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# Testing for Moderate Explosiveness in the Presence of Drift

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## Abstract

This paper considers a moderately explosive autoregressive(1) process with drift where the autoregressive root approaches unity from the right at a certain rate. We first develop a test for the null of moderate explosiveness under independent and identically distributed errors. We show that the  $t$  statistic is asymptotically standard normal regardless of whether the errors are Gaussian. This result is in sharp contrast with the existing literature wherein nonstandard limiting distributions are obtained under different model assumptions. When the errors are weakly dependent, we show that the  $t$  statistic based on a heteroskedasticity and autocorrelation robust standard error follows Student's  $t$  distribution in large samples. Monte Carlo simulations show that our tests have satisfactory size and power performance in finite samples. Applying the asymptotic  $t$  test to ten major stock indexes in the pre-2008 financial exuberance period, we find that most indexes are only mildly explosive or not explosive at all, which implies that the bout of the irrational rise was not as serious as previously thought.

*Keywords:* Heteroskedasticity and Autocorrelation Robust Standard Error, Irrational Exuberance, Local to Unity, Moderate Explosiveness, Student's  $t$  Distribution, Unit Root.

*JEL:* C12; C22

## 1 Introduction

Explosive processes have attracted much recent attention. Phillips and Magdalinos (2007a) consider moderately explosive (ME) processes where the autoregressive (AR) root is greater than unity but its deviation from unity decreases as the sample size increases. Such triangular array data processes have been shown to capture the ME behavior in many economic and financial time series. The work of Phillips and Magdalinos (2007a, hereafter PM) has stimulated many subsequent studies including Phillips and Magdalinos (2007b), Magdalinos and Phillips (2009), Phillips, Magdalinos, and Giraitis (2010), Phillips, Wu, and Yu (2011), Magdalinos (2012), and Phillips, Shi, and Yu (2014, 2015a,b), among others.

Research on explosive processes can be traced back to White (1958) and Anderson (1959). For a simple Gaussian AR(1) process  $y_t = \rho y_{t-1} + u_t$  ( $t = 1, 2, \dots, T$ ) with fixed  $\rho > 1$ ,  $y_0 = 0$ ,

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and independent and identically distributed (i.i.d.) Gaussian errors  $\{u_t\}$ , White (1958) shows that  $\rho^T(\hat{\rho} - \rho)/(\rho^2 - 1)$  converges to a standard Cauchy distribution, where  $\hat{\rho}$  is the ordinary least-squares (OLS) estimator of  $\rho$ . Anderson (1959) points out that the normality of the error process is necessary for this result. This poses a challenge in the application of explosive processes, as we have to use different reference distributions for different distributions of the errors, which are often not known.

Phillips and Magdalinos (2007a) show that for an ME process wherein  $\rho$  is parametrized as  $\rho := \rho_T = 1 + c/k_T$  for some  $c > 0$  and  $k_T = o(T) \rightarrow \infty$  as  $T \rightarrow \infty$ , the limiting behavior of the OLS estimator of  $\rho$  is invariant to the distribution of the errors. More specifically, it is shown that the coefficient-based statistic  $k_T \rho_T^T(\hat{\rho} - \rho_T)/(2c)$  converges weakly to the standard Cauchy distribution, even if the errors are not Gaussian. Inference can then be made without accounting for the exact distribution of the errors in large samples. More importantly, compared with the original explosive processes of White (1958) and Anderson (1959), ME processes are better able to capture the empirical regularities found in many economic and financial data, such as the Dow Jones Industrial Average.

In this paper, we generalize PM (2007a) to allow for an intercept in the AR(1) process and develop an asymptotically valid test for moderate explosiveness. The ME process under consideration, i.e.,  $y_t = \mu_T + \rho_T y_{t-1} + u_t$ , has two components: the stochastic ME component and the deterministic drift trend component, both of which can render the process explosive. We parametrize the deviation of  $\rho_T$  from unity by  $\rho_T = 1 + 1/T^{\alpha_0}$  for some  $\alpha_0 \in (0, 1)$ . The index  $\alpha_0$  then completely describes the degree of the explosive behavior. Generally, the deterministic trend component dominates the stochastic trend component, but when the drift  $\mu_T$  decreases to zero at a certain rate with the sample size, e.g.  $\mu_T T^{\alpha_0/2} \rightarrow 0$ , the stochastic trend will become stronger in relation to the drift component. This intuitively explains why the limiting distribution of the usual  $t$ -type test statistic for the integrated time series with drift is different from the one without drift. For more detailed discussion, see Dickey and Fuller (1979), Dickey and Fuller (1981), and MacKinnon (1996) in the unit root setting; Phillips (1987), Phillips and Perron (1988), and Müller and Graham (2003) in the local-to-unity setting; Phillips et al. (2014) and Phillips et al. (2015a,b) in the periodically collapsing explosive bubble setting. In contrast, this paper shows that under the null of moderate explosiveness, the asymptotic distributions of the OLS  $t$  statistic are the same for the cases with and without drift, even though the asymptotic distributions of the underlying OLS estimator of  $\rho_T$  are different. In particular, in the presence of i.i.d. errors, the OLS  $t$  statistic is asymptotically standard normal regardless of whether the drift is small or large, or simply equal to zero. This invariance property releases us from having to choose a reference distribution in practice. Compared with the nonstandard test of Wang and Yu (2015), who also accommodate a drift but assume a fixed  $\rho$  greater than 1, our asymptotic normal test is much easier to use, as critical values are readily available.

Another contribution of this paper is that we extend our basic results to allow for weakly dependent errors. The limiting distribution of the OLS estimator of  $\rho_T$  is still normal or mixed normal, but it now depends on the long-run variance (LRV) of the error process. We employ the simple average of the first few periodograms to estimate the LRV and construct the heteroskedasticity and autocorrelation robust (HAR) standard error of the OLS estimator of  $\rho_T$ . Under the fixed-smoothing asymptotics where the number of periodograms used in the LRV estimation is held fixed, we show that the  $t$  statistic based on the HAR standard error follows Student's  $t$  distribution in large samples. This result holds regardless of whether a drift term is present or not. The asymptotic  $t$  test achieves double robustness: it is asymptotically

valid no matter whether the errors are autocorrelated or not, and whether the drift is small, large or is simply not present.

Monte Carlo (MC) simulations show that the asymptotic normal test under i.i.d. errors and the asymptotic  $t$  test under weakly dependent errors have accurate size and satisfactory power in finite samples. When it is not clear whether the errors are i.i.d., we recommend using the HAR  $t$  test with a data-driven smoothing parameter.

To identify the degree of the moderate explosiveness of a time series in practice, we propose a two-step empirical testing strategy that involves pretesting.<sup>1</sup> The pretesting aims at detecting whether the series is an explosive process. This is necessary, as the ME process is essentially an explosive process. After finding evidence on explosiveness, we proceed to employ our asymptotic  $t$  test to obtain a confidence interval for the explosive index that measures the degree of explosiveness. The confidence interval consists of all possible null values of  $\rho_T$  or  $\alpha_0$  that are not rejected by our test. Categorizing the seemingly severe or slight explosiveness according to  $\alpha_0$  will be helpful in bubble identification, classification, and provision of warning. We apply our empirical testing strategy to ten major stock indexes in various countries/districts of the world in a period before the 2008 financial crisis. Interestingly, we find that most indexes are only mildly explosive, or not explosive at all. The pre-2008-financial-crisis bout of irrational rise did not seem so serious as previously thought. This is consistent with Greenspan (2008)'s perception that the financial bubble was not so large.

The rest of the paper is organized as follows. Section 2 establishes the limit theory for ME processes with a sample-size dependent drift. The drift is allowed to be small or large, or simply equal to zero. This section also compares our limit theory with the limit theory developed by Wang and Yu (2015) for severely explosive processes. Section 3 extends the results in Section 2 by allowing weakly dependent errors. Section 4 contains simulation evidence. Section 5 provides the empirical testing strategy and documents the empirical application. The last section concludes. Appendix A presents some technical lemmas that are used in the proofs of the key results, and Appendix B comprises the proofs of the key results. Proofs of the technical lemmas and some additional simulation results are relegated to the online supplement.

## 2 Asymptotic Normal Test Under i.i.d. Errors

### 2.1 Preliminaries

Following PM (2007a), we consider an ME series  $\{\xi_t\}$ :

$$\begin{aligned}\xi_t &= \rho\xi_{t-1} + u_t, \\ \rho &= \rho_T = 1 + \frac{1}{k_T},\end{aligned}\tag{1}$$

for  $t = 1, 2, \dots, T$ , where  $\{u_t\}$  is a sequence of i.i.d. innovations with  $Eu_t = 0$  and  $Eu_t^2 = \sigma^2 < \infty$ , and  $k_T$  increases with  $T$  but at a slower rate, i.e.,  $k_T \rightarrow \infty$  but  $k_T/T \rightarrow 0$  as  $T \rightarrow \infty$ . Under the rate condition on  $k_T$ , we can show that, for any  $a > 0$ ,  $\rho_T^{aT}$  grows at an exponential rate in  $T/k_T$ , which is faster than any polynomial rate in  $T/k_T$ ; see Lemma A.1 in Appendix A. In (1), we have implicitly set  $c$  to be 1. From an empirical point of view, we can do so without loss of generality, as the effect of having a parameter  $c$  can be captured by reparametrizing  $k_T$ .

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<sup>1</sup>There will be some size distortion from pretesting. In principle, a Bonferroni correction can be used to alleviate the problem.

That is, when  $c$  is a positive constant, we can let  $\rho_T = 1 + c/k_T = 1 + 1/(k_T/c) = 1 + 1/\tilde{k}_T$  for some  $\tilde{k}_T$ . When  $T$  is large enough,  $\tilde{k}_T$  will meet the requirements  $k_T \rightarrow \infty$  and  $k_T/T \rightarrow 0$ .

We further assume that the initial value of the ME process,  $\xi_0$ , satisfies  $\xi_0 = o_p(\sqrt{k_T})$  and that  $\xi_0$  is independent of  $\{u_t, t = 1, \dots, T\}$ . The triangular parametrization of  $\rho_T$  and the assumption on  $\xi_0$  ensure that an invariance principle can be established for the ME process. If  $\rho$  is a fixed value greater than 1, the effects of a nonzero initial value would not disappear, even asymptotically. In this case, as shown in Anderson (1959), an invariance principle is not applicable.

Define

$$X_T := (k_T)^{-1/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t \text{ and } Y_T := (k_T)^{-1/2} \sum_{j=1}^T \rho_T^{-j} u_j. \quad (2)$$

Let  $X$  and  $Y$  be independent random variables, each distributed as  $N(0, \sigma^2/2)$ . PM (2007a) show that

$$(X_T, Y_T)' \Rightarrow (X, Y)', \quad (3)$$

where “ $\Rightarrow$ ” signifies the weak convergence. Moreover, they show that

$$(k_T \rho_T^T)^{-2} \sum_{t=1}^T \xi_{t-1}^2 = Y_T^2/2 + o_p(1), \quad (4)$$

$$(k_T \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} u_t = X_T Y_T + o_p(1), \quad (5)$$

and

$$\frac{k_T \rho_T^T}{2} (\hat{\rho}_{T,\xi} - \rho_T) \Rightarrow X/Y, \quad (6)$$

where  $\hat{\rho}_{T,\xi}$  is the OLS estimator of  $\rho_T$  and  $X/Y$  follows the standard Cauchy distribution. See PM (2007a, page 122) for more details.

Let

$$\hat{\sigma}_{\rho,\xi}^2 = s_{T,\xi}^2 \left( \sum_{t=1}^n \xi_{t-1}^2 \right)^{-1} \text{ and } s_{T,\xi}^2 = \frac{1}{T-1} \sum_{t=1}^T (\xi_t - \hat{\rho}_{T,\xi} \xi_{t-1})^2.$$

Taking  $\hat{\sigma}_{\rho,\xi}$  as an estimator of the standard error of  $(\hat{\rho}_{T,\xi} - \rho_T)$ , we construct the OLS  $t$  statistic as follows

$$t_{\text{PM}} := \frac{\hat{\rho}_{T,\xi} - \rho_T}{\hat{\sigma}_{\rho,\xi}}. \quad (7)$$

Using (3)–(6), we can show that

$$t_{\text{PM}} \Rightarrow \frac{2X/Y}{\sigma/(Y/\sqrt{2})} = \frac{X}{\sigma/\sqrt{2}} \stackrel{d}{=} N(0, 1).$$

The symbol “ $\stackrel{d}{=}$ ” signifies the equivalence in distribution.

## 2.2 Model and Test for ME Processes with Drift

We consider an ME process with drift (MED) defined by

$$\begin{aligned} y_t &= \mu_T + \rho y_{t-1} + u_t, \\ \rho &= \rho_T = 1 + \frac{1}{k_T}. \end{aligned} \quad (8)$$

We maintain the following assumption.

**Assumption 2.1** (a)  $u_t \sim i.i.d.(0, \sigma^2)$ ; (b)  $k_T = T^{\alpha_0}$  for some  $\alpha_0 \in (0, 1)$ ; (c)  $\mu_T T^{\alpha_0/2} \rightarrow \nu \in [0, \infty]$  as  $T \rightarrow \infty$ ; (d)  $y_0$  is independent of  $\{u_t, t = 1, \dots, T\}$  and  $y_0 = o_p(\sqrt{k_T})$ .

Instead of assuming  $k_T = o(T)$ , which imposes only an upper bound on the rate of divergence of  $k_T$ , we assume an exact rate  $k_T = T^{\alpha_0}$  for  $\alpha_0 \in (0, 1)$  in Assumption 2.1. That is, we characterize the explosive rate of the deviation from unity explicitly. In this case, the AR coefficient becomes  $\rho_T = 1 + 1/T^{\alpha_0}$ . Given that  $\alpha_0$  is assumed to be fixed, we have in effect employed a somewhat restrictive data generating process. Under our parametrization,  $\alpha_0$  is the only parameter that characterizes the moderate deviation from unity for a random sample of size  $T$ . We will refer to  $\alpha_0$  as the explosive index and the ME process with explosive index  $\alpha_0$  as the  $\alpha_0$ -ME process.

The drift in our model can be both small or large. When  $\mu_T T^{\alpha_0/2} \rightarrow \infty$ , we say that the drift is large. When  $\mu_T$  is a fixed constant, then  $\mu_T T^{\alpha_0/2} \rightarrow \infty$ , and we have a large drift. On the other hand, when  $\mu_T T^{\alpha_0/2} \rightarrow \nu \in [0, \infty)$ , we say that the drift is small. In this case,  $\mu_T$  approaches zero at a certain rate with the sample size. Note that  $\nu$  can be arbitrarily close to zero or just equal to zero. So our model allows for a small drift or no drift at all. In practice, we do not know the size of the true drift. To avoid model misspecification, it is advisable to include a drift in our model specification.

Expanding (8), we obtain

$$\begin{aligned} y_t &= \rho_T^t y_0 + \sum_{j=1}^t \rho_T^{t-j} u_j + \mu_T (\rho_T^t - 1) / (\rho_T - 1) \\ &= \xi_t + \mu_T (\rho_T^t - 1) T^{\alpha_0}, \end{aligned} \tag{9}$$

where

$$\xi_t = \rho_T^t \xi_0 + \sum_{j=1}^t \rho_T^{t-j} u_j \text{ for } \xi_0 = y_0.$$

$\{\xi_t\}$  satisfies model (1) and is an ME process without drift. So, the stochastic approximations in (4) and (5) in Section 2.1 hold. When  $\mu_T \neq 0$ , the process  $\{y_t\}$  has two components: the stochastic ME component  $\xi_t$  and the deterministic nonlinear trend component  $\mu_T (\rho_T^t - 1) T^{\alpha_0}$ , both of which can render the process explosive. In particular, the stochastic ME component is shown to be a generalized random walk, which can be decomposed into a random walk and a sample-size dependent remainder. As the sample size goes to infinity, the remainder that characterizes the explosive deviation from the unit-root fundamental will decay.

Based on (9), we obtain Theorem 2.1 which characterizes the limits of the main sample statistics of interest.

