

1 HP97

The Hodrick and Prescott (1997, HP) Filter can be expressed in State Space Form (SSF) using the following Unobserved Component (UC) model structure:

$$y_t = y_t^* + y_t^c \quad (1a)$$

$$\Delta^2 y_t^* = \varepsilon_{1t} \quad (1b)$$

$$y_t^c = \phi \varepsilon_{2t}, \quad (1c)$$

where y_t is (100 times) the log of GDP, and ε_{1t} and ε_{2t} are *i.i.d.* $N(0, 1)$ and mutually uncorrelated. The standard deviation ϕ is the (square root of the) smoothing parameter, commonly set to 40 for quarterly macroeconomic data, implying a value of ' λ ' of 1600.

The '*numbered shock*' to '*named shock*' mapping is:

$$\begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \end{bmatrix} = \begin{bmatrix} \varepsilon_t^* \\ \varepsilon_t^c \end{bmatrix}, \quad (2)$$

where ε_t^* is the trend (or permanent) shock and ε_t^c is the cycle (or transitory) shock.

2 Shock recovery

2.1 State Space Models with lagged states

Kurz (2018) adopts the following general SSF with lagged states in the measurement:

$$\text{Measurement : } Z_t = D_1 X_t + D_2 X_{t-1} + R \varepsilon_t \quad (3a)$$

$$\text{State : } X_t = A X_{t-1} + C \varepsilon_t, \quad (3b)$$

where $\varepsilon_t \sim MN(0_m, I_m)$, D_1, D_2, A, R are C conformable system matrices, Z_t the observed variable and X_t the latent state variable, and m is the number of shocks $\{\varepsilon_{it}\}_{i=1}^2$.

2.2 HP97 in '*shock recovery*' SSF

To assess shock recovery, write the model in (1) in '*shock recovery*' SSF by collecting all observable variables in Z_t and all shocks (and other latent state variables) in X_t . Differencing y_t and y_t^c twice, and re-arranging the relations in (1) then yields:

$$\begin{aligned} \Delta^2 y_t &= \Delta^2 y_t^* + \Delta^2 y_t^c \\ &= \varepsilon_{1t} + \phi \Delta^2 \varepsilon_{2t} \\ &= \varepsilon_{1t} + \phi \varepsilon_{2t} - 2\phi \varepsilon_{2t-1} + \phi \varepsilon_{2t-2}, \end{aligned} \quad (4)$$

where $\Delta^2 y_t$ is the only observed variable.

The Measurement and State equations of the ‘*shock recovery*’ SSF corresponding to the relations in (4) are then given by:

$$\begin{aligned} \text{Measurement : } Z_t &= D_1 X_t + D_2 X_{t-1} + R \varepsilon_t \\ \Leftrightarrow \Delta^2 y_t &= \varepsilon_{1t} + \phi \varepsilon_{2t} - 2\phi \varepsilon_{2t-1} + \phi \varepsilon_{2t-2} \end{aligned} \quad (5a)$$

$$Z_t = \underbrace{\begin{bmatrix} 1 & \phi & 0 \end{bmatrix}}_{D_1} \underbrace{\begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \\ \varepsilon_{2t-1} \end{bmatrix}}_{X_t} + \underbrace{\begin{bmatrix} 0 & -2\phi & \phi \end{bmatrix}}_{D_2} \underbrace{\begin{bmatrix} \varepsilon_{1t-1} \\ \varepsilon_{2t-1} \\ \varepsilon_{2t-2} \end{bmatrix}}_{X_{t-1}} + \underbrace{\begin{bmatrix} 0 & 0 \end{bmatrix}}_R \underbrace{\begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \end{bmatrix}}_{\varepsilon_t} \quad (5b)$$

$$\text{State : } X_t = A X_{t-1} + C \varepsilon_t,$$

$$\underbrace{\begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \\ \varepsilon_{2t-1} \end{bmatrix}}_{X_t} = \underbrace{\begin{bmatrix} 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 1 & 0 \end{bmatrix}}_A \underbrace{\begin{bmatrix} \varepsilon_{1t-1} \\ \varepsilon_{2t-1} \\ \varepsilon_{2t-2} \end{bmatrix}}_{X_{t-1}} + \underbrace{\begin{bmatrix} 1 & 0 \\ 0 & 1 \\ 0 & 0 \end{bmatrix}}_C \underbrace{\begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \end{bmatrix}}_{\varepsilon_t}. \quad (5c)$$

2.3 Shock recovery

The diagonal of the steady-state variance/covariance matrix of the smoothed and filtered states X_t denoted by $P_{t|T}^*$ and $P_{t|t}^*$, respectively, are:

	$P_{t T}^*$	$P_{t t}^*$
ε_{1t}	0.9439	0.9995
ε_{2t}	0.0561	0.2006

(6)

indicating that the trend (or permanent) shock $\varepsilon_{1t} = \varepsilon_t^*$ cannot be recovered ($P^* \approx 1$), while the cycle shock $\varepsilon_{2t} = \varepsilon_t^c$ appears to be recoverable ($P^* \approx 0$). In [Figure 1](#), simulated states and estimated Kalman smoothed states are plotted for the two shocks of interest.

