An interpretable machine learning workflow with an application to economic forecasting

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Disclaimer: The views expressed here are my own and should not be represented as those of the Bank of England (BoE). All errors are ours.

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Motivation

Pros & Cons of ML relative to econometric approach

Advantages

- Often higher accuracy
- Lower risk of misspecification
- Return richer information set

Disadvantages

- Higher model complexity ("black box critique")
- Less analytical guarantees, e.g. risk of overfitting
- Often larger data requirement

The machine learning (ML) setting

Everything here is about supervised learning, i.e. minimising an error

$$\min_{\theta} \; \mathbb{E}_{\Omega}\left[||y - \hat{f}_{\theta}\|_{l}\right] .$$

However, many aspects can be transferred to unsupervised or reinforcement learning (only need some form of model prediction).

Problem: θ not identifying, i.e. degeneracy of parameter sets.

$\Rightarrow$ Black box problem.

ML workflow

The ML workflow

1. Comparison of model predictions ("horse race" if accuracy is the goal)

   $\Rightarrow$ Is there gain in using ML, should I continue?

2. Model decomposition into Shapley values

   $\Rightarrow$ Identify important features & uncover learned functional forms

3. Statistical testing: "Shapley regression"

   $\Rightarrow$ Establish confidence & standard *communication*

The linear regression model (LR)

$$(I) : \hat{f}(x_i) = x_i\hat{\beta} = \sum_{k=0}^{n} x_{i,k}\hat{\beta}_k + \hat{\epsilon} \quad \text{with} \quad (II) : \mathcal{H}_0^k : \beta_k = 0 \tag{1}$$

- Workhorse of econometric analysis
- Special: *local* and *global* model inference ($\hat{\beta} = const.$)
- Widely accepted to be interpretable (if not too many regressors)
- Belongs to class of additive local variable attributions

$$\Phi(x_i) \equiv \phi_0 + \sum_{k=1}^{n} \phi_k(x_i) = \hat{f}(x_i) \tag{2}$$

Shapley values as analogy between game theory and (ML) models

	Cooperative game theory	Machine learning
n	Players	Predictors / variables
$\hat{f}/\hat{y}$	Collective payoff	Predicted value for one observation
S	Coalition of players	Group of predictors in model
Source	Shapley (1953)	Štrumbelj and Kononenko (2010)
		Lundberg and Lee (2017)

Model Shapley decomposition: $\hat{f}(x_i) = \phi_0 + \sum_{k=1}^{n} \phi_k^S(\hat{f}; x_i)$

Why Shapley values? Because they are the only attribution scheme which is *local, linear, exact, respects the null, is consistent (Young, 1985), and allows for interactions*
(Agarwal et al., 2019).

Shapley regression (SR) for statistical inference (Joseph, 2019)

Auxiliary inference analysis on $\hat{f}$ in the space of Shapley values:

$$y_i = \sum_{k=0}^{n} \phi_{ki}^S \hat{\beta}_k^S + \hat{\epsilon}_i \qquad \text{with} \qquad \mathcal{H}_0^k(\Omega) : \beta_k^S \leq 0 \tag{3}$$

Universality: $\hat{f}$ can be any model.

Interpretation: $\hat{\beta}^S$ measures the alignment of model components with the target.

Validity: Eq. 3 relates to generated regressors (Pagan (1984)) imposing minor conditions. Inference generally only valid on test set (standard in ML) and some consideration on convergence rates (cross-fitting helpful, Chernozhukov et al. (2018)).

SR interpretation: alignment & learning progress

The true value of each β_k^S is either 1 (**signal**) or 0 (**pure noise**).

If $\mathcal{H}_1^k(\Omega) : \beta_k^S = 1$ is not rejected, we can say that information from variable k has been learned robustly (perfect alignment between y and ψ_k^S).

Learning asymptotics: β_k^S track learning progress and distinguish between signal from noise.

SR communication: Shapley share coefficients (SSC)

Normed summary statistic for the importance of x_k to the model $\hat{f}$ within a region Ω.

$$\Gamma_k^S(\hat{f},\Omega) \equiv \left[sign\left(\hat{\beta}_k\right) \left\langle \frac{|\phi_k^S(\hat{f})|}{\sum_{l=1}^m |\phi_l^S(\hat{f})|} \right\rangle_\Omega \right]^{(*)} \in [-1,1]$$

$$\stackrel{\hat{f}(x)=x\hat{\beta}}{=} \hat{\beta}_k^{(*)} \cdot \left\langle \frac{|(x_k - \langle x_k \rangle)|}{\sum_{l=1}^m |\hat{\beta}_k (x_l - \langle x_l \rangle)|} \right\rangle_\Omega \quad (4)$$

3 parts: **sign** (alignment of x_k and y), **size** (model fraction attributed to x_k) and **significance level** of $\hat{\beta}_k^S$ against $\mathcal{H}_0^k(\Omega)$.