**Theorem 2.1** *Let Assumption 2.1 hold with  $\nu \in (0, \infty]$ . Define  $1/\infty = 0$ . Then the following convergence results hold jointly:*

$$\begin{aligned} (a) & \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow (1 + Y/\nu)^2 / 2; \\ (b) & \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} \Rightarrow 1 + Y/\nu; \\ (c) & \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t \Rightarrow X + XY/\nu. \end{aligned}$$

When Assumption 2.1(c) holds with  $\nu = \infty$ , the convergence rates of the sample statistics in Theorem 2.1 are all higher than those obtained for the  $\alpha_0$ -ME processes without drift. The faster rates of convergence when the drift satisfies  $\mu_T T^{\alpha_0/2} \rightarrow \infty$  are due to the accumulation of the drift term. In large samples,  $\{y_t\}$  behaves like a deterministic trending process with consequential effects on the asymptotic behavior of the sample statistics. This also explains why  $\mu_T$  appears in the normalization factors in Theorem 2.1.

We proceed to investigate the asymptotic distribution of the OLS estimator  $\hat{\rho}_T$  of  $\rho_T$ . Define

$$Z_T := T^{-1/2} \sum_{t=1}^T u_t. \quad (10)$$

Using the Lindeberg-Feller central limit theorem, we can show that  $Z_T$  converges in distribution to  $Z$ , where  $Z \sim N(0, \sigma^2)$ . Moreover, the convergence holds jointly with the convergence in (3) with  $Z$  independent of  $(X, Y)$ ; see Wang and Yu (2015) or the proof of Theorem 3.3 in Appendix B.

To characterize the rate of convergence of the OLS estimator  $\hat{\rho}_T$  of  $\rho_T$ , we let

$$D_T = \begin{pmatrix} T^{1/2} & 0 \\ 0 & \mu_T T^{3\alpha_0/2} \rho_T^T \end{pmatrix}.$$

Then, for  $\mathbf{x}_t = (1, y_{t-1})'$ , we have

$$\begin{aligned} D_T^{-1} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right) D_T^{-1} &= \begin{pmatrix} \frac{1}{T} \sum_{t=1}^T 1 & \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T y_{t-1} \\ \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T y_{t-1} & \frac{1}{\mu_T^2 T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T y_{t-1}^2 \end{pmatrix} \\ &= \begin{pmatrix} 1 & O_p(T^{(\alpha_0-1)/2}) \\ O_p(T^{(\alpha_0-1)/2}) & \frac{1}{\mu_T^2 T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T y_{t-1}^2 \end{pmatrix} \Rightarrow \begin{pmatrix} 1 & 0 \\ 0 & (1 + Y/\nu)^2 / 2 \end{pmatrix}, \end{aligned}$$

using Theorem 2.1(a-b). In addition, using Theorem 2.1(c), we have

$$D_T^{-1} \sum_{t=1}^T \mathbf{x}_t u_t \Rightarrow (Z, X + XY/\nu)'$$

It then follows that

$$\begin{aligned} \mu_T T^{3\alpha_0/2} \rho_T^T (\hat{\rho}_T - \rho_T) &= e_2' \left[ D_T^{-1} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right) D_T^{-1} \right]^{-1} \left[ D_T^{-1} \sum_{t=1}^T \mathbf{x}_t u_t \right] \\ &\Rightarrow \frac{X + XY/\nu}{(1 + Y/\nu)^2 / 2} = \frac{2X}{1 + Y/\nu}, \end{aligned} \quad (11)$$

where  $e_2 = (0, 1)'$ .

When  $\nu = \infty$ , we have  $\mu_T T^{3\alpha_0/2} \rho_T^T (\hat{\rho}_T - \rho_T) \Rightarrow 2X$  and so  $\hat{\rho}_T$  is asymptotically normal. The rate of convergence of  $\hat{\rho}_T$  to  $\rho_T$  (i.e.,  $\mu_T^{-1} T^{-3\alpha_0/2} \rho_T^{-T}$ ) is faster than the rate of  $T^{-\alpha_0} \rho_T^{-T}$  in PM (2007a). When  $\nu \in (0, \infty)$ , the limit distribution is mixed normal. As in PM (2007a), it is a ratio of two independent normal random variables, but it is not the standard Cauchy distribution. Depending on the value of  $\nu$ , we obtain an asymptotically normal or mixed-normal distribution.

We now construct the  $t$  statistic as follows:

$$t_{\text{MED}} := \frac{\hat{\rho}_T - \rho_T}{\hat{\sigma}_\rho},$$

where

$$\hat{\sigma}_\rho^2 = s_T^2 e_2' \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right)^{-1} e_2 \text{ and } s_T^2 = (T-2)^{-1} \sum_{t=1}^T (y_t - \hat{\mu}_T - \hat{\rho}_T y_{t-1})^2.$$

Then we have

$$t_{\text{MED}} \Rightarrow \frac{2X}{(1+Y/\nu)} \left( \frac{1}{\sigma} \frac{(1+Y/\nu)}{\sqrt{2}} \right) = \frac{X}{\sigma/\sqrt{2}} \stackrel{d}{=} N(0, 1).$$

The limiting distribution of  $t_{\text{MED}}$  is the standard Gaussian distribution rather than some nonstandard distribution that involves functionals of Brownian motions. The main reason is that, after being normalized by the scaling matrix  $\mathbf{D}_T$ , the off-diagonal elements of  $\mathbf{D}_T^{-1} (\sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t') \mathbf{D}_T^{-1}$  vanish as  $T \rightarrow \infty$ . A key assumption behind this result is that  $\alpha_0 < 1$ . In contrast, these elements converge weakly to a nonzero constant or random variate in the conventional unit-root or local-to-unity framework.

The  $\alpha_0$ -ME process can be regarded as an approximation to the unit root process from the explosive side. When  $\alpha_0 \rightarrow 1$ , our parametrization resembles a near unit-root parametrization but on the explosive side. Note that when  $\alpha_0 = 1$ , we have  $\lim_{T \rightarrow \infty} \rho_T^T = \lim_{T \rightarrow \infty} (1+1/T)^T = e$ . So when  $\alpha_0 \rightarrow 1$  and  $\mu_T$  is a constant, the orders of  $\sum_{t=1}^T y_{t-1}^2$ ,  $\sum_{t=1}^T y_{t-1}$ , and  $\sum_{t=1}^T y_{t-1} u_t$  become close to  $O_p(T^3)$ ,  $O_p(T^2)$ , and  $O_p(T^{3/2})$ , respectively. These convergence rates match those in the local-to-unity case.

To investigate the asymptotic properties of the  $t$  test when  $\nu = 0$ , we establish the theorem below, which is a modified version of Theorem 2.1. Given that the proof is essentially the same as that for Theorem 2.1 with only minor modifications, we omit it here.

**Theorem 2.2** *Let Assumption 2.1 hold with  $\nu = 0$ . Then the following convergence results hold jointly:*

- (a)  $(T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow Y^2/2;$
- (b)  $(T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} \Rightarrow Y;$
- (c)  $(T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t \Rightarrow XY.$

The limiting behaviors of the sample statistics are the same as the case with no drift. Combining Theorem 2.2 with the argument for the asymptotic normal result for the case  $\nu > 0$ , we obtain

$$\frac{1}{2} T^{\alpha_0} \rho_T^T (\hat{\rho}_T - \rho_T) \Rightarrow \frac{X}{Y} \text{ and } t_{\text{MED}} \Rightarrow \frac{X}{\sigma/\sqrt{2}} \stackrel{d}{=} N(0, 1).$$

We formalize our asymptotic standard normal limit theory in the theorem below.

**Theorem 2.3** *Let Assumption 2.1 hold. Then  $t_{\text{MED}} \Rightarrow N(0, 1)$  as  $T \rightarrow \infty$ .*



Regardless of the size of the drift, the  $t$  statistic is asymptotically standard normal. This is a very encouraging and convenient result. We obtain the same limiting distribution even though the asymptotic distribution of the coefficient estimator is different for different drift sizes. Note that the  $t$  test based on the PM regression (with no intercept included) is asymptotically normal only in the absence of a drift term. The asymptotic normal  $t$ -test based on the PM regression can have a large size distortion if a drift is actually present. When the nature of the drift is not known, we recommend employing the  $t_{\text{MED}}$  test, which is asymptotically valid no matter whether the drift is small or large.

Wang and Yu (2015, hereafter WY) develop the limit theory for the model

$$y_t = \mu + \rho y_{t-1} + u_t, \quad u_t \sim i.i.d.(0, \sigma^2),$$

where both  $\mu$  and  $\rho$  are fixed and  $\rho > 1$ . Compared with a moderate deviation from unity, a fixed  $\rho$  value that is strictly greater than 1 can be viewed as a severely explosive (SE) parametrization.

The  $t$  statistic  $t_{\text{WY}}$  in WY (2015) is identical to  $t_{\text{MED}}$ . Let

$$\ddot{X}_T := \sum_{t=1}^T \rho^{-(T-t)} u_t \quad \text{and} \quad \ddot{Y}_T := \rho \sum_{j=1}^{T-1} \rho^{-j} u_j + \rho y_0.$$

WY (2015) show that  $(\ddot{X}_T, \ddot{Y}_T) \Rightarrow (\ddot{X}, \ddot{Y})$  and that

$$t_{\text{WY}} \Rightarrow t_{\text{WY},\infty}(y_0, \rho, \sigma^2, \mu) := \frac{\ddot{X}}{\ddot{Y} + \rho\mu/(\rho-1)} \cdot \left| \ddot{Y} + \frac{\rho\mu}{\rho-1} \right| \cdot \left( \frac{\rho^2 - 1}{\rho^2 \sigma^2} \right)^{1/2}. \quad (12)$$

The limiting distribution is nonstandard. It is also not pivotal, as it depends on the unknown parameters  $\rho$ ,  $\mu$ , and  $\sigma$ , and the initial value  $y_0$ . This feature makes the limiting distribution less convenient to use in empirical applications.

Plugging  $y_0 = o_p(T^{\alpha_0/2})$  and  $\rho = 1 + T^{-\alpha_0}$  into the random variable  $t_{\text{WY},\infty}(y_0, \rho, \sigma^2, \mu)$  and letting  $T \rightarrow \infty$ , we have

$$\begin{aligned} & t_{\text{WY},\infty}(y_0, \rho, \sigma^2, \mu) \\ &= \frac{T^{\alpha_0/2} X}{T^{\alpha_0/2} Y + \mu T^{\alpha_0}} \cdot \left| T^{\alpha_0/2} Y + \mu T^{\alpha_0} \right| \cdot \left( \frac{2/T^{\alpha_0}}{\sigma^2} \right)^{1/2} (1 + o_p(1)) \\ &= \frac{X}{\sigma/\sqrt{2}} \cdot \frac{|T^{\alpha_0/2} Y + \mu T^{\alpha_0}|}{T^{\alpha_0/2} Y + \mu T^{\alpha_0}} (1 + o_p(1)) = \frac{X}{\sigma/\sqrt{2}} (1 + o_p(1)) \Rightarrow N(0, 1), \end{aligned}$$

no matter whether  $\mu T^{\alpha_0}$  dominates  $T^{\alpha_0/2} Y$  or  $T^{\alpha_0/2} Y$  dominates  $\mu T^{\alpha_0}$ , in probability. Therefore, the distribution of  $t_{\text{WY},\infty}(y_0, \rho, \sigma^2, \mu)$  will become asymptotically standard normal. This is a type of informal sequential asymptotics. We first establish the limiting distribution of the  $t$  statistic for a fixed  $\rho > 1$  and a given initial value  $y_0$ . We then investigate the behavior of the limiting distribution when  $\rho$  approaches 1 from the right-hand side (i.e.,  $\rho = 1 + T^{-\alpha_0}$ ) and when the initial value becomes stochastically manageable (i.e.,  $y_0 = o_p(T^{\alpha_0/2})$ ). There is a smooth transition from the limiting distribution in the severely explosive case (i.e.,  $\rho$  is fixed and greater than 1) to that in the moderately explosive case (i.e.,  $\rho = 1 + T^{-\alpha_0}$  for  $\alpha_0 \in (0, 1)$ ).

### 3 Asymptotic $t$ Test Under Weakly Dependent Errors

The previous section has been confined to the case wherein the sequence of errors driving the model is independent and identically distributed. A natural extension is to develop a test for MED that does not rely on this strong assumption. Assumption 3.1 below allows the error process to have a general dependence structure.

**Assumption 3.1** (a)  $u_t = C(L)\varepsilon_t$  with  $\varepsilon_t \sim i.i.d.(0, \sigma^2)$ ,  $C(L) = \sum_{j=0}^{\infty} c_j L^j$ ,  $c_0 = 1$ , and  $L$  is the lag operator; (b)  $C(1) \in (0, \infty)$  and  $\sum_{j=0}^{\infty} j \cdot |c_j| < \infty$ ; (c)  $E|\varepsilon_t|^l < \infty$  for some  $l \geq 4$ ; (d)  $k_T = T^{\alpha_0}$  for some  $\alpha_0 \in (0, 1)$ ; (e)  $\mu_T T^{\alpha_0/2} \rightarrow \nu \in [0, \infty]$  as  $T \rightarrow \infty$ ; (f)  $y_0$  is independent of  $\{u_t, t = 1, \dots, T\}$  and  $y_0 = o_p(\sqrt{k_T})$ .

Assumptions 3.1(a)–(c) are the same as those maintained in Phillips and Solo (1992). Under these assumptions,  $\{u_t\}$  is weakly stationary.<sup>2</sup> Assumption 3.1(b) ensures that  $\{u_t\}$  has a martingale decomposition:

$$u_t = C(1)\varepsilon_t + \tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t, \quad (1)$$

where  $\tilde{\varepsilon}_t = \sum_{j=0}^{\infty} \tilde{c}_j \varepsilon_{t-j}$  and  $\tilde{c}_j = \sum_{k=j+1}^{\infty} c_k$ . In addition,  $\sum_{j=0}^{\infty} \tilde{c}_j^2 < \infty$  and so  $\text{var}(\tilde{\varepsilon}_t) < \infty$ . For more details, see Phillips and Solo (1992, Theorem 2.5). Using the martingale decomposition, we have

$$T^{-1/2} \sum_{t=1}^T u_t \Rightarrow N(0, \lambda^2),$$

where  $\lambda^2$  is the LRV of  $u_t$  defined by

$$\lambda^2 := \lim_{T \rightarrow \infty} T^{-1} E \left( \sum_{t=1}^T u_t \right)^2 = \sigma^2 C(1)^2.$$

The martingale decomposition also facilitates the proof of Lemma 3.1 below.

**Lemma 3.1** *Let Assumption 3.1 hold. Then*

(a)

$$\tilde{X}_T := T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t = C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} \varepsilon_t + o_p(1);$$

(b)

$$\tilde{Y}_T := T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} u_t = C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} \varepsilon_t + o_p(1);$$

(c)  $(\tilde{X}_T, \tilde{Y}_T) \Rightarrow (\tilde{X}, \tilde{Y})$  where  $\tilde{X}$  and  $\tilde{Y}$  are independent  $N(0, \lambda^2/2)$  random variables.

Lemma 3.1 shows that the effect of temporal dependence on the distribution of  $(\tilde{X}_T, \tilde{Y}_T)$  is to re-scale the distribution under i.i.d. errors by a constant  $C(1)$ . Then the asymptotic distributions of the main sample statistics under  $\nu \in (0, \infty]$  and under  $\nu = 0$  follow in a direct way from the approach that we pursue in Section 2. The proof of Theorem 3.1 is given in Appendix A while the proof of Theorem 3.2 is similar and is therefore omitted.

<sup>2</sup>We can also make a more general assumption that  $\varepsilon_t$  is a martingale difference sequence.

