Dynamic Panel Data Models

When the Past Predicts the Present

Jake Anderson

March 3, 2026

Outline

1. The Problem: Persistence in Panel Data
2. The FE Attempt and Nickell Bias
3. Arellano-Bond GMM
4. Decision Framework
5. Summary

GDP Growth Across 50 Countries

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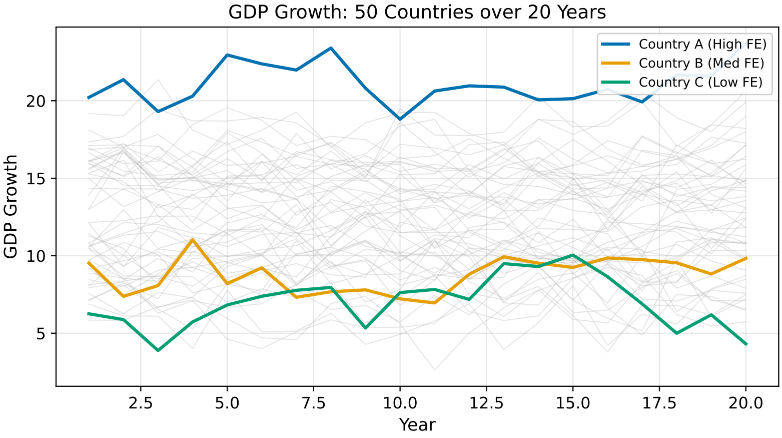

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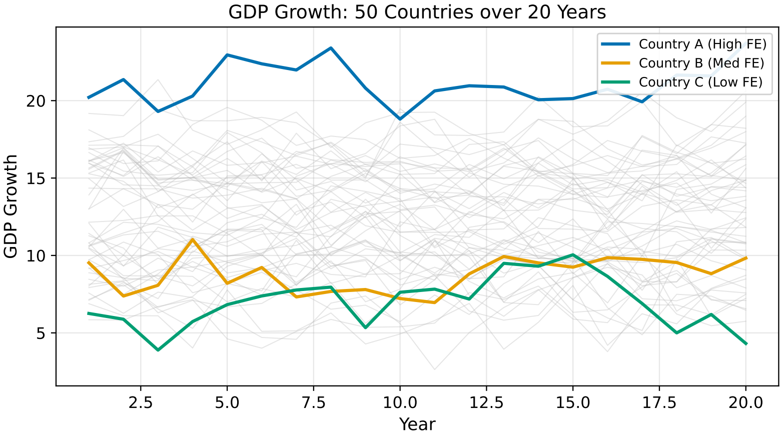

Some countries consistently grow faster than others. And growth seems **sticky**: a good year tends to follow a good year.

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$\Longrightarrow$ We need a model that includes **both** fixed effects and a lagged dependent variable.

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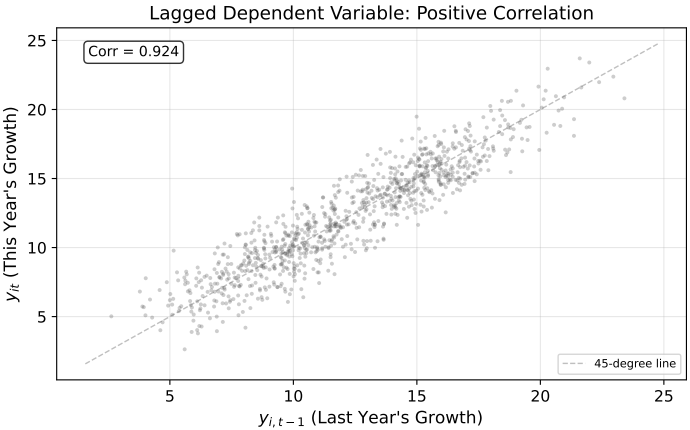
Goal: estimate ρ consistently. True value in our simulation: $\rho = 0.40$.

