COMBINING FILTER DESIGN WITH MODEL-BASED FILTERING
(WITH AN APPLICATION TO BUSINESS-CYCLE ESTIMATION)

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Abstract

Filters used to estimate unobserved components in time series are often designed on a priori grounds, so as to capture the frequencies associated with the component. A limitation of these filters is that they may yield spurious results. The danger can be avoided if the so-called ARIMA-model-based (AMB) procedure is used to derive the filter. However, parsimony of ARIMA models typically implies little resolution in terms of the detection of hidden components. It would be desirable to combine a higher resolution with consistency with the structure of the observed series.

We show first that for a large class of a priori designed filters, an AMB interpretation is always possible. Using this result, proper convolution of AMB filters can produce richer decompositions of the series that incorporate a priori desired features for the components, and fully respect the ARIMA model for the observed series. (Hence no additional parameter needs to be estimated.)

The procedure is discussed in detail in the context of business-cycle estimation by means of the Hodrick-Prescott filter applied to a seasonally adjusted series or a trend-cycle component.

Keywords: Time Series; Filtering and Smoothing; ARIMA models; Trend and Cycle Estimation; Hodrick-Prescott Filter.

JEL Classification: C22, C80, E32, E37.
1 Introduction and Summary

Filters used to estimate unobserved components (UC) –also called "signals"– in economic time series are often designed on a priori grounds, so as to capture the frequencies that should be associated with the signal of interest. We shall refer to them as a-priory designed (APD) filters, and their design is independent of the particular series at hand. It is well known that a limitation of APD filters is that they may produce spurious results (a trend, for example, could be extracted from white noise).

The spuriousness problem can, in principle, be avoided if the filter is derived following a model-based approach. The series features are captured through an ARIMA model, models for the components are derived, and the Wiener-Kolmogorov filter is used to obtain the Minimum Mean Squared Error (MMSE) estimator of the components. We shall refer to this approach as ARIMA-model-based (AMB) filtering. AMB filtering also presents limitations. Parsimony of the ARIMA models typically identified for economic series implies little resolution in terms of UC detection, so that the AMB decomposition cannot go much beyond the standard "trend-cycle +seasonal +irregular" decomposition. Thus, it would be nice to combine a higher resolution with lack of spuriousness and consistency with the structure of the overall observed series.

It is first seen that, for a fairly wide class of APD filter that are symmetric and linear, an AMB interpretation is always possible, whereby the signal obtained is the MMSE estimator of white noise in the decomposition of an ARIMA model (straightforward to obtain from the APD filter). Given that the signal of interest will not be, in general, white noise, the previous interpretation does not provide a sensible model, but allows for a Wiener-Kolmogorov representation of the APD filter. This representation permits us to integrate the APD filter within the AMB approach. An important case is the following.

To avoid contamination with undesired frequencies, estimation of a signal often implies two steps: the APD filter is applied to series that have already been filtered. For example, the business cycle can be estimated on the seasonally adjusted (SA) series or on the trend-cycle component; sampling error may be estimated on the SA series or on the irregular component; calendar effects can be estimated with filters applied to the detrended series, etc. Thus, in the first step, a basic component is estimated and, in the second step, the APD is applied to this estimator.

If the first step is performed using an AMB approach, it is seen that the two-step estimator of the signal is also the MMSE estimator of a component in a full UC model, where the models for the components are sensible and incorporate elements reflecting the desirable features of the components, as well as elements that guarantee consistency with the observed series model. The two-step procedure accepts thus a full model specification and the components can be estimated in a single step. In this way, it becomes possible to increase the resolution of AMB filters, while preserving the parsimony of the overall model (crucial for forecasting).

The result is discussed in detail in the context of business-cycle estimation with the Hodrick-Prescott (HP) filter applied to the trend-cycle or seasonally adjusted series. It is seen that there is an infinite number of admissible decompositions of the trend-cycle into a long-term trend and a (business-) cycle component, where the former captures the frequencies in a narrow band around zero, and the cycle is a standard ARMA (2,2) linear stationary stochastic cycle, with the AR roots associated with a cyclical frequency. Reparametrizing the HP filter in terms of the period ($\tau_0$) for which the gain of the filter is .5 (i.e., the cutting point between periods mostly associated with the
trend and those mostly associated with the cycle), it is seen that the choice of a particular $\tau_0$ identifies a unique decomposition. The models corresponding to this decomposition are derived and discussed.

2 Filter Design and Arima-Model-Based Filtering

2.1 Unobserved Components and Linear Filters

Consider the problem of estimating an unobserved component hidden in an observed time series (i.e., the problem of “signal extraction”). Obvious examples are Seasonal Adjustment, and Trend or Cycle estimation. The series variation that should be excluded from the signal of interest will be denoted “noise” (for example, the SA series could be the signal and the seasonal component the noise). Thus we consider the “signal plus noise” decomposition $x_t = m_t + c_t$, where $x_t$ is the observed series, $c_t$ the “signal”, $m_t$ the non-signal (or “noise”), which in general will not be white, and the two UC are orthogonal. In order to avoid phase effects that would distort the dating of turning points, we shall obtain the historical (or final) estimator of the signal with a two-sided convergent and symmetric linear filter, as in

$$\hat{c}_t = \cdots + v_k x_{t-k} + \cdots + v_0 x_t + \cdots + v_k x_{t+k} + \cdots,$$  \quad (2.1)

where $v_k \to 0$ as $k \to \infty$. The filter will always converge and hence accept finite approximations. First, we shall assume a doubly infinite realization of the series. Let $B$ and $F$ denote the Backward and Forward operators, such that $Bz_t = z_{t-1}$ and $Fz_t = z_{t+1}$, respectively ($F = B^{-1}$). We can write (2.1) as

$$\hat{c}_t = v(B, F)x_t$$  \quad (2.2)

where

$$v(B, F) = v_0 + \sum_{j=1}^{\infty} v_j (B^j + F^j).$$  \quad (2.3)

The weights in $v(B, F)$ are supposed to capture the “desired” features of the signal. Given that the features of a trend, a seasonal, or a cyclical component are often better described in the frequency domain, we obtain the Fourier Transform (FT) of the filter (2.3), which implies replacing $(B^j + F^j)$ in (2.3) by $(2 \cos(j \omega))$, where $\omega$ denotes the frequency in radians ($0 \leq \omega \leq \pi$). This transformation yields the gain function of the filter

$$G(\omega) = v_0 + 2 \sum_{j=1}^{\infty} v_j \cos(j \omega).$$  \quad (2.4)

The gain will determine how much the different frequencies will contribute to the signal. If $G(\omega_0) = 0$, the frequency $\omega_0$ will be fully ignored; when $G(\omega_0) = 1$, the frequency $\omega_0$ will be fully transmitted.
A cyclical frequency, $\omega$, is easily translated into the period $\tau$ of the associated cycle through

$$\tau = 2 \pi / \omega \quad (2.5)$$

The period $\tau$ denotes the number of units of time needed for the completion of a full cycle. Hence, for example, for the two extreme values of the frequency:

* $\omega = 0 \Rightarrow \tau \to \infty \Rightarrow$ Trend frequency
* $\omega = \pi \Rightarrow \tau = 2 \Rightarrow$ 2-period cycle.

Figure 1 plots the gain of a filter aimed at capturing a trend, while Figure 2 that of a filter aimed at removing the previous trend.

APD filters are often designed, on a-priori grounds, so as to capture (as best as possible) the series variation associated with the frequencies that characterize the signal of interest. The filter is applied to an observed series $x_t$ and let $g_x(\omega)$ denote the spectrum (or pseudo-spectrum when there are unit AR roots) of $x_t$. In the stationary case, $g_x(\omega)$ decomposes the variance of $x_t$ according to frequency. For example, in Figure 3 the shaded area represents the variance associated with the frequency interval $(\omega_0, \omega_1)$. The peaks of $g_x(\omega)$ are associated with trend and seasonal AR roots.