$\Gamma_k^S(\hat{f},\Omega)$ is proportional to the coefficient of the linear model in the linear regression case (equivalence to SR).

Full recipe

Application

Forecasting setup

- Target: YoY change in US unemployment on a 1 year horizon
- Predictors: FRED-MD data base, McCracken and Ng (2016); 9 selected variables, lagged target
- Sample period: 1962:M2 - 2019:M11 (no Covid, no stress)
  - validation & training (yearly): Until 1989:M12
  - Testing: 1990:M1–2019:M11 (pseudo real-time), out-of-bag (full)
- Models:
  - *classical ML model:* Artificial neural networks (MLP), random forest, support vector regression (SVR), gradient boosted trees
  - *linear regressions:* OLS, Ridge, Lasso
  - *auto-regressions:* AR(1), AR(p) with $p \leq 12$ by AIC
- Hyper-parameters: (time series) 5-fold cross-validation, every 3 years
- Model-aggregation: Bootstrap aggregation ('bagging' over 100 draws)

Variable selection: Capture different economic channels

Variable	Transformation	Name in Source
Unemployment	changes	UNRATE
3-month treasury bill	changes	TB3MS
Slope of the yield curve	changes	-
Real personal income	log changes	RPI
Consumption	log changes	DPCERA3M086SBEA
Industrial production	log changes	INDPRO
S&P 500	log changes	S&P 500
Business loans	second order log changes	BUSLOANS
CPI	second order log changes	CPIAUCSL
Oil price	second order log changes	OILPRICEx
M2 Money	second order log changes	M2SL

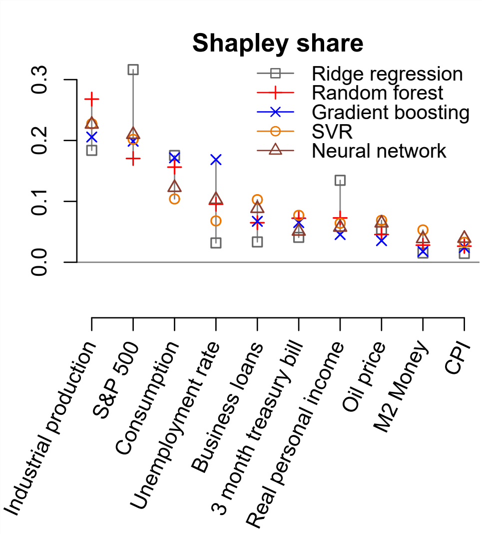
Transformations as suggested in McCracken and Ng (2016), using quarterly changes.

Step 1: Horse race results

Time period	01/1990–11/2019	01/1990–12/1999	01/2000–08/2008	09/2008–11/2019
Gradient boosting	**0.559** -	**0.460** -	**0.466** -	0.718 (0.353)
SVR	0.565 (0.323)	0.470 (0.328)	0.489 (0.219)	**0.709** -
Forest	0.581 (0.018)	0.472 (0.240)	0.471 (0.413)	0.762 (0.005)
Neural network	0.589 (0.009)	0.468 (0.336)	0.503 (0.070)	0.762 (0.001)
AR_1	0.608 (0.063)	0.472 (0.382)	0.503 (0.216)	0.811 (0.064)
AR_{12}	0.626 (0.001)	0.543 (0.011)	0.482 (0.356)	0.810 (0.001)
Lasso regression	0.637 (0.000)	0.498 (0.061)	0.474 (0.378)	0.886 (0.000)
Ridge regression	0.639 (0.000)	0.497 (0.065)	0.481 (0.272)	0.886 (0.000)
OLS regression	0.648 (0.000)	0.516 (0.016)	0.508 (0.053)	0.872 (0.000)

Forecast comparison in the baseline set-up using MAE. P-values in parentheses indicate the statistical significance for (one-sided) DM test. Sources: McCracken and Ng (2016) and authors' calculation.

