

Accepted Manuscript

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David I. Harvey, Stephen J. Leybourne, Robert Sollis, A.M. Robert Taylor

PII: S0927-5398(15)00096-1
DOI: doi: [10.1016/j.jempfin.2015.09.002](https://doi.org/10.1016/j.jempfin.2015.09.002)
Reference: EMPFIN 834

To appear in: *Journal of Empirical Finance*

Received date: 23 September 2014
Revised date: 24 July 2015
Accepted date: 11 September 2015



Please cite this article as: Harvey, David I., Leybourne, Stephen J., Sollis, Robert, Taylor, A.M. Robert, Tests for Explosive Financial Bubbles in the Presence of Non-stationary Volatility, *Journal of Empirical Finance* (2015), doi: [10.1016/j.jempfin.2015.09.002](https://doi.org/10.1016/j.jempfin.2015.09.002)

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TESTS FOR EXPLOSIVE FINANCIAL BUBBLES IN THE PRESENCE OF NON-STATIONARY VOLATILITY*

David I. Harvey^a, Stephen J. Leybourne^a, Robert Sollis^b and A.M. Robert Taylor^c

^aSchool of Economics, University of Nottingham

^bNewcastle University Business School

^cEssex Business School, University of Essex

July 23, 2015

Abstract

This paper studies the impact of permanent volatility shifts in the innovation process on the performance of the test for explosive financial bubbles based on recursive right-tailed Dickey-Fuller-type unit root tests proposed by Phillips, Wu and Yu (2011). We show that, in this situation, their supremum-based test has a non-pivotal limit distribution under the unit root null, and can be quite severely over-sized, thereby giving rise to spurious indications of explosive behaviour. We investigate the performance of a wild bootstrap implementation of their test procedure for this problem, and show it is effective in controlling size, both asymptotically and in finite samples, yet does not sacrifice power relative to an (infeasible) size-adjusted version of their test, even when the shocks are homoskedastic. We also discuss an empirical application involving commodity price time series and find considerably less emphatic evidence for the presence of explosive bubbles in these data when using our proposed wild bootstrap implementation of the Phillips, Wu and Yu (2011) test.

Keywords: Rational bubble; Explosive autoregression; Non-stationary volatility; Right-tailed unit root testing.

JEL Classification: C22; C12; G14.

*We are grateful to two anonymous referees and participants at the conference 'Recent Developments in Financial Econometrics and Empirical Finance', held at the University of Essex on June 12th and 13th 2014, for helpful comments. Correspondence to: Robert Taylor, Essex Business School, University of Essex, Wivenhoe Park, Colchester, CO4 3SQ, UK. Email: rtaylor@essex.ac.uk

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