ABSTRACT

Financial assets exhibit dramatic changes in behaviour. This work examined a two-regime Threshold autoregressive (TAR) models when the innovations follow a first-autoregressive order process. The Bayesian method is proposed to build in the linear first-order autoregressive process with identical distributed innovations. The practical usefulness of this method is demonstrated with simulated and real-life data using U.S.A quarterly real GDP as an example. In simulation experiments and real life example, an increase in first order process parameter, \( \rho \) value leads to better estimates in the proposed model. Also, the proposed model was compared with TAR model where the disturbance term does not exhibit regime switching. The proposed model performed well than the traditional TAR model using the simulated and real life data. An increase in first order process parameter, \( \rho \) will lead to better estimates and forecast. Hence, the proposed model performed well.

Keywords: Simulation, regime, GDP, simulation, real life data, Innovations.

1 Introduction

There are many macroeconomics variables that may vary over business cycle. Threshold autoregressive (TAR) models belong to such class of models that has different autoregressive representations in different regimes. Due to importance of TAR models to practitioners, numerous studies have been conducted, and several statistical inferences about the model have also been established. For instance, a linear approximation of the nonlinear TAR model was proposed by Giordano et al. (2022), called Linear- AIC to estimate the
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autoregressive order of the two regimes while Djeddour and Bou (2003) applied TAR model to forecast U.S. export from January, 1991 to December, 2004. They considered thresholds models that are special cases of procedure for non-linear models on average above TAR.

Different works on TAR model were also discussed in the context of Bayesian inference. Xia et al. 2012 considered Bayesian analysis of threshold autoregressive moving average model with exogenous inputs (TARMAX). Two different MCMC methods (Gibbs sampler and Metropolis algorithms) were used. One method was used to obtain iterative least squares estimates while the second method was used to estimate desired marginal posterior distributions. Safadi and Morettin (2000) also applied a Bayesian analysis to TAR moving average models in the case of two regimes while Ojo (2021) analyzed Nigerian inflation rate with Bayesian TAR model with special case where a variable trigger the first lag of dependent variable.

Bayesian analysis was carried out on a multivariate TAR model with missing data by Colderon et al. (2017) while a procedure for forecasting with multivariate TAR models was proposed by Calderon and Nieto (2021) through the predictive distribution using Bayesian approach. The strategy gave the forecasts for response and exogenous variables while the coverage percentages of the forecast intervals and variability of the predictive distributions were also considered.

Since the invention of TAR model by Tong (1983), different TAR models that exhibit different regime switching have been in existent. More importantly, attention has been drawn by researchers in knowing whether the error term of TAR model exhibits regime switching behaviour (see Chen (1988), Pan et al. (2017)). This invention started with the work of Chen (1988). Chen (1988) constructed a generalized framework for TAR model that made TAR model to be flexible in applications. In order to implement the proposed method, two series of quarterly macroeconomic variables (GNP and M1) were used.

A method of Bayesian stochastic search selection was introduced by Pan et al. (2017) to identify a threshold-dependent sequence with highest probability in a threshold autoregressive model. The innovation of the method was introduced to estimate the TAR model without assuming the fixed number of threshold values, thereby making it more flexible and useful. A hybrid Markov chain Monte Carlo method, which combines Metropolis-Hastings algorithm and Gibbs sampler were used to compute model parameters. Both simulation experiments and real data example demonstrated the usefulness of the proposed approach.

Bayesian analysis was carried out on multiple regimes of threshold autoregressive model with possible break points by Agiwal and Kumar (2020). Both Gibbs sampler and Metropolis–Hastings algorithm were applied to compute the estimates of parameter while both real data and simulated was tested for empirical evidence. Prediction of future values with the use of autoregressive process in disturbance term is of great importance to time series econometricians and practitioners. Apart from predicting the future values of series,

IASSL ISSN-2424-6271 109
autoregressive models helps under certain market conditions, such as when we have financial crises or periods of rapid technological changes.