We shall also use the term “spectrum” to refer to the pseudo-spectrum because both will be used in a similar way in the following sense. If, for example, the peak for $\omega = 0$ is very wide, there will be a lot
of stochastic variability in the trend. The trend will thus be highly stochastic (or “moving”). On the contrary, if the peak is narrow, the trend will have little stochastic variability and be stable. Two (extreme) examples are illustrated in figures 4-6.

\[ \hat{c}(\omega) = \hat{\omega} \]  
\[ \hat{G}(\omega) = \hat{G}(\omega) \]

Allowing for unit AR roots (see, for example, Maravall, 1988), the FT of the (pseudo-) Autocovariance Generating Function (ACGF) of the two sides of (2.2) yields:

\[ g_{\hat{c}}(\omega) = [G(\omega)]^2 g_{\hat{x}}(\omega) \]  
\[ (2.6) \]
where \( [G(\omega)]^2 \) is the Squared Gain (SG), which determines which parts of \( g_\omega(\omega) \) are passed on to the spectrum of the signal, and \( g_\hat{c}(\omega) \) is the spectrum of the estimated signal \( \hat{c}_t \). The SG provides information concerning the filter; information concerning the signal obtained is contained in its spectrum \( g_\hat{c}(\omega) \). “A priori” design may produce a filter with an appealing SG. But it can be wrongly applied to a series. As a simple example, a trend filter (Figure 7a) applied to a white-noise series (Figure 7b) will produce a trend component (Figure 7c), and hence a spurious result.

Therefore, the filter should depend on the particular series being analyzed. This consideration, and the spuriousness danger, fostered an alternative approach to filtering: the ARIMA - Model - Based (AMB) approach. Spuriousness is avoided by decomposing the series in such a way that its specific features are respected. These features are summarized in the ARIMA model identified for the series. From this ARIMA model, the UC models are derived so that they aggregate into the model for the observed series. The signal is estimated with the Wiener-Kolmogorov (WK) filter, which provides the MMSE estimator and, under our normality assumptions, the conditional expectation of the signal given the data [Hillmer and Tiao (1982), Burman (1980), and Gómez and Maravall (2001)]. We shall follow the AMB approach, as enforced in programs SEATS [Gómez and Maravall (1996)] and TSW [Caporello and Maravall (2004)]. The programs can be freely downloaded from the Bank of Spain web site [www.bde.es](http://www.bde.es).

Other efficient approaches to the estimation of signals in UC models are available [examples are Harvey (1989), García-Ferrer and del Hoyo (1992), Gersh and Kitagawa (1983), and Engle (1978)]. These approaches differ from the AMB one in several respects. In particular, no identification of an ARIMA model for the observed series is made and the models for the components are specified “a priori”.

### 2.2 Wiener-Kolmogorov Filter

Consider the decomposition of \( x_t \) into two uncorrelated components, as in

\[
x_t = m_t + c_t \tag{2.7}
\]

where the signal \( c_t \) follows the model

\[
\phi_c(B)c_t = \theta_c(B)a_{ct}, \quad a_{ct} \sim \text{wn}(0, V_c) \tag{2.8}
\]

and the model for the observed series is given by
\[ \phi(B) x_t = \theta(B) a_t , \quad a_t \sim \text{wn}(0,V_a) \tag{2.9} \]

where “wn” denotes a white-noise (i.e., normally identically independently distributed) variable, \( V_c \) and \( V_a \) are the variances of \( a_{ct} \) and \( a_t \), and \( \theta(B) \) is an invertible polynomial. We assume that \( \phi(B) \) can be factorized as

\[ \phi(B) = \phi_c(B) \phi_m(B) \tag{2.10} \]

with \( \phi_c(B) \) and \( \phi_m(B) \) containing the AR roots that will be assigned to the signal and non-signal respectively. Suppose, first, that model (2.9) is stationary and define the MA expressions

\[ \psi_c(B) = \theta_c(B)/\phi_c(B); \quad \psi(F) = \theta(F)/\phi(F). \]

The WK estimator of the signal for a realization \((x_{-\infty}, \ldots, x_\infty)\) is given by

\[ \hat{c}_t = \left[ \begin{array}{c}
\text{ACGF}(c_t) \\
\text{ACGF}(x_t)
\end{array} \right] x_t = \left[ \begin{array}{c}
k_c \psi_c(B) \psi_c(F) \\
\psi(B) \psi(F)
\end{array} \right] x_t \]

\[ = \nu(B,F) x_t; \quad k_c = V_c / V_a \tag{2.11} \]

Considering (2.10), it is obtained that the WK filter is equal to

\[ \nu(B,F) = k_c \frac{\theta_c(B) \phi_m(B)}{\theta(B)} \frac{\theta_c(F) \phi_m(F)}{\theta(F)} \tag{2.12} \]

a centered, symmetric, and convergent filter. The convergence does not depend on the roots of the AR polynomials, and in fact expression (2.12) can be extended to the unit root AR case (see Hannan, 1967, Sobel, 1967 and Bell, 1984). Notice that, writing the model for \( m_t \) (the non-signal) as

\[ \phi_m(B) m_t = \theta_m(B) a_{mt} ; \quad a_{mt} \sim \text{wn}(0,V_m) \tag{2.13} \]

then, letting \( k_m = V_m / V_a \), (2.7) implies the following identity

\[ \theta_m(B) \theta_m(F) \phi_c(B) \phi_c(F) k_m + \\
+ \theta_c(B) \theta_c(F) \phi_m(B) \phi_m(F) k_c = \theta(B) \theta(F) \tag{2.14} \]

### 2.3 A Basic Underidentification Problem

It is well known that UC decomposition of a time series model requires some identification restrictions [see, for example, Maravall (1985)]. The AMB approach proceeds as follows: Consider the model for \( x_t \) given by (2.9), and its decomposition into model (2.8) for \( c_t \) plus model (2.13) for \( m_t \). Given that \( x_t \) is observed, model (2.9) can be identified in the usual way. The problem is to derive from it models (2.8) and (2.13). The AR factorization (2.10) identifies the polynomials \( \phi_c(B) \) and \( \phi_m(B) \). What remains is identification of the MA polynomials \( \theta_c(B) \), \( \theta_m(B) \), and of the variances \( V_c \) and \( V_m \).
These parameters should be determined from the identity (2.14), and it is straightforward to see that there will be an infinite number of solutions. In order to reach identification (in the two component case), the AMB approach assumes first that the model for the signal is “balanced”, that is, the order of its AR polynomial (including unit roots) is equal to the order of its MA polynomial. Second, within the infinite decompositions that satisfy (2.14) and have a balanced signal, the one with the smoothest signal is selected. This is done through the “canonical” assumption, which requires the signal to be free of white-noise [see Box, Hillmer, and Tiao (1978), and Pierce (1978)]. A canonical signal will display a spectral zero, or, equivalently, a unit MA root. Under this assumption (balanced and canonical signal), a single decomposition of model (2.9) into models of the type (2.8) and (2.13) is obtained.

Standard ARIMA modelling favors parsimonious models, as simple as possible. Yet the simple model may hide a more complex structure that, given our sample limitations, standard estimation and testing procedures may not be able to detect. This difficulty is particularly noticeable in the range of cyclical frequencies. ARIMA identification relies heavily on differencing, and differencing often affects strongly the cyclical frequencies. As a consequence, the AMB method will only be able to extract an aggregate trend-cycle component, and separate identification of the trend and cycle will require additional assumptions. As an example, suppose that a series \( x_t \) is known by analysts to be cyclical, but that standard ARIMA identification yields the IMA (2,2) structure

\[
∇^2 x_t = (1 + \theta_1 B + \theta_2 B^2 ) a_t
\]

Model (2.16) and the UC (“trend + cycle”) model are observationally equivalent, but in the absence of a priori information, ARIMA identification will always choose the parsimonious model (2.16), which shows no evidence of cyclical behavior. This argument may explain the paradox that, while economists have known for a long time that many economic series are cyclical, estimation of ARIMA models for these series seldom evidences cyclical effects (complex AR roots for cyclical frequencies).