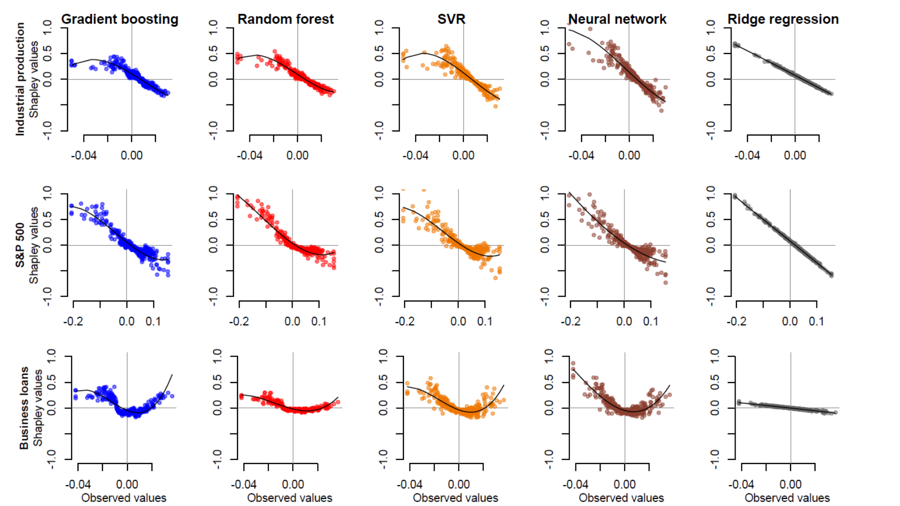
Step 2: Shapley value variable importance



Fraction of absolute feature Shapley values within test period 1990–2019 for all full-information models.

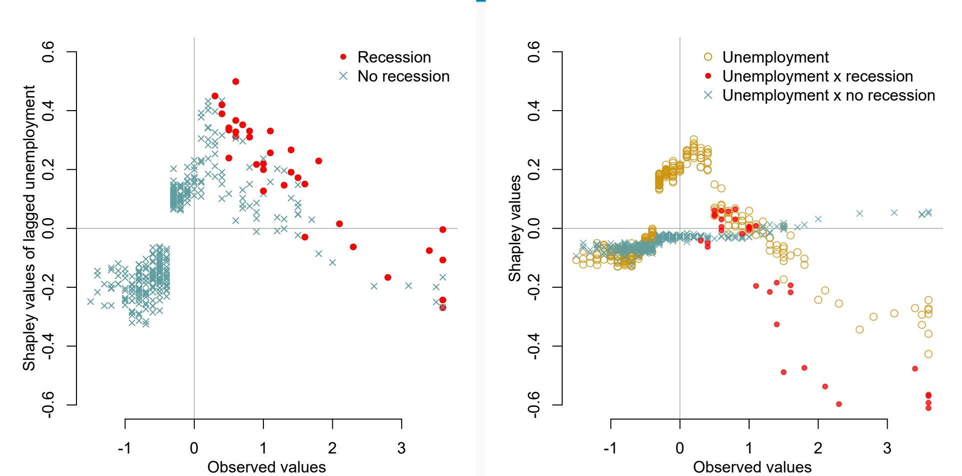
ML models largely agree on feature importances compared to linear Ridge regression.

Step 2: Learned functional forms (I): Non-linearities



Lines shows a polynomial fit of Shapley values (dots). Source: Authors' calculations.

Step 2: Learned functional forms (III): Regime learning



Interaction between lagged unemployment and recessions (red) as learned by the boosted tree. LEFT: Baseline model. RIGHT: Unemployment-recession interaction with a recession dummy in the model. Source: Authors' calculations.

Step 3: Statistical inference and communication

	Gradient boosting			Ridge regression		
	β^S	p-value	Γ^S	β^S	p-value	Γ^S
Industrial production	1.132	0.000	-0.217***	2.280	0.000	-0.185***
S&P 500	0.942	0.000	-0.191***	0.907	0.000	-0.317***
Consumption	1.103	0.000	-0.177***	0.966	0.012	-0.173**
Unemployment	1.443	0.000	+0.175***	9.789	0.000	+0.031***
Business loans	3.086	0.000	-0.066***	5.615	0.006	-0.035***
3-month treasury bill	4.273	0.000	-0.062***	-6.816	1.000	-0.042
Personal income	-0.394	0.682	+0.04	-0.658	0.870	+0.138
Oil price	0.298	0.387	-0.035	-2.256	0.973	-0.055
CPI	0.272	0.438	+0.021	-4.294	0.875	+0.014
M2 Money	-8.468	1.000	-0.016	-18.545	0.994	-0.009

Shapley regression of gradient boosting mode (left) and the ridge regression (right) for the forecasting predictions between 1990–2019. Significance levels: *p<0.1; **p<0.05; ***p<0.01. Source: Authors' calculations.

