$.

The transformations required to construct an irreducible data augmentation scheme are listed below. First α was transformed to γ through

$$\begin{aligned} \gamma_t &= \frac{\alpha_t - \alpha_0}{\sigma}, \qquad 0 \le t \le 500,\\ \alpha_t &= g_t^{\gamma,\sigma} = \alpha_0 + \sigma\gamma_t. \end{aligned}$$

Given γ, and for each pair of consecutive observation times t_{k-1} and t_k ($k = 1, 2, \ldots, 500$) on X, the following transformations were applied: first, we removed the term introduced from the leverage effect

$$H_t = X_t - \int_{t_{k-1}}^t \rho\exp\{g_t^{\gamma,\sigma}/2\}\,dW_s, \qquad t_{k-1} \le t \le t_k,$$

and consequently we set

$$\eta_1(t) = \int_{t_{k-1}}^{t} (1-\rho)^2 \exp\{\nu(\gamma_s, \sigma, \alpha_0)\}\, ds.$$

Then, U and Z may be defined again from (3.10) and (3.11), respectively, but based on H rather on X. The elements of the MCMC scheme are Z, γ, α_0 and the parameters $(\kappa_x, \mu_x, \kappa_\alpha, \mu_\alpha, \rho, \sigma)$.

Vague priors were assigned to all of the parameters, subject to positivity constraints for κ_x, κ_α, σ and for ρ to be in $(-1, 1)$. The chain was run several times for 50,000 iterations on different levels of augmentation by setting the number of imputed points to 2, 30, 40 and 50. As in [23], it was noted that a good choice of length of the overlapping blocks, needed for the updates of γ, may improve substantially the mixing of the chain. We used blocks with length corresponding to 8 observations. The acceptance rate rate for each block of γ was around 75% whereas the acceptance rate for each path of Z was around 95%. The time needed for such a MCMC run with $m = 40$ was roughly 4 hours in a mid-specification PC. We also noted a linear relationship between running times and m which confirms the fact that the computational complexity of the algorithm is $O(m)$ (see discussion for more). Figure 1 shows autocorrelation plots for all parameters. There is no sign of any increase in the autocorrelation to raise suspicions against the irreducibility of the chain. This confirms the fact that convergence time of the algorithm is independent of m. Figure 2 shows density plots for all parameters and on all of m. These plots may be used to monitor the deterioration of the discretization error. In this example, a choice of $m = 2$ may have been suboptimal whereas any value above 30 seems to perform well. Also, these plots reveal good agreement with the true values of the parameters which is also supported by Table 1.

6. Application: US treasury bill rates. To illustrate the time change methodology we fit a stochastic volatility model to US treasury bill rates. The dataset consists of 1809 weekly observations (Wednesday) of the 3-month US treasury bill rate from the 5th of January 1962 up to the 30th of August 1996. The data are plotted in Figure 3.

Previous analyses of these data include [3, 8, 9, 11, 15] and [16]. Apart from some slight deviations the adopted stochastic volatility models consisted of the following SDE:

$$\begin{aligned} dr_t &= (\theta_0 - \theta_1 r_t)\, dt + r_t^{\psi} \exp(\alpha_t/2)\, dB_t, \\ d\alpha_t &= \kappa(\mu - \alpha_t)\, dt + \sigma\, dW_t \end{aligned} \tag{6.1}$$

with independent Brownian motions B and W. In some cases the following equivalent model was used:

$$\begin{aligned} dr_t &= (\theta_0 - \theta_1 r_t)\, dt + \sigma_r r_t^{\psi} \exp(\alpha_t/2)\, dB_t, \\ d\alpha_t &= -\kappa\alpha_t\, dt + \sigma\, dW_t. \end{aligned} \tag{6.2}$$

