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# Oil Price Shocks and Economic Growth: The Volatility Link\*

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## Abstract

This paper shows that oil shocks primarily impact economic growth through the conditional variance of growth. We move beyond the literature that focuses on conditional mean point forecasts and compare models based on density forecasts. Over a range of dynamic models, oil shock measures and data we find a robust link between oil shocks and the volatility of economic growth. A new measure of oil shocks is developed and shown to be superior to existing measures and indicates that the conditional variance of growth increases in response to an indicator of local maximum oil price exceedance. The empirical results uncover a large pronounced asymmetric response of growth volatility to oil price changes. Uncertainty about future growth is considerably lower compared to a benchmark AR(1) model when no oil shocks are present.

key words: Bayes factors, predictive likelihoods, nonlinear dynamics, density forecast

JEL: C53, C32, C11, Q43

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# 1 Introduction

This paper provides new results to the debate on how oil shocks impact real economic growth. We find no evidence that oil shocks affect the conditional mean of economic growth using a variety of oil shock measures. However, oil shocks display a strong robust impact on the conditional variance of growth. Related to initial studies (Mork 1989, Hamilton 1996) that find oil price increases are relevant when they exceed the maximum oil price we find that they lead to increases in the conditional variance of growth and provide the best density forecasts for future growth.

The importance of oil price movements and their impact on economic growth was raised in Hamilton (1983). However, the subsequent literature is unclear on the role if any that oil plays in predicting economic growth. The initial findings from Mork (1989) and Hamilton (1996) were that oil price increases are relevant when they exceed the maximum oil price and oil price decreases have no significant effects on economic growth. These stylized facts were further confirmed by Hamilton (2003), Hamilton (2011) and Ravazzolo & Rothman (2013) among others.

This asymmetric response to oil shocks was challenged by Kilian & Vigfusson (2011*a*) and Kilian & Vigfusson (2011*b*). In lieu of testing the coefficients from a regression model, these papers focus on impulse response functions and found no significant difference between positive shocks and negative shocks. Hamilton (2011) argued that their results are caused by different data sets, measures of oil price and price adjustment.

The recent study by Kilian & Vigfusson (2013) performs a comprehensive predictive analysis of the effect of oil price shocks on economic growth. Among several economically plausible nonlinear specifications, they find that including negative oil price shocks further improves economic growth forecasting. In addition, the best predictive model preserves symmetry between positive and negative shocks.

One common feature for the majority of the literature is that the predictive models are nonlinear in oil prices, but linear in oil price shocks. First, a measure of oil price shocks is constructed such as net oil price increase (Hamilton 1996) or large oil price change (Kilian & Vigfusson 2013). Then, the constructed variable enters into a linear model as one regressor to have its predictive performance examined in a homoskedastic setting. One exception is Hamilton (2003), who has modelled the nonparametric conditional mean function to study the nonlinear marginal effect of the oil price on economic growth.

Although our paper is the first to explore the impact oil shocks have on economic uncertainty, other papers by Lee et al. (1995) and Elder & Serletis (2010) have investigated second order moments from oil prices. Lee et al. (1995) argue that an oil shock standardized by a GARCH model is more important to the conditional mean of growth. This two step estimation approach is extended to a bivariate GARCH-in-mean specification in Elder & Serletis (2010). The latter paper finds volatility in oil prices have a negative effect on several measures of output.

The most significant contribution of this paper is to demonstrate that oil shocks primarily affect economic growth through a volatility channel. We find little to no gains by including oil shocks into the conditional mean but very significant forecast improvements when oil shocks enter the conditional variance of real growth. Of course, this volatility channel does not show up in point forecasts of the conditional mean as the literature has focused on but becomes readily apparent in density forecasts.

Working with density forecasts have several advantages. First, a density forecast contains a complete description of future outcomes of growth, including the predictive mean. Second, a density forecast can provide a measure of economic uncertainty about the future and will be sensitive to models with different conditional moment specifications. For example, volatility measures and density intervals from the predictive density will be sensitive to heteroskedasticity. Lastly, density-forecasting based model comparison leads to standard Bayesian methods of model comparison based on Bayes factors. Predictive or marginal likelihoods automatically penalize complex models that do not improve predictions. From a classical perspective, density forecasts can be evaluated through scoring rules (Gneiting & Raftery 2007, Elliott & Timmermann 2008) which have a close equivalence to Bayesian predictive likelihoods and Bayes factors.

This volatility channel is shown to be robust to different oil shock measures and the use of industrial production index for output. We consider five measures of oil price shocks, four from the academic literature and one developed in this paper. The analysis also consider a range of different lag structures for the dependent variable and the oil shock measures.

One oil shock measure, an indicator variable on the net oil price increase, results in the best density forecasts. This specification dominates a GARCH model for growth as well as a hybrid GARCH model that includes these shocks. This implies that economic uncertainty increases in response to a local maximum oil price exceedance. However, the impact of this exceedance is independent of the shock size and we discuss some possible reasons for this. When an exceedance occurs the standard deviation on real growth

innovations, 2 quarters ahead, almost doubles. Thus our empirical results uncover a large pronounced asymmetric response of growth volatility to net oil price increases. An implication of our findings is that the uncertainty about future growth is considerably lower compared to a benchmark AR(1) model when no oil shocks are present.

The remainder of the paper is organized as follows. Section 2 reviews the data. Section 3 explains out-of-sample density forecasts and the computation method. Different lag structures are reviewed in Section 4. Oil price shocks are defined in Section 5 while Section 6 introduces the model that allows oil shocks to affect the conditional mean and conditional variance of growth. The empirical results are discussed in Section 7 while Section 8 reports robustness checks. Section 9 concludes and this is followed by an Appendix that provides details on posterior simulation methods.

## 2 Data

The paper restricts attention to two popular series: U.S. real GDP growth rate and Refiners' Acquisition Cost composite index (RAC). The first represents economic growth and the latter represents oil price.<sup>1</sup> For the oil price information, there is a fair amount of discussion regarding whether using real or nominal oil price data is appropriate. We use the nominal price following Hamilton (2003), because we believe that a nominal price shock is conceptually more related to behavioural responses from the economy.

Define  $O_t$  as the U.S. RAC composite index at time  $t$ .<sup>2</sup> The change in oil price, denoted by  $r_t$ , is defined as the log difference of  $O_t$ , scaled by 100. The economic growth rate, denoted by  $g_t$ , is defined as the log difference of the real GDP level scaled by 100.<sup>3</sup> The data spans from 1974Q1 to 2015Q3 with 166 observations in total. Figure 1 shows their time series plot.

## 3 Out-of-Sample Density Forecasts

To the best of our knowledge, all existing papers on the predictive relationship between oil prices and economic growth compare point forecasts. In this paper, we evaluate the predictive relationship from a more general perspective. Models can produce better density forecasts due to a more accurate predictive mean, as the literature has focused

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<sup>1</sup>Section 8 considers other variables.

<sup>2</sup>Obtained from [https://www.eia.gov/dnav/pet/pet\\_pri\\_rac2\\_dcu\\_nus\\_m.htm](https://www.eia.gov/dnav/pet/pet_pri_rac2_dcu_nus_m.htm).

<sup>3</sup>Data is from <https://fred.stlouisfed.org/series/GDPC1>.

on, but improvements may come from other higher order moments that affect the shape the density forecast. Although our focus is on density forecasts we also report the accuracy of models' predictive mean forecasts.

From a Bayesian perspective, density forecasts or the predictive density, integrates out parameter uncertainty. Model comparison is based on the predictive likelihood, which is the evaluation of the predictive density function at the realized data. Predictive likelihoods are the main input to construct Bayes factors. Although we conduct Bayesian inference the predictive likelihoods are equivalent to a log-scoring rule for density forecasts and there are well defined classical methods to compare models (Amisano & Giacomini 2007).

The predictive density at period  $t$  is defined as the distribution of the random variable of interest, in this case  $g_t$ , conditional on the past information  $I_{t-1} = \{g_{1:t-1}, r_{1:t-1}\}$ , for model  $\mathcal{M}$  as,

$$p(g_t | I_{t-1}, \mathcal{M}). \quad (1)$$

The predictive mean is derived from the predictive density function as

$$E(g_t | I_{t-1}, \mathcal{M}) = \int g_t p(g_t | I_{t-1}, \mathcal{M}) dg_t. \quad (2)$$

If we are only interested in the mean forecast and use it as a measure for model comparison, we can compare the observed growth data  $g_t$  to the predictive mean  $E(\tilde{g}_t | I_{t-1}, \mathcal{M})$  for model  $\mathcal{M}$ . A quadratic loss function implies the root mean squared forecast error (RMSFE) for  $\mathcal{M}$ , which is a traditional measure of fitness:

$$\text{RMSFE}_{\mathcal{M}} = \sqrt{\frac{1}{T - t_0 + 1} \sum_{t=t_0}^T (g_t - E(g_t | I_{t-1}, \mathcal{M}))^2}, \quad (3)$$

where  $t_0$  is the first period in the out-of-sample data and  $T$  is the total number of observations. The data from period  $t = 1$  to  $t_0 - 1$  are used as a training sample.

In order to evaluate density forecasts, we compute the predictive likelihood which is the value of the predictive density for a model evaluated at the observed data  $g_t$ . Models can be compared based on predictive likelihood values. A model with a larger value implies that the density forecast is more plausible, while a model with a smaller value indicates that the model has less support from the data. Of course model comparison

cannot be based on any single observation but over a range of out-of-sample density forecasts models' predictive likelihoods become informative.

The log-predictive likelihood (LPL) for  $g_t$ ,  $t = t_0, \dots, T$  can be decomposed into a sequence of the one-period ahead predictive likelihoods

$$\log p(g_{t_0:T} | I_{t_0-1}, \mathcal{M}) = \sum_{t=t_0}^T \log p(g_t | I_{t-1}, \mathcal{M}). \quad (4)$$

The predictive likelihood is an out-of-sample measure and its calculation is discussed below. The predictive likelihood favors parsimony and more complex models only deliver higher predictive likelihood values if their predictions are more accurate and otherwise leads to smaller values.

For illustration, consider two models under consideration:  $\mathcal{M}_0$  and  $\mathcal{M}_1$ , which may or may not nest each other. The log-predictive likelihoods of these models are  $LPL_0 = \log p(g_{t_0:T} | I_{t_0-1}, \mathcal{M}_0)$  and  $LPL_1 = \log p(g_{t_0:T} | I_{t_0-1}, \mathcal{M}_1)$ . The log-Bayes factor for these data is defined as  $\log BF_{01} = LPL_0 - LPL_1$ . If  $\log BF_{01} > 0$ , the data support model  $\mathcal{M}_0$  and vice versa. Values of  $\log BF_{01} > 5$  are considered very strong support for  $\mathcal{M}_0$  (Kass & Raftery 1995).

To account for sensitivity to prior elicitation, we let  $t_0 = 10$  in the application to include a training sample of size 10. The rest, 156 observations, are used for out-of-sample forecasts. Because we have many models, we report the log-predictive likelihood  $LPL_i$ , and for any pair of models, their log-predictive Bayes factors can be inferred easily from these.

Now the only problem is to compute the predictive likelihood values. All models in this paper are parametric, so we use  $\theta$  to represent the parameter vector of a model. The predictive likelihood at period  $t$  is obtained by integrating out the parameter uncertainty as follows:

$$p(g_t | I_{t-1}, \mathcal{M}) = \int p(g_t | \theta, I_{t-1}, \mathcal{M})p(\theta | I_{t-1}, \mathcal{M})d\theta.$$

The first part in the integral  $p(g_t | \theta, I_{t-1}, \mathcal{M})$  is the data density for model  $\mathcal{M}$ . The second part  $p(\theta | I_{t-1}, \mathcal{M})$  is the posterior density given data  $I_{t-1}$  for model  $\mathcal{M}$ . The posterior density is generally of an unknown form but with Markov chain Monte Carlo (MCMC) methods draws can be obtained from this distribution. Given a large sample  $\{\theta^{(i)}\}_{i=1}^M$  of MCMC draws from the posterior distribution  $p(\theta | I_{t-1})$  a simulation

consistent estimate of the predictive likelihood is calculated as

$$p(g_t | \widehat{I}_{t-1}, \mathcal{M}) = \frac{1}{M} \sum_{i=1}^M p(g_t | \theta^{(i)}, I_{t-1}, \mathcal{M}).$$

We choose  $M = 20,000$  after discarding 20,000 burnin samples to remove initial value's influence. Additional details on posterior simulation for the models is found in the Appendix.