**Theorem 3.1** *Let Assumption 3.1 hold with  $\nu \in (0, \infty]$ . Define  $1/\infty = 0$ . Then the following convergence results hold jointly:*

$$\begin{aligned} (a) \quad & \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow \left(1 + \tilde{Y}/\nu\right)^2 / 2; \\ (b) \quad & \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} \Rightarrow 1 + \tilde{Y}/\nu; \\ (c) \quad & \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t \Rightarrow \tilde{X} + \tilde{X}\tilde{Y}/\nu. \end{aligned}$$

**Theorem 3.2** *Let Assumption 3.1 hold with  $\nu = 0$ . Then the following convergence results hold jointly:*

$$\begin{aligned} (a) \quad & (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow \tilde{Y}^2 / 2; \\ (b) \quad & (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} \Rightarrow \tilde{Y}; \\ (c) \quad & (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t \Rightarrow \tilde{X}\tilde{Y}. \end{aligned}$$

Note that  $\sum_{t=1}^T y_{t-1}^2$ ,  $\sum_{t=1}^T y_{t-1}$ , and  $\sum_{t=1}^T y_{t-1} u_t$  have the same convergence rates as in the i.i.d. case. When  $\nu \in (0, \infty]$ , the OLS estimator  $\hat{\rho}_T$  of  $\rho_T$  satisfies

$$\mu_T T^{3\alpha_0/2} \rho_T^T (\hat{\rho}_T - \rho_T) \Rightarrow \frac{2\tilde{X}}{1 + \tilde{Y}/\nu}.$$

When  $\nu = 0$ , the coefficient estimator satisfies

$$\frac{1}{2} T^{\alpha_0} \rho_T^T (\hat{\rho}_T - \rho_T) \Rightarrow \frac{\tilde{X}}{\tilde{Y}}.$$

These two results are analogous to (11) and (6), respectively.

To make an inference on  $\rho_T$ , we need to estimate the LRV  $\lambda^2$  of  $\{u_t\}$ . Let

$$\hat{u}_t = y_t - \hat{\mu}_T - \hat{\rho}_T y_{t-1}$$

be the estimated residual. The commonly-used estimator of  $\lambda^2$  takes the form

$$\hat{\lambda}_K^2 = \frac{1}{T} \sum_{t=1}^T \sum_{s=1}^T Q_K(t, s) \hat{u}_t \hat{u}_s,$$

where  $Q_K(\cdot, \cdot)$  is a weighting function that depends on the smoothing parameter  $K$ . This includes the kernel LRV estimator if we let  $Q_K(t, s) = \kappa((t-s)/(TK^{-1}))$  for a kernel function  $\kappa(\cdot)$ . In this paper, we take a simple average of the first few periodograms to construct  $\hat{\lambda}_K^2$ . More specifically, we let  $K$  be even and

$$Q_K(t, s) = \frac{1}{K} \sum_{\ell=1}^K \phi_\ell \left( \frac{t}{T} \right) \phi_\ell \left( \frac{s}{T} \right),$$

where  $\phi_{2\ell}(x) = \sqrt{2} \sin(2\pi\ell x)$  and  $\phi_{2\ell-1}(x) = \sqrt{2} \cos(2\pi\ell x)$  are the Fourier basis functions. With the above weighting function,  $\hat{\lambda}_K^2$  takes the average form:

$$\hat{\lambda}_K^2 = \frac{1}{K} \sum_{\ell=1}^K \left[ \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_{\ell} \left( \frac{t}{T} \right) \hat{u}_t \right]^2. \quad (2)$$

Other basis functions can be used, leading to a new class of orthonormal series LRV estimators. For theoretical developments of this type of LRV estimators and their advantages, see, e.g. Phillips (2005), Müller (2007), and Sun (2011, 2013, 2014). For simplicity, we opt for the Fourier basis functions here.

On the basis of  $\hat{\lambda}_K^2$  in (2), we construct the  $t$  statistic as follows:

$$\tilde{t}_{\text{MED}} := \frac{\hat{\rho}_T - \rho_T}{\tilde{\sigma}_{\rho, K}},$$

where

$$\tilde{\sigma}_{\rho, K}^2 = \hat{\lambda}_K^2 e_2' \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right)^{-1} e_2.$$

The limiting distribution of the  $\tilde{t}_{\text{MED}}$  statistic is given in the theorem below.

**Theorem 3.3** *Let Assumption 3.1 hold. Under the fixed- $K$  asymptotics where  $T \rightarrow \infty$  for a fixed  $K$ , the following convergence results hold jointly:*

- (a)  $\hat{\lambda}_K^2 / \lambda^2 \Rightarrow \chi_K^2 / K$  where  $\chi_K^2$  is a random variable following the chi-square distribution with  $K$  degrees of freedom;
- (b)  $\tilde{t}_{\text{MED}} \Rightarrow t_K$  where  $t_K$  is the Student's  $t$  distribution with  $K$  degrees of freedom.

Theorem 3.3 holds for  $\nu \in [0, \infty]$ . The asymptotic theory for the  $\tilde{t}_{\text{MED}}$  statistic is valid regardless of whether the drift in the true process is small or large, or equal to zero. Theorem 3.3(a) indicates that if  $K \rightarrow \infty$ , then  $\hat{\lambda}_K^2$  will become consistent. This is a type of sequential asymptotics. More rigorously, under the joint asymptotics under which  $K \rightarrow \infty$  but  $K/T \rightarrow 0$  as  $T \rightarrow \infty$ , we can establish that  $\hat{\lambda}_K^2$  is consistent for  $\lambda^2$ . Theorem 3.3(b) shows that the HAR  $t$  statistic is asymptotically  $t$  distributed. As  $K$  increases, the  $t$  distribution becomes closer to the standard normal distribution. There is a growing literature showing that the fixed- $K$  asymptotic approximation for the studentized test statistic is more accurate than the corresponding increasing- $K$  asymptotic approximation. The reason is that the former captures the randomness in  $\hat{\lambda}_K^2$  while the latter does not.

To establish the asymptotic  $t$  theory in Theorem 3.3(b), we have to show that the estimator error in  $\hat{\rho}_T$  is asymptotically independent of the LRV estimator  $\hat{\lambda}_K^2$ . The asymptotic independence is due to the explosive behavior of the underlying time series. It is similar to the asymptotic independence of  $(X_T, Y_T)$  from  $Z_T$ , defined in (2) and (10), respectively. We also have to show that  $\{T^{-1/2} \sum_{t=1}^T \phi_{\ell}(\frac{t}{T}) \hat{u}_t\}$  forms an i.i.d. sequence in large samples. The key driving forces behind this result are the orthonormality of the basis functions  $\{\phi_{\ell}\}$  on  $L_2[0, 1]$  and the “zero mean” condition, i.e.,  $\int_0^1 \phi_{\ell}(r) dr = 1$ .

For the asymptotic  $t$  theory to hold, it is necessary to employ the orthonormal series LRV estimator. Using a kernel LRV estimator will not allow us to develop the convenient  $t$  approximation. Nevertheless, it will enable us to make asymptotically pivotal inferences — the limiting distribution of the associated  $t$  statistic will be a nonstandard mixed-normal distribution that is nuisance parameter free. It is not very convenient to use a nonstandard distribution, as critical values have to be simulated.

## 4 Monte Carlo Simulation

### 4.1 Simulation Evidence Under i.i.d. Errors

In this subsection, we conduct MC simulations to evaluate the finite sample performance of our asymptotic normal test, the  $t_{\text{MED}}$  test, when the errors are independently and identically distributed.

The data generating process (DGP) is given by

$$y_t = \mu_T + \rho y_{t-1} + u_t, \quad t = 1, 2, \dots, T, \quad (1)$$

where  $\rho = 1 + T^{-\alpha_0}$  with the initial value being  $y_0 = \mu_T$ . The intercept is set to be  $\mu_T = \nu T^{-\alpha_0/2}$  and we take  $\nu = 0, 2, T^{\alpha_0/4}$ , and  $T^{\alpha_0/2}$ . Such setting is compatible with  $y_0 = o_p(T^{\alpha_0/2})$ . We conduct two groups of MC simulations. The first group employs i.i.d. Gaussian errors while the second group employs i.i.d. uniform errors. That is,  $u_t \sim i.i.d.N(0, 1)$  or  $u_t \sim i.i.d.U(-\sqrt{3}, \sqrt{3})$ .

We examine the empirical size of the  $t_{\text{MED}}$  test. For comparison we also examine the empirical size of the  $t_{\text{PM}}$  and  $t_{\text{WY}}$  tests. The PM test based on the statistic in (7) ignores the intercept, while the WY test assumes that  $\rho$  is fixed and strictly larger than 1. The null hypothesis of interest is  $H_0 : \rho = 1 + 1/T^{\alpha_0}$  for different configurations of  $\alpha_0$  and  $T$ , where  $\alpha_0$  represents the degree of explosiveness for a sample of size  $T$ . To save place, we discuss the case with  $\alpha_0 = 0.5$  and  $T = 100$  in the main text. This case is representative of other configurations. More detailed simulation results are reported and discussed in the online supplement. For the  $t_{\text{PM}}$  test and the  $t_{\text{MED}}$  test, we use critical values from the standard normal distribution. The  $t_{\text{WY}}$  test is similar to the  $t_{\text{MED}}$  test but uses critical values from the asymptotic distribution shown in (12), which is simulated using true parameter values. To a great extent, we give the  $t_{\text{WY}}$  test some edge, as some of the true parameter values are not known under the null. The nominal level is 5%, and the number of simulation replications is 5,000.

We also examine the empirical power of the three competing tests. The parameter configuration is the same as those for size calculations except the DGP is generated under the local-to-unity alternative  $H_A : \rho = 1 + 1/T$ . To avoid the size difference in the power comparison, we simulate and compare the size-adjusted power using the empirical finite sample critical values obtained from the null distribution. Since the  $t_{\text{WY}}$  and  $t_{\text{MED}}$  tests are based on the same test statistic, the size-adjusted power of these two tests is identical. We report the power for the  $t_{\text{MED}}$  test only.

Table 1 reports the size and power results of the  $t_{\text{PM}}$ ,  $t_{\text{WY}}$ , and  $t_{\text{MED}}$  tests under Gaussian errors and uniform errors, respectively. The two groups of results are qualitatively similar, providing further evidence that normality of the errors is not necessary for these tests. First, as can be seen from the table, both the  $t_{\text{WY}}$  and  $t_{\text{MED}}$  tests have quite accurate size in all drift cases. Note that we employ the true parameter values to simulate the asymptotic distribution of the  $t_{\text{WY}}$  statistic. In an absolute and overall sense, the standard normal distribution approximates the distribution of the  $t_{\text{MED}}$  statistic very well. Second, we observe that when  $\nu = 0$ , the size performance of the  $t_{\text{MED}}$  test is not worse than that of the  $t_{\text{PM}}$  test, while as  $\nu$  departs farther away from zero, the  $t_{\text{PM}}$  test suffers from large size distortion but the  $t_{\text{MED}}$  test still enjoys a good size control. It is encouraging to see that the  $t_{\text{MED}}$  test dominates the  $t_{\text{PM}}$  test in terms of the size accuracy. Finally, both the  $t_{\text{PM}}$  and  $t_{\text{MED}}$  tests have satisfactory power performance. Simulation results in the online supplement show that the  $t_{\text{MED}}$  test is more powerful than the  $t_{\text{PM}}$  test. Given the simulation evidence, we can conclude that the  $t_{\text{MED}}$  test succeeds in controlling size without power loss.

Table 1: Size and power under i.i.d. errors:  $\alpha_0 = 0.5$  and  $T = 100$ .

|                            | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                 |                  | Power ( $\rho = 1 + 1/T$ ) |                  |
|----------------------------|--------------------------------------|-----------------|------------------|----------------------------|------------------|
|                            | $t_{\text{PM}}$                      | $t_{\text{WY}}$ | $t_{\text{MED}}$ | $t_{\text{PM}}$            | $t_{\text{MED}}$ |
| (a) i.i.d. Gaussian errors |                                      |                 |                  |                            |                  |
| $\nu = 0$                  | 0.050                                | 0.053           | 0.056            | 1.000                      | 1.000            |
| $\nu = 2$                  | 0.733                                | 0.056           | 0.055            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$     | 0.641                                | 0.056           | 0.055            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$     | 0.969                                | 0.058           | 0.055            | 1.000                      | 1.000            |
| (b) i.i.d. uniform errors  |                                      |                 |                  |                            |                  |
| $\nu = 0$                  | 0.049                                | 0.047           | 0.049            | 1.000                      | 1.000            |
| $\nu = 2$                  | 0.733                                | 0.047           | 0.048            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$     | 0.637                                | 0.047           | 0.048            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$     | 0.973                                | 0.047           | 0.048            | 1.000                      | 1.000            |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. The model used for the experiment is (1) with  $u_t \sim i.i.d.N(0, 1)$  in the i.i.d. Gaussian group and with  $u_t \sim i.i.d.U(-\sqrt{3}, \sqrt{3})$  in the i.i.d. uniform group. Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

## 4.2 Simulation Evidence Under Weakly Dependent Errors

Using the same DGP in (1), we examine the finite sample performance of the  $\tilde{t}_{\text{MED}}$  test under two different experiment designs in this subsection: the AR design and the moving average (MA) design. To save space, we only consider the case with  $\nu = T^{\alpha_0/4}$ , i.e.,  $\mu_T = T^{-\alpha_0/4}$ . In the AR design,  $u_t$  follows an AR(1) process  $u_t = \theta u_{t-1} + \sqrt{1 - \theta^2} e_{1,t}$ , where  $e_{1,t} \sim i.i.d.N(0, 1)$ . In the MA design,  $u_t = \theta e_{2,t-1} + \sqrt{1 - \theta^2} e_{2,t}$ , where  $e_{2,t} \sim i.i.d.N(0, 1)$ . By construction, the error has a unit variance in both designs. We take  $\theta = 0.00, 0.25, 0.50$ , and  $0.75$ . The  $\tilde{t}_{\text{MED}}$  statistic is based on the LRV estimator in (2). Following Phillips (2005), we choose  $K$  based on the asymptotic mean squared error (AMSE) criterion implemented using the AR(1) plug-in procedure. We round the data-driven value of  $K$  to a closest even number between 4 and  $T$ . For both the AR and MA designs, we consider different combinations of  $\alpha_0$  and  $T$ ; see Table 2 for the case with  $\alpha_0 = 0.5$  and  $T = 100$  and the online supplement for more detailed simulation evidence. For comparison, we also consider the  $t_{\text{MED}}$  test, which ignores the autocorrelation in  $\{u_t\}$ . The initial value is set to be  $y_0 = \mu_T$  and the number of simulation replications is 5,000.

Table 2 reports the size and power results of the  $t_{\text{MED}}$  and  $\tilde{t}_{\text{MED}}$  tests. The table shows that compared with the  $t_{\text{MED}}$  test, the  $\tilde{t}_{\text{MED}}$  test achieves a satisfactory size-adjusted power performance with only relatively small size distortion in both the AR and MA designs. This result is consistent with our theoretical analysis. Ignoring the autocorrelation leads to an inaccurate test.

Table 2: Size and power in the presence of autocorrelated errors:  $\alpha_0 = 0.5$  and  $T = 100$ .

|                 | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                        | Power ( $\rho = 1 + 1/T$ ) |                        |
|-----------------|--------------------------------------|------------------------|----------------------------|------------------------|
|                 | $t_{\text{MED}}$                     | $\hat{t}_{\text{MED}}$ | $t_{\text{MED}}$           | $\hat{t}_{\text{MED}}$ |
| (a) AR design   |                                      |                        |                            |                        |
| $\theta = 0.00$ | 0.053                                | 0.057                  | 1.000                      | 1.000                  |
| $\theta = 0.25$ | 0.134                                | 0.068                  | 1.000                      | 1.000                  |
| $\theta = 0.50$ | 0.242                                | 0.070                  | 1.000                      | 0.998                  |
| $\theta = 0.75$ | 0.413                                | 0.081                  | 0.993                      | 0.971                  |
| (b) MA design   |                                      |                        |                            |                        |
| $\theta = 0.00$ | 0.055                                | 0.060                  | 1.000                      | 1.000                  |
| $\theta = 0.25$ | 0.114                                | 0.060                  | 1.000                      | 1.000                  |
| $\theta = 0.50$ | 0.157                                | 0.066                  | 1.000                      | 1.000                  |
| $\theta = 0.75$ | 0.169                                | 0.066                  | 1.000                      | 1.000                  |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. The model used for the experiment is (1) with  $u_t = \theta u_{t-1} + \sqrt{1 - \theta^2} e_{1,t}$  under the AR design and with  $u_t = \theta e_{2,t-1} + \sqrt{1 - \theta^2} e_{2,t}$  under the MA design, where  $e_{1,t} \sim i.i.d.N(0, 1)$  and  $e_{2,t} \sim i.i.d.N(0, 1)$ . Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

## 5 Empirical Application

### 5.1 Background and Data: Explosive Ups of the World Stock Indexes

Before the “Great Recession” of 2007–2009, led by the loose monetary policy and irrational real estate boom, the U.S. stock market experienced a spectacular rise (Allen, Babus, and Carletti, 2009; Taylor, 2009; Allen and Carletti, 2010; Stiglitz, 2010). The most impressive phenomenon is that the Dow Jones Industrial Average (DJI) reached its peak at 14,198.1 points on October 12, 2007, after witnessing continuous gain. Most regard this type of increase as an explosive process and as the first half of a financial bubble episode (Phillips et al., 2015a). Shiller (2008) argued that the irrational prosperity was the root cause of the subprime crisis, which was the crux of the financial crisis. Greenspan (1996) coined the phrase “irrational exuberance” in his remark on December 5, 1996, to describe the herd phenomenon in the stock market.