3 Relationship between APD and AMB Filters

It would be desirable to mix the virtues of the AMB and the APD approaches in such a way that: a) there would be consistency with the observed series (no spurious results); b) filters and components would have desirable properties; c) the model-based structure could be preserved.

It is well-known that some important APD filters have been given a model-based interpretation (at least, as an approximation) whereby the filter can be seen as the one that provides the MMSE estimator of a component in a particular UC model. This interpretation may provide insights into the type of series for which the filter might be more appropriate [examples are the X11 interpretations of Cleveland-Tiao (1976) and Burridge-Wallis (1984)]. It might simply offer an alternative algorithm to compute the signal with the Kalman or WK filters and can be of help in improving the filter design; Pollock, (2003). We see next that, under fairly general conditions, the mapping “symmetric linear filter
AMB filter” is feasible. This result will allow us to incorporate the desired ad-hoc/model-based mixture.

3.1 “Naïve” Model-Based Interpretation

Assume the APD filter (2.2) is symmetric. Thus, if $B$ is a root, $B^{-1}$ is also a root, and $\nu(B, F)$ can be factorized as

$$\nu(B, F) = A(B) A(F) k_c$$  \hspace{1cm} (3.1)

with $A(B) = 1 + \sum_{j=1}^{k} a_j B^j$. We shall further assume that the coefficients of $A(B)$ are real, so that (3.1) can be interpreted as an ACGF (the filter gain will satisfy $0 \leq G(\omega) \leq 1$). As shown by (2.12), AMB filters will always satisfy these assumptions. From (2.2) and (3.1), the estimator of the signal can be expressed as

$$\hat{c}_t = [k_c A(B) A(F)] x_t$$  \hspace{1cm} (3.2)

which always accepts the following AMB interpretation.

**Result 1**

The estimator (3.2) is the MMSE estimator of the noise in the decomposition of $x_t$ into orthogonal signal $(m_t) +$ noise $(c_t)$, when $x_t$ follows the model

$$A(B) x_t = a_t$$  \hspace{1cm} (3.3)

with $a_t$ and $c_t$ white noises such that $V_{c}/V_{a} = k_c$.

More generally, if $A(B) = A_D(B) / A_N(B)$, then $\hat{c}_t$ is the MMSE estimator of the noise in a series that follows the (invertible) ARIMA model

$$A_D(B) x_t = A_N(B) a_t$$  \hspace{1cm} (3.4)

The result follows from straightforward application of the WK filter to a white noise signal when the model for the series is (3.3) or (3.4). This result gives a very simple way to find a AMB-type algorithm for our class of APD filters. The algorithm is based on the (artificial) assumption that $c_t$ is white noise, which implies that the (artificial) model for the “non-signal” $m_t$ is assumed of the type

$$A(B) m_t = \theta_m(B) a_{m_t} \quad ; \quad a_{m_t} \sim \text{n.}(0, V_m)$$  \hspace{1cm} (3.5)

where $\theta_m(B)$, $k_m = (V_m / V_a)$, and $k_c$ are determined from the identity

$$\theta_m(B) \theta_m(F) k_m + A(B) A(F) k_c = 1$$  \hspace{1cm} (3.6)
The algorithm is efficient, and (3.6) guarantees consistency with the overall series. But the models behind the algorithm do not provide a realistic interpretation, because the observed series will not follow in general the “fixed” model (3.3), nor would we expect the noise (i.e., the cycle to be white). This “signal + noise”-decomposition interpretation of a symmetric filter will be called the “naïve” model-based interpretation.

3.2 Mixed Estimation

Let \( P(B) \) denote a polynomial in \( B \) with real coefficients; we introduce the notation:
\[
\left| P(B) \right|^2 = P(B) P(F).
\]
Suppose we wish to apply a symmetric APD filter, say (3.1), to estimate some signal \( (c_t) \) in \( x_t \), but that the filter should be applied to the series clean of seasonality (perhaps also of noise). Consider the decomposition
\[
x_t = \hat{n}_t + \hat{s}_t
\]
where \( \hat{n}_t \) and \( \hat{s}_t \) are the seasonally adjusted (SA) series and seasonal component estimators respectively. We can follow a two-step procedure: First, AMB filtering to obtain the SA series estimator. Second, APD filtering to estimate the signal.

In the first step, we start with an ARIMA model identified for \( x_t \), say (2.9). From this, we derive the models for the SA series \( (n_t) \) and seasonal component \( (s_t) \), say
\[
\phi_n(B) n_t = \theta_n(B) a_{nt}, \quad a_{nt} \sim w.n.(0, V_n)
\]
\[
\phi_s(B) s_t = \theta_s(B) a_{st}, \quad a_{st} \sim w.n.(0, V_s)
\]
with \( a_{st} \) uncorrelated with \( a_{nt} \), \( \phi(B) = \phi_n(B) \phi_s(B) \), and \( x_t = n_t + s_t \). Finally, the WK estimator \( \hat{n}_t \) is obtained:
\[
\hat{n}_t = \frac{V_n}{V_a} \left| \frac{\theta_n(B) \phi_s(B)}{\theta(B)} \right|^2 x_t
\]

In the second step, we apply the APD filter to \( \hat{n}_t \).
\[
\hat{c}_t = k_c A(B) A(F) \hat{n}_t =
\]
\[
= k_n k_c \left| A(B) \theta_n(B) \phi_s(B) \right|^2 \theta(B) x_t
\]
\[
= v_c (B, F) x_t
\]
The estimator of \( m_t \) is \( \hat{m}_t = \hat{n}_t - \hat{c}_t = \left[ 1 - k_c A(B) A(F) \right] \hat{n}_t \), or, using (3.6),
\[
\hat{m}_t = \left[ k_m \theta_m(B) \theta_m(F) \right] \hat{n}_t
\]
The sum of the estimators \( \hat{m}_t + \hat{c}_t + \hat{s}_t \) yields the ARIMA model for \( x_t \).
3.3 Direct Estimation

Result 2

The 2-step estimators $\hat{m}_t, \hat{c}_t$, given by (3.10) and (3.11), plus $\hat{s}_t$, given by (3.9), accept a non-naïve AMB interpretation. They can be seen as the direct MMSE estimators of $m_t, c_t,$ and $s_t$ in a full UC model that aggregates into the ARIMA model for $x_t$.

Specifically, consider the UC model given by

$$x_t = m_t + c_t + s_t$$  
(3.12)

where $x_t$ and $s_t$ follow models (2.9) and (3.9), respectively, and the models for the cycle $c_t$ and trend $m_t$ are

$$c_t = A(B) \psi_n(B) a_{ct}$$  
(3.13)

$$m_t = \theta_m(B) \psi_n(B) a_{mt}$$  
(3.14)

where $\psi_n(B) = \theta_n(B) / \phi_m(B)$, $a_{ct} = wn(0,k_c V_n)$, $a_{mt} = wn(0,k_m V_n)$, and $a_{ct}$ is uncorrelated with $a_{mt}$. Direct application of the WK filter to the full UC model yields the 2-step estimators of the mixed approach.

Let $n_t = m_t + c_t$, and denote by $\delta_n(B)$, $\delta_m(B)$, and $\delta_c(B)$ the polynomials with the AR unit roots of the models for $n_t$, $m_t$, and $c_t$. Assuming that $\delta_m(B)$ and $\delta_c(B)$ do not share a root in common, then $\delta_n(B) = \delta_m(B) \delta_c(B)$. Thus

$$\psi_n(B) = \frac{\theta_n(B)}{\varphi_n(B) \delta_m(B) \delta_c(B)}$$

where $\varphi_n(B)$ is the stationary AR polynomial in the model for $n_t$. Given that the filter (3.1) is aimed at removing $m_t$, $A(B)$ will have zeros for the frequencies associated with the unit roots of $\phi_m(B)$, so that we can factorize $A(B)$ as $A(B) = a(B) \delta_m(B)$. In expression (3.13) there will be cancellation of unit roots, and the model for $c_t$ can be rewritten as

$$\varphi_n(B) \delta_c(B) c_t = a(B) \theta_n(B) a_{ct}$$  
(3.15)

The model for the cycle component contains APD filter elements [$a(B)$, and $k_c$ in (3.15)] that will capture desirable features of the filter, as well as series-dependent elements [$\psi_n(B)$ and $V_n$] that will impose consistency with the observed series model. (If the SA series $n_t$ is replaced by the trend-cycle $p_t$, the discussion extends trivially.)