The Lagged Relationship



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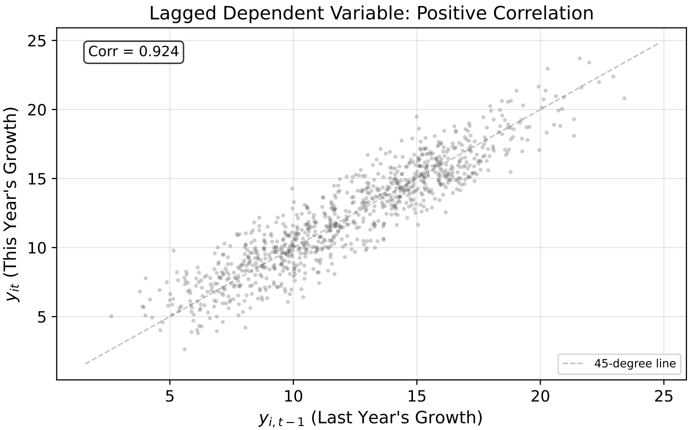
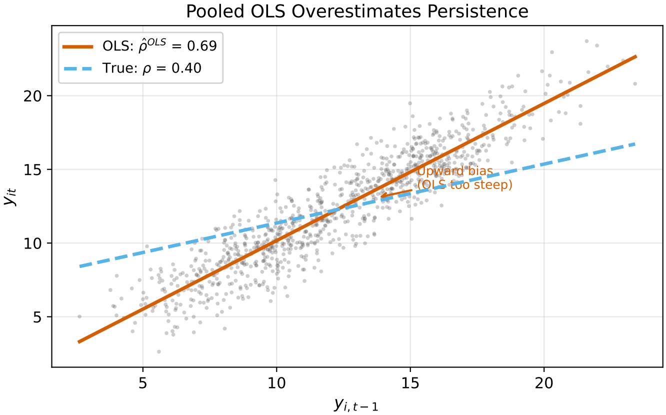


Strong positive correlation between y_{it} and $y_{i,t-1}$. But how much is true persistence, and how much is driven by the unobserved α_i?

Naive OLS: Just Regress y_{it} on $y_{i,t-1}$



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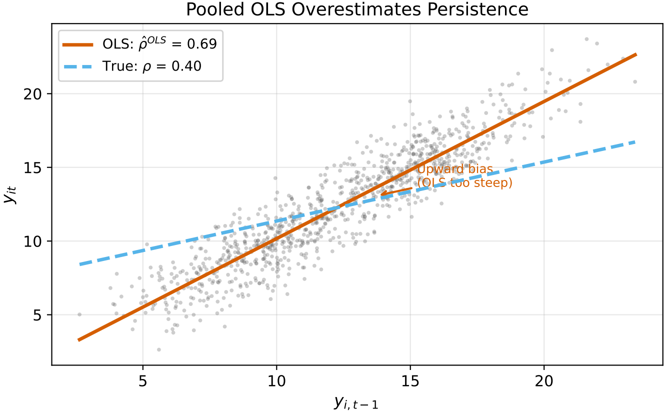

OLS estimates $\hat{\rho}^{OLS} \approx 0.69$. The true ρ is 0.40. Why the overestimate?

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Formally, $y_{i,t-1}$ depends on α_i (since $y_{i,t-1} = \rho\, y_{i,t-2} + \beta\, \text{invest}_{i,t-1} + \alpha_i + \varepsilon_{i,t-1}$), so:

$$\text{bias} = \frac{\text{Cov}(y_{i,t-1}, \alpha_i)}{\text{Var}(y_{i,t-1})} > 0$$

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$\Longrightarrow$ OLS **overestimates** ρ because it confuses level differences with persistence.

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Fixed Effects: The Natural Fix?

FE removes α_i by demeaning. The within-transformed model:

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Not quite. There is a subtle problem with demeaning when you have a lagged dependent variable.

Nickell Bias: Demeaning Creates New Correlation

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Concrete example. Suppose $\varepsilon_{i,5}$ is a large positive shock.