## 4 Lag Structure

Before investigating the impact of oil shocks on the conditional variance of growth it is important to have a well specified conditional mean. Although some papers mentioned this matter such as Kilian & Vigfusson (2011*a*) and Hamilton (2011), none provide a detailed study on the importance of lag structure for prediction. Below we discuss several different models of the conditional mean for economic growth in a homoskedastic setting.

### 4.1 ARX

Define  $q$  and  $p$  as the number of lags for economic growth and oil price change, respectively. In the ARX model, real GDP growth rate  $g_t$ , is modelled as,

$$g_t = \mu + \sum_{j=1}^q \alpha_j g_{t-j} + \sum_{j=1}^p \beta_j r_{t-j} + \sigma e_t, \quad e_t \stackrel{iid}{\sim} N(0, 1). \quad (5)$$

The maximum values of  $q$  and  $p$  are 4.

### 4.2 Almon Lag on ARX (ARX-A)

For the second model, we use a parsimonious Almon lag structure on the parameters (Almon 1965), which can be viewed as restricted ARX models. The recent literature on mixed frequency data models applies exponential Almon lag structure such as Clements & Galvão (2008). Because the exponential Almon lag structure imposes positivity on the coefficients, we use the original Almon lag specification instead. In this specification (ARX-A) the coefficients on the lag variables are a polynomial function of the lag period

as follows,

$$\begin{aligned}\alpha_j &= a_0 + a_1j + a_2j^2 + \dots + a_fj^f \\ \beta_j &= b_0 + b_1j + b_2j^2 + \dots + b_hj^h,\end{aligned}$$

where  $f < q$  and  $h < p$ . After simplification the model for economic growth is,

$$g_t = \mu + \sum_{i=0}^f a_i z(q, i) + \sum_{i=0}^h b_i s(p, i) + \sigma e_t, \quad e_t \stackrel{iid}{\sim} N(0, 1), \quad (6)$$

where  $z(q, i) = \sum_{j=1}^q g_{t-j} j^i$  and  $s(p, i) = \sum_{j=1}^p r_{t-j} j^i$ . The model reduces the number of coefficients from the ARX by  $q + p - f - h$ . The maximum values of  $f$  and  $h$  are 4.

### 4.3 ARX with a Single Lag (ARX-1)

This method aims to locate the single best predictor from the individual lags. Because the lag variables in a time series inevitably suffer from a certain degree of collinearity, focusing on one lag may improve forecasting accuracy. Specifically the ARX-1 model with only one lag of growth and one lag of oil is,

$$g_t = \mu + \alpha g_{t-q} + \beta r_{t-p} + \sigma e_t, \quad e_t \stackrel{iid}{\sim} N(0, 1). \quad (7)$$

The maximum values of  $q$  and  $p$  are 4.

### 4.4 ARX with a Moving Average Lag (ARX-MA)

The ARX and ARX-A models use all the lags up to  $q$  and  $p$ , whereas ARX-1 only uses one of the lags up to  $q$  and  $p$ . In between these two extremes is a 3-quarter moving average (ARX-MA) model,

$$g_t = \mu + \alpha \frac{1}{3} \sum_{j=q}^{q+2} g_{t-j} + \beta \frac{1}{3} \sum_{j=p}^{p+2} r_{t-j} + \sigma e_t, \quad e_t \stackrel{iid}{\sim} N(0, 1). \quad (8)$$

The maximum values of  $q$  and  $p$  are 4. This means that the furthest lag used is 6.

## 4.5 Results

Tables 1 – 4 show the log-predictive likelihood (LPL) and RMSFE of the models ARX, ARX-A, ARX-1 and ARX-MA, respectively. The results are from 156 one-period ahead

out-of-sample forecasts for each of the model specifications. The first out-of-sample forecast is for 1976Q4. Each model is re-estimated at each time period in the out-of-sample data. Each row of the table is associated with the number of lags of economic growth and each column is associated with the number of lags of oil price change. The values of the RMSFE are in brackets. A bold number means the best performance in each table. A common feature in these tables is that lags of  $r_t$  do not add value to prediction when the lags of economic growth is controlled for. The best model is a simple AR(1) model. These results indicate that oil price changes do not predict economic growth when oil changes enter the conditional mean in a linear framework. In the following the AR(1) will serve as a benchmark model for comparison.

## 5 Oil Price Shock Measures

Consistent with the literature, the previous section confirms the non-existence of a linear relationship between the oil price changes and economic growth. This section defines a number of *nonlinear oil shock* measures used in the literature as well as a new one. We follow the prevailing papers to adopt four types of oil price shocks: net price increase (Hamilton (1996)), symmetric/asymmetric net price change and large price change (Kilian & Vigfusson (2013)). The new measure we propose uses the sign of the net price increase and provides robustness to the magnitude of oil price changes.

Recall that  $O_t$  is the U.S. RAC composite index at time  $t$ . The following oil price shocks are constructed.

### 1. Net price increase

This is probably the most popular way to define an oil price shock, which is developed by Hamilton (1996) as

$$d_t^+ = 100 \max \left\{ 0, \log \frac{O_t}{O_t^*} \right\},$$

where  $O_t^* = \max\{O_{t-1}, \dots, O_{t-12}\}$  is the highest oil price in the past three years. Hamilton (1996) used one year history to construct  $O_t^*$ . Hamilton (2011) and Kilian & Vigfusson (2013) found that the three-year history is better for prediction. We report the results based on the three year net price increase in this paper.

### 2. Asymmetric net price change

Kilian & Vigfusson (2013) showed that a negative oil price shock may also improve prediction, but in an asymmetric way. Therefore, we include both positive and negative shocks to our predictive models in this paper. A positive shock  $d_t^+$  is defined the same as the net price increase. A negative shock is defined as

$$d_t^- = 100 \min \left\{ 0, \log \frac{O_t}{O_t^{**}} \right\},$$

where  $O_t^{**} = \min\{O_{t-1}, \dots, O_{t-12}\}$  is the lowest oil price in the past three years. Notice that there are two shock variables in this setting  $d_t^+$  and  $d_t^-$ .

### 3. Symmetric net price change

This is the best predictor in Kilian & Vigfusson (2013). They found that restricting a positive and a negative shock to have the same effect can further improve out-of-sample prediction. The new shock measure is

$$d_t^* = d_t^+ + d_t^-,$$

where  $d_t^+$  is the net price increase and  $d_t^-$  is the net price decrease. This variable treats positive and negative shock symmetrically. It is 0 when the price  $O_t$  is between the highest ( $O_t^*$ ) and the lowest ( $O_t^{**}$ ) historical price.

### 4. Large price increase

A shock may impact the economy only when it is unexpected, which is proxied by the “large deviation” in Kilian & Vigfusson (2013). We consider large price increase as

$$d_t^{large} = r_t I(r_t > \text{std}(\{r_{t-1}, \dots, r_{t-12}\})),$$

where  $I$  is the indicator function and equals 1 if its argument is true and 0 otherwise. The shock  $d_t^{large}$  is positive if the oil price change  $r_t$  is larger than the standard deviation of the oil price change in the past three years. Notice that this measure is asymmetric. If the price decreases, the shock  $d_t^{large}$  is zero.

### 5. Net price increase indicator

We construct a 0/1 indicator to signal an exceedance of  $O_t$  over  $O_t^*$  defined as

$$d_t^I = I(d_t^+ > 0),$$

where  $d_t^+$  is the net price increase. This indicator contains less information than the net price increase  $d_t^+$  but does not suffer from the large magnitudes that  $d_t^+$  can have for *outliers* and may be more robust in capturing an asymmetric response.

## 6 The Volatility Link

In this section we extend the literature to investigate the transition of oil shocks to the conditional variance of economic growth. Our starting point is the best benchmark model from Section 4 which was an AR(1) without exogenous variables ( $q = 1$  and  $p = 0$ ). We augment the AR(1) model by the aforementioned various types of oil price shocks to compare their predictive performance. The general heteroskedastic specification is

$$g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t, \quad e_t \stackrel{iid}{\sim} N(0, 1). \quad (9)$$

The shock  $d_{t-p}$  will be replaced by the previously defined measures:  $r_{t-p}$ ,  $d_{t-p}^+$ ,  $d_{t-p}^*$ ,  $d_{t-p}^{large}$  or  $d_{t-p}^I$ . For the asymmetric net price change,  $d_{t-p} = (d_{t-p}^+, d_{t-p}^-)'$  is a vector. The subscript  $t - p$  means a  $p$  period lag. Model (9) incorporates the lag effects from oil shocks on both the conditional mean and variance. The coefficient  $\lambda$  represents the impact of an oil shock  $d_{t-p}$  on the conditional mean of economic growth  $g_t$ . The coefficient  $\delta$  measures the impact of an oil price shock on the conditional variance of  $g_t$ . The  $\lambda$  and  $\delta$  are vectors when the shock  $d_{t-p}$  is a vector.

In this model the oil price shocks are transmitted to economic growth through two channels. The first one follows the existing literature to incorporate the shock in the conditional mean function. The second channel is the impact of an oil price shock on the volatility of economic growth. To the best of our knowledge, no one has investigated this issue before.<sup>4</sup> This latter channel will display little to no impact on predictive mean forecasts and it is critical to evaluate model forecasts from the more general metric of density forecasts.

In (9) the oil shock  $d_{t-p}$ , affects the mean and variance of economic growth at the same lag time  $p$ . Given the weak evidence for oil shocks appearing in the conditional mean we do not consider different lag lengths for  $d_t$  in the two moments. Nevertheless our analysis does investigate this possibility indirectly. This is done by considering

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<sup>4</sup>Elder & Serletis (2010) study the volatility/uncertainty of the oil price shock on the mean of economic growth. We, instead, check the oil price shock on the volatility of economic growth.

restricted modes. One is to shut down the conditional mean transmission channel by restricting  $\lambda = 0$ . The other is to restrict  $\delta = 0$  to turn off the volatility transmission channel. If we restrict both  $\lambda$  and  $\delta$  to be zero, we have the models in Section 4. By comparing the unrestricted and restricted models, we are able to assess oil price shocks impact on the conditional mean and conditional variance and which channel is more relevant.

## 7 Empirical Results

Table 5 summaries the best models based on out-of-sample density forecasts. This table reports the best models based on LPL values from the more extensive results contained in Tables 6-11. As before each model is re-estimated in the out-of-sample period and the forecast data is the same as in Section 4.5. Different oil shock measures are included along with restricted versions of the models and GARCH models. The final column of the Table 5 reports the log-predictive likelihood (LPL) values for the 156 out-of-sample periods.

Moving from the LPL of  $-173.6$  for the benchmark AR(1) model in Table 5 we see large improvements from most of the other specifications. Ignoring the model with  $d_{t-1}$  set to the large net price increase every other model improves upon the benchmark model. The log-Bayes factors for the new models against the benchmark model range from  $-2.6$  to  $17$ . Each of the improved models feature an oil shock measure that enters the conditional variance of real growth. With one exception, the best specification for each given oil measure occurs with the restriction of  $\lambda = 0$ . That is, density forecasts are better when the oil shock enters the conditional variance only. The transmission from the oil market to the conditional variance of real growth occurs with mostly 3 quarters lag, although, the top model has a lag of 2 quarters and is an important exception.