In this paper, we offer a Bayesian inference and estimator technique on threshold models that switches on the error term with autoregressive model. We will also highlight the strength and weaknesses of the procedure. The remainder of the paper is structured as follows. Section 2 gives the methodology which comprises the threshold model that incorporates the first order autoregressive, Bayesian method of estimation and numerical examples that involve both the Monte Carlo simulation and real life situations. Section 3 presents and discusses the results while Section 4 concludes.

2 Methodology

2.1 The Threshold autoregressive model

Consider a two-regime TAR model with a time series variable given as:

\[ y_t = \alpha_{10} + \alpha_{11}y_{t-1} + \cdots + \alpha_{1m}y_{t-m} + u_t. \quad \text{if} \ Z_{t-d} \leq \lambda \]  \hspace{1cm} (1)

\[ y_t = \alpha_{20} + \alpha_{21}y_{t-1} + \cdots + \alpha_{2m}y_{t-m} + u_t. \quad \text{if} \ Z_{t-d} \leq \lambda \]  \hspace{1cm} (2)

where \( u_t \sim N(0, h^{-1}) \) and \( \alpha_j = (\alpha_{j0}, \alpha_{j1}, \ldots, \alpha_{jm})' \)

Also, \( d \) is the delay parameter, \( Z_{t-d} \) is functions of the lags. The order of autoregressive for (1) and (2) is \( P=4 \).

Thus, threshold trigger can be simply be defined as:

\[ Z_{t-d} = \frac{\sum_{d=1}^{P} y_{t-d}}{d} \]  \hspace{1cm} (3)

If the error term follows a first autoregression, equation (1) and (2) become:

\[ y_t = \alpha_{10} + \alpha_{11}y_{t-1} + \cdots + \alpha_{1m}y_{t-m} + \rho u_{t-1} + \epsilon. \quad \text{if} \ Z_{t-d} \leq \lambda \]  \hspace{1cm} (4)

\[ y_t = \alpha_{20} + \alpha_{21}y_{t-1} + \cdots + \alpha_{2m}y_{t-m} + \rho u_{t-1} + \epsilon. \quad \text{if} \ Z_{t-d} \leq \lambda \]  \hspace{1cm} (5)

Assume \( d \) is an unknown parameter where \( \epsilon_t \sim N(0, h^{-1}\Omega) \), and

\[ \Omega = \frac{1}{1 - \rho^2} \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix} \]

The model in (4) and (5) is flexible to accommodate some interesting practical importance as follows:
1. It will predict future security prices.

2. It will become a non-homogenous regression model, if the variance is different for each of the regimes.

3. It will be in form of regime model.

The main reason for transforming the model by including of first autoregressive series is because there is interest in the volatility of macroeconomic variables in recent time(s) and, in particular, the disturbance term does exhibits regime-switching behaviour.

2.2 Bayesian Inference

In this section, Bayesian estimation procedure will be carried out. We will derive the Posterior distribution when the TAR model has switches in disturbance term with first order autoregression while derivation for model in (1) and (2) have been shown in the works of Koop and Potter (2003), Koop et al. (2005), and Ojo (2021).

The regimes in (4) and (5) can simply be written as:

\[ y_j = x_j\alpha_j + \epsilon_j \]  \hspace{1cm} (6)

where \( y_j \) denotes the data in the jth regime for \( j = 1, 2 \). The matrix \( x_j \) contains an intercept and lags of the dependent variable for observations in the jth regime, and \( \epsilon_j \) are errors, for \( j =1,2 \). The derivation of posterior distribution for model in (6) will follow the same manner of posterior distribution for normal linear regression model obtained by Adepoju and Ojo (2018).

The likelihood function of (6) is given as:

\[ L(\alpha_j, h) = \frac{h_j^{\frac{N}{2}}}{(2\pi)^{\frac{N}{2}}} \exp\left( -\frac{h}{2} (y_j - x_j\alpha_j)'(y_j - x_j\alpha_j) \right) \]  \hspace{1cm} (7)

Here, a suitable prior would be considered for Bayesian inference. However, it is worthwhile to briefly discuss the prior elicitation in TAR model, since this has received great attention in literature. Prior elicitation transforms domain knowledge of various kinds into well-defined prior distributions Mikkola, et al. 2023. In this work, we will focus on a familiar prior known as conjugate prior by translating existing knowledge into action.