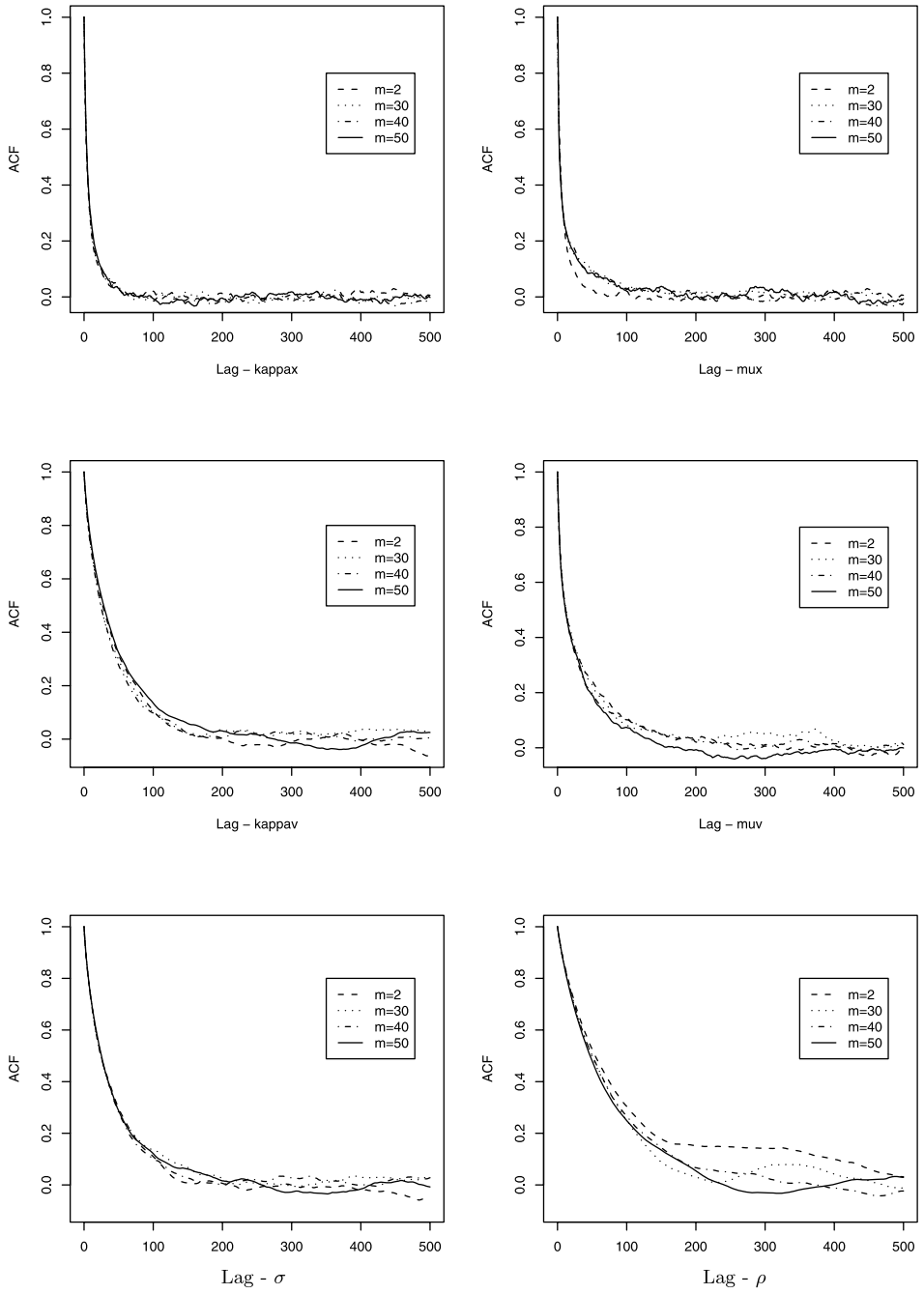

FIG. 1. *Autocorrelation plots of the parameter posterior draws for different numbers of imputed points* $m = 2, 30, 40, 50$. *Simulation example of Section 5.*