These results document an important transmission from the oil market to economic growth through the conditional variance of growth with a significant lag effect. This result is robust to different oil shock measures as well. Consistent with the existing literature, oil shocks in the conditional mean are not generally important nor does allowing heteroskedasticity alter those findings.

The model with the largest LPL value includes the new oil shock, net price increase indicator. The log-Bayes factor for this model against the AR model is  $17$  and is decisive evidence in favor of it. This measure works much better than the other shock measures.

The predictive Bayes factor between this model and the best model with the other oil price measures (symmetric net price change) is 7.7 which is strong evidence in favor of the new measure.

In order to learn more about where the gains from using oil shock measures in the conditional variance of growth come from we plot the cumulative log-predictive Bayes factors. It is calculated as

$$\text{cumlog}BF_t^{01} = \log p(y_{t_0:t} | y_{1:t_0-1}, \mathcal{M}_0) - \log p(y_{t_0:t} | y_{1:t_0-1}, \mathcal{M}_1),$$

to compare  $\mathcal{M}_0$  to  $\mathcal{M}_1$ . An increase (decrease) in  $\text{cumlog}BF_t^{01}$  at time  $t$  is support for model  $\mathcal{M}_0$  ( $\mathcal{M}_1$ ). Cumulative log-Bayes factors appear in Figure 2. This is the Bayes factor of the model in (9) with different oil shock measures against the AR(1) benchmark models at each time in the out-of-sample period. Except for the one oil shock all models make regular gains against the AR(1). The improvements these models offer are not due to a few observations but are widespread over the out-of-sample period.

An expanded set of forecasts results are reported in Tables 6-11. These tables report a range of forecast results for different oil shock measures, lag lengths and parameter restrictions. Included in each of the tables is the RMSFE in parentheses. These tables confirm our findings that oil shocks do predict economic growth through a volatility channel. We can observe that 4 out of 5 shock measures (the exception is the net price increase) have larger LPL when restricting  $\lambda = 0$ . Incorporating oil price shocks directly into the conditional mean of economic growth is not supported by the data.

Turning to the RMSFE from point forecasts of the conditional mean and comparing the second columns ( $\delta \neq 0, \lambda \neq 0$ ) in Tables 6-11 to the baseline AR(1) model, the best specification in each table does result in a lower RMSFE. However, the gains are small, the AR(1) model has a RMSFE of 0.7354 while the best heteroskedastic model (large net price increase) delivers 0.7266.

In conclusion, oil price shocks affect the volatility of economic growth. From both LPL and RMSFE, we can conclude that the best models are always associated with  $\delta \neq 0$ , which means that an oil price shock predicts the volatility of economic growth. In addition, Table 12 shows the full sample posterior summary of  $\delta$  from the best models for each type of oil price shock. None of their 90% density intervals include 0.

## 7.1 Volatility of Growth

Our results indicate that oil shocks predict volatility changes in real growth. To further investigate this we estimate an AR(1)-GARCH(1,1) model for heteroskedasticity for comparison,

$$g_t = \mu + \alpha g_{t-1} + e_t, \quad (10a)$$

$$e_t \sim N(0, \sigma_t^2), \quad (10b)$$

$$\sigma_t^2 = \omega_0 + \omega_1 e_{t-1}^2 + \omega_2 \sigma_{t-1}^2. \quad (10c)$$

See the Appendix for additional details on this specification including estimation. Figure 3 displays the full-sample posterior mean of the standard deviations over time for the best models of each shock type using (9). The black line in each panel is the standard deviation from the GARCH model. The first four panels clearly show that the oil price shock associated with the Gulf War in 1990Q3 exaggerates the volatility of economic growth compared to GARCH. The worst two measures based on the LPL, asymmetric net price change and large price increase, are plotted in the second and fourth panel. It is obvious that the volatilities are distorted relative to the AR(1)-GARCH(1,1) model. The final panel of this figure shows the model with the net price increase indicator to be the closest to the GARCH implied standard deviation.

In attempt to disentangle the time series effect and the oil shock effect on the volatility of growth, we propose a hybrid model to incorporate both impacts into the second moment. Specifically, the AR-GARCH-Shock model is define as,

$$g_t = \mu + \alpha g_{t-1} + \exp(\delta d_{t-2}) e_t, \quad (11a)$$

$$e_t \sim N(0, \sigma_t^2), \quad (11b)$$

$$\sigma_t^2 = \omega_0 + \omega_1 e_{t-1}^2 + \omega_2 \sigma_{t-1}^2. \quad (11c)$$

In this model  $d_{t-2}$  is the net price increase indicator. The volatility now has two parts: the oil shock effect  $\exp(\delta d_{t-2})$  and the GARCH component  $\sigma_t^2$ .

The LPL for the density forecasts from the two GARCH specification are found in the final two entries in Table 5. The GARCH models do improve upon the AR benchmark model but they are still inferior to the best specification which only has oil shocks directing the conditional variance. For instance, the log-Bayes factor for the model with the net price increase indicator entering the conditional variance in (9)

against the AR(1)-GARCH(1,1) is 10.6 while it is 7.8 against the AR(1)-GARCH(1,1)-shock. We conclude that the GARCH parameterization is not a proxy for oil shock effects on the conditional variance. Oil price shocks contain additional information value for forecasting output.

These results can be seen from Figure 4. These are cumulative log-Bayes factors for each specification against the AR(1)-GARCH(1,1) model. The figure shows an upward trend of the log-Bayes factor of the best model with the net price increase indicator against the benchmark. One exceptional period is between 2005-2007, when several oil price shocks are identified but economic growth is tranquil. But the drop in the Bayes factor during that period is quickly compensated during the financial crisis in 2008-2009, when the GARCH model predicts a large volatility but the oil price shocks do not.

Figure 5 displays the cumulative log-Bayes factors of three models (the AR(1), the model with the net price increase indicator in the volatility, the AR(1)-GARCH(1,1)) against the AR(1)-GARCH(1,1)-Shock model. Interestingly, model (9) with the net price increase indicator is still the best except for the period around 2007.

## 7.2 Net Price Increase Indicator

This section discusses in more detail the net price increase indicator and the implication of the best forecasting model.

First, the indicator function is critical to the improved performance of this oil shock measure. Although the net price increase shock does improve the LPL (Table 5) it is nowhere near as good as the indicator version. Figure 6 shows a histogram of the shocks measured by net price increase. The largest shock is associated with the Gulf War in 1990. It is about 10 times larger than the shocks in the left tail. An exponential transformation implies that the variance change associated with this shock is  $e^{10}$  times larger than a small shock! Given the heterogeneous nature of net price increase shocks it is not surprising that the indicator function performs better.

The effect of these two oil shocks on the conditional standard deviation can be seen in the top and bottom panels of Figure 3. While the net price increase leads to some extreme measures of volatility the indicator function preserves the direction of the measure but removes the extreme values.

Full sample estimates of the best forecasting model are reported in Table 13 along with the AR(1) model. Adding oil shocks into the conditional variance causes important

changes. First, when no oil shock is present the conditional standard deviation is much smaller (0.2854 versus 0.5265), meaning that we are much more certain about growth than the AR model would lead us to conclude. On the other hand, when an oil shock is present the conditional standard deviation doubles (0.2854 to  $0.5705 = 0.2854 \exp(0.6927)$ ). Thus our empirical results uncover a large pronounced asymmetric response of growth volatility to net oil price increases. The impact of this oil shock happens with a two quarter lag.

## 8 Robustness

This section considers robustness checks from three perspectives: priors, structural stability and data.

### 8.1 Prior Sensitivity Check

We did a prior sensitivity check on the best model (9) with net price increase indicator when  $\lambda = 0$  and  $\delta \neq 0$ . By changing the prior parameters relative to the original prior, we propose four alternative settings: loose, tight, very loose and very tight. Details and results are shown in Table 14. Except for the very tight prior, all other settings shows that the log-predictive likelihoods are robust to prior changes. Even for the very tight case, the log-predictive likelihood is still strongly supported by the data against the benchmark linear model.

### 8.2 Structural Instability

We estimated the benchmark linear model AR(1) with a 5-year rolling window to control for structural instability. The log-predictive likelihood and RMSFE are  $-171.6$  and  $0.7734$ , respectively. In comparison to the AR(1) model without a rolling window ( $LPL = -173.6$  and  $RMSFE = 0.7354$ ), the gain on the density forecast is not prominent and there is even a loss in precision of the point forecasts.

For the other models we perform a subsample analysis. The data are split into three periods 1976Q4 – 1989Q4 (before Gulf War), 1990Q1 – 2002Q4 (before oil price surge) and 2003Q1 – 2015Q3. Table 15 shows the forecast results in each subsample along with the full sample result as a reference. The rank of the models is stable over time.

Using the net price increase indicator as a shock measure is always competitive in each subsample.

### 8.3 Data

The shocks are constructed by using the 3-year window according to the standard literature such as Hamilton (2003) and Kilian & Vigfusson (2013). As a robustness check, we also reconstruct these measures by using only a one year window. These results favor the same heteroskedasticity model with the net price increase indicator shock.

By using industrial production as another proxy for output (<https://fred.stlouisfed.org/series/INDPRO>), we carried out the same analysis as we did on real GDP. Industrial production growth is monthly data with a full sample size of 499. We use 10 observations as a training sample and the out-of-sample period has 479 observations.

The best of the homoskedastic specifications was the ARX-MA which has an out-of-sample LPL of  $-471.9$  and RMSFE of  $0.6354$ . As in the GDP case, Table 16 shows there is strong evidence that oil shocks impact the conditional variance of industrial production growth. The log-Bayes factor of the best heteroskedastic oil shock specification against the AR(1) is  $26.9 = -445 - (-471.9)$ . This model uses the net price increase indicator.

## 9 Conclusion

This paper shows that the primary channel in which oil shocks effect real growth is through the conditional variance of real growth and not the conditional mean. The paper performs an extensive forecasting analysis using different models, oil shock measures as well as real growth measures to demonstrate the robustness of this volatility link.

Incorporating oil shocks into the conditional variance of real growth leads to large improvements in density forecasts but little to no improvement in conditional mean point forecasts. A new shock measure, net price increase indicator, produces the best density forecasts. An implication of our findings is that the uncertainty about future growth is considerably lower compared to a benchmark AR(1) model when no oil shocks are present.

# A Sampling Steps for ARX, ARX-A, ARX-1 and ARX-MA

The sampling method is straightforward when we confront models of equations (5), (6), (7), and (8). The posterior distribution is conjugate and we apply Gibbs sampler. For simplicity, we use the following matrix form to represent models of equations of (5), (6), (7), and (8).

$$g = X\bar{\beta} + u \quad u \sim NID(0, \sigma^2 I),$$

where  $g$  is a vector growth rates with dimension of  $T$ , which is total number of observations. Let  $\bar{\beta}$  denote the parameter vector we are interested. Let  $X = [X_1, \dots, X_t]'$  and the input of each element various according to the following models.

ARX: Let  $\bar{\beta} = [\mu, \alpha_{1:q}, \beta_{1:p}]'$  with dimension of  $p + q + 1$ , and corresponding  $X_t = [1, g_{t-1}, \dots, g_{t-q}, r_{t-1}, \dots, r_{t-p}]$  for  $t = 1, \dots, T$ .

ARX-A: Let  $\bar{\beta} = [\mu, a_{1:f}, b_{1:h}]'$  with dimension of  $f + h + 1$ . Let  $X_t = [1, z(q, 0), \dots, z(q, f), s(p, 0), \dots, s(p, h)]$  for  $t = 1, \dots, T$ , and the  $X$  has  $T$  rows and  $f + h + 1$  columns. Please refer to section 4.2 for details of the polynomial construction.