Remark: The approach to Result 2 is closely related to the derivation of the “Consistency with the Data” check of Bell and Hillmer (1984), developed in the context of AMB seasonal adjustment.
4 An application to Trend and Cycle estimation with the Hodrick-Prescott filter

ADP filters have often been used in the context of trend extraction for business-cycle analysis [Hodrick and Prescott (1980), Baxter and King (1999), Pollock (2000), Canova (1998)]. We focus on the Hodrick and Prescott (HP) filter, which has been the center of considerable attention [Kydland and Prescott (1990), Cogley and Nason (1995), Gómez (2001), Harvey and Trimbur (2003), and Kaiser and Maravall (2001)].

4.1 Model-Based Implementation of the Hodrick-Prescott Filter

The so-called Hodrick-Prescott (HP) filter is an APD filter that decomposes the series, as in (2.7), into a relatively long-term trend \( m_t \) plus a cycle \( c_t \), often called “business cycle”. The filter is a particular case of the Butterworth family of filters [see Gómez (2001)], and can be derived as the solution of the minimization of the Loss Function

\[
LF = \left[ \sum_{t=1}^{T} c_t^2 + \lambda \sum_{t=3}^{T} (\nabla^2 m_t)^2 \right]
\]

where the first term penalizes poor fit and the second term penalizes lack of smoothness. The parameter \( \lambda \) balances the relative importance of the two and determines thus the relative smoothness of \( m_t \) (larger values of \( \lambda \) will imply smoother trend series).

The HP filter can also be derived from a “model based”- type algorithm [King-Rebelo (1993)] whereby the cycle is obtained as the estimator of the noise in an UC model

\[
t = m_t + c_t,
\]

This UC model implies that

\[
\nabla^2 x_t = a_m t + \nabla^2 c_t
\]

which can be expressed as an IMA (2,2) model, say

\[
\nabla^2 x_t = (1 + \theta_1^{\text{HP}} B + \theta_2^{\text{HP}} B^2) b_t = \theta_1^{\text{HP}} (B) b_t
\]

where \( \theta_1^{\text{HP}} \), \( \theta_2^{\text{HP}} \), and \( V_b \) are easily obtained from \( \lambda \) (see the Appendix). Accordingly, the HP filter can also be obtained as the WK filter that provides the estimator of \( c_t \) (assumed w.n.), when the series follows model (4.3). (This is simply a particular case of Result 1.) The WK filters to obtain \( \hat{m}_t \) and \( \hat{c}_t \) are:

\[
\hat{m}_t = k_m \frac{1}{\theta_1^{\text{HP}} (B) \theta_2^{\text{HP}} (F)} x_t = \nabla_m F (B,F) x_t
\]

(4.4a)
\[ \hat{c}_t = k_c \frac{\nabla^2 \nabla^2}{\theta_{HP}(B) \theta_{HP}(F)} \quad x_t = \nabla^c_{HP}(B,F) x_t \]  

(4.4b)

where \( \nabla = 1 - F \) and \( k_m = V_m / V_b \), \( k_c = V_c / V_b \). From (4.2) and (4.3), the following identity between ACGF has to hold

\[ \theta_{HP}(B) \theta_{HP}(F) = k_m + \nabla^2 \nabla^2 k_c \]  

(4.5)

Therefore, expression (4.4a) can be rewritten as

\[ \hat{m}_t = \left[ \frac{1}{1 + \lambda \nabla^2 \nabla^2} \right] x_t \]

where we have used, from (4.1), \( k_c / k_m = V_c / V_m = \lambda \). The gain of the trend filter is the FT of the term in brackets, which yields

\[ G_m(\omega) = \frac{1}{1 + 4 \lambda (1 - \cos \omega)^2} \]  

(4.6)

and \( G_c(\omega) = 1 - G_m(\omega) \). Both gains are represented (for \( \lambda = 1600 \)) in Figure 9, for the range \( 0 \leq \omega \leq \pi / 2 \).

![Fig. 9: Gain of HP Filter](image)

Despite this “model-based” representation, the filter is an APD filter and the danger of spuriousness becomes an issue [as shown in Maravall (1995)]. Yet, notwithstanding academic criticism [see, for example, Harvey and Jäger (1993)], the HP filter has become the most widely used procedure to estimate business cycles in applied work [see, for example, International Monetary Fund (1993), Giorno et al. (1995), European Commission (1995), and European Central Bank (2000)]. Can this be rationalized within an AMB perspective? To answer the question, we start by reviewing some very basic concepts having to do with the cycle.
4.2 Basic Model for a Cycle

a) Simplest case: Deterministic Model

A standard expression for a deterministic cycle is $c_t = A \cos(\omega t + B)$, where $A$ is the Amplitude, $B$ is the Phase and $\omega$ is the Frequency (number of cycles per unit of time) measured in radians. An equivalent representation to the previous cosine function is given by the second order difference equation:

$$c_t + \phi_1 c_{t-1} + \phi_2 c_{t-2} = 0$$

or $(1+\phi_1 B + \phi_2 B^2) c_t = \phi_c(B) c_t = 0$, when the roots of $\phi_c(B) = 0$ are complex and associated with the frequency $\omega$. In this deterministic case, the spectrum of $c_t$ degenerates into a single spike for $\omega$.

b) Linear Stochastic Cycles

Economic cycles typically do not behave in a deterministic way. Period and amplitude, are not constant, and evolve with some randomness. One way to incorporate this randomness is by introducing every period a stochastic shock, as in, for example,

$$c_t + \phi_1 c_{t-1} + \phi_2 c_{t-2} = a_t \sim w.n. (0, V_c)$$

Thus, a) every period the "deterministic equilibrium" (4.7) is perturbed by a stochastic shock (with zero mean and moderate variance). b) The shocks will affect the cycle characteristics (for example, a sequence of positive shocks may increase the duration of an expansion). What is obtained now is a distribution of frequencies (or periods) around the value $\omega_0$ (or $\tau_0$) of the deterministic equation. This distribution of frequencies is precisely the spectrum of the AR(2) model (4.8), a typical spectrum of a stochastic cycle (Figure 10).

The spectrum of the cycle provides centrality measures (mode, mean, median), confidence intervals around these measures, and an idea of how stable or moving the cycle is. In Figure 11, the cycle with the narrower peak will produce cyclical oscillations with periods closer on average to the modal value.
The stochastic shock perturbing equation (4.8) can be different from white noise and allow for some autocorrelation. A more general stochastic cycle can be represented by the ARMA (2, Q) model

\[ \phi_c(B)c_t = \theta_c(B)a_t \quad (4.9) \]

with \( \phi_c(B) \) containing complex roots associated with a cyclical frequency, and often \( Q = 2 \). The MA part may affect the width or the minima of the cycle spectrum. For example, if \( \theta_c(B) = 1 - B^2 = (1 - B)(1 + B) \), the cycle spectrum will display zeros for \( \omega = 0 \) and \( \omega = \pi \), as in Figure 12.

The presence of spectral zeros will make the cycle component "canonical", so that no additive white noise can be extracted from it. (See the Appendix in Hillmer and Tiao, 1982.)