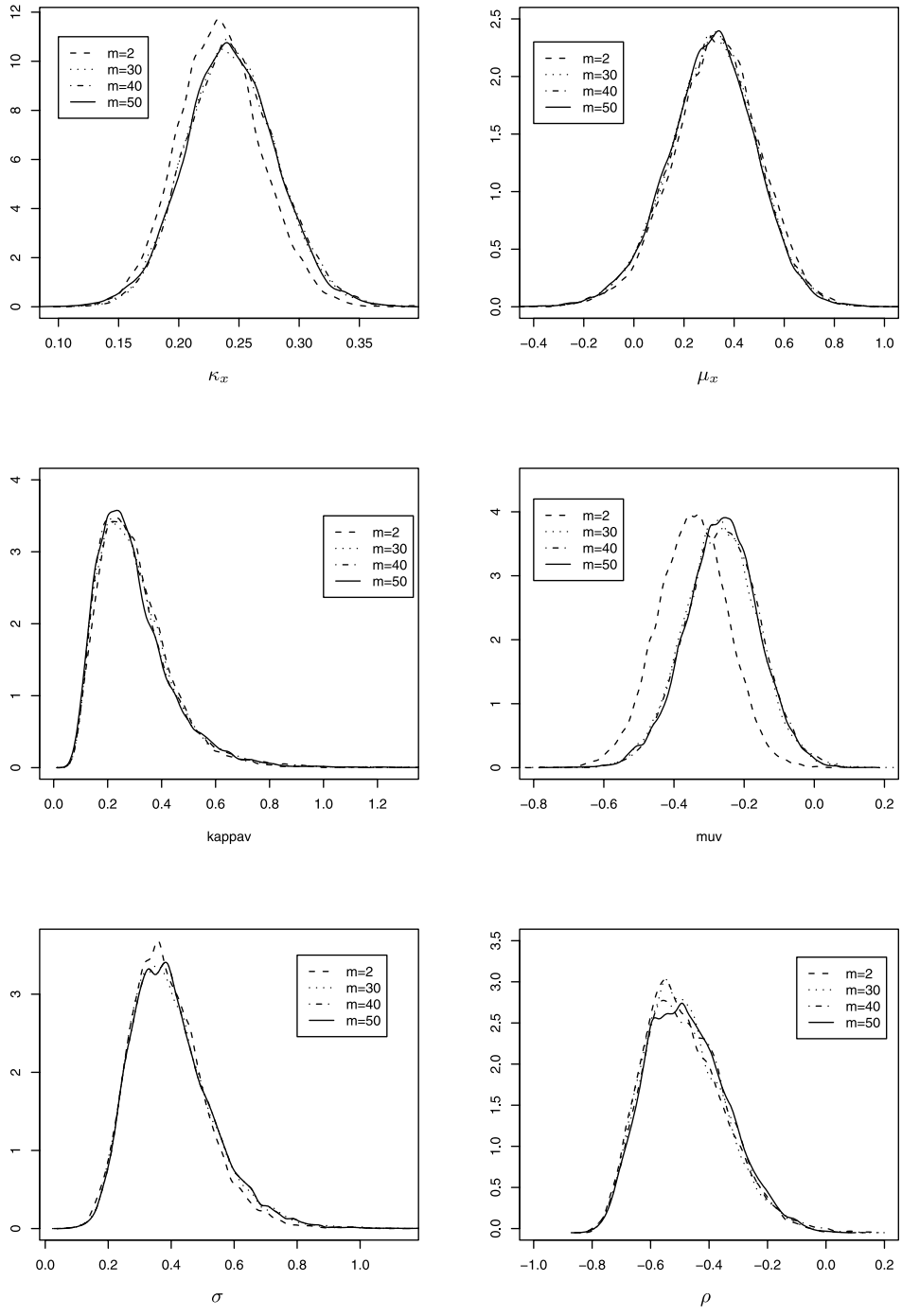

FIG. 2. *Kernel densities of the posterior draws of all the parameters for different numbers of imputed points* $m = 2, 30, 40, 50$. *Simulation example of Section* 5.