ARX-1: Let  $\bar{\beta} = [\mu, \alpha, \beta]'$ . The  $X$  has a dimension of  $T$  by 3, where each  $X_t = [1, g_{t-1}, r_{t-1}]$  for  $t = 1, \dots, T$ .

ARX-MA: Let  $\bar{\beta} = [\mu, \alpha, \beta]'$ . The  $X$  has a dimension of  $T$  by 3, where each  $X_t = [1, \frac{1}{3} \sum_{j=q}^{q+2} g_{t-j}, \frac{1}{3} \sum_{j=p}^{p+2} r_{t-j}]$  for  $t = 1, \dots, T$ .

The  $p(\cdot)$  and  $I$  respectively denote the conditional posterior density and information set. The following is a generalization of each steps of sampler. At each  $i$ th MCMC draw,

1. Draw  $\sigma^{-2(i)} \sim p(\sigma^{-2} | \bar{\beta}^{(i-1)}, I)$
2. Jointly Draw  $\bar{\beta}^{(i)} \sim p(\bar{\beta} | \sigma^{-2(i)}, I)$

For models of (5), (6) (7), and (8), the priors are  $\bar{\beta} \sim MN(b, B)$  and  $\sigma^{-2} \sim Gamma(\chi, \nu)$ . The  $MN$  denotes multivariate normal distribution. We set  $b$  and  $B$  be respectively a vector of zeros and an identity matrix. We set  $\chi = 3$  and  $\nu = 1$  correspondingly for the prior of  $\sigma^{-2}$ . Let  $I$  denote as information set. The conditional posterior distribution for  $\bar{\beta}$  and  $\sigma^{-2}$  are the following:

$$\bar{\beta} | \sigma^2, I \sim MN(M, V^{-1}) \quad V = (\sigma^{-2} X'X + B^{-1}) \quad M = V^{-1}(\sigma^{-1} X'g + B^{-1}b)$$

$$\sigma^{-2}|\bar{\beta}, I \sim \text{Gamma}\left(\chi + \frac{T}{2}, \nu + \frac{1}{2}u'u\right)$$

## B Sampling Steps for the Shock Model

### B.1 Net Price Increase, Symmetric Net Price Change, Large Price Increase, Net Price Increase Indicator

The sampling steps on  $\mu, \beta, \lambda, \sigma$  of shock model<sup>5</sup> are similar as they are sampled in previous section. Besides, we apply the Metropolis-Hasting (MH) algorithm on  $\delta$  due to its non-conjugate feature.

$$\begin{aligned} g_t &= \mu + \beta g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t & e_t &\stackrel{iid}{\sim} N(0, 1) \\ (\mu, \beta, \lambda) &\sim MN(b, B), & \delta &\sim N(a, A), & \sigma^{-2} &\sim \text{Gamma}(\chi, \nu) \end{aligned}$$

The  $I$  is the information set. Let  $b$  be a vector of zeros and  $B$  be an identity matrix. We set  $a = 0, A = 1, \chi = 3$  and  $\nu = 1$ . At each  $i$ th MCMC draw, the parameter space is sampled by the following conditional posterior density:

1. Draw  $\sigma^{-2(i)} \sim p(\sigma^{-2} | \mu^{(i-1)}, \beta^{(i-1)}, \lambda^{(i-1)}, \delta^{(i-1)}, I)$
2. Jointly Draw  $\mu^{(i)}, \beta^{(i)}, \lambda^{(i)} \sim p(\mu | \beta^{(i-1)}, \lambda^{(i-1)}, \delta^{(i-1)}, \sigma^{-2(i)}, I)$
3. Draw  $\delta^{(i)} \sim p(\delta | \mu^{(i)}, \beta^{(i)}, \lambda^{(i)}, \sigma^{-2(i)}, I)$

Step 1 and 2 are sampled through the following transformations:

$$\frac{g_t}{\exp(\delta d_{t-p})} = \frac{\mu}{\exp(\delta d_{t-p})} + \frac{\beta g_{t-1}}{\exp(\delta d_{t-p})} + \frac{\lambda d_{t-p}}{\exp(\delta d_{t-p})} + \sigma e_t \quad (13a)$$

$$g_t^* = \mu x_{t-1}^* + \beta g_{t-1}^* + \lambda d_{t-p}^* + \sigma e_t \quad (13b)$$

where the  $x_{t-1}^*$  is  $\frac{1}{\exp(\delta d_{t-p}^*)}$ . The equation (13b) is derived with given  $\delta$ . Then, we can easily sample the  $\{\mu, \beta, \lambda, \sigma^2\}$  under perfect conjugacy. For simplicity, the equation (13b) is rewritten in the following matrix form:

$$g = X\bar{\beta} + u \quad u \sim NID(0, \sigma^2 \mathbf{1})$$

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<sup>5</sup>Equation (9)

The  $g$  and  $X$  are respectively a vector of  $g_{1:T}$  and  $T$  by 3 matrix. Let  $X = [X_1, \dots, X_T]'$  and  $X_t = [x_{t-1}^*, g_{t-1}^*, d_{t-p}^*]$  for  $t = 1, \dots, T$ . We set  $\bar{\beta} = [\mu, \beta, \lambda]'$  and  $I$  as the information set. The conditional posterior distribution of  $\bar{\beta}$  and  $\sigma^{-2}$  are the following:

$$\bar{\beta} | \sigma^{-2}, I \sim MN(M, V^{-1}) \quad V = (\sigma^{-2} X^T X + B^{-1}) \quad M = V^{-1} (\sigma^{-1} X^T g + B^{-1} b)$$

$$\sigma^{-2} | \bar{\beta}, I \sim \text{Gamma} \left( \chi + \frac{T}{2}, \nu + \frac{1}{2} u' u \right)$$

As mentioned early, the  $\delta$  is sampled through the Metropolis-Hastings algorithm of random walk. To simplify the notations, we set  $m_t(\mu, \beta, \delta) = \mu + \beta g_{t-1} + \lambda d_{t-p}^n$ . The step 3 is then sampled by the following density function,

$$p(\delta | \sigma^2, \mu, \beta, \lambda, x) \propto \exp \left( -\frac{(\delta - a)^2}{2A} \right) \exp \left( -\delta \sum_{t=1}^T d_{t-p} \right) \exp \left( -\frac{1}{2\sigma^2} \sum_{t=1}^T \frac{(g_t - m_t(\mu, \beta, \delta))^2}{\exp(2\delta d_{t-p})} \right)$$

with given  $\mu^{(i)}, \beta^{(i)}, \lambda^{(i)}$  and  $\sigma^{-2(i)}$ , the  $\delta^{(i)}$  at  $i$ th MCMC iteration is sampled such as: We first draw  $\delta^{new} = \delta^{(i-1)} + N(0, s)$ , where  $s$  is the tuning parameter for adjusting the acceptance probability and set  $\delta^{old} = \delta^{(i-1)}$ . Then, we decide on accepting  $\delta^{new}$  or keeping  $\delta^{old}$  according to the following rule,

$$\theta = \min \left[ \frac{p(\delta^{new} | \mu^{(i)}, \beta^{(i)}, \lambda^{(i)}, \sigma^{-2(i)}, I)}{p(\delta^{old} | \mu^{(i)}, \beta^{(i)}, \lambda^{(i)}, \sigma^{-2(i)}, I)}, 1 \right] \quad (14)$$

Next, we draw  $u \sim \text{Uniform}(0, 1)$ , if  $u \leq \theta$ , set  $\delta^{(i)} = \delta^{new}$ , otherwise set  $\delta^{(i)} = \delta^{old}$ .

## B.2 Asymmetric Net Price Change

$$g_t = \mu + \alpha g_{t-1} + \lambda_1 d_{t-p}^+ + \lambda_2 d_{t-p}^- + \sigma \exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-) e_t \quad e_t \stackrel{iid}{\sim} N(0, 1) \quad (15a)$$

$$(\mu, \beta, \lambda_1, \lambda_2) \sim MN(b, B), \quad \delta_1 \sim N(a_1, A_1), \quad \delta_2 \sim N(a_2, A_2), \quad \sigma^{-2} \sim \text{Gamma}(\chi, \nu) \quad (15b)$$

Let  $b$  and  $B$  be respectively a vector of zeros and an identity matrix. We set  $a_1 = a_2 = 0$  and  $A_1 = A_2 = 1$  correspondingly. The  $I$  denotes information set. At each  $i$ th MCMC draw, we apply the Gibbs sampler to the following conditional posterior density:

1. Draw  $\sigma^{-2(i)} \sim p(\sigma^{-2} | \mu^{(i-1)}, \beta^{(i-1)}, \lambda_1^{(i-1)}, \lambda_2^{(i-1)}, \delta_1^{(i-1)}, \delta_2^{(i-1)}, I)$

2. Jointly Draw  $\mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)} \sim p(\mu, \beta, \lambda_1, \lambda_2 | \delta_1^{(i-1)}, \delta_2^{(i-1)}, \sigma^{-2(i)}, I)$
3. Draw  $\delta_1^{(i)} \sim p(\delta_1 | \mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)}, \sigma^{-2(i)}, \delta_2^{(i-1)}, I)$
4. Draw  $\delta_2^{(i)} \sim p(\delta_2 | \mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)}, \sigma^{-2(i)}, \delta_1^{(i)}, I)$

Step 1 and 2 can be sampled under perfect conjugacy if all variables of equation (15a) are divided by  $\exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-)$  such as:

$$g_t^* = \mu x_{t-1}^* + \beta g_{t-1}^* + \lambda_1 d_{t-p}^{+*} + \lambda_2 d_{t-p}^{-*} + \sigma e_t \quad (16)$$

The  $x_{t-1}^*$  is denoted as  $\frac{1}{\exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-)}$ . Again, for simplicity, we rewrite the equation (16) as the following matrix form:

$$g = X\bar{\beta} + u \quad u \sim NID(0, \sigma^2 \mathbf{I})$$

Let the  $g$  and  $X$  denote respectively a vector of  $g_{1:T}$  and  $X = [X_1, \dots, X_T]'$ , a  $T$  by 4 matrix such as  $X_t = [x_{t-1}^*, g_{t-1}^*, d_{t-p}^{+*}, d_{t-p}^{-*}]$  for  $t = 1, \dots, T$ . Let  $\bar{\beta} = [\mu, \beta, \lambda_1, \lambda_2]'$  as the parameter space.

$$\bar{\beta} | \sigma^{-2}, I \sim MN(M, V^{-1}) \quad V = (\sigma^{-2} X^T X + B^{-1}) \quad M = V^{-1} (\sigma^{-1} X^T g + B^{-1} b)$$

$$\sigma^{-2} | \bar{\beta}, I \sim \text{Gamma} \left( \chi + \frac{T}{2}, \nu + \frac{1}{2} u' u \right)$$

Due to its lack of conjugacy, the  $\delta_1$  and  $\delta_2$  are sampled through the Metropolis-Hastings algorithm of random walk. To simplify the notations, we set  $m_t = \mu + \beta g_{t-1} + \lambda_1 d_{t-p}^+ + \lambda_2 d_{t-p}^-$ . The step 3 is sampled with the following joint density,

$$p(\delta_1 | \sigma^2, \mu, \beta, \lambda_1, \lambda_2, \delta_2, I) \propto \exp \left( - \frac{(\delta_1 - a_1)^2}{2A_1} \right) \exp \left( - \delta_1 \sum_1^T d_{t-p}^+ \right) \exp \left( - \frac{1}{2\sigma^2} \sum_{t=1}^T \frac{(g_t - m_t)^2}{\exp(2\delta_1 d_{t-p}^+ + 2\delta_2 d_{t-p}^-)} \right)$$

The following example shows posterior sampling steps of  $\delta_1^{(i)}$ : given  $\mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)}, \delta_2^{(i-1)}$  and  $\sigma^{-2(i)}$ , we first draw  $\delta_1^{new} = \delta_1^{(i-1)} + N(0, s)$ , where  $s$  is the tuning parameter for adjusting the acceptance probability. Let  $\delta_1^{old} = \delta_1^{(i-1)}$ . Then, we decide on accepting

$\delta_1^{new}$  or keeping  $\delta_1^{old}$  according to the following rule,

$$\theta = \min \left[ \frac{p(\delta_1^{new} | \mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)}, \delta_2^{(i-1)} \sigma^{-2(i)}, I)}{p(\delta_1^{old} | \mu^{(i)}, \beta^{(i)}, \lambda_1^{(i)}, \lambda_2^{(i)}, \delta_2^{(i-1)} \sigma^{-2(i)}, I)}, 1 \right]$$

Next, we draw  $u \sim Uniform(0, 1)$ , if  $u \leq \theta$ , set  $\delta_1^{(i)} = \delta_1^{new}$ , otherwise set  $\delta_1^{(i)} = \delta_1^{old}$ .