Pros & Cons of ML relative to econometric approach [revisited]

Advantages

- Often higher accuracy
  Initial motivation (step 1)
- Lower risk of misspecification
  SR distinguishes signal from noise (step 3)
- Return richer information set
  Learned functional forms (step 2)

Disadvantages

- Higher model complexity ("black box critique")
  Learned functional forms (step 2)
- Less analytical guarantees, e.g. risk of overfitting
- Often larger data requirement
  SR tracks learning (step 3)

Bonus: Experts vs 'robots' (I)

We (experts) hand-picked inputs, BUT should we not let data and algorithms speak freely?

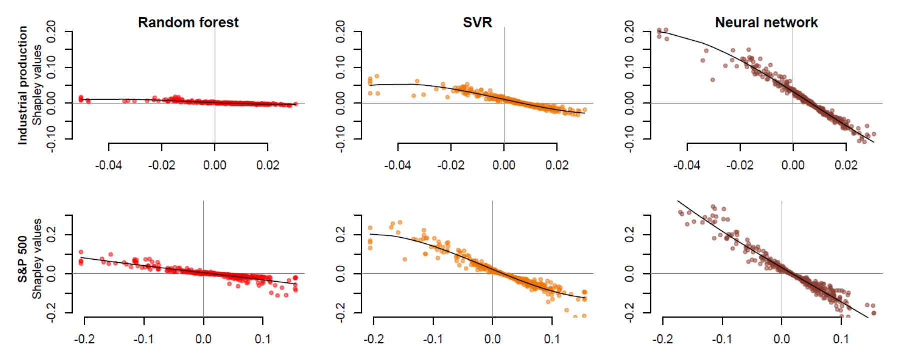
	Key features	All features	PCA_1	PCA_2	PCA_3	PCA_5	PCA_7
Gradient boosting	0.56	0.58	0.67	0.53	**0.52**	0.54	0.57
SVR	0.57	0.57	0.61	**0.52**	**0.52**	0.55	0.59
Random forest	0.58	0.55	0.62	**0.52**	0.53	0.55	0.61
Neural network	0.59	0.57	0.69	**0.52**	0.53	0.55	0.55
Lasso	0.64	0.63	0.65	0.56	**0.54**	0.56	0.59
Ridge	0.64	0.58	0.65	0.56	**0.54**	0.56	0.58
OLS	0.65	0.80	0.65	0.56	**0.54**	0.56	0.59

Comparison of the forecasting performance (MAE) when using different input data. Source: Authors' calculations.

Yes, to some extent.

Bonus: Experts vs 'robots' (II)

BUT black box problem returns: No consistent signal anymore.



Learned functional forms. Lines shows a polynomial fit of Shapley values (dots). Source: Authors' calculations.

⇒ Combination of experts <u>and</u> robots best (complements).

Take-away messages

- We propose an interpretable ML workflow
  1. Model test evaluation ("horse race")
  2. Shapley decomposition of individual predictions
  3. Shapley regression for statistical inference
- Perform macro forecasting exercise of US unemployment
- ML models outperform conventional ones and learn endogenously: nuanced, meaningful and stable functional forms & to identify different points in the business cycle (recessions vs normal times)
- Expert vs 'robots': Expert-led model construction leads to best trade-off in terms of performance and interpretability.
- Loads of robustness checks: data amount, transformations, horizon, real-time data, **winsorisation, effects of randomness, Shapley value computation**.

$\Rightarrow$ Approach opens the door to more ML applications.

Thanks for listening

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Detour: Shapley values in cooperative game theory

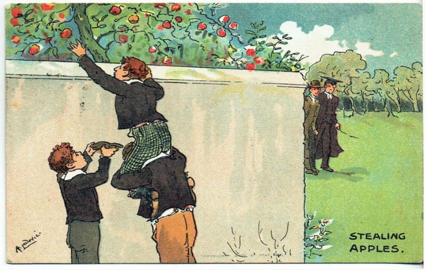
- How much does player A contribute a collective payoff f obtained by a group of n? (Shapley, 1953).
- Observe payoff of the group with and without player A.
- Contribution depends on the other players in the game.
- All possible coalitions S need to be evaluated.

$$\phi_A = \sum_{S \subseteq n \setminus A} \frac{|S|!(|n| - |S| - 1)!}{|n|!} [f(S \cup \{A\} - f(S)] \tag{5}$$

$2^{|n|-1}$ coalitions are evaluated. Computationally complex!