4.3 A Modified Hodrick-Prescott Filter

We introduce a change in the parametrization. The filter, as presented in Section 4.1, depends on a parameter \( \lambda \) that does not have an easy interpretation. Knowing \( \lambda \), the gain \( G(\omega) \) of the filter is given by (4.6), and using (2.5), it can alternatively be expressed as a function of the period (Figures 13a and b).
Consider $\omega_0$ and $\tau_0$, the values for which the gain equals $\frac{1}{2}$, i.e.,

$$G(\omega_0) = \frac{1}{2}, \quad \text{where} \quad \omega_0 = \frac{2\pi}{\tau_0}. \quad (4.10)$$

Heuristically, for $\tau < \tau_0$, $(\omega < \omega_0)$, most of the series variation will go to the trend, and for $\tau > \tau_0$, $(\omega > \omega_0)$, to the cycle. Thus $\tau_0$ (or $\omega_0$) represent the “cutting point” for the trend-cycle partition. In fact, $\omega_0$ is the parameter used by engineers to characterize the filter in its Butterworth expression. The relationship between the two parameters, $\lambda_0$ and $\tau_0$, is obtained from solving (4.10), which yields, considering (4.6),

$$\tau_0 = \frac{2\pi}{a \cos \left(1 - \frac{1}{2\sqrt{\lambda_0}}\right)} \quad (4.11)$$

The parameter $\tau$ has a more direct interpretation than $\lambda$. For example, “cycles with periods beyond 10 years should be mostly assigned to the trend” is a more easy-to-understand assumption than “$\lambda = 1600$ for quarterly data”. Therefore, a sensible strategy to apply the HP filter could be to start with the a priori choice of the cutting point $\tau_0$. Following Kaiser and Maravall (2001), two modifications will be made to the standard application of the HP filter.

a) It has often been pointed out that the behavior of the estimated cycle for the end periods is highly unstable. This instability is mostly due to the fact that the HP is a two-sided filter, and hence is subject to revisions as more data become available. Preliminary estimators can be obtained with the WK filter applied to the available series extended with forecasts and backcasts. Standard application of the HP filter can be seen to be the same as the WK implementation, with the series extended with forecasts and backcasts generated by the (fixed) model (4.3), which imply large forecast errors. When the series is extended with an appropriate ARIMA model, end-point stability is significantly increased. In what follows we assume that the filter is always applied to appropriately extended series.

b) As with "seasonal noise", we do not wish highly transitory noise to contaminate the cyclical signal. Thus we shall apply the filter to the trend-cycle component (or noise-free SA series), which shall be denoted $p_t$.

When these modifications are incorporated, we shall refer to the resulting filter as the “Modified Hodrick-Prescott” (MHP) filter.
4.4 Two-Step Estimation of the Cycle

Assume that the series follows the general ARIMA model

\[ \phi(B)\nabla^d\nabla_r^d x_t = \theta(B) a_t \quad ; \quad a_t \sim \text{w.n.} (0, V_a) , \]  

where \( r \) denotes the number of observations per year, \( \nabla \) and \( \nabla_r \) denote the regular and seasonal differencing, \( d \) and \( d_r \) are nonnegative integers (in practice, \( d = 0, 1, 2 \), \( d_r = 0, 1 \)), \( \phi(B) \) is a stationary autoregressive polynomial in \( B \), and \( \theta(B) \) is an invertible moving average polynomial in \( B \).

a) First Step

If \( u_t \) denotes the noise contained in the series, and \( s_t \) its seasonal component, we consider the decomposition of \( x_t \) into orthogonal components, as in

\[ x_t = p_t + s_t + u_t \quad (4.13) \]

where the first component \( p_t \) is the signal of interest for the posterior extraction of the cycle, namely the trend-cycle component. To estimate \( p_t \) we follow the AMB procedure. The AR polynomials of the component models are determined from the factorization of the AR polynomial of the ARIMA model for \( x_t \) according to the following rule. Let \( \omega \) denote the frequency of a root expressed in radians. If \( \omega \in \left[ 0, \frac{2\pi}{r} \right) \), the root is allocated to the trend-cycle; if \( \omega \) is a seasonal frequency (for example \( \omega = \frac{2\pi j}{r} \), \( j = 1, \ldots, 6 \), for monthly series,) the root is allocated to the seasonal component; finally, when \( \omega \in (\frac{2\pi}{r}, \pi) \) and is not a seasonal frequency, the root is allocated to the irregular component. Thus cycles with period longer than a year will be part of the trend-cycle component, while cycles with periods shorter than a year will go to the irregular one. Following this rule, the polynomial \( \phi(B) \) can be factorized as \( \phi(B) = \phi_p(B) \phi_s(B) \phi_u(B) \), and model (4.12) can be rewritten as \( [\phi_p(B)\nabla^D](\phi_s(B) S^{d_r})(\phi_u(B))] x_t = \theta(B) a_t \), where \( D = d + d_r \), \( S \) is the annual aggregation operator \( S = 1 + B + \ldots + B^{r^{-1}} \), and use has been made of the identity \( \nabla r = \nabla S \).

The first parenthesis groups the trend-cycle AR roots, and the second and third parenthesis group the seasonal and the irregular AR roots, respectively.

The components will have models of the type

\[ \phi_p(B)\nabla^D p_t = \theta_p(B) a_{pt} \quad ; \quad a_{pt} \sim \text{w.n.} (0, V_p) \]  

\[ \phi_s(B) S^{d_r} s_t = \theta_s(B) a_{st} \quad ; \quad a_{st} \sim \text{w.n.} (0, V_s) \]  

\[ \phi_u(B) u_t = \theta_u(B) a_{ut} \quad ; \quad a_{ut} \sim \text{w.n.} (0, V_u) \]

with the variables \( a_{pt} \), \( a_{st} \), \( a_{ut} \) mutually uncorrelated. Consistency between the “reduced form” model (4.12) and the “structural model” (4.14a, b, c) requires that the MA polynomials \( \theta_p(B) \), \( \theta_s(B) \), \( \theta_u(B) \), and the variances \( V_p, V_s, V_u \), satisfy the identity...
\[ \phi(B) \alpha_t = \phi_s(B) S^{d_r} \phi_u(B) \theta_p(B) \alpha_{pt} + \]
\[ + \phi_p(B) \psi(B) \psi_u(B) \theta_s(B) \alpha_{ct} + \]
\[ + \phi_p(B) \phi_s(B) \psi^0 S^{d_r} \theta_u(B) \alpha_{ut} . \]

Applying (2.12), the WK estimators of the trend-cycle, seasonal and irregular components are given by

\[
\hat{p}_t = \frac{V_p}{V_a} \left[ \frac{\theta_p(B) \phi_s(B) \phi_u(B) S^{d_r}}{\theta(B)} \right]^2 x_t \quad (4.16a)
\]

\[
\hat{s}_t = \frac{V_s}{V_a} \left[ \frac{\theta_s(B) \psi_p(B) \phi_u(B) \psi^D \theta^0 S^{d_r}}{\theta(B)} \right]^2 x_t \quad (4.16b)
\]

\[
\hat{u}_t = \frac{V_u}{V_a} \left[ \frac{\theta_u(B) \phi_p(B) \phi_s(B) \psi^D S^{d_r}}{\theta(B)} \right]^2 x_t \quad (4.16c)
\]

and it is straightforward to verify that \( x_t = \hat{p}_t + \hat{s}_t + \hat{u}_t \).

**b) Second Step**

In the MHP procedure, the trend-cycle estimator \( \hat{p}_t \) is used as input to the HP filter. From (4.4b), (4.5) and (4.16a),

\[
\hat{c}_{t} = k_c \frac{(1-B)^2 (1-F)^2}{\theta_{HP}(B) \theta_{HP}(F)} \hat{p}_t = \\
= k_c \frac{V_p}{V_a} \left[ \frac{\theta_p(B) \phi_s(B) \phi_u(B) \psi^D S^{d_r}}{\theta_{HP}(B) \theta(B)} \right]^2 x_t , \quad (4.16d)
\]

\[
\hat{m}_{t} = k_m \frac{V_p}{V_a} \left[ \frac{\theta_p(B) \phi_s(B) \phi_u(B) S^{d_r}}{\theta_{HP}(B) \theta(B)} \right]^2 x_t \quad (4.16e)
\]

For a finite sample, extending the series \( x_t \) with backcasts and forecasts computed with the correct model (4.12), the above expressions provide the MHP two-step estimators of the cycle \( (c_t) \) and trend \( (m_t) \), respectively.