The correlation between the true (simulated) and estimated Kalman smoothed shocks can be analyzed by simply computing $\text{Corr}(X_t, \hat{X}_{t|T})$, where $X_t = [\varepsilon_{1t} \ \varepsilon_{2t} \ \varepsilon_{2t-1}]'$ and $\hat{X}_{t|T} = E_T X_t = E_T [\varepsilon_{1t} \ \varepsilon_{2t} \ \varepsilon_{2t-1}]'$, yielding (for the first two elements of X_t):

	$\text{Corr}(X_t, \hat{X}_{t T})$
ε_{1t}	0.2368
ε_{2t}	0.9713

(7)

As can be seen from (7), the estimated permanent shock ε_{1t} is only weakly correlated (0.2368) with the true value, while the estimated cyclical shock ε_{2t} is highly correlated (0.9713). These facts can also be seen from [Figure 1](#) below.

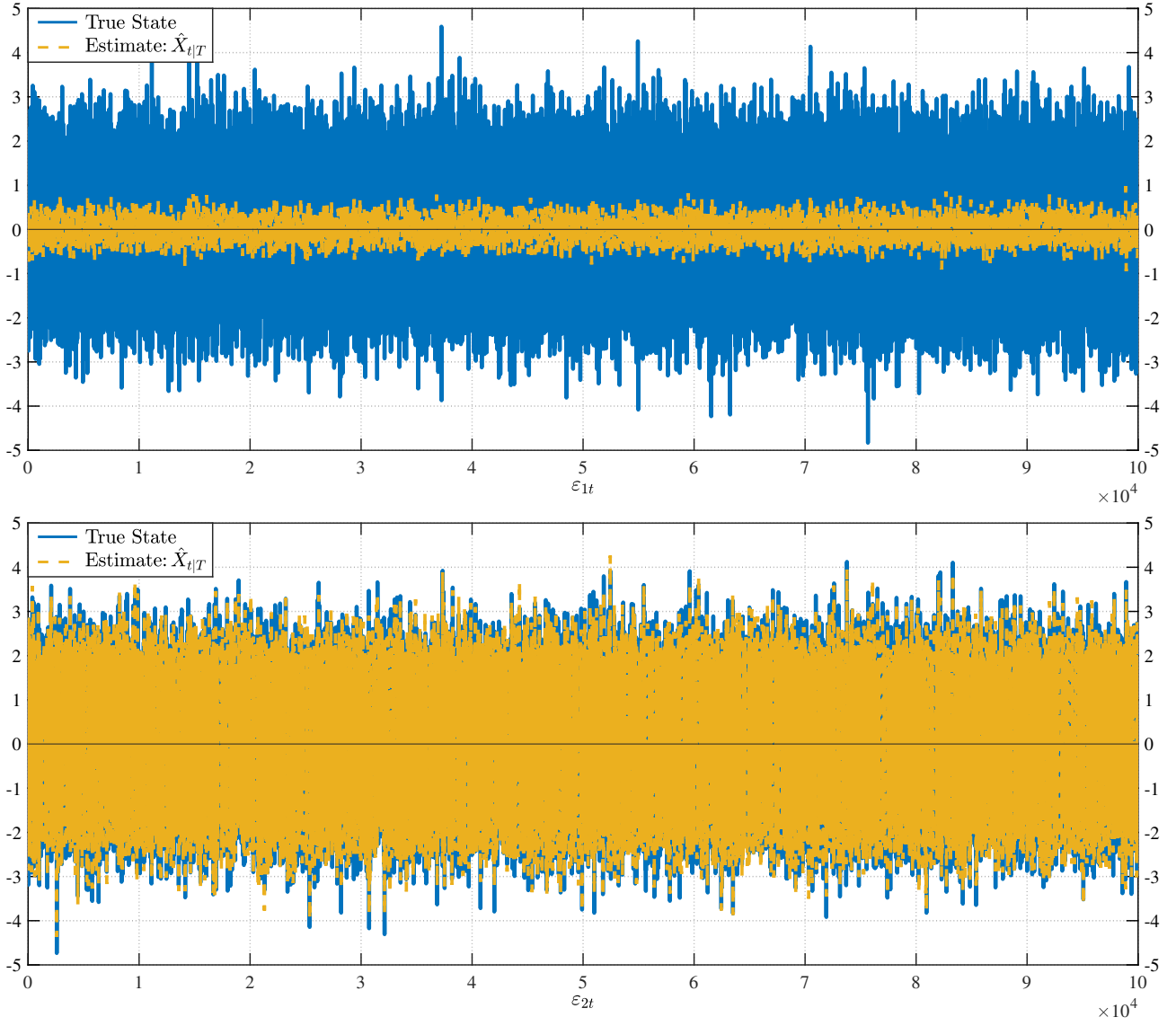


Figure 1: Comparison of true shocks and Kalman Smoothed estimates $\varepsilon_{t|T}$.