- $\bar{y}_i$ includes $y_{i,5}$, which is inflated by $\varepsilon_{i,5} \implies \bar{y}_i$ goes **up**.
- Look at year 4: $\ddot{y}_{i,4} = y_{i,4} - \bar{y}_i$ goes **down** (the mean was inflated by the year-5 shock, but $y_{i,4}$ was not).
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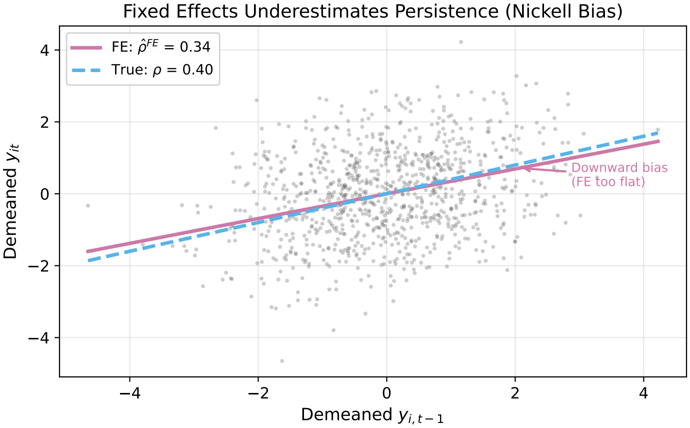
This is the **Nickell bias** (Nickell, 1981). It arises purely from the mechanical relationship between demeaning and the lagged dependent variable.

FE Estimate: Biased Downward



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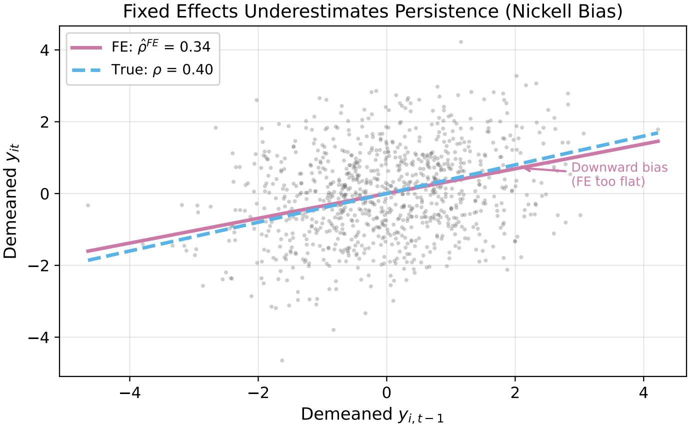
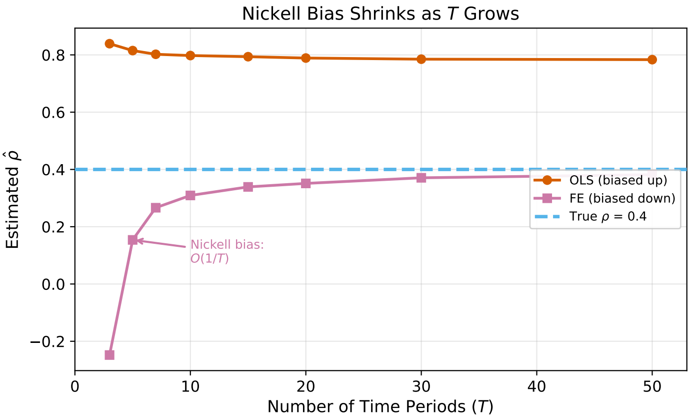


FE estimates $\hat{\rho}^{FE} \approx 0.34$, well below the true $\rho = 0.40$. FE overcorrects: it removes α_i but introduces a new bias in the opposite direction.