Intuitive Shapley value example: the Victorian bad boys

- Three siblings (strong [S], tall [T] & smart [M]) set off to nick some apples A (pay-off) from the neighbour's tree
- For each sibling, sum over marginal contribution to coalitions of one and two
- So, the Shapley value of the strong sibling [S] is then:



Source: 6oxgangsavenueedinburgh

$$\phi_S = \frac{1}{6}[A(S) - A(\emptyset)] + \frac{1}{6}[A(T,S) - A(T)] + \frac{1}{6}[A(M,S) - A(M)] + \frac{1}{3}[A(T,M,S) - A(T,M)] \quad (6)$$

Back

Numerical calculation of Shapley component for a math. model

The Shapley value of a feature is the weighted sum of marginal contributions to all possible coalitions of other features (players):

$$\phi_k^S(\hat{f}, x_i) = \sum_{S \subseteq \mathcal{C} \setminus \{k\}} \frac{|S|!(n-|S|-1)!}{n!} \left(\hat{f}(x_i|S \cup \{k\}) - \hat{f}(x_i|S) \right) \quad (7)$$

$$= \sum_{S \subseteq \mathcal{C} \setminus \{k\}} \omega_S \left(\mathbb{E}_b[\hat{f}(x_i)|S \cup \{k\}] - \mathbb{E}_b[\hat{f}(x_i)|S] \right) \quad (8)$$

$$\text{with} \quad \mathbb{E}_b[\hat{f}(x_i)|S] \equiv \int \hat{f}(x_i)\,\mathrm{d}b(\bar{S}) = \frac{1}{|b|} \sum_b \hat{f}(x_i|\bar{S}) \quad (9)$$

"Excluded" features are integrated out over background b, which is an informative dataset determining ϕ_0. E.g. training dataset or sample of untreated population.

There are some challenges (and solutions) to the calculation of (1)–(3).

Challenges in calculating model Shapley values

- Computational complexity: Generally intractable for large feature sets ($n!$ in 1)

  ⇒ *Solutions:*
  - Coalition sampling
  - Feature grouping: important and 'others'
  - Model specific algorithms (e.g. Lundberg et al. (2018))

- Feature dependence: Equation 8 assumes independence

  ⇒ *Solutions:*
  - Use exact method for trees and compare
  - Calculate higher-order terms of Shapley-Taylor index (Agarwal et al., 2019) and compare relative magnitudes

- Expectation consistency: Integration in (9) can break consistency

  ⇒ *Solutions:* When comparing models, their background values ϕ_0 need to coincide (or close). Mostly the case in practical applications. See Joseph (2019).

Back

SR properties (proofs in Joseph (2019))

- SR identical to LR in case of LR (reassuringly the wheel was not reinvented)
- Inference only strictly valid locally within input region Ω (non-linearity of ML models)
- SR coefficients $\hat{\beta}^S$ gauge the learning process of $\hat{f}$:
  - $\mathcal{H}_0^k$ rejected: useful information contained x_k
  - And $\mathcal{H}_1^k$ *not* rejected: x_k robustly learned (perfect alignment, asymptotic limit)
  - Generally, $\hat{\beta}_k^S > / < 1$ measure under/over-reliance on x_k, respectively
- $\beta^S \in \{0, 1\}^m$ only possible true values, corresponding to the "no-signal" ($\mathcal{H}_0^k$) or "signal" ($\mathcal{H}_1^k$) cases, respectively
- SR allow to control for different error structures within ML models.
- SR coefficients $\hat{\beta}^S$ not really useful for communication (no scale information).