Sampling  $\delta_2$  is exactly same manner as sampling the  $\delta_1$  with the following joint density:

$$p(\delta_2 | \sigma^2, \mu, \beta, \lambda_1, \lambda_2, \delta_1, I) \propto \exp \left( -\frac{(\delta_2 - a_2)^2}{2A_2} \right) \exp \left( -\delta_2 \sum_{t=1}^T d_{t-p}^- \right) \exp \left( -\frac{1}{2\sigma^2} \sum_{t=1}^T \frac{(g_t - m_t)^2}{\exp(2\delta_1 d_{t-p}^+ + 2\delta_2 d_{t-p}^-)} \right)$$

## C AR(1)-GARCH(1,1)

The AR(1)-GARCH(1,1) is introduced in section 7.1.

$$g_t = \mu + \beta g_{t-1} + e_t \quad (19a)$$

$$e_t \stackrel{iid}{\sim} N(0, \sigma_t^2) \quad (19b)$$

$$\sigma_t^2 = \omega_0 + \omega_1 e_{t-1}^2 + \omega_2 \sigma_{t-1}^2 \quad (19c)$$

The sampling approach is the standard Metropolis-Hasting (MH) algorithm with random walk. Each step is sampled through MH. The prior each of the parameter  $(\mu, \beta, \omega_0, \omega_1, \omega_2)$  follows a standard normal distribution under the constraints of  $\omega_0 > 0$ ,  $\omega_1 > 0$ ,  $\omega_2 > 0$  and  $\omega_1 + \omega_2 < 1$ . The joint posterior density is:

$$p(\mu, \beta, \omega_0, \omega_1, \omega_2) \propto p(\mu)p(\beta)p(\omega_0)p(\omega_1)p(\omega_2) \prod_{t=1}^T \frac{1}{\sqrt{2\pi\sigma_t^2}} \exp \left( -\frac{(g_t - \mu - \beta g_{t-1})^2}{2\sigma_t^2} \right) I_{\omega_0 > 0}(\omega_0) I_{\omega_1 > 0}(\omega_1) I_{\omega_2 > 0}(\omega_2) I_{\omega_1 + \omega_2 < 1}(\omega_1, \omega_2)$$

The  $p(\mu), p(\beta), p(\omega_0), p(\omega_1)$  and  $p(\omega_2)$  are the prior densities. Let  $I$  denote the information set. A single move random walk sampler is applied and it is iterated in the following steps:

1. Draw  $\mu^{(i)} \sim p(\mu | \beta^{(i-1)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, I)$
2. Draw  $\beta^{(i)} \sim p(\beta | \mu^{(i)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, I)$

3. Draw  $\omega_0^{(i)} \sim p(\omega_0|\mu^{(i)}, \beta^{(i)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, I)$
4. Draw  $\omega_1^{(i)} \sim p(\omega_1|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_2^{(i-1)}, I)$
5. Draw  $\omega_2^{(i)} \sim p(\omega_2|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_1^{(i)}, I)$

The  $p(\cdot)$  denotes the conditional posterior density. For each  $i$ th MCMC draw, the  $\mu$  can be sampled in such way: draw  $\mu^{new} = \mu^{(i-1)} + N(0, s)$ , where  $s$  is a tuning parameter used for adjusting the acceptance probability. We set  $\mu^{old} = \mu^{(i-1)}$ . Next evaluate the following,

$$\theta = \min \left[ 1, \frac{p(\mu^{new}|\beta^{(i-1)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, I)}{p(\mu^{old}|\beta^{(i-1)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, I)} \right]$$

Draw a  $u \sim Uniform(0, 1)$ . If  $u \leq \theta$  set  $\mu^{(i)} = \mu^{new}$ , and otherwise set  $\mu^{(i)} = \mu^{old}$ . The other parameters are sampled in the exactly the same manner.

## D AR(1)-GARCH(1,1)-Shock

This model is a hybrid model which incorporate both oil shocks and GARCH model. It is introduced in section 7.1.

$$g_t = \mu + \beta g_{t-1} + \exp(\delta d_{t-p}) e_t \quad (21a)$$

$$e_t \stackrel{iid}{\sim} N(0, \sigma_t^2) \quad (21b)$$

$$\sigma_t^2 = \omega_0 + \omega_1 e_{t-1}^2 + \omega_2 \sigma_{t-1}^2. \quad (21c)$$

The sampling approach is exactly the same as AR(1)-GARCH(1,1) with one extra step on  $\delta$ . The prior for AR(1)-GARCH(1,1)-Shock is the same as AR(1)-GARCH(1,1) with  $\delta \sim N(0, 1)$ . The joint posterior density becomes:

$$p(\mu, \beta, \delta, \omega_0, \omega_1, \omega_2) \propto p(\mu)p(\delta)p(\beta)p(\omega_0)p(\omega_1)p(\omega_2) \prod_{t=1}^T \frac{1}{\sqrt{2\pi\sigma_t^2} \exp(2\delta d_{t-p})} \exp \left( -\frac{(g_t - \mu - \beta g_{t-1})^2}{2\sigma_t^2 \exp(2\delta d_{t-p})} \right) I_{\omega_0 > 0}(\omega_0) I_{\omega_1 > 0}(\omega_1) I_{\omega_2 > 0}(\omega_2) I_{\omega_1 + \omega_2 < 1}(\omega_1, \omega_2)$$

The  $p(\mu), p(\beta), p(\omega_0), p(\omega_1)p(\omega_2)$  and  $p(\delta)$  represent prior densities. Some restrictions on the sampling:  $\omega_0 > 0, \omega_1 > 0, \omega_2 > 0$  and  $\omega_1 + \omega_2 < 1$ . Let  $I$  be the information set. The sampling steps are iterated in the following ways:

1. Draw  $\mu^{(i)} \sim p(\mu|\beta^{(i-1)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, \delta^{(i-1)}, I)$
2. Draw  $\beta^{(i)} \sim p(\beta|\mu^{(i)}, \omega_0^{(i-1)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, \delta^{(i-1)}, I)$
3. Draw  $\omega_0^{(i)} \sim p(\omega_0|\mu^{(i)}, \beta^{(i)}, \omega_1^{(i-1)}, \omega_2^{(i-1)}, \delta^{(i-1)}, I)$
4. Draw  $\omega_1^{(i)} \sim p(\omega_1|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_2^{(i-1)}, \delta^{(i-1)}, I)$
5. Draw  $\omega_2^{(i)} \sim p(\omega_2|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_1^{(i)}, \delta^{(i-1)}, I)$
6. Draw  $\delta^{(i)} \sim p(\delta|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_1^{(i)}, \omega_2^{(i)}, I)$

The  $p(\cdot)$  represents the conditional posterior density. For  $i$ th MCMC draw, the  $\delta$  can be sampled such that, we draw  $\delta^{new} = \delta^{(i-1)} + N(0, s)$ , where  $s$  is a tuning parameter for adjusting the acceptance probability. Let  $\delta^{old} = \delta^{(i-1)}$ . Next we evaluate the following,

$$\theta = \min \left[ 1, \frac{p(\delta^{new}|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_1^{(i)}, \omega_2^{(i)}, I)}{p(\delta^{old}|\mu^{(i)}, \beta^{(i)}, \omega_0^{(i)}, \omega_1^{(i)}, \omega_2^{(i)}, I)} \right]$$

Draw a  $u \sim Uniform(0, 1)$ . If  $u \leq \theta$  set  $\mu^{(i)} = \mu^{new}$ , and otherwise set  $\mu^{(i)} = \mu^{old}$ . The other parameters are sampled in the exactly the same manner.

Table 1: The Log-predictive Likelihood and RMSFE of ARX

	$p = 0$	$p = 1$	$p = 2$	$p = 3$	$p = 4$
$q = 0$	-183.2 (0.7778)	-186.2 (0.8190)	-190.9 (0.8489)	-197.1 (0.97718)	-197.4 (0.9841)
$q = 1$	<b>-173.6</b> <b>(0.7354)</b>	-176.2 (0.7646)	-180.9 (0.7950)	-185.7 (0.9214)	-188.8 (0.9550)
$q = 2$	-173.7 (0.7408)	-178.7 (0.7929)	-181.5 (0.8036)	-185.9 (0.9315)	-189.3 (0.9683)
$q = 3$	-176.4 (0.7662)	-182.2 (0.8399)	-186.1 (0.8931)	-188.5 (0.9590)	-192.0 (0.9956)
$q = 4$	-180.5 (0.7938)	-184.6 (0.8321)	-189.4 (0.93789)	-190.8 (0.9939)	-194.3 (1.0099)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table.

$$\text{ARX: } g_t = \mu + \sum_{i=1}^q \alpha_i g_{t-i} + \sum_{i=1}^p \beta_i r_{t-i} + \sigma e_t$$

Table 2: The Log-predictive Likelihood and RMSFE of ARX-A

	$b_{1:g} = 0$	$g = 1$	$g = 2$	$g = 3$
$a_{1:f} = 0$		-222.96 (1.2559)	-220.87 (1.2196)	-219.63 (1.1409)
$f = 1$	-179.4 <b>(0.7847)</b>	-183.3 (0.8073)	-187.1 (0.8637)	-189.1 (0.9044)
$f = 2$	<b>179.3</b> (0.8116)	-184.5 (0.8219)	-188.7 (0.8875)	-190.3 (0.9326)
$f = 3$	-180.6 (0.8275)	-185.3 (0.8260)	-189.6 (0.8956)	-191.3 (0.9409)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. ARX-A:  $g_t = \mu + \sum_{i=0}^f a_i z(q, i) + \sum_{i=0}^h b_i s(p, i) + \sigma e_t$ , where  $z(q, i)$  and  $s(p, i)$  correspond to Almond lag polynomials. In the table  $q = 4$  and  $p = 4$ .