Nickell Bias Shrinks as T Grows



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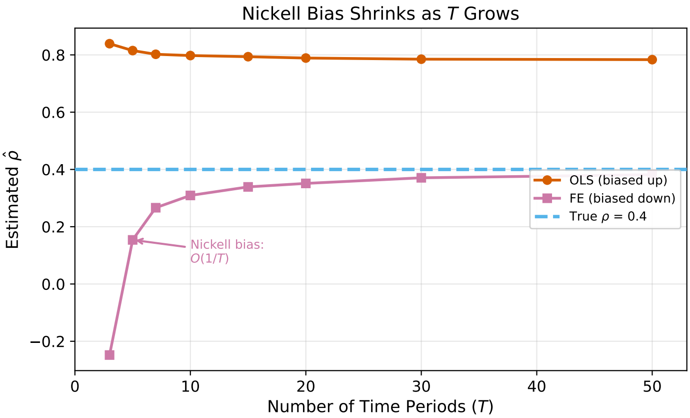

The FE bias is $O(1/T)$ (roughly proportional to $1/T$): it is severe for short panels ($T = 3, 5$) but shrinks as T grows. The OLS bias barely moves because it stems from cross-sectional heterogeneity, not from T.

The Bounds: OLS Up, FE Down

We now have two biased estimators that bracket the truth:

Estimator	$\hat{\rho}$	**Bias direction**
OLS	≈ 0.69	Upward (ignores α_i)
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Both OLS and FE are biased. Is there a way out?

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The plan:

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2. First-differencing creates its own endogeneity problem, so find **valid instruments** for the resulting equation.

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$\implies$ This is the Arellano-Bond (1991) approach.

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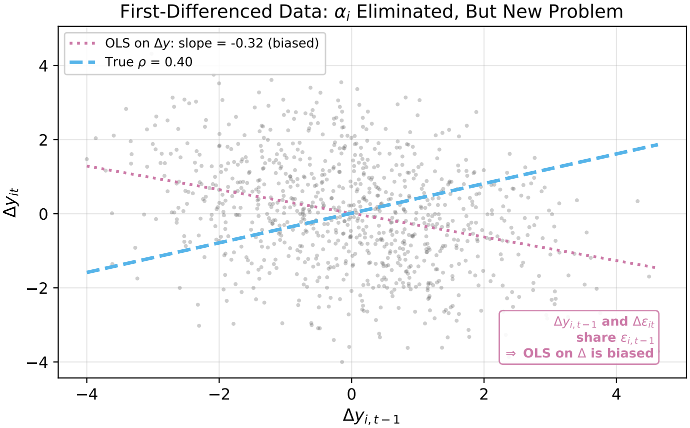
What goes wrong if we try?

OLS on First-Differenced Data: Still Wrong



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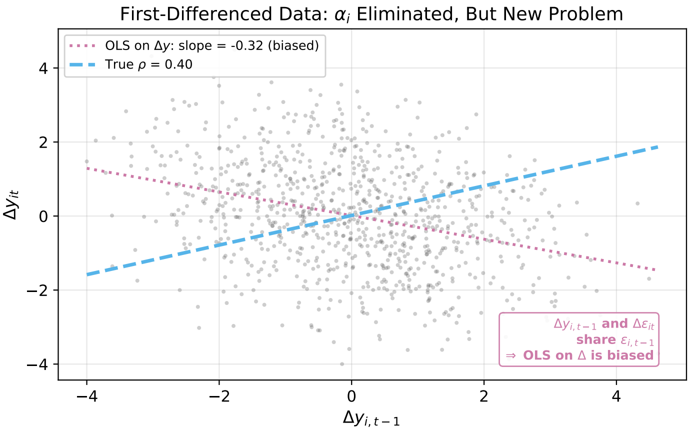

OLS on the differenced data gives a slope of ≈ -0.32, wildly wrong (true $\rho = 0.40$). First-differencing removed α_i, but something else went wrong. What?