The familiar natural conjugate prior, Normal-Gamma prior (Koop and Potter 2003, Koop et al. 2005) and non-informative prior will be extended. Assuming that parameter \( d \) is unknown with non-informative prior over \( 1, \ldots, m \), that is, \( P(m=i) = \frac{1}{m} \). The non-informative of this will be achieved by setting the hyperparameters to zero.
Also, assume a Normal Gamma prior is used for each of the regime we have;

\[ P(\alpha_j, h_j) \sim NG(\alpha_j^o, Q_j^o, \frac{1}{S_j^o}, v_j^o) \quad j = 1, 2. \] (8)

Using Bayes theorem, the density of the conjugate prior will be:

\[
P(\alpha_j, h_j) = P(\alpha_j|h_j)P(h_j) = \frac{\left(\frac{v_j^o}{2}\right)^{\frac{v_j^o+k}{2}}}{\frac{k^\frac{k}{2}}{2\pi^\frac{k}{2}}|Q_j^o|^{\frac{k}{2}}\Gamma\left(\frac{v_j^o}{2}\right)} \times \exp\left(-\frac{h_j}{2}(\alpha_j - \alpha_j^o)'(Q_j^o)^{-1}(\alpha_j - \alpha_j^o) + \frac{v_j^o}{S_j^o - 2}\right) \tag{9}
\]

where

\[
P(\alpha_j|h_j) = \frac{h_j^k}{2\pi^\frac{k}{2}|Q_j^o|^{\frac{k}{2}}\Gamma\left(\frac{v_j^o}{2}\right)} \exp\left(-\frac{h_j}{2}(\alpha_j - \alpha_j^o)'(Q_j^o)^{-1}(\alpha_j - \alpha_j^o)\right)
\]

and

\[
P(h_j) = \frac{1}{\Gamma\left(\frac{v_j^o}{2}\right)(\frac{2S_j^o}{v_j^o})}h_j^{\frac{v_j^o}{2} - 1}\exp\left(-\frac{hv_j}{2S_j^o}\right)
\]

Equation (9) is simply the distribution of prior known as multivariate Normal-Gamma prior. Posterior distribution summarises one’s updated knowledge in Bayesian inference by balancing prior knowledge with observed data. Since the prior is a natural conjugate prior, posterior distribution will also have the same functional form as the prior. The prior used has the advantage that analytical results are available so that posterior simulator is not required. Posterior distribution can be obtained from the relation given below:

\[ P(\alpha_j, h_j|\lambda, m_j) \propto L(\alpha_j, h_j)P(\alpha_j, h_j) \] (10)

Combining equation (7) with (8), we have the posterior distribution given as:
Bayesian Analysis of Threshold Autoregressive Model

\[
\begin{align*}
&= \frac{h_j^N}{(2\pi)^{N/2}} \exp \left( -\frac{h_j}{2} (y_j - x_j \alpha_j)' (y_j - x_j \alpha_j) \right) \\
&\times \frac{h_j^{v_0 + k - 1}}{2\pi^{k/2} |Q_j^o|^{1/2}} \Gamma \left( \frac{v_0}{2} \right) \left( \frac{2S_0^o}{v_0} \right)^{v_0/2} \\
&\times \exp \left( -\frac{h_j}{2} (\alpha_j - \alpha_j^o)' (Q_j^o)^{-1} (\alpha_j - \alpha_j^o) + \frac{v_0^o}{S_0^o - 2} \right)
\end{align*}
\]

(11)

Ignoring the terms that do not depend on \( \alpha_j \) and \( h_j \), we have the same functional form as the prior distribution. Hence, the posterior distribution is:

\[
P(\alpha_j, h_j | \lambda, m_j) \sim NG(\alpha_j^*, Q_j^*, \frac{1}{S_j^*}, v_j^*) \quad j = 1, 2.
\]