**4.5 A Complete Unobserved Component Model**
In the MHP two-step procedure, a full decomposition of the series is finally obtained, namely

$$x_t = \hat{m}_t + \hat{c}_t + \hat{s}_t + \hat{u}_t$$  \hspace{1cm} (4.17)

where the estimators are given by the expressions (4.16b-e). The question is: can these estimators be the direct MMSE estimators of the UCs in a full decomposition of the series of the type

$$x_t = m_t + c_t + s_t + u_t$$  \hspace{1cm} (4.18)

where $m_t$, $c_t$, $s_t$, and $u_t$ are the (orthogonal) trend, cycle, seasonal, and irregular components, all with sensible models that aggregate into the ARIMA model (4.12) identified for the series $x_t$? The answer is in the affirmative, and follows from Result 2.

**Result 3**

Let $x_t$ be an observed series that follows the general ARIMA model (4.12). Consider the UC model consisting of the aggregate equation (4.18), the models for the seasonal and irregular components (4.14b, c) (obtained from the standard AMB decomposition of $x_t$, as in the first of the two-step procedure,) plus the following models for the trend and cycle components:

$$\theta_{\text{HP}}(B) \nabla^D m_t = \psi_p(B) a_{mt}, \quad a_{mt} \sim w.n.(0,k_m V_p);$$  \hspace{1cm} (4.19)

$$\theta_{\text{HP}}(B) c_t = \psi_p(B) \nabla^{2-D} a_{ct}, \quad a_{ct} \sim w.n.(0,k_c V_p);$$  \hspace{1cm} (4.20)

where $\psi_p(B) = \theta_p(B)/\phi_p(B)$, and $a_{st}$, $a_{ut}$, $a_{mt}$, and $a_{ct}$ are mutually uncorrelated. Then, the MMSE estimators of $m_t$, $c_t$, $s_t$, and $u_t$ in the full model are the MHP two-step estimators (4.16b-e).

(The result follows from direct application of the WK filter to the complete UC model.) Further,

$$\hat{m}_t + \hat{c}_t = H(B,F) \left[ k_m + \nabla^2 (1-F)^2 k_c \right] x_t,$$

where

$$H(B,F) = \frac{V_p}{V_a} \left\| \frac{\theta_p(B)\phi_s(B)\phi_u(B)S_d}{\theta_{\text{HP}}(B)\theta(B)} \right\|^2$$

and, considering (4.5), it is obtained that

$$\hat{m}_t + \hat{c}_t = \frac{V_p}{V_a} \left\| \frac{\theta_p(B)\phi_s(B)\phi_u(B)S_d}{\theta(B)} \right\|^2 x_t.$$
or, according to (4.16a), \( \hat{m}_t + \hat{c}_t = \hat{p}_t \). Similarly, from (4.2) and (4.3), it is straightforward to show that the components also satisfy \( m_t + c_t = p_t \), with \( p_t \) given by (4.14a). Thus aggregation of the four components or of the four estimators yields the ARIMA model for the observed series.

Some features of the complete UC model are worth mentioning.

1) The argument has been made for the historical estimators, which can be assumed for the central years of a long-enough series. Estimation of the signal at the end points of the series is equal to the application of the full filter to the series extended with forecasts and backcasts. End-point estimation of the trend and cycle in the 2-step procedure requires forecasts and backcasts of the trend-cycle component, while the full UC model requires forecasts and backcasts of the observed series \( x_t \). The two extension procedures however are identical because the forecasts of \( p_t \) are obtained by extending further the series \( x_t \) with more forecasts and backcasts. In both procedures, the forecasts of \( x_t \) are computed with the identified model. Having the same filter and the same extended series, the preliminary trend and cycle estimators obtained with the 2-step method will be identical to the direct estimators in the full UC model. (Notice that MMSE forecasts of the cycle can be obtained in the same way as end-point estimators. Thus the forecasts will also be identical.)

2) A similar result can be derived when the estimator of the SA series \( \hat{n}_t \) is used as input of the HP filter. However, part of the irregular (or transitory noise) component will be absorbed by \( m_t \) and (mostly) \( c_t \), and the cyclical signal will be contaminated by noise.

3) The model is obtained from the AMB decomposition by simply splitting the trend-cycle component into separate (long-term) trend and cycle components, with the split determined by the choice of the “cutting point” \( \tau_0 \) (or \( \lambda_0 \)) for the HP filter.

4) The seasonal and irregular components are those of the standard AMB decomposition. What are new are the trend and cycle models. These models share the polynomials \( \theta_{HP}(B) \) and \( \psi(B) \), but given that the shared AR roots are stationary, the estimators MSE will be bounded and converge to a finite value (Pierce, 1979).

5) The models for the trend and cycle components incorporate “a priori” and series-dependent features. The first ones \( \theta_{HP}(B), k_m, \) and \( k_c \) are determined by the parameter \( \tau_0 \) (or \( \lambda_0 \)) and reflect desirable features of the filter (broadly, how to split the frequencies between trend and cycle). The polynomial \( \psi_p(B) \) and the variance \( \psi_p \) are series dependent, and guarantee consistency with the model identified for the series.

6) Given that \( p_t \) is obtained from the AMB decomposition of \( x_t \), both components, trend and cycle, have to be canonical and will display a spectral zero (almost always for \( \omega = \pi \)).
7) The order of integration at the zero frequency of the trend will be equal to that of the observed series.

8) The cycle will be stationary as long as \( d < 3 \). The spectrum of the cycle will have the shape of a distribution skewed to the right (for quarterly or monthly series), and with a well-defined mode. Besides the spectral zero for \( \omega = \pi \), when \( d < 2 \) the spectrum will contain an additional zero for \( \omega = 0 \) (and hence, will be doubly canonical).

9) We have concluded that the MHP 2-step procedure is the same as MMSE estimation of the components in a full UC model, and that the reduced form of this model is the ARIMA model identified for the observed series. The two models are observationally equivalent; they will fit equally well the data, and have the same likelihood and forecast functions. One may disagree with the specification of the components, but the results cannot be properly called spurious.

4.6 First Example: The Cycle in the Airline Model

We consider the so-called “Airline model”, popularized by Box and Jenkins (1970), which has been found appropriate for many economic series. For quarterly series the model is given by

\[
V \nabla^4 x_t = (1 + \theta_1 B)(1 + \theta_4 B^4) a_t
\]

with \( |\theta_1| < 1 \) and \(-1 < \theta_4 < 0\). Setting \( V_a = 1 \), and \( \theta_1 = - .4 \), \( \theta_4 = - .6 \) (the values used by Box and Jenkins), the AMB decomposition of \( x_t \) with program SEATS into (4.13) yields the following models for the components.

\[
V^2 p_t = (1 + .119 B - .881 B^2) a_{pt} , \quad V_p = .064 \quad (4.22a)
\]

\[
S s_t = (1 - .046 B + .463 B^2) a_{st} , \quad V_s = .019 \quad (4.22b)
\]

\[
u_t = w.n.(0, V_u = .305) . \quad (4.22c)
\]