The Problem: $\Delta y_{i,t-1}$ and $\Delta\varepsilon_{it}$ Share a Term

Expand the terms:

$$\begin{aligned} \Delta y_{i,t-1} &= y_{i,t-1} - y_{i,t-2} \quad \text{contains } \varepsilon_{i,t-1} \\ \Delta\varepsilon_{it} &= \varepsilon_{it} - \varepsilon_{i,t-1} \quad \text{also contains } \varepsilon_{i,t-1} \end{aligned}$$

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What variable is correlated with $\Delta y_{i,t-1}$ but uncorrelated with $\Delta\varepsilon_{it}$?

Step 2: Use $y_{i,t-2}$ as an Instrument

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- $\Delta y_{i,t-1} = y_{i,t-1} - y_{i,t-2}$, and $y_{i,t-1}$ depends on $y_{i,t-2}$ through the dynamic model
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Validity (exclusion restriction):

- $\Delta\varepsilon_{it} = \varepsilon_{it} - \varepsilon_{i,t-1}$, which contains only period-t and period-$(t-1)$ errors
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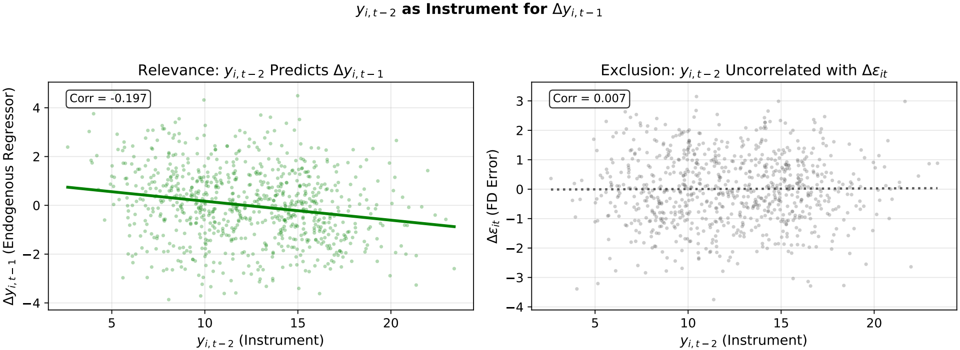
This exclusion restriction is an **assumption**. It fails if the original errors ε_{it} are serially correlated, since then $y_{i,t-2}$ would correlate with $\varepsilon_{i,t-1}$ inside $\Delta\varepsilon_{it}$.

The Instrument in Action



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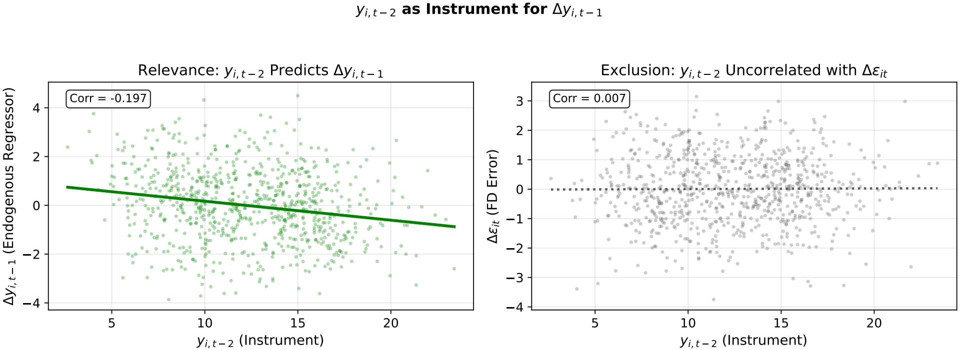

Left: $y_{i,t-2}$ predicts $\Delta y_{i,t-1}$ (relevance). The correlation is negative because $y_{i,t-2}$ appears with a minus sign in $\Delta y_{i,t-1} = y_{i,t-1} - y_{i,t-2}$. Any nonzero correlation suffices for relevance.