The global stock markets were also affected by such a rise. Different economies experienced different degrees of boom during the exuberance period, largely owing to their corresponding global financial participation and dependence on the U.S. economy. China, for instance, held massive foreign exchange reserves, especially the U.S. treasury bonds, in the pre-2008 period (Woo, Garnaut, and Song, 2013). Along with the American economic prosperity and appreciation of the dollar, a great deal of capital entered into China’s foreign exchange market, stimulating the explosive growth of China’s major stock indexes.

Greenspan (2008) argued that not all of the increasingly growing processes should be characterized by irrational exuberance and that the bubble was not so large. We are sympathetic to this argument. Sometimes it is better to describe a surge series as a mildly explosive process instead of a severe explosion. Furthermore, some series may have only a unit root or be trend-stationary and do not pertain to the so-called “explosive” process.

Table 3: Description of stock indexes.

| Region       | Country/District | Stock index | Peak date    |
|--------------|------------------|-------------|--------------|
| Americas     | U.S.             | DJI         | Oct 12, 2007 |
|              | Brazil           | IBOVESPA    | May 30, 2008 |
| Asia-Pacific | China            | CSI300      | Oct 19, 2007 |
|              | Hong Kong        | HSI         | Nov 02, 2007 |
|              | Australia        | AS51        | Nov 02, 2007 |
| Europe       | France           | FCHI        | Jun 01, 2007 |
|              | Germany          | GDAXI       | Jul 13, 2007 |
|              | Italy            | ITLMS       | May 18, 2007 |
| Africa       | Egypt            | CASE        | Apr 24, 2008 |
|              | Nigeria          | NGSEINDX    | Mar 07, 2008 |

In this study, we examine ten major stock indexes listed in Table 3. These ten indexes are representatives of the world stock markets in different continents: Americas, Asia-Pacific, Europe, and Africa. We select the most representative stock index for each country/district and collect weekly observations. The data are taken from the *Wind Economic Database*. We choose each stock index’s highest point in the pre-2008-financial-crisis period as the end point of the rise, and take 100 periods before this highest point.<sup>3</sup> We take the same sample window width for different stock index time series so that the difference in the moderate explosiveness depends only on the explosive index  $\alpha_0$ . The window width  $T = 100$  is roughly in line with Allen and Carletti (2010)’s argument that Federal Reserve’s low interest rate policy in 2005 is the most immediate and important reason to cause prices to take off. Other window widths have also been examined, and the results are available upon request.

Figure 1 plots the ten stock indexes. All of the ten indexes experienced considerable rises, revealing the co-movement among the major stock markets in the world. On the one hand, several series display relatively pronounced explosive features, even though there are some random ups and downs around their explosion paths; see, e.g. DJI, CSI300, HSI, and CASE. On the other hand, some series, such as AS51 and ITLMS, are more like difference-stationary processes with stochastic trends or even trend-stationary processes with deterministic linear trends, rather than explosive processes. It is worth noting that the stock indexes in three Western European countries — France, Germany, and Italy — have similar growth patterns, as Figure 1 shows. However, further investigations are required to detect whether they are explosive processes and, if they are, to identify their degrees of explosiveness.

## 5.2 Empirical Testing Strategy

Our empirical study starts with a two-step empirical testing strategy. The first step is a pretest aimed at confirming whether each index is an explosive process. This is necessary, as the  $\alpha_0$ -ME process is essentially an explosive process. We propose to use the right-tailed augmented

<sup>3</sup>The decay counterpart in a bubble is essentially the reverse of the exuberance phase. Here we focus on investigating the exuberance episode. Letting the highest point be the end point is plausible for studying the explosive degree, since the highest point represents the termination of the growth phase. If the values before the highest point are not significantly less than the highest point, we have a good reason to believe that this rise is not an explosive process.



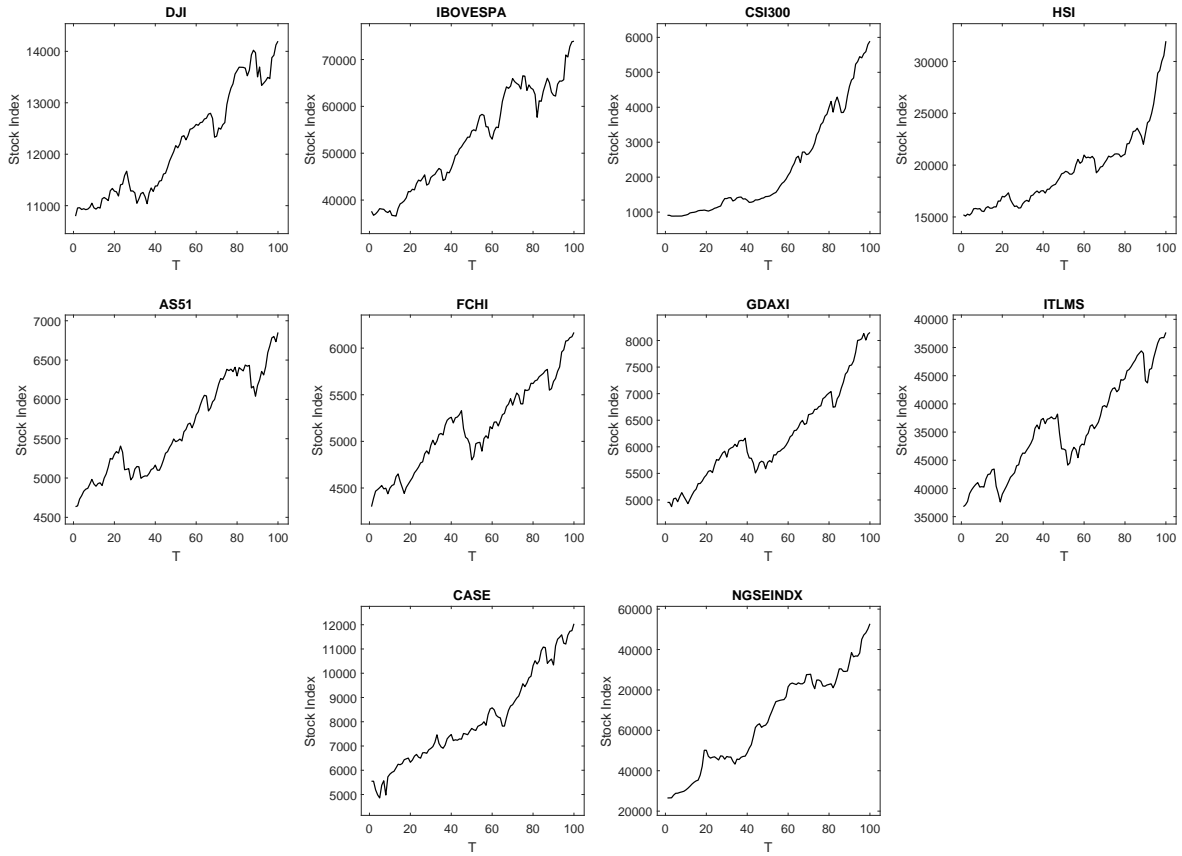


Figure 1: Time series plot of different stock indexes.

Dickey-Fuller (RADF) method and the supremum augmented Dickey-Fuller (SADF) method, both of which are adopted in Phillips et al. (2011) and are designed to test the null hypothesis  $\rho = 1$  against the alternative hypothesis  $\rho > 1$ . The RADF test is the conventional augmented Dickey-Fuller (ADF) unit root test but uses the right-tailed critical values. We use the RADF test in order to target at the explosive alternative. The SADF method employs a sequence of forward recursive RADF unit root tests, using subsets of the sample data increased by one observation at each pass until the full observations are used. The limiting distribution of the SADF statistic under the null  $\rho = 1$  is obtained by Phillips et al. (2011, Section 2), viz.

$$\begin{aligned} \text{SADF}(r_0) &= \sup_{r \in [r_0, 1]} \text{ADF}_r \\ &\Rightarrow t_{\text{SADF}, \infty} := \sup_{r \in [r_0, 1]} \left[ \left( \int_0^r \tilde{W}(s) dW(s) \right) \left( \int_0^r \tilde{W}^2(s) ds \right)^{-1/2} \right], \quad (1) \end{aligned}$$

where  $r_0$  is the smallest window size and  $W(s)$  and  $\tilde{W}(s)$  are the standard Brownian motion and its demeaned version.

The second step is to perform our asymptotic  $t$  test,  $\tilde{t}_{\text{MED}}$ , on the indexes that are regarded as explosive according to the first step. We invert the  $\tilde{t}_{\text{MED}}$  test and construct a confidence interval (set) for each explosive index. The confidence interval consists of all the values of  $\alpha_0$  that are not rejected by our asymptotic  $t$  test. In practice, we may discretize the interval  $\alpha_0 \in (0, 1)$  and consider a grid of values, say,

$$\{H_0 : \rho = 1 + T^{-\alpha_0} | \alpha_0 \in \{0.01, 0.02, \dots, 0.99\}\}.$$

We can also consider a more refined grid of  $\alpha_0$  if needed. Conceptually, smaller values of  $\alpha_0$ , such as  $\alpha_0 \leq 0.30$ , correspond to high deviations of the AR roots from the unity and highly explosive behaviors. Larger values of  $\alpha_0$ , such as  $\alpha_0 \geq 0.70$ , correspond to low deviations of the AR roots from the unity and mildly explosive behaviors. This informative label will be useful in conveying the severity of bubbles, if they exist, to policy makers.

### 5.3 Empirical Results

Table 4 reports the results of the RADF and SADF tests in the first step and the asymptotic  $t$  test for those explosive stock indexes in the second step. In implementing the SADF test, we follow the empirical rule recommended by Phillips et al. (2015a) to set the user-chosen parameter,  $r_0 = 0.01 + 1.8/\sqrt{T}$ , and accordingly use the asymptotic critical values given in the same paper.<sup>4</sup> At the 5% significance level, the combination of RADF and SADF tests indicates that DJI, IBOVESPA, CSI300, HSI, GDAXI, CASE, and NGSEINDX follow the explosive processes in their respective sampling periods. However, the major stock indexes of some countries, such as Australia, France, and Italy, could not be described by explosive processes.

For the seven explosive stock indexes, the results of the asymptotic  $t$  test in Table 4 show that their explosive indices  $\alpha_0$  largely fall in the range from 0.70 to 0.99. This indicates that most stock indexes during the pre-2008 exuberance period are only mildly explosive.<sup>5</sup> Take

<sup>4</sup>In practice, we choose  $r_0 = \lfloor (0.01 + 1.8/\sqrt{T})T \rfloor / T$  to ensure that  $r_0T$  is a positive integer. The right-tailed critical values for the ADF statistic are available from Phillips et al. (2011, Table 1).

<sup>5</sup>When we take other window widths,  $T = 80$  and  $120$  for examples, similar remarks apply and the conclusions remain unchanged. They are not reported to conserve space.

Table 4: Testing for moderately explosive behaviors.

| Stock index     | Step 1:                 |       | Step 2:                     |
|-----------------|-------------------------|-------|-----------------------------|
|                 | Explosive behavior test |       | Moderate explosiveness test |
|                 | ADF                     | SADF  | Confidence interval         |
| DJI             | 0.201                   | 1.506 | $\alpha_0 \in [0.78, 0.99]$ |
| IBOVESPA        | 0.078                   | 3.592 | $\alpha_0 \in [0.79, 0.99]$ |
| CSI300          | 3.548                   | 5.665 | $\alpha_0 \in [0.71, 0.99]$ |
| HSI             | 3.103                   | 8.207 | $\alpha_0 \in [0.56, 0.82]$ |
| AS51            | -0.012                  | 0.557 | Non-explosion               |
| FCHI            | -0.148                  | 0.313 | Non-explosion               |
| GDAXI           | 1.201                   | 2.635 | $\alpha_0 \in [0.75, 0.99]$ |
| ITLMS           | -0.227                  | 0.413 | Non-explosion               |
| CASE            | 1.050                   | 1.638 | $\alpha_0 \in [0.76, 0.99]$ |
| NGSEINDX        | 0.210                   | 7.544 | $\alpha_0 \in [0.83, 0.99]$ |
| Critical values |                         |       |                             |
| 90%             | -0.440                  | 1.100 |                             |
| 95%             | -0.080                  | 1.370 |                             |
| 99%             | 0.600                   | 1.880 |                             |

**Note:** This table reports the results of the RADF and SADF tests and the results of the asymptotic  $t$  test,  $\tilde{t}_{MED}$ . The lag length for each regression in the RADF and SADF tests is selected by the Akaike information criterion, with the maximum lag set to 8. The critical values for the RADF and SADF tests are from Phillips et al. (2011) and Phillips et al. (2015a), respectively. For the asymptotic  $t$  test, we report the confidence intervals for the explosive index.

Table 5: Testing for unit root.

|                 | ADF    |                  | KPSS  |
|-----------------|--------|------------------|-------|
|                 | Level  | First difference |       |
| AS51            | -0.012 | -9.163           | 3.225 |
| FCHI            | -0.148 | -9.296           | 3.086 |
| ITLMS           | -0.227 | -4.778           | 3.002 |
| Critical values |        |                  |       |
| 1% (99%)        | -3.498 | -3.498           | 0.739 |
| 5% (95%)        | -2.891 | -2.891           | 0.463 |
| 10% (90%)       | -2.583 | -2.583           | 0.347 |

**Note:** This table reports the results of the ADF and KPSS tests. The lag length for the ADF test is selected by the Akaike information criterion, with the maximum lag set to 8. The critical values for the ADF (left-tailed) and KPSS (right-tailed) tests are from MacKinnon (1996) and Kwiatkowski et al. (1992), respectively.

the DJI and CSI300 as examples. The DJI in the 100 booming weeks before October 12, 2007 could be described by an MED process with the AR parameter  $\rho = 1 + T^{-\alpha_0}$  for some  $\alpha_0 \in [0.78, 0.99]$ . This signifies that the U.S. stock market witnessed an explosive process with a quite slow pace of explosion. For CSI300 — the main stock index in the largest developing country (China) — we fail to reject the null  $\rho = 1 + T^{-\alpha_0}$  with  $\alpha_0 \in [0.71, 0.99]$ . Again, while the process is explosive, it is only mildly explosive.

Similarly, for IBOVESPA and GDAXI, the confidence intervals of  $\alpha_0$  are  $[0.79, 0.99]$  and  $[0.75, 0.99]$ , respectively. These two stock markets responded closely to the “irrational exuberance” in the US. For CASE and NGSEINDEX, two representative indexes in the African stock market, the degrees of explosiveness are also quite mild. African countries’ thin market capitalization and shortage of liquidity led to the volatility and vulnerability of the stock markets (Allen, Otchere, and Senbet, 2011), making them easily affected by the mild exuberance from external economies.

The HSI of Hong Kong is relatively special. We fail to reject the null of  $\rho = 1 + T^{-\alpha_0}$  for  $\alpha_0 \in [0.56, 0.82]$ . Thus, the Hong Kong market appeared to be more explosive. This could be due to the smaller scale of the market, which made an explosive outburst relatively easier.