TABLE 1
Summaries of the posterior draws for the simulation example of Section 5 for $m = 50$

Parameter	True value	Post. mean	Post. SD	Post. 2.5%	Post. median	Post. 97.5%
κ_x	0.2	0.244	0.038	0.173	0.243	0.321
μ_x	0.1	0.313	0.174	−0.046	0.317	0.641
κ_α	0.3	0.304	0.148	0.110	0.277	0.672
μ_α	−0.2	−0.268	0.107	−0.484	−0.267	−0.059
σ	0.4	0.406	0.130	0.202	0.390	0.705
ρ	−0.5	0.477	0.138	−0.657	−0.491	−0.066

The model in (6.1) was chosen, as posterior draws of its parameters exhibit substantially less autocorrelation. In line with [15] and [16], we also set $\psi = 1$. References [8, 9] and [11] assume general "elasticity of variance" ψ but their estimates do not indicate a significant deviation from 1. By setting $X_t = \log(r_t)$, the volatility of X_t becomes $\exp(\alpha_t/2)$. Therefore the U-time for two consecutive observation times t_{k-1} and t_k is defined as

$$\eta_1(t) = \int_{t_{k-1}}^{t} \exp(\alpha_t)\, ds,$$

and U and Z are given by (3.10) and (3.11), respectively. We also transformed α to γ as in Section 5:

$$\gamma_t = \frac{\alpha_t - \alpha_0}{\sigma},$$
$$\alpha_t = g_t^{\gamma,\sigma} = \alpha_0 + \sigma\gamma_t.$$

We constructed appropriate MCMC schemes based on Z and γ to sample from the posterior of the parameters $\theta_0, \theta_1, \kappa, \mu$ and σ. The time was measured in years setting the distance between successive Wednesdays to $5/252$. Noninformative priors were assigned to all the parameters, restricting κ and σ to be positive to ensure identifiability and eliminate the possibility of explosion. The algorithm was run for 50,000 iterations and for m equal to 2, 10 and 20. To optimize the efficiency of the chain we set the length of the overlapping blocks of γ to 10 which produced an acceptance rate of 51.9%. The corresponding acceptance rate for Z was 98.6%.

The kernel density plots of the posterior parameters and likelihood (Figure 4) indicate that a discretization corresponding to an m of 10 or 20 provide reasonable approximations. A choice of $m = 2$ produces similar parameter posterior draws but the log-likelihood plot (bottom right) seems to be slightly off. The relevant autocorrelation plots of Figure 5 do not provide evidence of increasing autocorrelation in m. Finally, summaries of the posterior draws for all the parameters are provided in Table 2. The parameters κ, μ and σ are different from 0 verifying the existence of stochastic volatility. On the other hand, there is no evidence to support