Table 3: The Log-predictive Likelihood and RMSFE of ARX-1

	$\beta_{1,p} = 0$	$p = 1$	$p = 2$	$p = 3$	$p = 4$
$\alpha_{1,q} = 0$	-183.2 (0.7778)	-186.2 (0.8190)	-185.5 (0.7961)	-186.9 (0.8652)	-186.1 (0.8161)
$q = 1$	<b>-173.6</b> <b>(0.7354)</b>	-176.2 (0.7640)	-175.8 (0.7460)	-177.2 (0.8108)	-177.3 (0.7652)
$q = 2$	-186.1 (0.7658)	-185.8 (0.8302)	-182.8 (0.7831)	-183.9 (0.8557)	-183.8 (0.8097)
$q = 3$	-183.1 (0.7823)	-190.9 (0.8672)	-188.4 (0.8345)	-186.7 (0.8691)	-186.4 (0.8244)
$q = 4$	-187.7 (0.8030)	-191.0 (0.8479)	-192.2 (0.8470)	-189.4 (0.8751)	-189.3 (0.8380)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. ARX-1:  $g_t = \mu + \alpha g_{t-q} + \beta r_{t-p} + \sigma e_t$

Table 4: The Log-predictive Likelihood and RMSFE of ARX-MA

	$\beta = 0$	$p = 1$	$p = 2$	$p = 3$	$p = 4$
$\alpha = 0$	-183.2 (0.7779)	-186.3 (0.8048)	-184.9 (0.7970)	-184.0 (0.7929)	-182.9 (0.7774)
$q = 1$	<b>-175.7</b> <b>(0.7412)</b>	-177.6 (0.7632)	-177.0 (0.7586)	-178.0 (0.7610)	-178.6 (0.7538)
$q = 2$	-181.0 (0.7684)	-183.3 (0.7890)	-182.5 (0.7866)	-183.2 (0.7884)	-183.6 (0.7752)
$q = 3$	-184.4 (0.7914)	-187.3 (0.8119)	-187.2 (0.8141)	-185.3 (0.8021)	-185.0 (0.7902)
$q = 4$	-187.8 (0.8007)	-190.6 (0.8386)	-189.1 (0.8233)	-186.8 (0.8204)	-186.6 (0.8000)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. ARX-MA:  $g_t = \mu + \alpha \frac{1}{3} \sum_{i=q}^{q+2} g_{t-i} + \beta \frac{1}{3} \sum_{i=p}^{p+2} r_{t-i} + \sigma e_t$ .

Table 5: Summary of the Best Forecasting Models

<b>Benchmark Homoskedastic Model</b>			
$g_t = \mu + \alpha g_{t-q} + \beta r_{t-p} + \sigma e_t, e_t \stackrel{iid}{\sim} N(0, 1).$			
Model	$q$	$p$	LPL
ARX	1	0	-173.6
<b>Heteroskedastic Model: Oil Shock Enters Conditional Mean and Variance</b>			
$g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t, e_t \stackrel{iid}{\sim} N(0, 1).$			
Oil Shock, $d_{t-p}$	Oil Shock-lag, $p$	Restriction	LPL
Net Price Increase	3	$\delta \neq 0, \lambda \neq 0$	-165.5
Asymmetric Net Price Change	3	$\delta_{1:2} \neq 0, \lambda_{1:2} = 0$	-167.9
Symmetric Net Price Change	3	$\delta \neq 0, \lambda = 0$	-164.3
Large Net Price Increase	3	$\delta \neq 0, \lambda = 0$	-176.2
Net Price Increase Indicator	2	$\delta \neq 0, \lambda = 0$	<b>-156.6</b>
Oil Price Log-difference	3	$\delta \neq 0, \lambda = 0$	-169.4
<b>GARCH Models</b>			
Model Type	Shock Type	Shock-lag	LPL
AR(1)-GARCH(1,1)	N/A	N/A	-167.2
AR(1)-GARCH(1,1)-Shock	Net Price Increase Indicator	2	-164.4

This Table reports the largest log-predictive likelihoods (LPL) for a range of models and oil shock measures. The top entry is the best homoskedastic model from Tables 1-4. The second set of results are the bold entries for LPL from Tables 6-11. The GARCH models are defined in Section 7.1. The bold entry denotes the largest LPL value.

Table 6: Forecasts from Heteroskedastic model. Shock: oil price log-difference

	$\delta \neq 0, \lambda \neq 0$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
$p = 1$	-180.9 (0.7763)	-174.7 (0.7372)	-176.2 (0.7640)
$p = 2$	-172.7 (0.7490)	-169.7 ( <b>0.7304</b> )	-175.8 (0.7460)
$p = 3$	-174.0 (0.7759)	<b>-169.4</b> (0.7468)	-177.0 (0.8099)
$p = 4$	-177.8 (0.7985)	-174.1 (0.7429)	-177.3 (0.7656)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p} = r_{t-p} = \ln \frac{O_{t-p}}{O_{t-p-1}}$ . Model:  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t$ .

Table 7: Forecasts from Heteroskedastic model. Shock: net price increase

	$\delta \neq 0, \lambda \neq 0$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
$p = 1$	-174.3 (0.7407)	-171.3 (0.7378)	-173.9 (0.7667)
$p = 2$	-171.3 (0.8103)	-169.0 ( <b>0.7304</b> )	-176.1 (0.7665)
$p = 3$	<b>-165.5</b> (0.7734)	-166.1 (0.7443)	-171.4 (0.7550)
$p = 4$	-170.0 (0.8408)	-170.5 (0.7467)	-175.2 (0.8241)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p} = \max\{0, \ln \frac{O_{t-p}}{O_{t-p}^*}\}$ . Model:  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t$ .

Table 8: Forecasts from Heteroskedastic model. Shock: asymmetric net price change

	$\delta_{1:2} \neq 0, \lambda_{1:2} \neq 0$	$\delta_{1:2} \neq 0, \lambda_{1:2} = 0$	$\delta_{1:2} = 0, \lambda_{1:2} \neq 0$
$p = 1$	-188.2 (0.7360)	-174.5 (0.7432)	-192.1 (0.7693)
$p = 2$	-186.4 (0.8169)	-171.7 ( <b>0.7306</b> )	-185.8 (0.7688)
$p = 3$	-181.2 (0.7784)	<b>-167.9</b> (0.7405)	-182.8 (0.7551)
$p = 4$	-183.0 (0.8379)	-174.8 (0.7579)	-186.1 (0.8223)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p}^+ = \max\{0, \ln \frac{O_{t-p}}{O_{t-p}^*}\}$ ,  $d_{t-p}^- = \min\{0, \ln \frac{O_{t-p}}{O_{t-p}^{**}}\}$ . Model:  $g_t = \mu + \alpha g_{t-1} + \lambda_1 d_{t-p}^+ + \lambda_2 d_{t-p}^- + \sigma \exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-) e_t$ .

Table 9: Forecasts from Heteroskedastic model. Shock: symmetric net price change

	$\delta \neq 0, \lambda \neq 0$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
$p = 1$	-174.4 (0.7519)	-170.5 (0.7444)	-176.1 (0.7951)
$p = 2$	-170.2 (0.8525)	-169.0 ( <b>0.7292</b> )	-177.2 (0.7714)
$p = 3$	-169.3 (0.7441)	<b>-164.3</b> (0.7399)	-173.4 (0.8081)
$p = 4$	-174.9 (0.8493)	-173.1 (0.7610)	-176.8 (0.8468)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p} = \max\{0, \ln \frac{O_{t-p}}{O_{t-p}^*}\} + \min\{0, \ln \frac{O_{t-p}}{O_{t-p}^{**}}\}$ . Model:  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p}) e_t$ .

Table 10: Forecasts from Heteroskedastic model. Shock: large net price increase

	$\delta \neq 0, \lambda \neq 0$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
$p = 1$	-180.4 (0.7617)	-177.3 (0.7311)	-176.6 (0.7542)
$p = 2$	-182.9 (0.7467)	-178.0 (0.7281)	-178.2 (0.7428)
$p = 3$	-179.1 (0.7627)	<b>-176.2 (0.7266)</b>	-176.8 (0.7641)
$p = 4$	-184.5 (0.9459)	-179.3 (0.7433)	-179.4 (0.8812)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p} = r_{t-p}I\{r_{t-p} > \text{std}\{r_{t-p-1}, \dots, r_{t-p-12}\}\}$ , where  $I(\cdot)$  is the indicator function and the symbol std represents one standard deviation of past three years oil price change rates. Model:  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p})e_t$ .

Table 11: Forecasts from Heteroskedastic model. Shock: net price increase indicator

	$\delta \neq 0, \lambda \neq 0$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
$p = 1$	-170.2 (0.7699)	-165.8 (0.7427)	-178.9 (0.7625)
$p = 2$	-157.2 (0.7321)	<b>-156.6 (0.7318)</b>	-173.4 (0.7367)
$p = 3$	-159.2 (0.7446)	-158.4 (0.7455)	-173.9 (0.7381)
$p = 4$	-158.0 (0.7331)	-158.6 (0.7536)	-172.9 (0.7332)

This table reports log-predictive likelihood values and root mean squared forecast errors (RMSFE) in parentheses for the 156 out-of-sample observations. A bold number indicates the largest (smallest) value of the log-predictive likelihoods (RMSFE) in the table. Shock Definition:  $d_{t-p} = I(d_t^+ > 0)$ .  $I(\cdot)$  is the indicator function. Model:  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p})e_t$ .

Table 12: Posterior Summary of  $\delta$

Shock, $d_{t-p}$	Mean	90% DI
Oil Price Log-difference	0.0172	(0.0106, 0.0234)
Net Price Increase	0.0416	(0.0226, 0.0627)
Asymmetric Net Price Change	$\delta_1$ 0.0453	(0.0256, 0.0676)
	$\delta_2$ 0.0290	(0.0081, 0.0467)
Symmetric Net Price Change	0.0362	(0.0244, 0.0475)
Large Net Price Increase	0.0160	(0.0042, 0.0287)
Net Price Increase Indicator	0.6927	(0.4939, 0.8947)

This table reports full sample posterior statistics of  $\delta$  from the best models according to LPL values from Tables 6–11. The model is  $g_t = \mu + \alpha g_{t-1} + \lambda d_{t-p} + \sigma \exp(\delta d_{t-p})e_t$  except for Asymmetric Net Price Change it is  $g_t = \mu + \alpha g_{t-1} + \lambda_1 d_{t-p}^+ + \lambda_2 d_{t-p}^- + \sigma \exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-)e_t$ . 90% DI is the 90 % density interval.

Table 13: Posterior Summary of the Best Forecasting Model

	Mean	90% DI		Mean	90% DI
	Best Shock Model			AR(1)	
$\mu$	0.4536	(0.3472,0.5600)	$\mu$	0.4173	(0.2948,0.5382)
$\alpha$	0.3995	(0.2902,0.5073)	$\alpha$	0.3764	(0.2577,0.4959)
$\sigma$	0.2854	(0.2298,0.3520)	$\sigma$	0.5262	(0.4402,0.6262)
$\delta$	0.6927	(0.4939,0.8947)			

This table reports posterior estimates for  $g_t = \mu + \alpha g_{t-1} + \sigma \exp(\delta d_{t-2}) e_t$ ,  $e_t \sim N(0, 1)$  with  $d_{t-2}$  equal to net price increase indicator and the benchmark AR(1), ( $\delta = 0$ ).

Table 14: Prior Sensitivity Analysis

	Priors	LPL	RMSFE
Very Loose	$A = 5I, \chi = 10, \nu = 2, B = 5$	-156.2	0.7274
Loose	$A = 2I, \chi = 5, \nu = 1, B = 2$	-156.2	0.7289
Original	$A = I, \chi = 3, \nu = 1, B = 1$	-156.6	0.7316
Tight	$A = 0.5I, \chi = 3, \nu = 1.5, B = 0.5$	-157.4	0.7339
Very Tight	$A = 0.25I, \chi = 3, \nu = 3, B = 0.25$	-160.5	0.7368

This table reports log-predictive likelihood (LPL) values and root mean squared forecast errors (RMSFE) for the best forecasting model using different prior settings. The oil shock is the net price increase indicator with restrictions of  $\lambda = 0$  and  $\delta \neq 0$ .