ML inference recipe (full details in Joseph (2019))

1. Cross-validation, training and testing of model $\hat{f}$
2. Model decomposition
   - 2.1 Shapley value decomposition $\Phi^S(\hat{f})$ [Eq. 7]
   - 2.2 (optional) Mapping of Φ^S to desired decomposition $\hat{\Psi}(\Phi^S(\hat{f}))$
3. Model inference
   - 3.1 Shapley regression [Eq. 3] with appropriate standard errors.
   - 3.2 Assessment of model bias and component robustness based on $\hat{\beta}^S$ over region Ω: [VEINs may be appropriate (Chernozhukov et al. (2018))]

     Robustness: $\mathcal{H}_0^c : \{\hat{\beta}_c^S = 0|\Omega\}$ rejected and $\mathcal{H}_1^c : \{\hat{\beta}_c^S = 1|\Omega\}$ not rejected for individual components

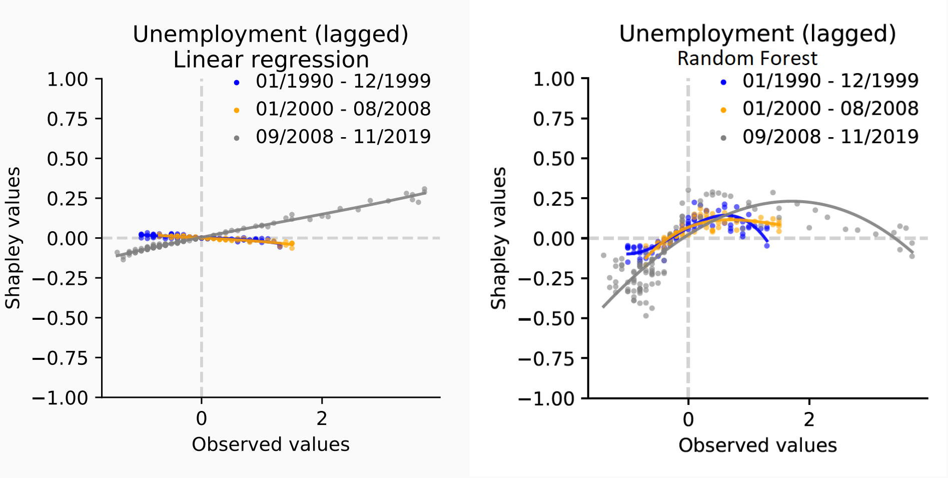
     Unbiasedness: $\mathcal{H}_1^c : \{\hat{\beta}_c^S = 1|\Omega\}$ not rejected $\forall c \in \{1, \ldots, C\}$, or inclusion condition
   - 3.3 Calculate Shapley share coefficients (SSC) $\Gamma^S(\hat{f}, \Omega)$ [Eq. 4] and their standard errors

Robustness analysis of horse race (part of it)

	Gradient boosting	SVR	Random forest	Neural Network	Ridge regression	AR_1
Prediction horizon h (lag between response and predictors in months)						
1	0.20	0.19	**0.17**	0.18	0.18	**0.17**
3	0.28	0.28	**0.27**	**0.27**	**0.27**	**0.27**
6	0.41	0.41	**0.39**	0.42	0.43	0.41
12 (baseline)	**0.56**	0.57	0.58	0.59	0.64	0.61
24	0.68	0.67	**0.62**	0.69	0.73	0.79
36	0.64	0.63	**0.61**	0.72	0.72	0.80
Training set size (in months)						
60	0.83	0.87	**0.79**	0.84	0.87	0.95
120	0.63	0.67	**0.57**	0.66	0.66	0.71
240	0.58	**0.56**	0.57	0.58	0.61	0.67
360	**0.57**	0.58	0.58	0.60	0.61	0.64
480	**0.56**	0.57	0.57	0.57	0.63	0.62
max (baseline)	**0.56**	0.57	0.58	0.59	0.64	0.61
Transformation span l (in months)						
1	0.57	0.60	**0.55**	0.59	0.64	-
3 (baseline)	**0.56**	0.57	0.58	0.59	0.64	-
6	**0.60**	**0.60**	**0.60**	0.67	0.66	-
9	**0.65**	0.68	0.67	0.70	0.70	-
12	0.68	0.74	0.70	0.71	0.74	**0.61**
Winsorisation at 1% and 99%						
Yes (baseline)	**0.56**	0.57	0.58	0.59	0.64	0.61
No	**0.56**	0.59	0.58	0.60	0.64	0.61

MAE for forecasting US unemployment one year out. Source: Author's calculations.

Step 2: Learned functional forms: Stability



Lines shows a polynomial fit of Shapley values (dots). Shapley values are computed on the out-of-bag predictions (look-ahead bias, but no model drift). Extreme values, below 2.5% and above 97.5% quantile, are excluded.

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