For the second step, in order to split the trend-cycle \( (p_t) \) into trend \( (m_t) \) plus cycle \( (c_t) \), the polynomial \( \theta_{HP} (B) \), as well as \( k_c \) and \( k_m \) are needed. Setting \( \lambda = 1600 \), it is obtained that (see the Appendix)

\[
\theta_{HP} (B) = 1 - 1.7771 B + .7994 B^2 , \quad V_b = 2001.4 \quad (4.23)
\]

so that \( k_m = 1/2001.4 \) and \( k_c = 1600/2001.4 \). The models for the trend and cycle can now be specified as

\[
(1 - 1.777 B + .799 B^2) V^2 m_t = (1 + .119 B - .881 B^2) a_{mt} \quad (4.24)
\]

\[
(1 - 1.777 B + .799 B^2) c_t = (1 + .119 B - .881 B^2) a_{ct} \quad (4.25)
\]
with $V_m = .32 \times 10^{-4}$ and $V_c = .0512$. The model for $m_t$ is $I(2)$ while the model for $c_t$ is stationary; both are noninvertible due to a spectral zero at $\omega = \pi$. The AMB spectral decomposition of $x_t$ into $p_t$ and $s_t$ is presented in Figure 14 (the spectrum of $u_t$ is a constant,) and the spectral decomposition of $p_t$ into $m_t$ and $c_t$ is displayed in Figure 15. Although the spectrum of $p_t$ does not exhibit any peak for a cyclical frequency, it can be split into a smooth nonstationary peak around the zero frequency ($m_t$), and a stationary spectrum with a well-defined peak for a cyclical frequency ($c_t$). The period associated with this peak is approximately 13 years. Figure 16 exhibits the squared gains of the filters to estimate the trend-cycle, trend, and cycle, all of which display sensible shapes.
Figures 17 to 21 provide an example: the decomposition of a Spanish quarterly economic indicator over a 30 year period. For the cycle, the 95% confidence interval implied by the revision error has also been included. The standard error (SE) of the revision for the concurrent estimator of the cycle is about 1/3 of the SE of its one-period-ahead forecast error, and it takes about 3 years for the revision to become negligible.

Forecasts of the cycle (and associated SE) can be obtained in the same way as end-point (preliminary) estimators. However, due to the size of the SE, and to the fact that the stationary model for the cycle implies a forecast function that converges to zero, these forecasts are of limited interest in practice.
It is of interest that the cycle obtained in the 2-step procedure, that mixes data-consistency with ad-hoc desirable features, turns out to be an ARMA (2,2) model with the AR roots associated with a cyclical frequency: that is, a linear stochastic process of the type discussed in section 4.2b. This model, given by (4.25), has $\theta_{HP} (B)$ as the AR polynomial, which is determined a priori from $\tau_0$ (or $\lambda_0$). This a priori choice will shape the eventual ACF of $c_t$, its eventual forecast function, and strongly influence its spectrum.

On the other hand, the MA polynomial $\theta_p (B)$ and $V_p$ in model (4.25) are determined from the model for $p_t$, obtained in the AMB decomposition of the model for the observed series. Factorization of $\theta_p (B)$ yields $\theta_p (B) = (1 + B)(1 - .958 B)$. The first root implies a spectral zero for $\omega = \pi$, and the second root implies a spectral (local) minimum close to zero for $\omega = 0$.

4.7 A Remark on Identification

Incorporation of the HP filter to the AMB procedure implies decomposing the trend-cycle component ($p_t$) into orthogonal trend ($m_t$) and a stationary cycle ($c_t$). Considering (4.22a), (4.24), and (4.25), this decomposition is of the type

$$IMA (2,2) = ARIMA (2,2,2) + ARMA (2,2)$$

trend-cycle  long-term trend  cycle

Given the IMA (2,2) model for $p_t$, the decomposition in the right-hand-side of the identity depends on $\theta_{HP} (B)$, $k_m$, and $k_c$, all determined from the HP-filter parameter $\lambda$. Therefore, for each value $\lambda$ in $R^+$, a different “trend + cycle” decomposition of the same trend-cycle component will be obtained. Specifying a particular value of $\lambda$, a particular decomposition is obtained. For example, setting $\lambda = 400$ and applying the algorithm in the Appendix, yields a model similar to the one in the previous example (for which $\lambda = 1600$), but with the new set of parameters

$$\theta_{HP} (B) = 1 - 1.6857B + .7284B^2;$$

$$k_c = .7284; \quad k_m = .00182$$

Thus (4.22b and 4.22c) remain unchanged in the new UC model, but the AR polynomial in (4.24) and (4.25) will now be (4.26), and $V_c = k_c V_p / V_a = .0012$, $V_m = k_m V_p / V_a = .0466$. Figure 22 compares the spectra of the two decompositions of $p_t$ obtained for the two values of $\lambda$. In both cases, the sum of the trend and the cycle spectra yields the same aggregate spectrum: that of the IMA (2,2) model for $p_t$ given by (4.22a), the dotted line in the figure.
The basic identification problem in terms of the cycle and trend components can be seen as the choice of an appropriate value for $\lambda$ or $\tau$. At this stage, desirable features can be introduced: for example, a priori choice of the cycle period $\tau_0$ that is the cutting point between periods that belong mostly to the cycle or to the trend. Setting $\tau = \tau_0$ identifies a particular decomposition.

4.8 Second Example: Stationary Series

Although the naïve model-based derivation of the HP filter, given by (4.1), implied an I(2) trend, Result 3 holds for any order of integration. Consider, for example, the stationary AR(1) model $(1-\theta B)x_t = \alpha_t$, $\nu_a = 1$. The AMB decomposition yields $x_t = p_t + u_t$, with the following models for the components $(1-\theta B)p_t = (1+\theta B)\alpha_{pt}$, $\nu_p = .247$; $u_t = w.n.$, $\nu_u = .309$. Therefore, the complete unobserved component model is given by $x_t = m_t + c_t + u_t$, where the components follow the models

$$
(1-\theta B)\theta_{hp}(B)m_t = (1+\theta B)a_{mt}
$$
$$
a_{mt} = w.n.(0, \nu_m)
$$
$$
\theta_{hp}(B)c_t = (1-\theta B)(1+B)^2a_{ct}
$$
$$a_{ct} = w.n.(0, \nu_c)
$$
$$u_t = w.n.(0, \nu_u);
$$

with $\nu_m = k_m \nu_p / \nu_a$ and $\nu_c = k_c \nu_p / \nu_a$. Assuming annual data and $\lambda = 7$ (the value approximately equivalent to the quarterly value of 1600), the associated parameters in $\theta_{hp}(B)$, plus $k_m$ and $k_c$ are given in Table A of the Appendix. The spectral decomposition of the AR(1) is shown in Figure 23; it is indeed a decomposition of a trend-cycle into separate trend and cycle.
4.9 Distortion in MMSE Estimation of the Cycle Component

MMSE (historical) estimation of $c_t$ in the full UC model provides an expression of the type

$$\hat{c}_t = \eta(B,F) x_t,$$

and, from the ARIMA model for $x_t$, one can obtain $\hat{c}_t$ as a filter applied to $a_t$, say $\hat{c}_t = \xi(B,F) a_t$. Back to the Airline model example of Section 4.6, after simplification, it is obtained that

$$\hat{c}_t = \left[ k_c V_p \theta_p (B) \theta_{HP} (B) \theta_p (F) \nabla \nabla_3 \right] a_t \quad (4.27)$$

where $\nabla = 1-F$, $\nabla_3 = 1-F^4$ and $\theta(F) = (1-.4 F) (1-.6 F^4)$. The spectrum of $\hat{c}_t$ is shown in Figure 24. Comparison of the spectrum of the component (4.25) with that of its estimator (4.27) illustrates a well-known feature of MMSE estimation (see, Nerlove, Grether and Carvalho, 1979): the estimator underestimates the variance of the component. For the case of the cyclical component, this loss of variance affects mostly the lower frequencies. As a result, the estimator inflates the relative importance of the higher frequencies and the spectral peak is pushed to the right, implying a shorter period. Therefore, when interpreting an estimated cycle in the model-based framework, one should be aware that MMSE estimation will bias downwards the modal period implied by the theoretical model for the cycle.
5 Conclusions and a Final Remark on Structure and Identification

In section 1 the main conclusions were summarized. Some are worth stressing now. We have seen that, for an important class of linear symmetric filters, a “naïve” AMB derivation exists. Further, using this derivation, it becomes then possible to incorporate components with desirable band-pass features into the AMB approach without violating the series observed structure. In this way, the resolution of the AMB decomposition can be improved beyond the standard “trend-cycle + seasonal + transitory - irregular” decomposition.