(12)

where

\[
Q_j^* = \frac{1}{(x_j' x_j)}
\]

\[
\alpha_j^* = Q_j^* (\frac{1}{Q_j^o} \alpha_j^o + x_j' x_j \hat{\alpha}_j)
\]

\[
v_j^* = T_j + v_0^o \quad (T_j \text{ is member of observation})
\]

\[
S_j^* = \frac{v_0^o S_j^o + SSE + (\hat{\alpha}_j - \alpha_j^o) x_j' x_j Q_j^* \frac{1}{v_0^o} (\hat{\alpha}_j - \alpha_j^o)}{v_0^o}
\]

SSE is the sum of squared error and \( \hat{\alpha}_j \) is the ordinary least squares estimator (see Adepoju and Ojo (2018) for more details)

The hyperparameters are set to be:

\( \alpha_j^o = 0, k = 0.05, (S_j^o)^2 = 1, v_0^o = 2, Q_j^o = kI_o, \) where \( I_o \) is an identity matrix. First autoregressive parameter, \( 0 < \rho < 1; \) \( \rho \) are set to be: 0.2, 0.5, and 0.9.

2.3 Numerical analysis

To implement the proposed model, the empirical evidence using both simulated and real-life data will be illustrated for the performance of the proposed model. We will compare the properties of our Bayesian model estimation procedures for the proposed model with TAR model where the disturbance term does not exhibit regime switching.
2.3.1 Simulation study

We consider a data generating procedure used by Chen and Lee (1995) in this simulation study. It follows as:

\[ y_t = 0.45 + 0.05y_{t-1} + 0.2y_{t-2} + 0.18y_{t-3} + 0.15y_{t-4} + \rho u_{t-1} + \epsilon. \quad \text{if } Z_{t-d} \leq \lambda \]  

\[ y_t = 0.8 + 0.65y_{t-1} - 0.5y_{t-2} - 0.3y_{t-3} + 0.09y_{t-4} + \rho u_{t-1} + \epsilon. \quad \text{if } Z_{t-d} \leq \lambda \]  

In this simulation we set the number of observations to be \( n = 200 \). The time series data were generated from multivariate Gaussian distribution with means and specified variance-covariance. The coefficient vector was set to be in equation (8) while the innovations, were also simulated from Gaussian distribution. This will enable the simulated data set to be used in the proposed model.

2.3.2 Real data analysis

To illustrate the usefulness of this proposed model, we provide a real-life data example to illustrate the proposed model in application. We consider quarterly real GDP data of U.S.A. The data contains 244 values of real GDP between first quarter of year 1960 and last quarter of year 2021. We use the same prior settings as used in the simulation section.

3 Results and Discussion

In this Section, results of both simulated and real-life data will be presented when there is regime switching in error term of TAR model by first autoregressive process. Table 1 shows the simulation results obtained by using the process illustrated in Sub-section 4.1. The mean and standard deviation for the first and second regimes were recorded for all the parameters of the model given in (8). All the mean estimates are close to the true parameter values for the first and second regimes across all the rho values considered. However, when \( \rho = 0.9 \), the mean estimates for the regimes (first and second) are closer to the true parameter values than the other \( p \) values.

Also, the standard deviation for all parameters of the first regimes when \( \rho = 0.9 \) are smaller than when \( \rho = 0.5 \) and \( \rho = 0.2 \), except for the intercept and parameters. On the contrary, as the \( p \) decreases, Standard deviations for all parameters for the second regimes decreases as \( p \) decreases.
Table 2 presents posterior results for parameter estimates for each regime. As the $\rho$ increases, the mean of the first and second regimes also increases for all the parameters of the model. However, the standard deviation decreases as the $\rho$ value increases for all the regimes of the model. In Tables 3 and 4, posterior mean and standard deviation of TAR model without the first autoregressive process in the disturbance term are presented for simulated and real life, respectively. Comparing with Tables 3 and 4 (TAR model without the first autoregressive process) with Tables 1 and 2 (TAR model with the first autoregressive process) shows that results of TAR model when the disturbance term follows a first autoregressive process are better than TAR model that the disturbance term does not follows a first autoregressive process. Figures 1 and 2 show the plots of posterior for delay parameter, $d$. Since different values of $d$ imply different threshold triggers, which makes the interpretation of the threshold to differs across $d$. Hence, the posterior for $d$ allocates most of the probability to $d = 1$, and $d = 3$, for simulated and real life data, respectively.
Table 1: Posterior results using simulated data for TAR model with switches in error term having first autoregressive.