Table 15: Out-of-Sample Forecasts for Subsamples

Model	LPL	RMSFE
1976Q4 to 1989Q4		
Net Price Increase	-69.10	0.9742
Asymmetric Net Price Change	-70.43	0.9732
Symmetric Net Price Change	<b>-67.35</b>	0.9742
Large Net Price Increase	-75.82	<b>0.9476</b>
Net Price Increase Indicator	-67.77	0.9582
Benchmark AR(1)	-74.53	0.9760
AR(1)-GARCH(1,1)	-74.38	0.9779
1990Q1 to 2002Q4		
Net Price Increase	-49.55	0.5561
Asymmetric Net Price Change	-49.96	0.5462
Symmetric Net Price Change	-49.54	0.5443
Large Net Price Increase	-51.13	0.5482
Net Price Increase Indicator	<b>-45.36</b>	0.5553
Benchmark AR(1)	-50.19	<b>0.5430</b>
AR(1)-GARCH(1,1)	-46.36	0.5545
2003Q1 to 2015Q3		
Net Price Increase	-47.43	0.6268
Asymmetric Net Price Change	-47.52	0.6236
Symmetric Net Price Change	-47.43	0.6215
Large Net Price Increase	-49.23	0.6124
Net Price Increase Indicator	<b>-43.43</b>	0.6079
Benchmark AR(1)	-48.88	<b>0.6019</b>
AR(1)-GARCH(1,1)	-46.50	0.6183
1976Q4 to 2015Q3		
Net Price Increase	-166.1	0.7550
Asymmetric Net Price Change	-167.9	0.7551
Symmetric Net Price Change	-164.3	0.7714
Large Net Price Increase	-176.2	0.7641
Net Price Increase Indicator	<b>-156.6</b>	<b>0.7332</b>
Benchmark AR(1)	-173.6	0.7352
AR(1)-GARCH(1,1)	-167.2	0.7432

This table reports the log-predictive likelihood (LPL) and root-mean squared forecasts error (RMSFE) for different subsamples. Bold denotes the largest LPL (smallest RMSFE) in a subsample. The heteroskedastic model with different oil shocks ( $\lambda = 0$  and  $\delta \neq 0$ ) is included along with a homoskedastic AR(1) and AR(1)-GARCH(1,1).

Table 16: Robustness Check under Industrial Production Index

Shock Type, $d_{t-p}$	$\delta \neq 0, \lambda = 0$	$\delta = 0, \lambda \neq 0$
Net Price Increase	-450 (0.6352)	-469 (0.6328)
Asymmetric Net Price Change	-453 (0.6333)	-487 (0.6385)
Symmetric Net Price Change	-460 (0.6351)	-469 (0.6369)
Large Net Price Increase	-470 (0.6333)	-471 (0.6385)
Net Price Increase Indicator	-445 (0.6348)	-469 (0.6384)

The table displays the log-predictive likelihood and RMSFE (parenthesis) for the best heteroskedastic shock models using industrial production as economic growth. The full sample size is 499 with the out-of-sample size of 480. The oil shock is measured using the past 36 months. The best homoskedastic model (ARX-MA) delivers a LPL of  $-471.9$  and RMSFE of  $0.6354$ .

Figure 1: RAC Composite Quarterly Oil Price (Top)  
RAC Composite Quarterly Percentage Change of Oil Price (Middle)  
U.S Quarterly Real GDP Growth Rates (Bottom)

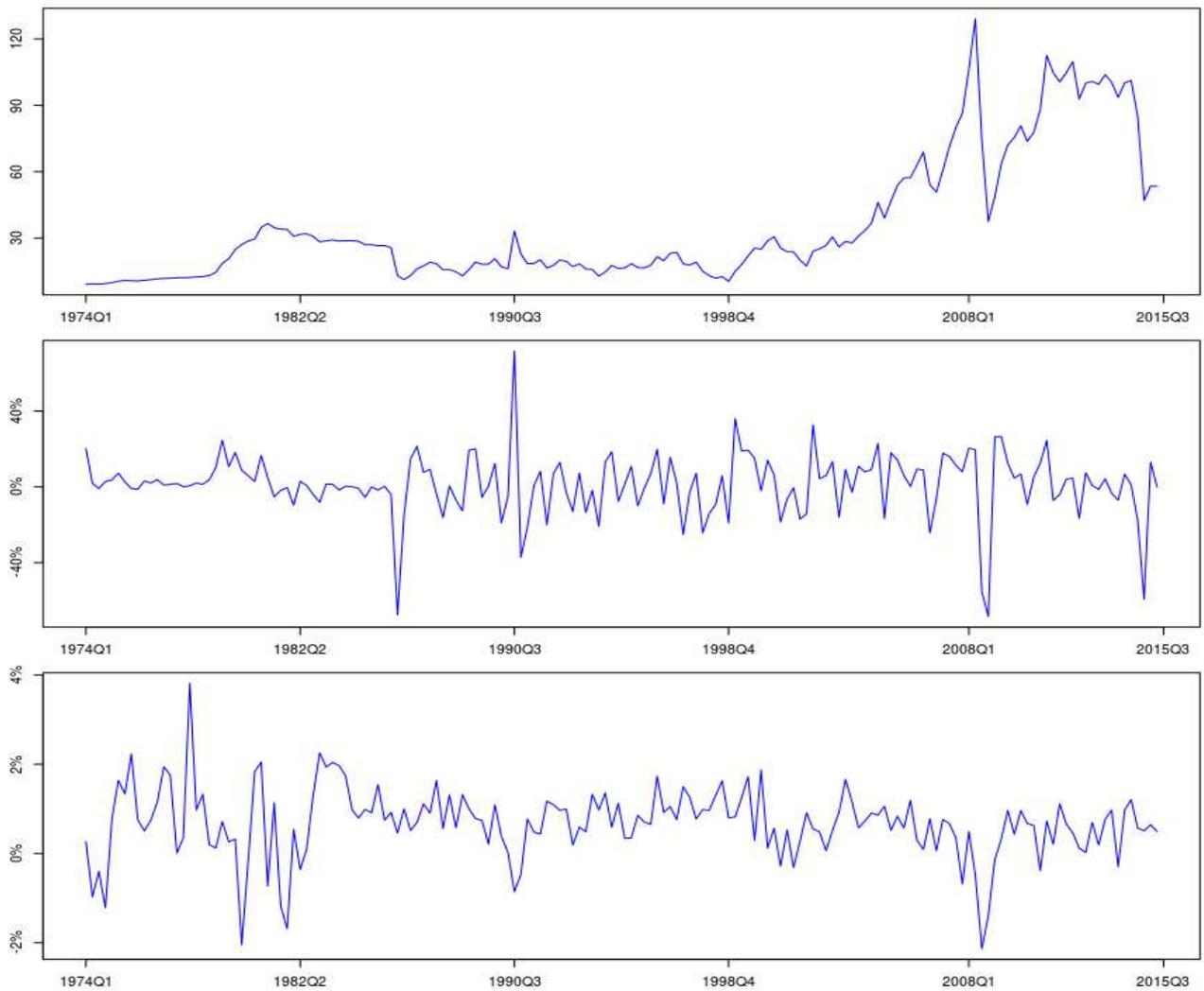
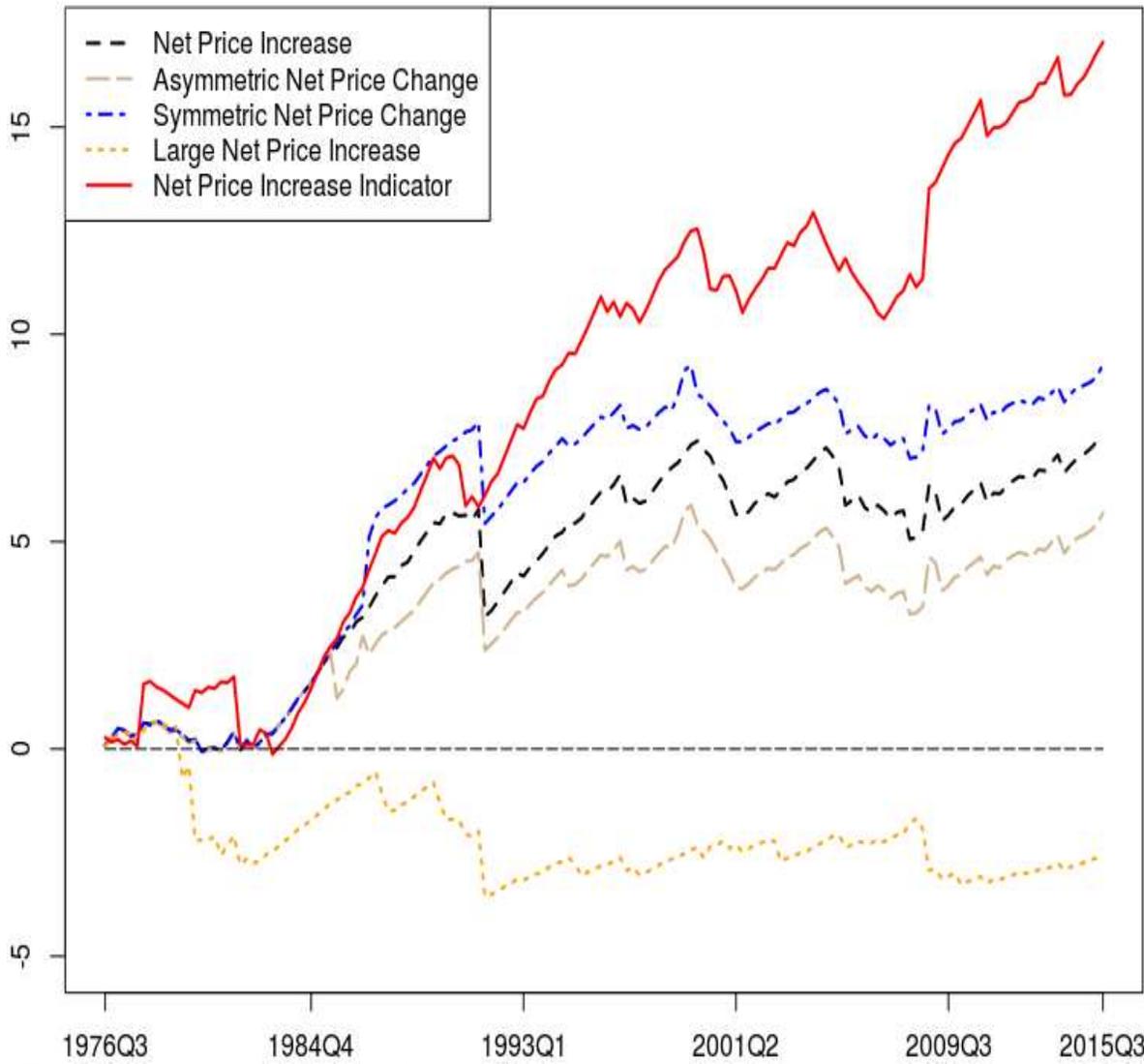
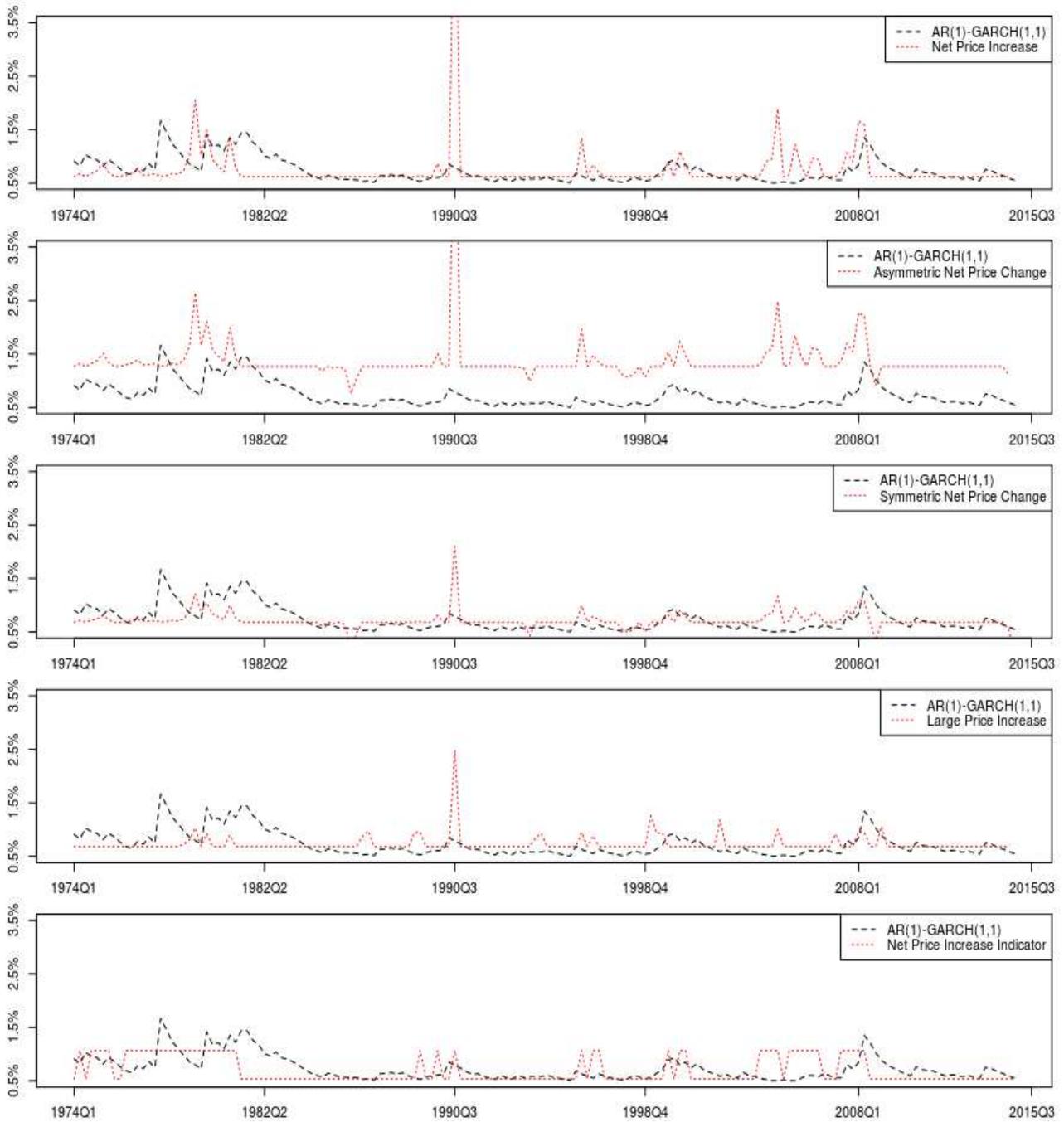