The previous result is applied to business-cycle estimation. It is seen that the standard practice of applying an HP-type filter to a SA or trend-cycle series (a two-step procedure) can always be interpreted as a one-step optimal estimation of an UC in an AMB approach, where the cycle is a standard stochastic cycle that follows an ARMA(2,2) model, even when no cyclical structure is made evident through direct estimation of a model to the observed series. Some clarifications to the discussant’s comments will help in understanding the previous results.

The discussant centers on two points: (A) the drawbacks of the AMB approach; (B) how adding ad-hoc procedures will not offer any improvement. The drawbacks mentioned in (A) are the following:

1. Lack of “continuity” in forecast, meaning that direct ARIMA forecast of the series will be different from the indirect one obtained by adding the component’s forecasts. This is false: by construction, in the AMB approach, direct and indirect forecasting are identical. (Hint: the component’s forecasts are obtained with the WK filters applied to the series extended enough with the direct forecasts. Given that the WK filters sum to 1, the result follows.)

2. Lack of proper statistical models for the components. This is also false. I will use a very simple example to clarify the point. Let $p_t$ and $u_t$ denote orthogonal trend-cycle and white-noise irregular components, and assume the Structural Time Series Model (STSM) for series $x_t$:

\[
\begin{align*}
\text{MODEL I:} & \quad x_t = p_t + u_t, \\
& \quad \forall \; p_t = v_t, \quad \text{Var}(v_t) = .64; \\
& \quad u_t = w.n., \quad \text{Var}(u_t) = .2.
\end{align*}
\]

It is easily seen that Model I implies that $x_t$ follows the IMA(1,1) model

\[
\forall \; x_t = (1-.2B) a_t, \quad \text{Var}(a_t) = 1.
\]

(IMA(1,1) models often fit well annual GNP series; see for example, the series in Maddison, 1991.) The AMB approach would yield the decomposition

\[
\begin{align*}
\text{MODEL II:} & \quad x_t = p_t + u_t, \\
& \quad \forall \; p_t = (1+B)v_t, \quad \text{Var}(v_t) = .16; \\
& \quad u_t = w.n., \quad \text{Var}(u_t) = .36.
\end{align*}
\]

The trend in Model II is smoother and the white noise removed larger than in Model I (moreover, no STSM could accommodate a positive MA parameter). But, Model II is as proper as Model I. Ultimately, the decomposition of the series $x_t$ is not identified. The STSM implicitly adds the
restriction that the order of the MA polynomial in the trend component model is lower than the order of the AR one (see Hotta, 1983, and Maravall, 1995). The AMB identification restriction is to remove, from the signal, as much noise as possible. “Chacun son gout” in terms of identification restrictions, but models I and II are observationally equivalent, and no test based on the series will discriminate between them.

Be that as it may, the AMB and STSM approaches provide both sensible alternative solutions to similar problems. Each one has it virtues: for example, the STSM format facilitates the treatment of heteroscedastic component innovations or of common trends; the AMB format permits derivations such as the joint distribution of the theoretical estimators and facilitates outlier detection. More than compete, they complement and certainly can help each other (even more so in a field – that of UC models – plagued with ambiguities). We have no proselytizing intention towards Mr. Fernández; on the contrary, we encourage him to continue the work and look forward to his progress.

Point (B) of the discussant is that adding the ad-hoc HP filter to the AMB approach will yield “spurious and misleading” results. His final advice is that we should: (i) use a STS model, (ii) include in it a cyclical component, (iii) test for its significance and “not to try to hunt for what there is no evidence of”. Well, the procedure he recommends can be easily translated into the AMB framework: add an AR(2) factor to the ARIMA model for the series and, if not significant, drop it. As can be expected from the model’s similarities, the two approaches offer similar testing possibilities. Still, in these UC models, simple classical testing has some limitations. First, most often, the model finally chosen for the series is not reached at the first trial. The data mining effect can be large and we may be seriously fooling ourselves with test sizes. Second, should this simple testing set the limits of our analysis? For quarterly data, the ratio of the trend and cycle innovation variances implied by the standard HP filter (assuming the variance of the series innovations is 1), is in the order of $10^{-4}$; for monthly data, it is in the order of $10^{-7}$. With the number of observations usually available for macroeconomic series, it is extremely unlikely that such small values can be detected as significant.

In fact, the testing limitations are related to one of the main points of the paper. Standard business-cycle analysis, as practiced at many important agencies, applies HP-type filters to SA or trend-cycle series, with a fairly broad agreement on the period over which the cycle should be measured (8-15 years). Yet direct estimation of cycles (using the AMB or the STSM approach) seldom evidences the presence of these cycles. How can the two facts be reconciled? The paper shows that (with some minor modifications) the above practice can be seen as optimal estimation of a standard stochastic cycle in a complete and sensible UC model that aggregates into whatever model may have been directly identified for the observed series. As long as it is made explicit, this represents an admissible way of looking at the data. It may be useful or useless, but it will provide exactly the same likelihood as the model identified for the data (be that an ARIMA or a STSM, with or without a cyclical component). No testing can reject the model that contains the cycle.

The discussant hates a priori restrictions, but ultimately they are tantamount to progress in science. Econometrics itself is a good example. As Working (1927) already pointed out, without these restrictions, economists could not even talk about demand or supply!
Appendix: Computation of $\theta_1^{HP}, \theta_2^{HP}$, and $V_b$ for the HP Filter given $\lambda$

WK implementation of the HP filter requires the IMA(2,2) specification (4.3) for $x_t$, namely, the parameters $\theta_1^{HP}, \theta_2^{HP}$, and $V_b$. Given $\lambda$, they can be obtained as follows. (All square roots are taken with their positive sign.) Compute sequentially:

1. $a = 2, \quad b = -\frac{1}{\sqrt{\lambda}}, \quad k = -b^2, \quad s = ab$
2. $z = \sqrt{\frac{1}{2\lambda} \left( 1 + \sqrt{1 + 16\lambda} \right)}; \quad r = \frac{s}{z}$
3. $m_1 = -\frac{a + r}{2}, \quad n_1 = \frac{z - b}{2}$
4. $m_2 = -\frac{a - r}{2}, \quad n_2 = -\frac{z - b}{2}$
5. Of the two complex numbers $(m_1 + in_1)$ and $(m_2 + in_2)$ pick up the one with smallest modulus. Let this number be $R = M + iN$; then,

$$\theta_1^{HP} = 2M, \quad \theta_2^{HP} = M^2 + N^2, \quad V_b = \frac{1 + 6\lambda}{1 + (\theta_1^{HP})^2 + (\theta_2^{HP})^2}$$

Notice that implementation of the WK filter requires $k_c$ and $k_m$, computed as $k_c = \lambda / V_b$ and $k_m = 1 / V_b$. The following table presents the values of $\theta_1^{HP}, \theta_2^{HP}, V_b$, and the period $\tau$ associated with a filter gain equal to .5, for several values of $\lambda$. The first three values comprise the standard quarterly value $\lambda = 1600$, and the monthly and annual values implied by temporal aggregation following the criterion of Maravall and del Río (2001), which preserves the period of the cycle associated with a gain of .5. [This criterion yields values that are close to those proposed by Ravn and Uhlig (2002).]

TABLE A: WK Filter Parameters for Different Values of $\lambda$

<table>
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<tr>
<th>FREQUENCY OF OBSERV.</th>
<th>$\lambda$</th>
<th>$\theta_1$</th>
<th>$\theta_2$</th>
<th>$V_b$</th>
<th>$\tau$ (approx.)</th>
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</thead>
<tbody>
<tr>
<td>Approx. equivalent values under aggregation</td>
<td>Monthly</td>
<td>130 000</td>
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<td>.9282</td>
<td>140 050</td>
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<td></td>
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<td>-1.8710</td>
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<td>16 385</td>
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REFERENCES