Finally, the three series, AS51, FCHI, and ITLMS, are neither explosive processes nor MED processes. When the unit root null against the explosive root alternative is not rejected by either the RADF or SADF method, we can use the conventional unit root tests to examine these three indexes further. In this paper, we employ the ADF test and Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test, the critical values of which are obtained from MacKinnon (1996) and Kwiatkowski, Phillips, Schmidt, and Shin (1992), respectively. Table 5 reports the unit root test results. According to the ADF results, all three time series have a unit root at the 5% level, but their differences have no unit root and appear to be stationary. The KPSS results also provide significant evidence that the three time series are difference-stationary instead of being trend-stationary. Thus, we may conclude that the AS51, FCHI, and ITLMS are all  $I(1)$  processes during their respective sampling periods. These quantitative testing results lend some supplementary support to the conclusion that the rises in Australia, France, and Italy’s stock markets were not explosive.

To sum up, we find evidence that seven of the ten major stock indexes under our consid-

eration are moderately explosive, while the remaining ones are nonexplosive and difference-stationary processes. However, for the former group of indexes, the degree of explosiveness is quite mild. This finding is consistent with the remark of Jagannathan, Kapoor, and Schaumburg (2013): the 2008 financial crisis was more like a symptom than the disease. Despite the severity and ample effects (Martin and Ventura, 2012; Miao and Wang, 2015; Kunieda and Shibata, 2016), this financial crisis was similar to past crises (Allen and Carletti, 2010) that did not show an extremely serious irrational explosion.

## 6 Conclusion

This paper considers a moderately explosive process with a drift wherein the AR root is greater than one by a margin diminishing with the sample size. New asymptotic approximations are established to test for the degree of the moderate explosiveness. We show that the usual  $t$  statistic under i.i.d. errors follows the standard normal distribution in large samples no matter whether the dominating component of the true data process is the stochastic ME trend or the deterministic drift trend. We extend this result to allow for some dynamics in the error process and show that the HAR  $t$  statistic is asymptotically  $t$  distributed. Monte Carlo experiments lend some support to our asymptotic results.

The paper also proposes a two-step empirical testing strategy that involves first identifying whether a time series is explosive or not and then employing our asymptotic  $t$  test to measure the degree of moderate explosiveness if it is indeed explosive. We apply our empirical strategy to ten major stock indexes in the world during the pre-2008 financial exuberance period. The results show that seven of these indexes follow the MED processes with AR root slightly larger than unity; i.e., the explosive index  $\alpha_0$  largely falls in the range from 0.70 to 0.99. In addition, the other three stock indexes are nonexplosive and difference-stationary processes. These results conform with Greenspan (2008)'s perception and imply that the stock market boom before the 2008 financial crisis is not as explosive as in the existing literature.

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## Appendix

Appendix A states some technical lemmas that are used in the proofs of the key results in Sections 2 and 3. The proofs of these lemmas are available from the online supplement. Appendix B presents the proofs of the key results of the paper.

### Appendix A. Technical Lemmas

**Lemma A.1** *Let  $\rho_T = 1 + c/k_T$  for some  $c > 0$  and  $k_T$  satisfy  $1/k_T + k_T/T = o(1)$ . Then  $\rho_T^{-aT} = o(k_T^b/T^b)$  for any  $a$  and  $b \in \mathbb{R}^+$ . In addition, if  $k_T = 1/T^{\alpha_0}$  for some  $\alpha_0 \in (0, 1)$ , then  $\rho_T^{-aT} = o(1/T^b)$  for any  $a$  and  $b \in \mathbb{R}^+$ .*

**Lemma A.2** *Let Assumption 2.1 hold. Then*

$$(a) \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j = o_p(1);$$

$$(b) \left(T^{3\alpha_0/2} \rho_T^{2T}\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j = o_p(1).$$

**Lemma A.3** *Let Assumption 2.1 hold. Then*

$$\left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \xi_{t-1} = Y_T + o_p(1).$$

**Lemma A.4** *Let Assumption 3.1 hold. Then*

$$(a) \left(T^{\alpha_0} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j u_t = o_p(1);$$

$$(b) \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j = o_p(1);$$

$$(c) \left(T^{3\alpha_0/2} \rho_T^{2T}\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j = o_p(1).$$

**Lemma A.5** *Let Assumption 3.1 hold. Then*

$$(a) \left(T^{\alpha_0} \rho_T^T\right)^{-1} \sum_{t=1}^T \xi_{t-1} u_t = \tilde{X}_T \tilde{Y}_T + o_p(1);$$

$$(b) \left(T^{\alpha_0} \rho_T^T\right)^{-2} \sum_{t=1}^T \xi_{t-1}^2 = \tilde{Y}_T^2/2 + o_p(1);$$

$$(c) \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \xi_{t-1} = \tilde{Y}_T + o_p(1).$$



**Lemma A.6** *Let Assumption 3.1 hold. Then*

$$(a) \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^t = O(T^{\alpha_0} \rho_T^T);$$

$$(b) \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=t}^T \rho_T^{t-1-j} u_j = o_p(\sqrt{TT^{\alpha_0}} \rho_T^T).$$

## Appendix B: Proofs of the Key Results

**Proof of Theorem 2.1:** Part (a). Using (9), we obtain

$$\begin{aligned} & \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 = \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0})^2 \\ &= \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \left( \sum_{t=1}^T \xi_{t-1}^2 + \mu_T^2 T^{2\alpha_0} \sum_{t=1}^T \rho_T^{2t-2} + 2\mu_T T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} \right. \\ & \quad \left. + T\mu_T^2 T^{2\alpha_0} - 2\mu_T T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} - 2\mu_T^2 T^{2\alpha_0} \sum_{t=1}^T \rho_T^{t-1} \right) \\ &= \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \xi_{t-1}^2 + (T^{\alpha_0} \rho_T^{2T})^{-1} \frac{\rho_T^{2T} - 1}{\rho_T^2 - 1} + \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} \\ & \quad - \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \xi_{t-1} + O\left(T^{(1-\alpha_0)} \rho_T^{-2T} + \rho_T^{-T}\right) \\ &= \frac{Y_T^2}{2\mu_T^2 T^{\alpha_0}} + \frac{1}{2} + \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} + o_p(1), \end{aligned}$$

by (4) and Lemmas A.1 and A.3.

Since  $T^{\alpha_0} (\rho_T^2 - 1) \rightarrow 2$  as  $T \rightarrow \infty$ , we have

$$\begin{aligned} & \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} = \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \left( \rho_T^{t-1} \xi_0 + \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j \right) \rho_T^{t-1} \\ &= \frac{2}{\mu_T} \xi_0 (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \rho_T^{2t-2} + \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=1}^{t-1} \rho_T^{2(t-1)-j} u_j \\ &= \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=1}^T \rho_T^{2(t-1)-j} u_j - \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j + o_p\left(\mu_T^{-1} T^{-\alpha_0/2}\right) \\ &= \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \rho_T^{2(t-1)} \sum_{j=1}^T \rho_T^{-j} u_j + o_p\left(\mu_T^{-1} T^{-\alpha_0/2}\right) \\ &= \frac{2}{\mu_T} (T^{2\alpha_0} \rho_T^{2T})^{-1} \frac{\rho_T^{2T} - 1}{\rho_T^2 - 1} T^{\alpha_0/2} Y_T + o_p(1) = \frac{Y_T}{\mu_T T^{\alpha_0/2}} + o_p(1), \end{aligned}$$

by  $\xi_0 = o_p(T^{\alpha_0/2})$  and Lemma A.2(b). The key assumption behind this result is that

$\mu_T T^{\alpha_0/2} \rightarrow \nu > 0$ . Thus,

$$\mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow \frac{1}{2} + \frac{Y^2}{2\nu^2} + \frac{Y}{\nu} = \frac{1}{2} \left( 1 + \frac{Y}{\nu} \right)^2.$$

Part (b). The normalized sample mean is

$$\begin{aligned} \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} &= \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0}) \\ &= \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} + 1 - T^{(1-\alpha_0)} \rho_T^{-T} \\ &= \frac{Y_T}{\mu_T T^{\alpha_0/2}} + 1 + o_p(1) \Rightarrow 1 + \frac{Y}{\nu}, \end{aligned}$$

by (3) and Lemmas A.1 and A.3.

Part (c). The normalized sample covariance is

$$\begin{aligned} \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t &= \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0}) u_t \\ &= \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} u_t + (T^{\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T \rho_T^{t-1} u_t - (T^{\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T u_t \\ &= \frac{X_T Y_T}{\mu_T T^{\alpha_0/2}} + \frac{1}{T^{\alpha_0/2}} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t + O_p \left( T^{(1-\alpha_0)/2} \rho_T^{-T} \right) + o_p(1) \Rightarrow X + \frac{XY}{\nu}, \end{aligned}$$

by (3), (5), and Lemma A.1.

The joint convergence of (a), (b), and (c) follows from the Cramér-Wold theorem.  $\square$

**Proof of Lemma 3.1:** Parts (a) and (b). We prove (b) first. Using the decomposition in (1), we have

$$\begin{aligned} T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} u_t &= T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} C(1) \varepsilon_t + T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} (\tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t) \\ &= C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} \varepsilon_t + T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} (\tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t). \end{aligned}$$

But

$$\begin{aligned} \sum_{t=1}^T \rho_T^{-t} (\tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t) &= \sum_{t=1}^T \rho_T^{-t} \tilde{\varepsilon}_{t-1} - \sum_{t=1}^T \rho_T^{-t} \tilde{\varepsilon}_t = \sum_{t=0}^{T-1} \rho_T^{-(t+1)} \tilde{\varepsilon}_t - \sum_{t=1}^T \rho_T^{-t} \tilde{\varepsilon}_t \\ &= \rho_T^{-1} \tilde{\varepsilon}_0 - \rho_T^{-T} \tilde{\varepsilon}_T + \sum_{t=1}^{T-1} \left( \rho_T^{-(t+1)} - \rho_T^{-t} \right) \tilde{\varepsilon}_t \\ &= \rho_T^{-1} \tilde{\varepsilon}_0 - \rho_T^{-T} \tilde{\varepsilon}_T - T^{-\alpha_0} \sum_{t=1}^{T-1} \rho_T^{-(t+1)} \tilde{\varepsilon}_t. \end{aligned}$$

Since  $\text{var}(\tilde{\varepsilon}_t) < \infty$ , we have

$$T^{-\alpha_0/2} \rho_T^{-1} \tilde{\varepsilon}_0 = o_p(1) \quad \text{and} \quad T^{-\alpha_0/2} \rho_T^{-T} \tilde{\varepsilon}_T = o_p(1).$$

Now, using the Cauchy inequality, we obtain

$$\begin{aligned} \text{var} \left( \sum_{t=1}^{T-1} \rho_T^{-(t+1)} \tilde{\varepsilon}_t \right) &= \left( \sum_{t=1}^{T-1} \rho_T^{-2(t+1)} \right) \text{var}(\tilde{\varepsilon}_t) + 2 \sum_{t < s}^{T-1} \rho_T^{-(t+s+2)} \text{cov}(\tilde{\varepsilon}_t, \tilde{\varepsilon}_s) \\ &= \left( \sum_{t=1}^{T-1} \rho_T^{-2(t+1)} \right) \text{var}(\tilde{\varepsilon}_t) + \left( 2 \sum_{t < s}^{T-1} \sum_{j=0}^{\infty} \tilde{c}_j \tilde{c}_{(s-t)+j} \rho_T^{-(t+s+2)} \right) \text{var}(\varepsilon_t) \\ &= O \left( \frac{\rho_T^{-4} - \rho_T^{-2(T+1)}}{1 - \rho_T^{-2}} \right) + O \left( \sum_{t < s}^{T-1} \left( \sum_{j=0}^{\infty} \tilde{c}_j^2 \right) \rho_T^{-(t+s+2)} \right) \\ &= O(T^{\alpha_0}) + O \left( \left( \sum_{t=1}^{T-1} \rho_T^{-(t+1)} \right)^2 \right) = O(T^{\alpha_0}) + O \left( \left( \frac{1}{\rho_T} - \frac{1}{\rho_T} \right)^2 (\rho_T - 1)^{-2} \right) \\ &= O(T^{2\alpha_0}). \end{aligned}$$

Therefore

$$T^{-\alpha_0/2} \left( T^{-\alpha_0} \sum_{t=1}^{T-1} \rho_T^{-(t+1)} \tilde{\varepsilon}_t \right) = O_p \left( T^{-\alpha_0/2} \right) = o_p(1).$$

Combining the above results yields

$$\tilde{Y}_T = T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} u_t = C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-t} \varepsilon_t + o_p(1).$$

To prove part (a), we use the same arguments, starting with

$$T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t = C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} \varepsilon_t + T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} (\tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t).$$

But

$$\begin{aligned} \sum_{t=1}^T \rho_T^{-(T-t)-1} (\tilde{\varepsilon}_{t-1} - \tilde{\varepsilon}_t) &= \rho_T^{-T} \tilde{\varepsilon}_0 - \rho_T^{-1} \tilde{\varepsilon}_T + (\rho_T - 1) \sum_{t=1}^{T-1} \rho_T^{-(T-t)-1} \tilde{\varepsilon}_t \\ &= T^{-\alpha_0} \sum_{t=1}^{T-1} \rho_T^{-(T-t)-1} \tilde{\varepsilon}_t + O_p(1). \end{aligned}$$

By similar calculations, we have

$$\begin{aligned}
& \text{var} \left( \sum_{t=1}^{T-1} \rho_T^{-(T-t)-1} \tilde{\varepsilon}_t \right) \\
&= \left( \sum_{t=1}^{T-1} \rho_T^{-2(T-t+1)} \right) \text{var}(\tilde{\varepsilon}_t) + 2 \sum_{t < s}^{T-1} \rho_T^{-(T-t)-1} \rho_T^{-(T-s)-1} \text{cov}(\tilde{\varepsilon}_t, \tilde{\varepsilon}_s) \\
&= \left( \sum_{t=1}^{T-1} \rho_T^{-2(t+1)} \right) \text{var}(\tilde{\varepsilon}_t) + \left( 2 \sum_{t < s}^{T-1} \sum_{j=0}^{\infty} \tilde{c}_j \tilde{c}_{(s-t)+j} \rho_T^{-(T-t)-1} \rho_T^{-(T-s)-1} \right) \text{var}(\varepsilon_t) \\
&= O(T^{\alpha_0}) + O \left( \sum_{t < s}^{T-1} \left( \sum_{j=0}^{\infty} \tilde{c}_j^2 \right) \rho_T^{-(T-t)-1} \rho_T^{-(T-s)-1} \right) \\
&= O(T^{\alpha_0}) + O \left( \left( \sum_{t=1}^{T-1} \rho_T^{-(T-t+1)} \right)^2 \right) = O(T^{2\alpha_0}).
\end{aligned}$$

Therefore

$$T^{-\alpha_0/2} \left( T^{-\alpha_0} \sum_{t=1}^{T-1} \rho_T^{-(T-t)-1} \tilde{\varepsilon}_t \right) = O_p \left( T^{-\alpha_0/2} \right) = o_p(1).$$

Combining the above results yields

$$\tilde{X}_T = T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t = C(1) T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t+1)} \varepsilon_t + o_p(1).$$

Part (c). This follows immediately from Parts (a) and (b) and equation (3).  $\square$

**Proof of Theorem 3.1:** The proof is similar to that of Theorem 2.1, but we employ Lemmas A.4(c) and A.5 which accommodate weak dependence in  $\{u_t\}$ . For completeness, we sketch the proof here.