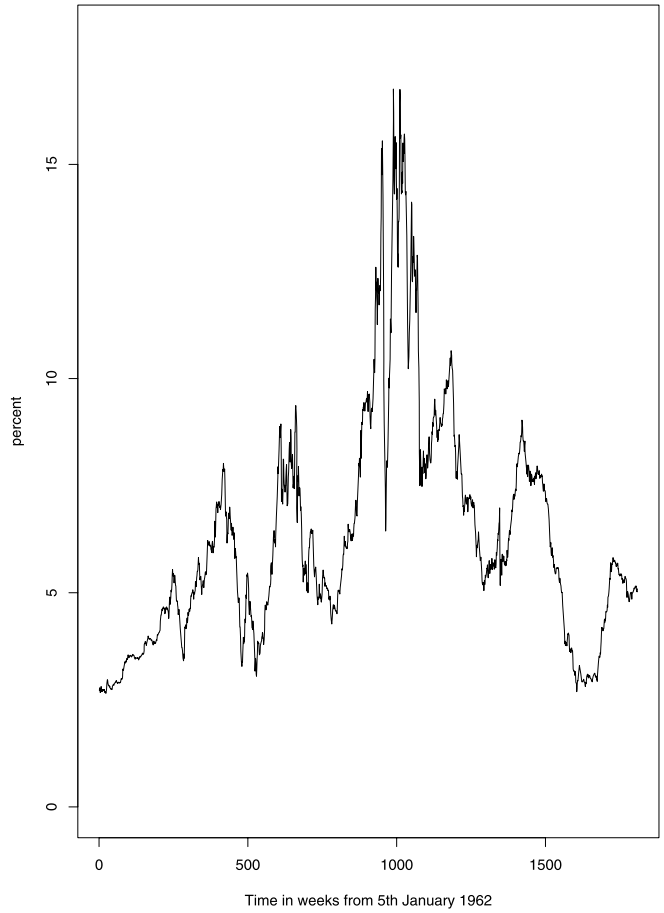

FIG. 3. *Weekly* 3*-month US treasury bill rate from the* 5*th of January* 1962 *up to the* 30*th of August* 1996.

the existence of mean reversion on the interest rate process as θ_0 and θ_1 are not far from 0. The results are in line with those of [8, 9] and [16].

7. Discussion. Data augmentation MCMC schemes constitute a very useful tool for likelihood-based inference on diffusion models. They may not have the appealing properties of complete elimination of the time discretization error [4], or the closed form approximate likelihood expressions of [1], but nevertheless they give a satisfactory and very general solution to the problem. However, data augmentation schemes require careful construction to avoid the degeneracy issues described at the beginning of this paper.

Here, we introduce an innovative transformation which operates by altering the time axis of the diffusion. To accommodate the special features of time change transformations, we also introduce a novel efficient MCMC scheme which mixes