Figure 2: Cumulative Predictive Bayes Factors



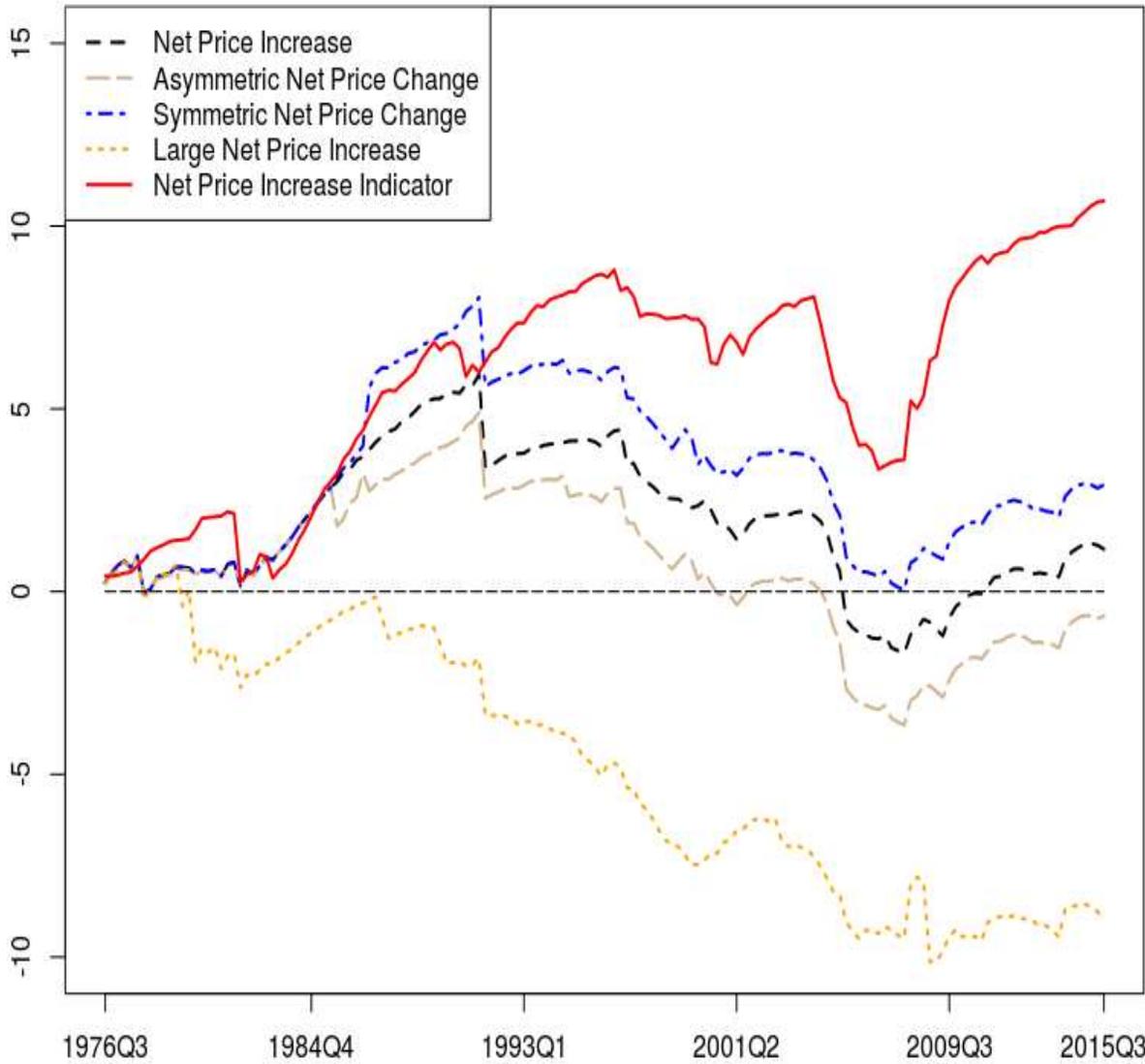
This figure plots the cumulative Bayes factor at each point in time in favour of a model against the benchmark AR(1) model. Various dash lines represent model (9) with corresponding shock variables.

Figure 3: Volatility of Real Growth



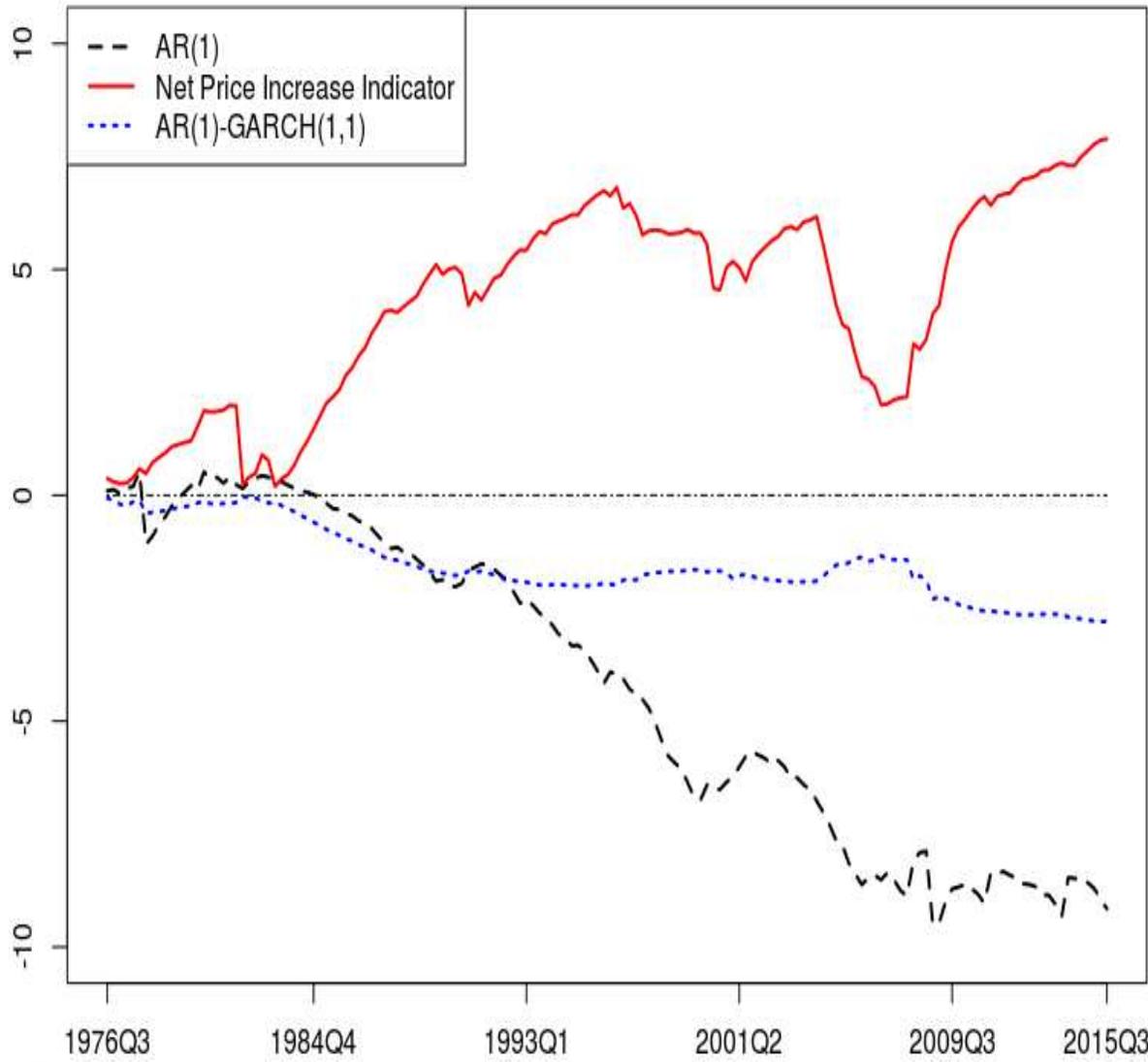
Every dashed line of each sub-figure represents the posterior mean of  $\sigma \exp(\delta d_{t-p})$ . For the case of asymmetric net price change, it is the posterior mean of  $\sigma \exp(\delta_1 d_{t-p}^+ + \delta_2 d_{t-p}^-)$ . Each plot has a different oil shock entering the conditional variance and represents the best specification from Tables 7 - 11. The AR(1)-GARCH(1,1) model is defined in Section 7.1.

Figure 4: Cumulative Predictive Bayes Factors



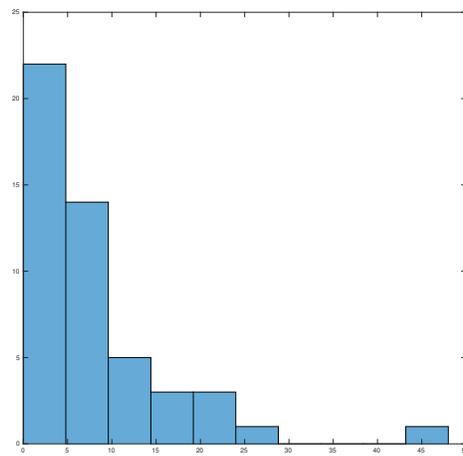
This figure plots the cumulative Bayes factor at each point in time in favour of a model against the AR(1)-GARCH(1,1) model of (10). Various dash lines represent model (9) with corresponding shock variables.

Figure 5: Cumulative Predictive Bayes Factors



This figure plots the cumulative Bayes factor at each point in time in favour of a model against the AR(1)-GARCH(1,1)-Shock model of (11).

Figure 6: Net Price Increase Shocks



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