<table>
<thead>
<tr>
<th>Rho</th>
<th>FRP(^a)</th>
<th>Mean</th>
<th>SD</th>
<th>SRP(^b)</th>
<th>Mean</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{10}=0.45)</td>
<td>0.5360</td>
<td>0.2861</td>
<td>(\alpha_{20}=0.8)</td>
<td>0.2581</td>
<td>0.2993</td>
</tr>
<tr>
<td>(\rho = 0.5)</td>
<td>(\alpha_{10}=0.45)</td>
<td>0.5822</td>
<td>0.2737</td>
<td>(\alpha_{20}=0.8)</td>
<td>0.6138</td>
<td>0.4338</td>
</tr>
<tr>
<td>(\rho = 0.9)</td>
<td>(\alpha_{10}=0.45)</td>
<td>0.4230</td>
<td>0.4015</td>
<td>(\alpha_{20}=0.8)</td>
<td>0.7899</td>
<td>0.5197</td>
</tr>
<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{11}=-0.05)</td>
<td>-0.2300</td>
<td>0.2542</td>
<td>(\alpha_{21}=-0.65)</td>
<td>-0.8745</td>
<td>0.1481</td>
</tr>
<tr>
<td>(\rho = 0.5)</td>
<td>(\alpha_{11}=-0.05)</td>
<td>-0.1349</td>
<td>0.2798</td>
<td>(\alpha_{21}=-0.65)</td>
<td>-0.7855</td>
<td>0.1566</td>
</tr>
<tr>
<td>(\rho = 0.9)</td>
<td>(\alpha_{11}=-0.05)</td>
<td>-0.0554</td>
<td>0.2596</td>
<td>(\alpha_{21}=-0.65)</td>
<td>-0.6675</td>
<td>0.1640</td>
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<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{12}=0.2)</td>
<td>0.0119</td>
<td>0.2865</td>
<td>(\alpha_{22}=-0.5)</td>
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<td>(\rho = 0.5)</td>
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<td>0.1837</td>
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<td>(\rho = 0.9)</td>
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<td>0.1978</td>
<td>0.2656</td>
<td>(\alpha_{22}=-0.5)</td>
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<td>0.1862</td>
</tr>
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<td>(\rho = 0.2)</td>
<td>(\alpha_{13}=0.18)</td>
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<td>0.2649</td>
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<td>0.1744</td>
</tr>
<tr>
<td>(\rho = 0.5)</td>
<td>(\alpha_{13}=0.18)</td>
<td>0.1112</td>
<td>0.2679</td>
<td>(\alpha_{23}=-0.3)</td>
<td>-0.4040</td>
<td>0.1890</td>
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<tr>
<td>(\rho = 0.9)</td>
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<td>0.1786</td>
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<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{14}=0.15)</td>
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<td>0.1807</td>
<td>0.1976</td>
<td>(\alpha_{24}=0.09)</td>
<td>0.0819</td>
<td>0.2659</td>
</tr>
</tbody>
</table>

\(^a\)FRP - First Regime Parameter
\(^b\)SRP - Second Regime Parameter
Bayesian Analysis of Threshold Autoregressive Model

Table 2: Posterior results using real life data for TAR model with switches in error term having first autoregressive.