2.4 Shock Identities

Kalman Filter estimates of the permanent and transitory shocks ε_{1t} and ε_{2t} are linked by the identity:

$$E_t \varepsilon_{2t} = \phi E_t \varepsilon_{1t}, \quad (8)$$

and the corresponding Kalman Smoother estimates are linked by the *dynamic* identity:

$$\Delta^2 E_T \varepsilon_{1t} = \frac{1}{\phi} E_T \varepsilon_{2t-2}. \quad (9)$$

The filtered and smoothed estimates of the contemporaneous correlations are, respectively:

Corr($\hat{X}_{t t}, \hat{X}_{t t}$)			and	Corr($\hat{X}_{t T}, \hat{X}_{t T}$)		
	ε_{1t}	ε_{2t}			ε_{1t}	ε_{2t}
ε_{1t}	1.0000	1.0000		ε_{1t}	1.0000	-0.1907
ε_{2t}	1.0000	1.0000		ε_{2t}	-0.1907	1.0000

Note that ε_{1t} and ε_{2t} were generated as *i.i.d.* $N(0, 1)$ and mutually uncorrelated.

Running regressions corresponding to (8) and (9) obtained from the simulated data (without an intercept) yields regression coefficient of 40 and $0.025 = 1/40$ when the smoothing parameter was set to $\lambda = 1600 = 40^2$ in the simulation. The regression fit is perfect, yielding an R^2 of 1 and a residual sum of squares of exactly 0 (see Panels (a) and (b) in Table 1, respectively). The file HP97.m replicates the output summarized here.

Filter Identity. Dependent variable: Ete2(t)				
Variable	Estimate	stderr(HAC)	t-stat(HAC)	p-value
Ete1(t)	40.000000	0.000000	619573092194908800.000000	0.000000
R-squared	:		1.000000	No. of Regressors : 1.000000
Rbar-squared	:		1.000000	Plus Const.(if exist) : 1.000000
SE of regression	:		0.000000	Mean(y) : 0.004701
Sum Squared Errors	:		0.000000	Stdev(y) : 0.898496
Log-likelihood	:		355982.354905	AIC : -74.034148
F-statistic	:	383870816571960950165161046978854912.000000	AICc : -74.034148	
Pr(F-statistic)	:		0.000000	BIC : -74.033427
No. of observations	:		10000.000000	HQIC : -74.033904
Std.err.MLE (div by T)	:		0.000000	DW-stat. : 2.016162
Include Pre-whitening	:		0.000000	HAC Trunct.Lag. : 12.000000

(a) Kalman Filter

Smoother Identity. Dependent variable: $\Delta^2 ETe1(t)$				
Variable	Estimate	stderr(HAC)	t-stat(HAC)	p-value
ETe2(t-2)	0.025000	0.000000	20042737735416592.000000	0.000000
R-squared	:		1.000000	No. of Regressors : 1.000000
Rbar-squared	:		1.000000	Plus Const.(if exist) : 1.000000
SE of regression	:		0.000000	Mean(y) : -0.000006
Sum Squared Errors	:		0.000000	Stdev(y) : 0.024396
Log-likelihood	:		353018.214591	AIC : -73.455443
F-statistic	:	401711335930692148013508656627712.000000	AICc : -73.455443	
Pr(F-statistic)	:		0.000000	BIC : -73.454722
No. of observations	:		9998.000000	HQIC : -73.455199
Std.err.MLE (div by T)	:		0.000000	DW-stat. : 3.659113
Include Pre-whitening	:		0.000000	HAC Trunct.Lag. : 12.000000

(b) Kalman Smoother

Table 1: Shock identity regressions using Kalman filter and smoother estimates.

Since $\varepsilon_{1t} = \Delta^2 y_t^*$ and $\varepsilon_{2t} = \frac{1}{\phi} y_t^c$, this implies that the output from the standard HP-Filter will give the corresponding identity to (9) as:

$$\begin{aligned}
\Delta^2 \underbrace{E_T \varepsilon_{1t}}_{\Delta^2 y_t^*} &= \frac{1}{\phi} \underbrace{E_T \varepsilon_{2t-2}}_{\frac{1}{\phi} y_{t-2}^c} \\
\Leftrightarrow \Delta^4 y_t^* &= \frac{1}{\phi^2} y_{t-2}^c, \\
\Leftrightarrow \Delta^4 \text{HP-trend}_t &= \frac{1}{\phi^2} \text{HP-cycle}_{t-2},
\end{aligned}$$

so that a regression of the fourth differenced HP-trend on a twice lagged HP-cycle will give a coefficient estimate of $\frac{1}{40^2} = \frac{1}{1600} = 0.000625$. The HP-Filter appears to be able to recover the transitory cyclical shock $\varepsilon_{2t} = \varepsilon_t^c$, but not the permanent shock. HP-Filter estimates of ε_{1t} and ε_{2t} induce a negative correlation between trend-cycle shocks, ie., $\text{Corr}(E_T \varepsilon_{1t}, E_T \varepsilon_{2t}) = -0.1907$, despite being generated with zero correlation.