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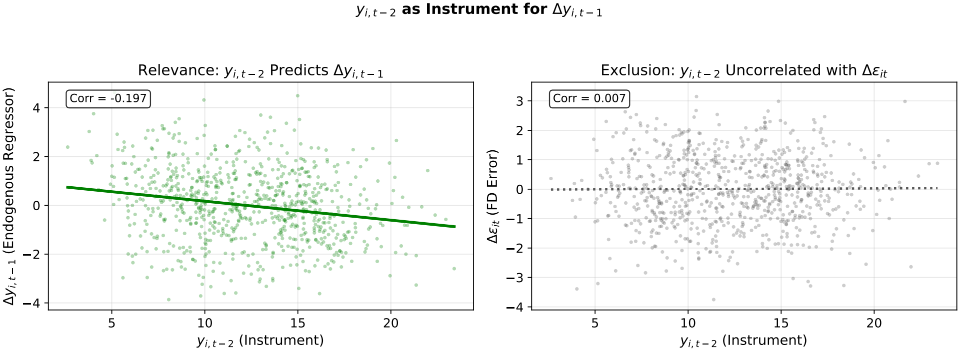

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Right: $y_{i,t-2}$ is uncorrelated with $\Delta\varepsilon_{it}$ (exclusion). This single-period instrument looks weak, but AB uses many lags, which collectively provide strong identification.

Expanding the Instrument Set

The set of valid instruments **grows with** t:

Period	**Available instruments for** $\Delta y_{i,t-1}$
$t = 3$	$y_{i,1}$
$t = 4$	$y_{i,1},\ y_{i,2}$
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This creates many **moment conditions**. A moment condition is a restriction on population averages. Here, it says each instrument is uncorrelated with the error, the same logic as an IV exclusion restriction:

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We need a way to combine all these moment conditions into a single estimate. That is what GMM does.

GMM: Combining Many Instruments

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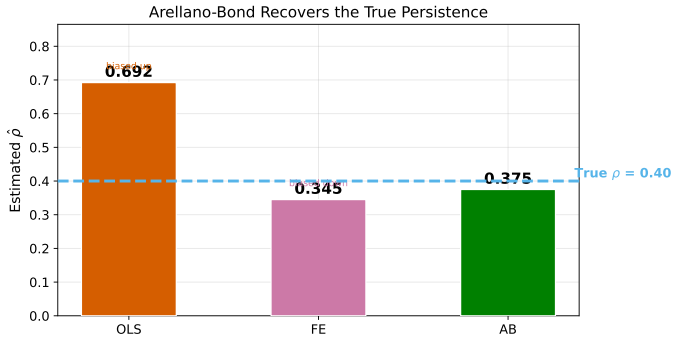
Note: "One-step" GMM uses a preliminary weighting matrix; "two-step" re-estimates with an optimal weighting matrix from step-1 residuals. Two-step is more efficient.

The Result: AB Recovers the True ρ



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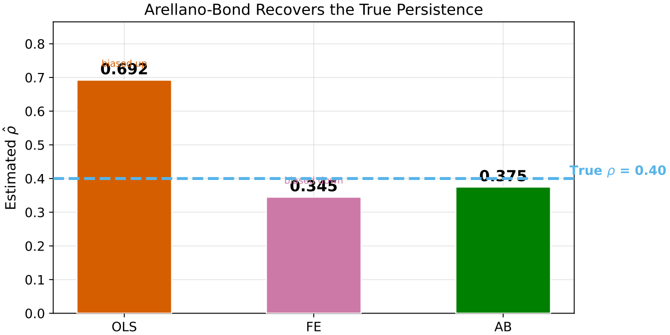

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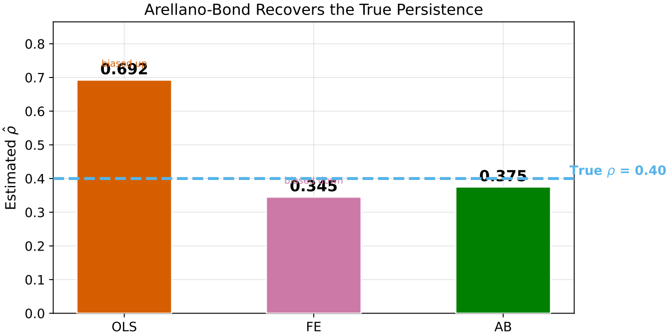

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$\Longrightarrow$ By first-differencing (to remove α_i) and instrumenting (to handle the $\Delta\varepsilon_{it}$ correlation), AB produces a consistent estimator.