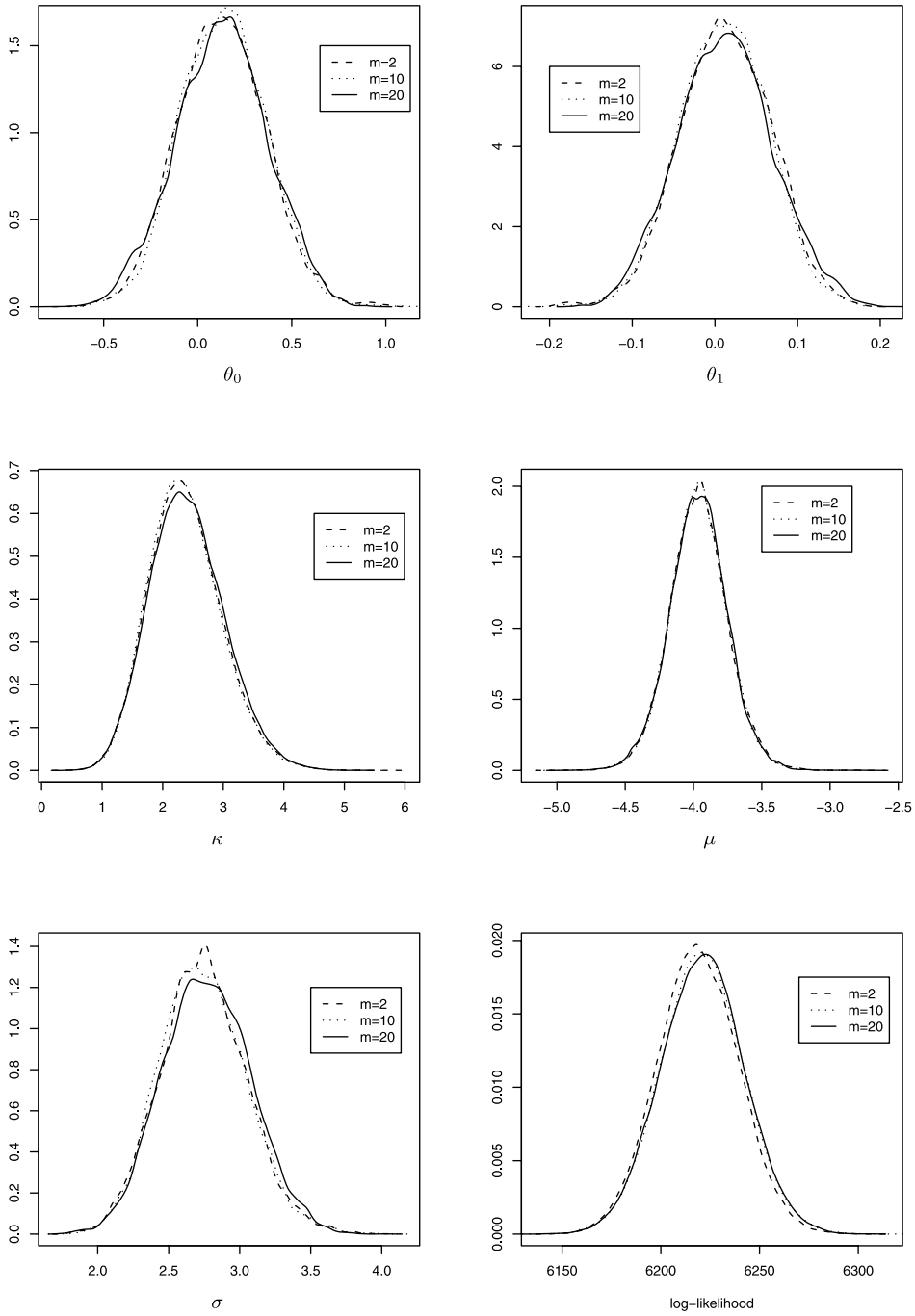

FIG. 4. *Kernel densities of the posterior draws of all the parameters and the log-likelihood for different values of imputed points* $m = 2, 10, 20$. *Example on weekly* 3*-month US treasury bill rates.*