Part (a). Using (9), we obtain

$$\begin{aligned}
& \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 = \mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0})^2 \\
&= (T^{3\alpha_0} \rho_T^{2T})^{-1} \left( \mu_T^{-2} \sum_{t=1}^T \xi_{t-1}^2 - 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} + 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} + T^{2\alpha_0} \sum_{t=1}^T \rho_T^{2t-2} \right) + o(1) \\
&= (T^{3\alpha_0} \rho_T^{2T})^{-1} \left( \mu_T^{-2} \sum_{t=1}^T \xi_{t-1}^2 - 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} + 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} \right) + \frac{1}{2} + o(1).
\end{aligned}$$

It follows from Lemmas A.5(b&c) that

$$(T^{3\alpha_0} \rho_T^{2T})^{-1} \mu_T^{-2} \sum_{t=1}^T \xi_{t-1}^2 = \frac{\tilde{Y}_T^2}{2\mu_T^2 T^{\alpha_0}} + o_p(1),$$

and

$$(T^{3\alpha_0} \rho_T^{2T})^{-1} \left( 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} \right) = O_p \left( \frac{\tilde{Y}_T}{\mu_T T^{\alpha_0/2} \rho_T^T} \right) = o_p(1).$$

Moreover, using  $\xi_0 = o_p(T^{\alpha_0/2})$  and Lemma A.4(c), we obtain

$$\begin{aligned}
& (T^{3\alpha_0} \rho_T^{2T})^{-1} \left( 2\mu_T^{-1} T^{\alpha_0} \sum_{t=1}^T \xi_{t-1} \rho_T^{t-1} \right) = 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \left( \rho_T^{t-1} \xi_0 + \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j \right) \rho_T^{t-1} \\
& = 2\xi_0 \mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \rho_T^{2t-2} + 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=1}^{t-1} \rho_T^{2(t-1)-j} u_j \\
& = 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=1}^T \rho_T^{2(t-1)-j} u_j - 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j + o_p\left(\mu_T^{-1} T^{-\alpha_0/2}\right) \\
& = 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T \rho_T^{2(t-1)} \sum_{j=1}^T \rho_T^{-j} u_j + o_p\left(\mu_T^{-1} T^{-\alpha_0/2}\right) \\
& = 2\mu_T^{-1} (T^{2\alpha_0} \rho_T^{2T})^{-1} \frac{\rho_T^{2T} - 1}{\rho_T^2 - 1} T^{\alpha_0/2} \tilde{Y}_T + o_p(1) = \frac{\tilde{Y}_T}{\mu_T T^{\alpha_0/2}} + o_p(1),
\end{aligned}$$

when  $\nu \in (0, \infty]$ .

Combining the above results and Lemma 3.1(c) leads to

$$\mu_T^{-2} (T^{3\alpha_0} \rho_T^{2T})^{-1} \sum_{t=1}^T y_{t-1}^2 \Rightarrow \frac{1}{2} + \frac{\tilde{Y}^2}{2\nu^2} + \frac{\tilde{Y}}{\nu} = \frac{1}{2} \left( 1 + \frac{\tilde{Y}}{\nu} \right)^2.$$

Part (b). By Lemmas 3.1(c), A.1, and A.5(c), we have

$$\begin{aligned}
\mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} & = \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0}) \\
& = \mu_T^{-1} (T^{2\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} + 1 - T^{(1-\alpha_0)} \rho_T^{-T} \\
& = \frac{\tilde{Y}_T}{\mu_T T^{\alpha_0/2}} + 1 + o_p(1) \Rightarrow 1 + \frac{\tilde{Y}}{\nu}.
\end{aligned}$$

Part (c). It follows from Lemmas 3.1(c), A.1, and A.5(a) that

$$\begin{aligned}
& \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T y_{t-1} u_t = \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T (\xi_{t-1} + \mu_T T^{\alpha_0} \rho_T^{t-1} - \mu_T T^{\alpha_0}) u_t \\
& = \mu_T^{-1} (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} u_t + (T^{\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T \rho_T^{t-1} u_t + O_p\left(\left(T^{\alpha_0/2} \rho_T^T\right)^{-1} T^{1/2}\right) \\
& = \frac{\tilde{X}_T \tilde{Y}_T}{\mu_T T^{\alpha_0/2}} + \tilde{X}_T + o_p(1) \Rightarrow \tilde{X} + \frac{\tilde{X} \tilde{Y}}{\nu}.
\end{aligned}$$

The joint convergence of the results in the theorem follows from the Cramér-Wold theorem.

□

**Proof of Theorem 3.3:** We prove the case with  $\nu \in (0, \infty]$  only. The proof for the case with  $\nu = 0$  is essentially the same with only minor modifications. Detailed calculations for the latter case are available upon request.

Part (a). Note that

$$\hat{u}_t = y_t - \hat{\mu}_T - \hat{\rho}_T y_{t-1} = u_t - \begin{pmatrix} 1, & y_{t-1} \end{pmatrix} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right)^{-1} \sum_{t=1}^T \mathbf{x}_t u_t.$$

So

$$\begin{aligned} & \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \hat{u}_t \\ &= \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) u_t - \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \begin{pmatrix} 1, & y_{t-1} \end{pmatrix} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right)^{-1} \sum_{t=1}^T \mathbf{x}_t u_t \\ &= \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) u_t \\ & \quad - \left[ \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \begin{pmatrix} 1, & y_{t-1} \end{pmatrix} \mathbf{D}_T^{-1} \right] \left[ \mathbf{D}_T^{-1} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right) \mathbf{D}_T^{-1} \right]^{-1} \mathbf{D}_T^{-1} \sum_{t=1}^T \mathbf{x}_t u_t, \end{aligned}$$

where

$$\begin{aligned} \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \begin{pmatrix} 1, & y_{t-1} \end{pmatrix} \mathbf{D}_T^{-1} &= \left( \frac{1}{T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right), \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) y_{t-1} \right) \\ &= \left( o(1), \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) y_{t-1} \right). \end{aligned}$$

For the second element in the above vector, using Lemma A.6(a), we have

$$\begin{aligned} & \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) y_{t-1} \\ &= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) [\xi_{t-1} + \mu_T (\rho_T^{t-1} - 1) T^{\alpha_0}] \\ &= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \xi_{t-1} + \frac{1}{\sqrt{T} T^{\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) (\rho_T^{t-1} - 1) \\ &= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \xi_{t-1} + o(1). \end{aligned}$$

By Lemmas 3.1(b&c) and A.6, we have, for  $\nu > 0$ ,

$$\begin{aligned}
& \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \xi_{t-1} = \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \left( \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j + \rho_T^{t-1} \xi_0 \right) \\
&= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j + \left[ \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1} \right] o_p \left( T^{\alpha_0/2} \right) \\
&= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j + o_p \left( \frac{1}{\mu_T T^{\alpha_0/2} T^{(1-\alpha_0)/2}} \right) \\
&= \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=1}^T \rho_T^{t-1-j} u_j - \frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=t}^T \rho_T^{t-1-j} u_j + o_p(1) \\
&= \frac{1}{\mu_T \sqrt{T} T^{\alpha_0} \rho_T^T} \left[ \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1} \right] \tilde{Y}_T + o_p \left( \mu_T^{-1} T^{-\alpha_0/2} \right) + o_p(1) \\
&= O_p \left( \frac{1}{\mu_T T^{\alpha_0/2} T^{(1-\alpha_0)/2}} \right) + o_p(1) = o_p(1).
\end{aligned}$$

Therefore

$$\frac{1}{\mu_T \sqrt{T} T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) y_{t-1} = o_p(1),$$

and

$$\frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \hat{u}_t = \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) u_t + o_p(1) = C(1) \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \varepsilon_t + o_p(1).$$

Now under Assumption 3.1,

$$\frac{1}{\sqrt{T}} \sum_{j=1}^{[Tr]} u_t \Rightarrow \lambda W(r).$$

Since  $\phi_\ell(\cdot)$  is continuously differentiable, using summation by parts and the continuous mapping theorem, we have

$$\frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \hat{u}_t \Rightarrow \lambda \eta_\ell \text{ for } \eta_\ell = \int_0^1 \phi_\ell(r) dW(r), \quad (\text{A.1})$$

jointly over  $\ell = 1, \dots, K$ . Since  $\phi_\ell(\cdot)$  are orthonormal bases, we have  $\eta_\ell \sim i.i.d.N(0, 1)$ . It then follows that

$$\hat{\lambda}_K^2 / \lambda^2 \Rightarrow \frac{1}{K} \sum_{\ell=1}^K \eta_\ell^2 = \frac{1}{K} \chi_K^2.$$

Part (b). Note that

$$\begin{aligned}
& \mu_T T^{3\alpha_0/2} \rho_T^T (\hat{\rho}_T - \rho_T) \\
&= \left( \frac{1}{\mu_T^2 T^{3\alpha_0} \rho_T^{2T}} \sum_{t=1}^T y_{t-1}^2 \right)^{-1} \frac{1}{\mu_T T^{3\alpha_0/2} \rho_T^T} \sum_{t=1}^T y_{t-1} u_t + o_p(1) \\
&= \frac{\tilde{X}_T + \tilde{X}_T \tilde{Y}_T / \nu}{(1 + \tilde{Y}_T / \nu)^2 / 2} + o_p(1) = \frac{2\tilde{X}_T}{1 + \tilde{Y}_T / \nu} + o_p(1) \Rightarrow \frac{2\tilde{X}}{1 + \tilde{Y} / \nu}.
\end{aligned}$$

It is easy to show that the above convergence holds jointly with (A.1) for  $\ell = 1, \dots, K$ . Moreover, using Lemma A.6(a), we have

$$\begin{aligned}
& \left| \text{cov} \left( T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} \varepsilon_t, \frac{1}{\sqrt{T}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \varepsilon_t \right) \right| \\
&= \left| \frac{\sigma^2}{\sqrt{T^{1+\alpha_0}}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^{-(T-t)-1} \right| = \left| \frac{\sigma^2}{\sqrt{T^{1+\alpha_0} \rho_T^{T+1}}} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^t \right| \\
&= O \left( \frac{1}{\sqrt{T^{1+\alpha_0} \rho_T^{T+1}}} T^{\alpha_0} \rho_T^T \right) = o(1).
\end{aligned}$$

This implies that  $\tilde{X}$  is independent of  $\{\eta_1, \dots, \eta_K\}$ .

Let  $\eta_0 = \sqrt{2}\tilde{X}/\lambda$ , then  $\eta_0 \sim N(0, 1)$ , and  $\eta_0$  is independent of  $\{\eta_1, \dots, \eta_K\}$ . Now

$$\begin{aligned}
\frac{\hat{\rho}_T - \rho_T}{\tilde{\sigma}_{\rho, K}} &= \frac{\mu_T T^{3\alpha_0/2} \rho_T^T (\hat{\rho}_T - \rho_T)}{\sqrt{\hat{\lambda}_T^2} \sqrt{e_2' \left[ \mathbf{D}_T^{-1} \left( \sum_{t=1}^T \mathbf{x}_t \mathbf{x}_t' \right) \mathbf{D}_T^{-1} \right]^{-1} e_2}} \\
&\Rightarrow \frac{\frac{2\tilde{X}}{1 + \tilde{Y} / \nu}}{\sqrt{\frac{\sum_{\ell=1}^K \eta_\ell^2}{K} \lambda^2}} \frac{1 + \tilde{Y} / \nu}{\sqrt{2}} = \frac{\eta_0}{\sqrt{\frac{\sum_{\ell=1}^K \eta_\ell^2}{K}}} =^d t_K,
\end{aligned}$$

as desired.  $\square$



## Online Supplement to “Testing for Moderate Explosiveness”

This supplement presents (i) proofs of the technical lemmas given in Appendix A and (ii) additional Monte Carlo simulation evidence.

### Supplement A: Proofs of the Technical Lemmas in Appendix A

**Proof of Lemma A.1:** For the first part of the lemma, we use  $\lim_{T \rightarrow \infty} \ln(1 + 1/T)^T = e$  to obtain

$$\rho_T^T = \left(1 + \frac{c}{k_T}\right)^T = \left[\left(1 + \frac{c}{k_T}\right)^{\frac{k_T}{c}}\right]^{\frac{cT}{k_T}} \rightarrow e^{\frac{cT}{k_T}}, \text{ as } T \rightarrow \infty.$$

Therefore,

$$\frac{\rho_T^{-\alpha T}}{(k_T/T)^b} = O\left(\frac{(T/k_T)^b}{e^{ac(T/k_T)}}\right) = o(1),$$

as desired. The second part of the lemma can be proved in the same way.  $\square$

**Proof of Lemma A.2:** Part (a). Using summation by parts, we have

$$\begin{aligned} & \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j = \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{j=1}^T \left(\sum_{t=1}^j \rho_T^{t-1-j}\right) u_j \\ &= \left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{j=1}^T \frac{1 - \rho_T^j}{\rho_T^j (1 - \rho_T)} u_j = T^{-\alpha_0/2} \rho_T^{-T} \sum_{j=1}^T \frac{\rho_T^j - 1}{\rho_T^j} u_j. \end{aligned} \quad (\text{S.1})$$

Now

$$\begin{aligned} & E \left[ T^{-\alpha_0/2} \rho_T^{-T} \sum_{j=1}^T \frac{\rho_T^j - 1}{\rho_T^j} u_j \right]^2 = \sigma^2 T^{-\alpha_0} \rho_T^{-2T} \sum_{j=1}^T \left(1 - \rho_T^{-j}\right)^2 \\ & \leq \sigma^2 T^{-\alpha_0} \rho_T^{-2T} \sum_{j=1}^T 2 \left(1 + \rho_T^{-2j}\right) = O\left(T^{1-\alpha_0} \rho_T^{-2T}\right) = o(1), \end{aligned}$$

by Lemma A.1. Therefore,  $\left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j$  converges in mean-square to 0, and we obtain  $\left(T^{3\alpha_0/2} \rho_T^T\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j = o_p(1)$ .

Part (b). We write

$$\begin{aligned} & \left(T^{3\alpha_0/2} \rho_T^{2T}\right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j = \left(T^{3\alpha_0/2} \rho_T^{2T}\right)^{-1} \sum_{j=1}^T \left(\sum_{t=1}^j \rho_T^{2(t-1)-j}\right) u_j \\ &= \left(T^{3\alpha_0/2} \rho_T^{2T}\right)^{-1} \sum_{j=1}^T \left(\frac{\rho_T^{2j} - 1}{\rho_T^j (\rho_T^2 - 1)}\right) u_j = O(1) T^{-\alpha_0/2} \rho_T^{-2T} \sum_{j=1}^T \left(\frac{\rho_T^{2j} - 1}{\rho_T^j}\right) u_j. \end{aligned} \quad (\text{S.2})$$

Now, using Lemma A.1, we have

$$\begin{aligned} & E \left[ T^{-\alpha_0/2} \rho_T^{-2T} \sum_{j=1}^T \left( \frac{\rho_T^{2j} - 1}{\rho_T^j} \right) u_j \right]^2 = \sigma^2 T^{-\alpha_0} \rho_T^{-4T} \sum_{j=1}^T \left( \rho_T^j - \rho_T^{-j} \right)^2 \\ & \leq 2\sigma^2 T^{-\alpha_0} \rho_T^{-4T} \sum_{j=1}^T \left( \rho_T^{2j} + \rho_T^{-2j} \right) = O \left( T^{-\alpha_0} \rho_T^{-4T} \right) \left( T^{\alpha_0} \rho_T^{2T} + T^{\alpha_0} \right) = o(1). \end{aligned}$$

Therefore,  $(T^{3\alpha_0/2} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j \rightarrow 0$  in mean-square, which implies that

$$\left( T^{3\alpha_0/2} \rho_T^{2T} \right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j = o_p(1),$$

as desired.  $\square$

**Proof of Lemma A.3:** We have

$$\begin{aligned} & \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \xi_{t-1} = \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \left( \rho_T^{t-1} \xi_0 + \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j \right) \\ & = \xi_0 \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \rho_T^{t-1} + \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j \\ & = \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \rho_T^{t-1} \sum_{j=1}^T \rho_T^{-j} u_j - \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j + o_p(1) \\ & = \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \rho_T^{t-1} \sum_{j=1}^T \rho_T^{-j} u_j + o_p(1), \end{aligned} \tag{S.3}$$

by  $\xi_0 = o_p(T^{\alpha_0/2})$  and Lemma A.2(a). Now

$$\begin{aligned} & \left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \rho_T^{t-1} \sum_{j=1}^T \rho_T^{-j} u_j = T^{-\alpha_0} \rho_T^{-T} \left( \sum_{t=1}^T \rho_T^{t-1} \right) Y_T \\ & = T^{-\alpha_0} \rho_T^{-T} \left( \frac{\rho_T^T - 1}{\rho_T - 1} \right) Y_T = \left( 1 - \rho_T^{-T} \right) Y_T = Y_T + o_p(1). \end{aligned}$$

Combining the above two results completes the proof of the lemma.  $\square$

**Proof of Lemma A.4:** Part (a). Note that

$$\begin{aligned}
& E \left| (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j u_t \right| \\
& \leq (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} E |u_j u_t| \leq (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} (E u_j^2)^{1/2} (E u_t^2)^{1/2} \\
& = \text{var}(u) \frac{1}{\rho_T - 1} (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T (1 - \rho_T^{t-T-1}) = \text{var}(u) \rho_T^{-T} \sum_{t=1}^T (1 - \rho_T^{t-T-1}) \\
& = \text{var}(u) \left[ T \rho_T^{-T} - \rho_T^{-T} \sum_{t=1}^T \rho_T^{t-T-1} \right] = \text{var}(u) \left[ T \rho_T^{-T} - \rho_T^{-2T} \frac{\rho_T^T - 1}{\rho_T - 1} \right] = o(1),
\end{aligned}$$

by Lemma A.1. Part (a) follows, as convergence in  $L^1$  implies convergence in probability.