<table>
<thead>
<tr>
<th>Rho</th>
<th>FRP(^a)</th>
<th>Mean</th>
<th>SD</th>
<th>SRP(^b)</th>
<th>Mean</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{10})</td>
<td>0.3921</td>
<td>0.1675</td>
<td>(\alpha_{20})</td>
<td>-0.0881</td>
<td>0.1396</td>
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<tr>
<td>(\rho = 0.5)</td>
<td>(\alpha_{10})</td>
<td>0.4389</td>
<td>0.2090</td>
<td>(\alpha_{20})</td>
<td>-0.0434</td>
<td>0.2021</td>
</tr>
<tr>
<td>(\rho = 0.9)</td>
<td>(\alpha_{10})</td>
<td>0.3405</td>
<td>0.2877</td>
<td>(\alpha_{20})</td>
<td>0.0263</td>
<td>0.2388</td>
</tr>
<tr>
<td>(\rho = 0.2)</td>
<td>(\alpha_{11})</td>
<td>-0.2364</td>
<td>0.2132</td>
<td>(\alpha_{21})</td>
<td>-0.2701</td>
<td>0.1458</td>
</tr>
<tr>
<td>(\rho = 0.5)</td>
<td>(\alpha_{11})</td>
<td>-0.1525</td>
<td>0.2094</td>
<td>(\alpha_{21})</td>
<td>-0.2577</td>
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<td>(\rho = 0.9)</td>
<td>(\alpha_{11})</td>
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<td>(\alpha_{12})</td>
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<td>(\alpha_{13})</td>
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<td>0.2384</td>
<td>(\alpha_{23})</td>
<td>0.0166</td>
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<td>(\rho = 0.5)</td>
<td>(\alpha_{13})</td>
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<td>0.2308</td>
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<td>0.1152</td>
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<tr>
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<td>0.2024</td>
<td>(\alpha_{24})</td>
<td>-0.0430</td>
<td>0.1043</td>
</tr>
</tbody>
</table>

\(^a\)FRP - First Regime Parameter
\(^b\)SRP - Second Regime Parameter

Table 3: Posterior results using simulated data for TAR model without switches in error term having first autoregressive.

<table>
<thead>
<tr>
<th>First Regime Parameter</th>
<th>Mean</th>
<th>SD</th>
<th>Second Regime Parameter</th>
<th>Mean</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\alpha_{10})</td>
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<td>0.4271</td>
<td>(\alpha_{20})</td>
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<td>0.3111</td>
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<td>(\alpha_{10})</td>
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<tr>
<td>(\alpha_{10})</td>
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</tr>
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<td>0.3505</td>
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<td>0.2703</td>
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<td>(\alpha_{14})</td>
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<td>0.3453</td>
<td>(\alpha_{24})</td>
<td>-0.1181</td>
<td>0.2896</td>
</tr>
</tbody>
</table>

Table 4: Posterior results using real life data for TAR model without switches in error term having first autoregressive.

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<th>First Regime Parameter</th>
<th>Mean</th>
<th>SD</th>
<th>Second Regime Parameter</th>
<th>Mean</th>
<th>SD</th>
</tr>
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<td>0.1314</td>
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<td>(\alpha_{14})</td>
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<td>0.2411</td>
<td>(\alpha_{24})</td>
<td>-0.0495</td>
<td>0.1063</td>
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</table>
Figure 1: Posterior of delay parameter for simulated data

Figure 2: Posterior of delay parameter for real life data
4 Conclusion

Threshold autoregressive model has become attractive to practitioners. Apart from its flexibility in applications, new innovations in regime switching have been developed recently. In this work, we considered a threshold autoregressive when the disturbance terms has a regime switching with the first autoregressive process. The novel Bayesian method was used to evaluate this model. The posterior inference was carried out via Bayesian procedures using both simulated and real life data.

The results obtained from the simulation show that as the $\rho$ increases, the values of $P$ will lead to a better model. This was also supported by the results obtained using real life-data. However, when the threshold autoregressive model with regime switching in disturbance terms with the first autoregressive process was compared with the threshold autoregressive model without regime switching in disturbance term; the results of the former were better than the latter, which implies that the proposed model will make a better forecast. Therefore, practitioners are advised to take advantage of the model.

Conflict of interest

There is no conflict of interest.

Funding statement

There is no funding.

Code availability

The code used can be obtained from the corresponding author.

References