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   - AR(2) in $\Delta\varepsilon$: we should *not* find this. Why? $\Delta\varepsilon_{it}$ and $\Delta\varepsilon_{i,t-2}$ share no terms unless ε_{it} itself is autocorrelated. So AR(2) in the differenced errors is really a test for AR(1) in the original errors.

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2. **Sargan/Hansen test of overidentifying restrictions:**
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$\implies$ Report both tests. If AR(2) is significant or Sargan rejects, the AB assumptions are in doubt.

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$\Longrightarrow$ Always report AR(2) and Sargan/Hansen p-values alongside your AB estimates.

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$\implies$ We need additional instruments. Where do they come from?

System GMM: Blundell-Bond

Blundell and Bond (1998) proposed **System GMM**: stack two equations:

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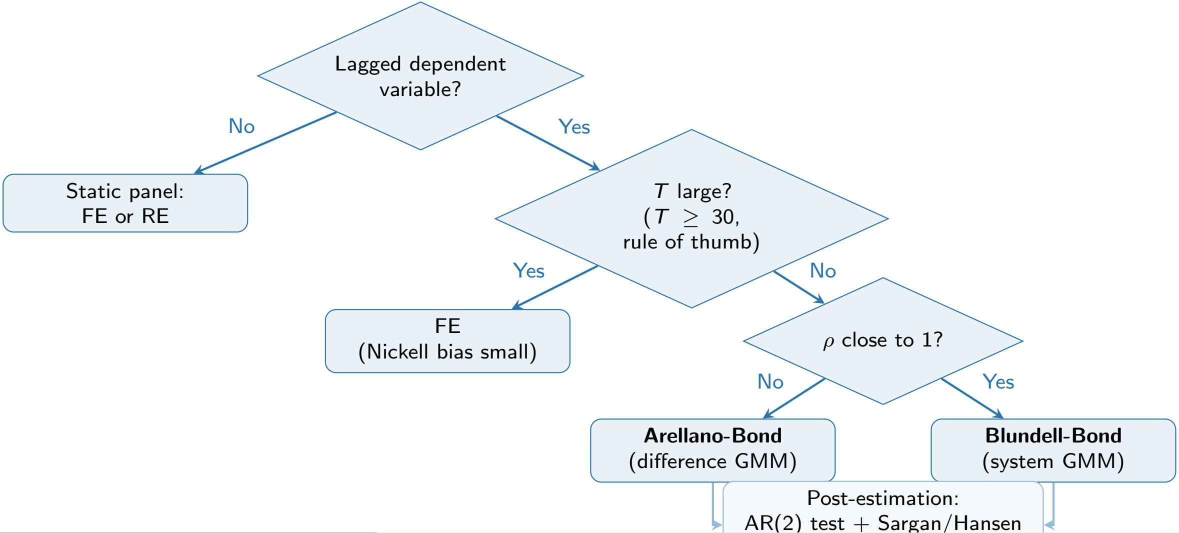
$\implies$ System GMM adds an assumption: $\mathrm{E}[\Delta y_{i,t} \cdot \alpha_i] = 0$ (each country's growth has settled to its long-run average by the start of the sample). This is testable via the difference-in-Sargan test.

Outline

1. The Problem: Persistence in Panel Data
2. The FE Attempt and Nickell Bias
3. Arellano-Bond GMM
4. Decision Framework
5. Summary

Decision Flowchart



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$\implies$ When your panel model has a lagged dependent variable and small T, use AB or System GMM, not OLS or FE. First-difference to remove the fixed effect, then instrument to restore consistency.

Thank you!

jakeanderson@g.ucla.edu