Part (b). Under Assumption 3.1, (S.1) still holds and so

$$\begin{aligned}
& (T^{3\alpha_0/2} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j = T^{-\alpha_0/2} \rho_T^{-T} \sum_{j=1}^T \frac{\rho_T^j - 1}{\rho_T^j} u_j \\
& = T^{-\alpha_0/2} \rho_T^{-T} \sum_{j=1}^T u_j + T^{-\alpha_0/2} \rho_T^{-T} \sum_{j=1}^T \rho_T^{-j} u_j \\
& = T^{(1-\alpha_0)/2} \rho_T^{-T} \frac{1}{\sqrt{T}} \sum_{j=1}^T u_j + \rho_T^{-T} \tilde{Y}_T = o_p(1),
\end{aligned}$$

by Lemmas 3.1(b&c) and A.1.

Part (c). Using (S.2), we have

$$\begin{aligned}
& (T^{3\alpha_0/2} \rho_T^{2T})^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{2(t-1)-j} u_j = O(1) \times \left[ T^{-\alpha_0/2} \rho_T^{-2T} \sum_{j=1}^T (\rho_T^j - \rho_T^{-j}) u_j \right] \\
& = O(1) T^{-\alpha_0/2} \rho_T^{-T+1} \sum_{j=1}^T \rho_T^{-(T-j)-1} u_j + O(1) T^{-\alpha_0/2} \rho_T^{-2T} \sum_{j=1}^T \rho_T^{-j} u_j \\
& = O(1) \rho_T^{-T+1} \tilde{X}_T + O(1) \rho_T^{-2T} \tilde{Y}_T = o_p(1),
\end{aligned}$$

by Lemma 3.1.  $\square$

**Proof of Lemma A.5:** Part (a). We have

$$\begin{aligned}
& (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \xi_{t-1} u_t = (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \left( \rho_T^{t-1} \xi_0 + \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j \right) u_t \\
&= \frac{\xi_0}{T^{\alpha_0/2}} \left( T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t \right) + (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=1}^{t-1} \rho_T^{t-1-j} u_j u_t \\
&= (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=1}^T \rho_T^{t-1-j} u_j u_t - (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=t}^T \rho_T^{t-1-j} u_j u_t + o_p(1) \\
&= (T^{\alpha_0} \rho_T^T)^{-1} \sum_{t=1}^T \sum_{j=1}^T \rho_T^{t-1-j} u_j u_t + o_p(1) \\
&= \left( T^{-\alpha_0/2} \sum_{t=1}^T \rho_T^{-(T-t)-1} u_t \right) \left( T^{-\alpha_0/2} \sum_{j=1}^T \rho_T^{-j} u_j \right) + o_p(1) = \tilde{X}_T \tilde{Y}_T + o_p(1),
\end{aligned}$$

using  $\xi_0 = o_p(T^{\alpha_0/2})$  and Lemmas 3.1 and A.4(a).

Part (b). By squaring  $\xi_t = \rho_T \xi_{t-1} + u_t$ , we have

$$\xi_t^2 - \xi_{t-1}^2 = (\rho_T^2 - 1) \xi_{t-1}^2 + 2\rho_T \xi_{t-1} u_t + u_t^2,$$

that is,

$$(\rho_T^2 - 1) \xi_{t-1}^2 = \xi_t^2 - \xi_{t-1}^2 - 2\rho_T \xi_{t-1} u_t - u_t^2.$$

So

$$(\rho_T^2 - 1) \sum_{t=1}^T \xi_{t-1}^2 = \xi_T^2 - \xi_0^2 - 2\rho_T \sum_{t=1}^T \xi_{t-1} u_t - \sum_{t=1}^T u_t^2.$$

Using Part (a), we now have

$$\begin{aligned}
& (T^{\alpha_0} \rho_T^T)^{-2} \sum_{t=1}^T \xi_{t-1}^2 = \frac{1}{T^{2\alpha_0} \rho_T^{2T} (\rho_T^2 - 1)} \xi_T^2 + o_p(1) \\
&= \frac{1}{T^{2\alpha_0} \rho_T^{2T} (\rho_T^2 - 1)} \left( \rho_T^T \xi_0 + \sum_{j=1}^T \rho_T^{T-j} u_j \right)^2 + o_p(1) \\
&= \frac{1}{T^{\alpha_0} (\rho_T^2 - 1)} \left( T^{-\alpha_0/2} \sum_{j=1}^T \rho_T^{-j} u_j \right)^2 + o_p(1) = \frac{\tilde{Y}_T^2}{2} + o_p(1).
\end{aligned}$$

Part (c). The proof is similar to that of Lemma A.3. According to Lemma A.4(b), the equation (S.3) still holds under Assumption 3.1. So

$$\left( T^{3\alpha_0/2} \rho_T^T \right)^{-1} \sum_{t=1}^T \xi_{t-1} = T^{-\alpha_0} \rho_T^{-T} \left( \sum_{t=1}^T \rho_T^{t-1} \right) \tilde{Y}_T = \tilde{Y}_T + o_p(1).$$

□

**Proof of Lemma A.6:** Part (a). Since  $\phi_\ell(\cdot)$  is bounded, we have

$$\left| \frac{1}{T^{\alpha_0} \rho_T^T} \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^t \right| = O \left( \frac{1}{T^{\alpha_0} \rho_T^T} \sum_{t=1}^T \rho_T^t \right) = O \left( \frac{1}{T^{\alpha_0} \rho_T^T} (T^{\alpha_0} \rho_T^T) \right) = O(1),$$

where we have used  $\sum_{t=1}^T \rho_T^t = O(T^{\alpha_0} \rho_T^T)$ , which holds by elementary calculations.

Part (b). Since

$$\begin{aligned} & \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \sum_{j=t}^T \rho_T^{t-1-j} u_j = \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) u_j \\ &= \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) C(1) \varepsilon_j + \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) (\tilde{\varepsilon}_{j-1} - \tilde{\varepsilon}_j) \\ &= \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) C(1) \varepsilon_j + \phi_\ell \left( \frac{1}{T} \right) \rho_T^{-1} \tilde{\varepsilon}_0 - \sum_{t=1}^T \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-T} \tilde{\varepsilon}_T \\ & \quad + \sum_{j=1}^{T-1} \left[ (\rho_T^{-1} - 1) \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} + \phi_\ell \left( \frac{j+1}{T} \right) \rho_T^{-1} \right] \tilde{\varepsilon}_j \\ &= \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) C(1) \varepsilon_j + O \left( T^{-\alpha_0} \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \tilde{\varepsilon}_j \right) \\ & \quad + o_p \left( \sqrt{T} T^{\alpha_0} \rho_T^T \right), \end{aligned}$$

it suffices to show that

$$\sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \varepsilon_j = o_p \left( \sqrt{T} T^{\alpha_0} \rho_T^T \right),$$

and

$$T^{-\alpha_0} \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \tilde{\varepsilon}_j = o_p \left( \sqrt{T} T^{\alpha_0} \rho_T^T \right).$$

But

$$\begin{aligned} & \text{var} \left[ \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \varepsilon_j \right] \\ &= O(1) \sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right)^2 = O(1) \sum_{j=1}^T \left( \sum_{t=1}^j \rho_T^{t-1-j} \right)^2 \\ &= O(T^{2\alpha_0}) \sum_{j=1}^T \left( 1 - \rho_T^{-j} \right)^2 = O(TT^{2\alpha_0}), \end{aligned}$$

and

$$\begin{aligned}
& \text{var} \left[ \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \tilde{\varepsilon}_j \right] \\
&= \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right)^2 \text{var}(\tilde{\varepsilon}_j) \\
&\quad + 2 \sum_{j < s}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \left( \sum_{t=1}^s \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-s} \right) \text{cov}(\tilde{\varepsilon}_j, \tilde{\varepsilon}_s) \\
&= O(T^{2\alpha_0}) \sum_{j=1}^{T-1} (1 - \rho_T^{-j})^2 \\
&\quad + \left[ 2 \sum_{j < s}^{T-1} \sum_{k=0}^{\infty} \tilde{c}_k \tilde{c}_{(s-j)+k} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \left( \sum_{t=1}^s \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-s} \right) \right] \text{var}(\varepsilon_j) \\
&= O(TT^{2\alpha_0}) + O \left( \sum_{j < s}^{T-1} \left( \sum_{k=0}^{\infty} \tilde{c}_k^2 \right) \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \left( \sum_{t=1}^s \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-s} \right) \right) \\
&= O(TT^{2\alpha_0}) + O \left( \left[ \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \right]^2 \right) \\
&= O(TT^{2\alpha_0}) + O \left( \left[ \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \rho_T^{t-1-j} \right) \right]^2 \right) \\
&= O(TT^{2\alpha_0}) + O(T^2T^{2\alpha_0}) = O(T^2T^{2\alpha_0}).
\end{aligned}$$

So

$$\sum_{j=1}^T \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \varepsilon_j = O_p(\sqrt{T}T^{\alpha_0}) = o_p(\sqrt{T}T^{\alpha_0} \rho_T^T),$$

and

$$T^{-\alpha_0} \sum_{j=1}^{T-1} \left( \sum_{t=1}^j \phi_\ell \left( \frac{t}{T} \right) \rho_T^{t-1-j} \right) \tilde{\varepsilon}_j = O_p(T) = o_p(\sqrt{T}T^{\alpha_0} \rho_T^T),$$

as desired.  $\square$

## Supplement B: Monte Carlo Simulation Evidence

As mentioned in the main text, we conduct two sets of Monte Carlo simulations. The first set is based on i.i.d. errors while the second set is based on weakly dependent errors. The main text has reported and discussed the simulation results for the case with  $\alpha_0 = 0.5$  and  $T = 100$ . In this section, we consider additional combinations of  $\alpha_0$  and  $T$ , and provide more evidence for the conclusions given in the main text.

Tables S.1-S.3 report the empirical size and power results of the  $t_{\text{PM}}$ ,  $t_{\text{WY}}$ , and  $t_{\text{MED}}$  tests under i.i.d. errors for three explosive indices  $\alpha_0 = \{0.3, 0.5, 0.8\}$  and two sample sizes

$T \in \{100, 150\}$ . Conceptually, the three explosive indices represent the explosive behavior of severe, moderate, and mild degrees, respectively. First, as is clear from the tables, the size performance of the three tests based on i.i.d. Gaussian errors is qualitatively similar to that based on i.i.d. uniform errors. For example, the empirical size of the  $t_{\text{PM}}$  test is 5.0% in the case wherein  $\alpha_0 = 0.3$ ,  $T = 100$ , and  $\nu = 0$  under i.i.d. Gaussian errors, while the corresponding size under i.i.d. uniform errors is 4.7%. Similarly, the  $t_{\text{MED}}$  test has a size of 5.1% under i.i.d. Gaussian errors and 5.3% under i.i.d. uniform errors when  $\alpha_0 = 0.5$ ,  $T = 150$ , and  $\nu = T^{\alpha_0/4}$ . This is in line with our theoretical analysis that normality of the errors is not necessary for these tests.

The second feature is that when  $\nu \neq 0$ , both the  $t_{\text{WY}}$  test and  $t_{\text{MED}}$  test have quite accurate size. Take the case with  $\alpha_0 = 0.5$ ,  $T = 100$ ,  $\nu = T^{\alpha_0/4}$ , and  $u_t \sim i.i.d.N(0, 1)$  as an example. The empirical size of the  $t_{\text{MED}}$  test is 5.5%, whereas the corresponding size of the  $t_{\text{WY}}$  test is 5.6%. Note that the asymptotic distribution of the  $t_{\text{WY}}$  statistic is simulated by employing the true parameter values. The standard normal approximation to the distribution of the  $t_{\text{MED}}$  statistic appears to be very accurate.

When  $\nu = 0$ , as Tables S.1-S.3 show, the  $t_{\text{PM}}$  test has satisfactory size performance for at least the cases with  $\alpha_0 = 0.3$  and  $\alpha_0 = 0.5$ . This is expected, as the  $t_{\text{PM}}$  statistic is based on a regression without a drift term. In such cases, we observe that the size performance of the  $t_{\text{MED}}$  test is not worse than that of the  $t_{\text{PM}}$  test. For example, when  $\alpha_0 = 0.5$ ,  $T = 150$ , and  $\nu = 0$ , the null rejection probabilities of the  $t_{\text{PM}}$  and  $t_{\text{MED}}$  tests are around 5% for both Gaussian and uniform errors. We also notice that these two tests have some size distortion when  $\alpha_0$  is large and close to 1. This is not surprising because when  $\alpha_0 \rightarrow 1$ , the ME root  $\rho_T = 1 + T^{-\alpha_0}$  will approach a unit root, a scenario that is not accommodated by our asymptotic theory. But the size distortion decreases as  $T$  increases or as  $\nu$  departs farther away from zero. In fact, as  $\nu$  becomes larger (i.e.,  $\mu_T$  becomes larger), the  $t_{\text{PM}}$  test suffers from increasing size distortion while the  $t_{\text{MED}}$  test enjoys a good size control. For example, the empirical size of the  $t_{\text{MED}}$  test is 5.4% when  $\alpha_0 = 0.8$ ,  $T = 150$ ,  $\nu = T^{\alpha_0/2}$ , and  $u_t \sim i.i.d.U(-\sqrt{3}, \sqrt{3})$ , which is much closer to the nominal level than that of the  $t_{\text{PM}}$  test, which is nearly 100.0%. According to the size accuracy, the  $t_{\text{MED}}$  test dominates the  $t_{\text{PM}}$  test.

Finally, the  $t_{\text{MED}}$  test is more powerful than the  $t_{\text{PM}}$  test in our simulation experiments. For example, when  $\alpha_0 = 0.8$ ,  $T = 150$ ,  $\nu = T^{\alpha_0/4}$ , and  $u_t \sim i.i.d.U(-\sqrt{3}, \sqrt{3})$ , the size-adjusted power of the  $t_{\text{PM}}$  test is 71.0% while that of the  $t_{\text{MED}}$  test is 75.5%. As  $\alpha_0$  decreases, the local-to-unity alternative departs more from the null of moderate explosiveness, and the power of the tests approaches 100%. This explains why the  $t_{\text{PM}}$  and  $t_{\text{MED}}$  tests always reject when  $\alpha_0 = 0.3$  and 0.5. Our simulation evidence clearly shows that the  $t_{\text{MED}}$  test outperforms the  $t_{\text{PM}}$  test in terms of both size accuracy and power performance.