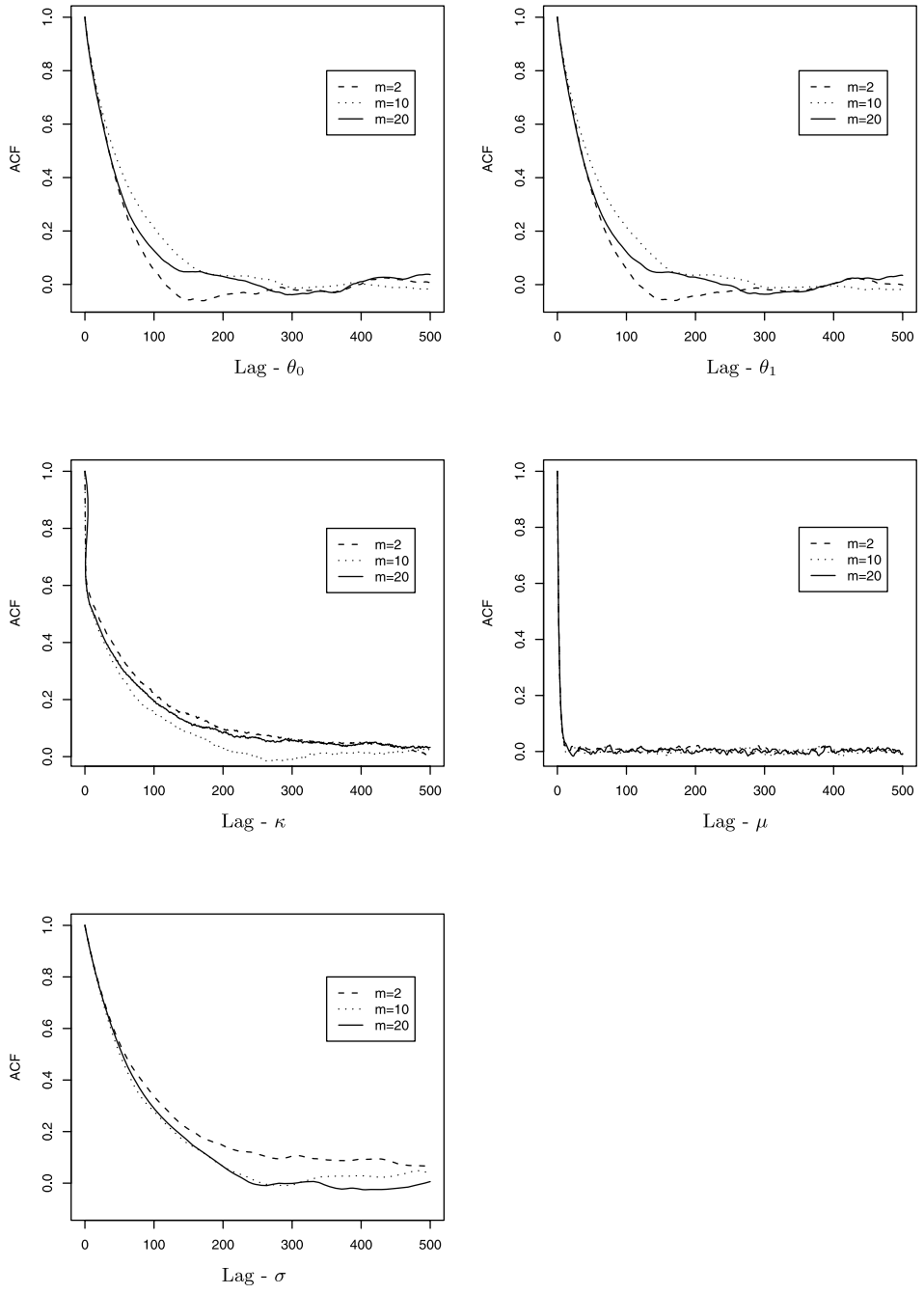

FIG. 5. *Autocorrelation plots for the posterior draws of the model parameters for different numbers of imputed points* $m = 2, 10, 20$ *for the analysis of weekly* 3*-month US treasury bill rates.*

TABLE 2
Summaries of the posterior draws for the stochastic volatility model of weekly 3-month US treasury bill rates

Parameter	Post. mean	Post. SD	Post. 2.5%	Post. median	Post. 97.5%
θ_0	0.130	0.238	−0.347	0.132	0.589
θ_1	0.013	0.057	−0.096	0.013	0.125
κ	2.403	0.620	1.319	2.360	3.745
μ	−3.966	0.211	−4.384	−3.964	−3.547
σ	2.764	0.311	2.199	2.750	3.420

rapidly and is not prohibitively computationally expensive. Our method is also easy to implement and introduces no additional approximation error other than that included in methodologies based on a discretization of the diffusion path. Moreover, it has a broad range of applications which include general stochastic volatility models.

One clear advantage of the time change methodology is that in its pure form produces algorithms whose mixing time is bounded as m goes to infinity, as in [30]. In addition, the computing cost per iteration of our methods is $O(m)$ as with other competing methods. Thus the overall computing cost of our approach is $O(m)$ which compares favourably with competing methods that are typically $O(m^2)$. In our experience mixing properties of the methods introduced in this paper are good in comparison with competing methods for these types of models and data. Furthermore we have found out that implementation can routinely be carried out in a few hours on a mid-specification PC.

Further work will consider problems with state-dependent volatility and models which involve jump diffusions, to which the methodology introduced here can be easily applied. Fundamental to our approach here has been the introduction of a noncentered parametrization to decouple dependence inherent in the model between missing data and volatility parameters. However, noncentered constructions are not unique, as illustrated by the choice in the diffusion context between the state rescaling approaches of [17, 30] and the time-stretching strategy adopted here. Clearly, further work is required to investigate the relative merits of these approaches in different situations.

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