Tables S.4-S.6 report the empirical size and power results of the  $t_{\text{MED}}$  and  $\tilde{t}_{\text{MED}}$  tests under both the AR design and the MA design. The results for the sample size  $T = 100$  are similar to those for  $T = 150$ . In view of the size accuracy, the  $t_{\text{MED}}$  test performs well when  $\theta = 0$ , as there is no autocorrelation. However, this test has large size distortion when  $\theta$  is different from 0. The size distortion increases significantly as  $\theta$  becomes larger. In contrast, the size distortion of the  $\tilde{t}_{\text{MED}}$  test is substantially smaller than that of the standard  $t_{\text{MED}}$  test. For example, in the case wherein  $\alpha_0 = 0.3$ ,  $T = 150$ , and  $\theta = 0.75$ , the size results of  $\tilde{t}_{\text{MED}}$  are 4.0% under the AR design and 5.9% under the MA design, respectively, both of which are quite smaller than 36.3% and 15.4%, the corresponding size levels of  $t_{\text{MED}}$ . Other parameter configurations also lead to the observation that the  $\tilde{t}_{\text{MED}}$  test is more accurate and is therefore preferred when the errors are serially correlated. This result is consistent with our asymptotic theory. Ignoring

Table S.1: Size and power under i.i.d. errors with  $\alpha_0 = 0.3$ .

|                        | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                 |                  | Power ( $\rho = 1 + 1/T$ ) |                  |
|------------------------|--------------------------------------|-----------------|------------------|----------------------------|------------------|
|                        | $t_{\text{PM}}$                      | $t_{\text{WY}}$ | $t_{\text{MED}}$ | $t_{\text{PM}}$            | $t_{\text{MED}}$ |
| $T = 100$              | (a) i.i.d. Gaussian errors           |                 |                  |                            |                  |
| $\nu = 0$              | 0.050                                | 0.056           | 0.055            | 1.000                      | 1.000            |
| $\nu = 2$              | 0.603                                | 0.058           | 0.055            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$ | 0.397                                | 0.060           | 0.055            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$ | 0.601                                | 0.058           | 0.055            | 1.000                      | 1.000            |
|                        | (b) i.i.d. uniform errors            |                 |                  |                            |                  |
| $\nu = 0$              | 0.047                                | 0.049           | 0.046            | 1.000                      | 1.000            |
| $\nu = 2$              | 0.598                                | 0.048           | 0.046            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$ | 0.393                                | 0.048           | 0.046            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$ | 0.596                                | 0.048           | 0.046            | 1.000                      | 1.000            |
| $T = 150$              | (a) i.i.d. Gaussian errors           |                 |                  |                            |                  |
| $\nu = 0$              | 0.050                                | 0.052           | 0.051            | 1.000                      | 1.000            |
| $\nu = 2$              | 0.626                                | 0.057           | 0.051            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$ | 0.428                                | 0.053           | 0.051            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$ | 0.663                                | 0.057           | 0.052            | 1.000                      | 1.000            |
|                        | (b) i.i.d. uniform errors            |                 |                  |                            |                  |
| $\nu = 0$              | 0.051                                | 0.061           | 0.054            | 1.000                      | 1.000            |
| $\nu = 2$              | 0.618                                | 0.055           | 0.053            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/4}$ | 0.420                                | 0.058           | 0.054            | 1.000                      | 1.000            |
| $\nu = T^{\alpha_0/2}$ | 0.652                                | 0.055           | 0.053            | 1.000                      | 1.000            |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .



Table S.2: Size and power under i.i.d. errors with  $\alpha_0 = 0.5$ .

|                        | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |          |           | Power ( $\rho = 1 + 1/T$ ) |           |
|------------------------|--------------------------------------|----------|-----------|----------------------------|-----------|
|                        | $t_{PM}$                             | $t_{WY}$ | $t_{MED}$ | $t_{PM}$                   | $t_{MED}$ |
| $T = 100$              | (a) i.i.d. Gaussian errors           |          |           |                            |           |
| $\nu = 0$              | 0.050                                | 0.053    | 0.056     | 1.000                      | 1.000     |
| $\nu = 2$              | 0.733                                | 0.056    | 0.055     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/4}$ | 0.641                                | 0.056    | 0.055     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/2}$ | 0.969                                | 0.058    | 0.055     | 1.000                      | 1.000     |
|                        | (b) i.i.d. uniform errors            |          |           |                            |           |
| $\nu = 0$              | 0.049                                | 0.047    | 0.049     | 1.000                      | 1.000     |
| $\nu = 2$              | 0.733                                | 0.047    | 0.048     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/4}$ | 0.637                                | 0.047    | 0.048     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/2}$ | 0.973                                | 0.047    | 0.048     | 1.000                      | 1.000     |
| $T = 150$              | (a) i.i.d. Gaussian errors           |          |           |                            |           |
| $\nu = 0$              | 0.050                                | 0.056    | 0.051     | 1.000                      | 1.000     |
| $\nu = 2$              | 0.740                                | 0.054    | 0.051     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/4}$ | 0.689                                | 0.053    | 0.051     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/2}$ | 0.992                                | 0.053    | 0.051     | 1.000                      | 1.000     |
|                        | (b) i.i.d. uniform errors            |          |           |                            |           |
| $\nu = 0$              | 0.051                                | 0.053    | 0.053     | 1.000                      | 1.000     |
| $\nu = 2$              | 0.731                                | 0.053    | 0.053     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/4}$ | 0.678                                | 0.053    | 0.053     | 1.000                      | 1.000     |
| $\nu = T^{\alpha_0/2}$ | 0.991                                | 0.053    | 0.053     | 1.000                      | 1.000     |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

Table S.3: Size and power under i.i.d. errors with  $\alpha_0 = 0.8$ .

|                        | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |          |           | Power ( $\rho = 1 + 1/T$ ) |           |
|------------------------|--------------------------------------|----------|-----------|----------------------------|-----------|
|                        | $t_{PM}$                             | $t_{WY}$ | $t_{MED}$ | $t_{PM}$                   | $t_{MED}$ |
| $T = 100$              | (a) i.i.d. Gaussian errors           |          |           |                            |           |
| $\nu = 0$              | 0.118                                | 0.256    | 0.261     | 0.133                      | 0.142     |
| $\nu = 2$              | 0.576                                | 0.049    | 0.050     | 0.320                      | 0.391     |
| $\nu = T^{\alpha_0/4}$ | 0.795                                | 0.048    | 0.048     | 0.407                      | 0.553     |
| $\nu = T^{\alpha_0/2}$ | 1.000                                | 0.052    | 0.051     | 0.978                      | 0.999     |
|                        | (b) i.i.d. uniform errors            |          |           |                            |           |
| $\nu = 0$              | 0.113                                | 0.241    | 0.257     | 0.136                      | 0.142     |
| $\nu = 2$              | 0.591                                | 0.045    | 0.048     | 0.289                      | 0.364     |
| $\nu = T^{\alpha_0/4}$ | 0.807                                | 0.044    | 0.047     | 0.399                      | 0.527     |
| $\nu = T^{\alpha_0/2}$ | 1.000                                | 0.048    | 0.053     | 0.982                      | 1.000     |
| $T = 150$              | (a) i.i.d. Gaussian errors           |          |           |                            |           |
| $\nu = 0$              | 0.118                                | 0.240    | 0.246     | 0.207                      | 0.192     |
| $\nu = 2$              | 0.615                                | 0.052    | 0.054     | 0.498                      | 0.524     |
| $\nu = T^{\alpha_0/4}$ | 0.883                                | 0.051    | 0.054     | 0.695                      | 0.741     |
| $\nu = T^{\alpha_0/2}$ | 1.000                                | 0.051    | 0.055     | 1.000                      | 1.000     |
|                        | (b) i.i.d. uniform errors            |          |           |                            |           |
| $\nu = 0$              | 0.118                                | 0.235    | 0.235     | 0.200                      | 0.196     |
| $\nu = 2$              | 0.610                                | 0.055    | 0.055     | 0.515                      | 0.553     |
| $\nu = T^{\alpha_0/4}$ | 0.880                                | 0.052    | 0.054     | 0.710                      | 0.755     |
| $\nu = T^{\alpha_0/2}$ | 1.000                                | 0.053    | 0.054     | 1.000                      | 1.000     |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

Table S.4: Size and power in the presence of autocorrelated errors: the case with  $\alpha_0 = 0.3$ .

|                 | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                          | Power ( $\rho = 1 + 1/T$ ) |                          |
|-----------------|--------------------------------------|--------------------------|----------------------------|--------------------------|
|                 | $t_{\text{MED}}$                     | $\tilde{t}_{\text{MED}}$ | $t_{\text{MED}}$           | $\tilde{t}_{\text{MED}}$ |
| $T = 100$       | (a) AR design                        |                          |                            |                          |
| $\theta = 0.00$ | 0.056                                | 0.059                    | 1.000                      | 1.000                    |
| $\theta = 0.25$ | 0.123                                | 0.061                    | 1.000                      | 1.000                    |
| $\theta = 0.50$ | 0.221                                | 0.054                    | 1.000                      | 1.000                    |
| $\theta = 0.75$ | 0.356                                | 0.045                    | 1.000                      | 1.000                    |
|                 | (b) MA design                        |                          |                            |                          |
| $\theta = 0.00$ | 0.055                                | 0.059                    | 1.000                      | 1.000                    |
| $\theta = 0.25$ | 0.108                                | 0.056                    | 1.000                      | 1.000                    |
| $\theta = 0.50$ | 0.143                                | 0.058                    | 1.000                      | 1.000                    |
| $\theta = 0.75$ | 0.155                                | 0.056                    | 1.000                      | 1.000                    |
| $T = 150$       | (a) AR design                        |                          |                            |                          |
| $\theta = 0.00$ | 0.052                                | 0.055                    | 1.000                      | 1.000                    |
| $\theta = 0.25$ | 0.119                                | 0.056                    | 1.000                      | 1.000                    |
| $\theta = 0.50$ | 0.215                                | 0.053                    | 1.000                      | 1.000                    |
| $\theta = 0.75$ | 0.363                                | 0.040                    | 1.000                      | 1.000                    |
|                 | (b) MA design                        |                          |                            |                          |
| $\theta = 0.00$ | 0.051                                | 0.056                    | 1.000                      | 1.000                    |
| $\theta = 0.25$ | 0.103                                | 0.055                    | 1.000                      | 1.000                    |
| $\theta = 0.50$ | 0.144                                | 0.055                    | 1.000                      | 1.000                    |
| $\theta = 0.75$ | 0.154                                | 0.059                    | 1.000                      | 1.000                    |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. In the AR design,  $u_t = \theta u_{t-1} + \sqrt{1 - \theta^2} e_{1,t}$ , while in the MA design,  $u_t = \theta e_{2,t-1} + \sqrt{1 - \theta^2} e_{2,t}$ , where  $e_{1,t} \sim i.i.d.N(0, 1)$  and  $e_{2,t} \sim i.i.d.N(0, 1)$ . Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

the autocorrelation leads to an inaccurate test.

On the other hand, as can be seen from Tables S.4-S.6, the size-adjusted power of the  $\tilde{t}_{\text{MED}}$  test is close to that of the  $t_{\text{MED}}$  test, in both the AR and MA cases. Take the case with  $\alpha_0 = 0.5$ ,  $T = 100$ , and  $\theta = 0.75$  as an example. The  $\tilde{t}_{\text{MED}}$  test has a power of 97.1% under the AR design, whereas the corresponding power of the  $t_{\text{MED}}$  test is 99.3%. Under the MA design, the power level of both the  $\tilde{t}_{\text{MED}}$  and  $t_{\text{MED}}$  tests reaches 100%. Given these observations, we can conclude that the  $\tilde{t}_{\text{MED}}$  test achieves a satisfactory size-adjusted power performance with only relatively small size distortion.

Table S.5: Size and power in the presence of autocorrelated errors: the case with  $\alpha_0 = 0.5$ .

|           | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                        | Power ( $\rho = 1 + 1/T$ ) |                        |
|-----------|--------------------------------------|------------------------|----------------------------|------------------------|
|           | $t_{\text{MED}}$                     | $\hat{t}_{\text{MED}}$ | $t_{\text{MED}}$           | $\hat{t}_{\text{MED}}$ |
| $T = 100$ |                                      |                        | (a) AR design              |                        |
|           | $\theta = 0.00$                      | 0.053                  | 0.057                      | 1.000                  |
|           | $\theta = 0.25$                      | 0.134                  | 0.068                      | 1.000                  |
|           | $\theta = 0.50$                      | 0.242                  | 0.070                      | 1.000                  |
|           | $\theta = 0.75$                      | 0.413                  | 0.081                      | 0.993                  |
|           |                                      |                        | (b) MA design              |                        |
|           | $\theta = 0.00$                      | 0.055                  | 0.060                      | 1.000                  |
|           | $\theta = 0.25$                      | 0.114                  | 0.060                      | 1.000                  |
|           | $\theta = 0.50$                      | 0.157                  | 0.066                      | 1.000                  |
|           | $\theta = 0.75$                      | 0.169                  | 0.066                      | 1.000                  |
| $T = 150$ |                                      |                        | (a) AR design              |                        |
|           | $\theta = 0.00$                      | 0.052                  | 0.053                      | 1.000                  |
|           | $\theta = 0.25$                      | 0.127                  | 0.064                      | 1.000                  |
|           | $\theta = 0.50$                      | 0.243                  | 0.064                      | 1.000                  |
|           | $\theta = 0.75$                      | 0.430                  | 0.074                      | 0.998                  |
|           |                                      |                        | (b) MA design              |                        |
|           | $\theta = 0.00$                      | 0.051                  | 0.055                      | 1.000                  |
|           | $\theta = 0.25$                      | 0.111                  | 0.061                      | 1.000                  |
|           | $\theta = 0.50$                      | 0.155                  | 0.063                      | 1.000                  |
|           | $\theta = 0.75$                      | 0.169                  | 0.062                      | 1.000                  |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. In the AR design,  $u_t = \theta u_{t-1} + \sqrt{1 - \theta^2} e_{1,t}$ , while in the MA design,  $u_t = \theta e_{2,t-1} + \sqrt{1 - \theta^2} e_{2,t}$ , where  $e_{1,t} \sim i.i.d.N(0, 1)$  and  $e_{2,t} \sim i.i.d.N(0, 1)$ . Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .

Table S.6: Size and power in the presence of autocorrelated errors: the case with  $\alpha_0 = 0.8$ .

|           | Size ( $\rho = 1 + 1/T^{\alpha_0}$ ) |                        | Power ( $\rho = 1 + 1/T$ ) |                        |
|-----------|--------------------------------------|------------------------|----------------------------|------------------------|
|           | $t_{\text{MED}}$                     | $\hat{t}_{\text{MED}}$ | $t_{\text{MED}}$           | $\hat{t}_{\text{MED}}$ |
| $T = 100$ |                                      |                        | (a) AR design              |                        |
|           | $\theta = 0.00$                      | 0.049                  | 0.051                      | 0.556                  |
|           | $\theta = 0.25$                      | 0.121                  | 0.061                      | 0.525                  |
|           | $\theta = 0.50$                      | 0.250                  | 0.077                      | 0.398                  |
|           | $\theta = 0.75$                      | 0.459                  | 0.111                      | 0.272                  |
|           |                                      |                        | (b) MA design              |                        |
|           | $\theta = 0.00$                      | 0.048                  | 0.051                      | 0.552                  |
|           | $\theta = 0.25$                      | 0.099                  | 0.056                      | 0.531                  |
|           | $\theta = 0.50$                      | 0.144                  | 0.065                      | 0.489                  |
|           | $\theta = 0.75$                      | 0.157                  | 0.065                      | 0.483                  |
| $T = 150$ |                                      |                        | (a) AR design              |                        |
|           | $\theta = 0.00$                      | 0.055                  | 0.057                      | 0.763                  |
|           | $\theta = 0.25$                      | 0.126                  | 0.069                      | 0.666                  |
|           | $\theta = 0.50$                      | 0.252                  | 0.074                      | 0.512                  |
|           | $\theta = 0.75$                      | 0.465                  | 0.103                      | 0.330                  |
|           |                                      |                        | (b) MA design              |                        |
|           | $\theta = 0.00$                      | 0.054                  | 0.055                      | 0.740                  |
|           | $\theta = 0.25$                      | 0.106                  | 0.062                      | 0.688                  |
|           | $\theta = 0.50$                      | 0.150                  | 0.066                      | 0.630                  |
|           | $\theta = 0.75$                      | 0.163                  | 0.066                      | 0.615                  |

**Note:** This table reports the empirical size and size-adjusted power of 5% tests with 5,000 Monte Carlo replications. In the AR design,  $u_t = \theta u_{t-1} + \sqrt{1 - \theta^2} e_{1,t}$ , while in the MA design,  $u_t = \theta e_{2,t-1} + \sqrt{1 - \theta^2} e_{2,t}$ , where  $e_{1,t} \sim i.i.d.N(0, 1)$  and  $e_{2,t} \sim i.i.d.N(0, 1)$ . Different parameter combinations are configured to conduct simulations for the null of moderate explosiveness  $\rho = 1 + 1/T^{\alpha_0}$  against the alternative of local-to-unity  $\rho = 1 + 1/T$ .