How Are Shocks to Trend and Cycle Correlated?
A Simple Methodology for Unidentified Unobserved Components Models

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How Are Shocks to Trend and Cycle Correlated?  
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Daisuke Nagakura*

Abstract
In this paper, we propose a simple methodology for investigating how shocks to trend and cycle are correlated in unidentified unobserved components models, in which the correlation is not identified. The proposed methodology is applied to U.S. and U.K. real GDP data. We find that the correlation parameters are negative for both countries. We also investigate how changing the identification restriction results in different trend and cycle estimates. It is found that estimates of the trend and cycle can vary substantially depending on the identification restrictions imposed.

Keywords: Business Cycle Analysis; Trend; Cycle; Permanent Component; Transitory Component; Unobserved Components Model  
JEL classification: C01, E32

*Economist, Institute for Monetary and Economic Studies, Bank of Japan (E-mail: daisuke.nagakura@boj.or.jp)

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1 Introduction

In business cycle analysis, it is often supposed that real GDP consists of two unobserved components (UC): a permanent and a transitory component. Shocks to the permanent component have long-lasting effects, whereas shocks to the transitory component are temporary and vanish in the long run. Following convention, we refer to these two components as “trend” and “cycle”, respectively. Estimating these two components has been an important issue in business cycle analysis. The UC model is one of the most commonly used models for this purpose (see, for example, Harvey (1985), Clark (1987) and Watson (1986) for applications of UC models). In this model, the trend is assumed to be a random walk and the cycle is assumed to be stationary.

Although it is conventional to assume that shocks to the trend and cycle are uncorrelated for the identification of model parameters, this assumption is unreasonable, as argued by Clark (1987, pp.800–801) and Zarnowitz and Ozyildirim (2006). Morley, Nelson, and Zivot (2003) (2003, henceforth MNZ) estimate a UC model with a stationary AR(2) cycle process, (the UC–AR(2) model), for U.S. quarterly real GDP. They show that one can identify and estimate the correlation parameter under this specification of cycle. Their estimate of the correlation parameter of – 0.9062 is significantly different from zero. MNZ argue that the finding of a negative correlation increases the importance of real shocks for the macroeconomy.

The objective of this paper is to reinvestigate how shocks to these two components are correlated by applying an unidentified UC model, in which a correlation is not identified without imposing an identification restriction. The paper also investigates how changing identification restriction results in different trend and cycle estimates. The empirical part shows that the trend and cycle estimates are substantially different depending on the identification restriction imposed. Our empirical result suggests that it is important to impose an appropriate identification restriction for properly estimating the trend and cycle. We also discuss on what is an appropriate identification restriction.

In this paper, we consider a UC–ARMA(2, 1) model. The UC–ARMA(2, 1) model is observationally equivalent to MNZ’s UC–AR(2) model in the sense that these two UC models have the same autocovariance structure. A difficulty in applying the UC–ARMA(2, 1) model is that, unlike the UC–AR(2) model, it has a correlation parameter that cannot be identified (and hence estimated) without imposing an identification restriction. We show that for the correlation parameter, there is an upper bound implied by an unrestricted ARIMA(2, 1, 2) model, which is an observationally equivalent alternative representation of the UC–ARMA(2, 1) model. We propose a simple methodology for finding the implied upper bound.  

1In independent work that is closely related to ours, Oh, Zivot, and Creal (2008) use a similar methodology. They focus on comparing the estimates of trend and cycle obtained through the Beveridge-Nelson decomposition (Beveridge and Nelson, 1981) with the estimates of trend and cycle obtained from UC models with correlated shocks. By contrast, our focus is an investigation of the correlation.
The proposed methodology is applied to U.S. and U.K. real GDP data. For both countries, it is found that the upper bounds of the correlations are negative. This implies that the two shocks are negatively correlated. We use UC-ARMA(2, 1) models, estimated under different identification restrictions, to estimate the trend and cycle. We found that estimates of the trend and cycle can vary substantially depending on the identification restrictions imposed. We also found that setting the MA(1) parameter equal to zero, or specifying the cycle as an AR(2) process, is not supported by the data on U.K. real GDP.

The rest of the paper is organized as follows. In the next section, we briefly overview the identification problem of UC models. In Section 3, we propose a simple methodology to find an upper bound of the correlation for unidentified UC models. In Section 4, we apply the proposed methodology to U.S. and U.K. real GDP data. The final section concludes the paper.

2 Overview of the identification problem of UC models

Let \( \{y_t\}_{t=0}^T \) be an observed time series, such as the log of real GDP. We suppose that \( y_t \) is the sum of two unobserved stochastic processes, a random walk process \( \tau_t \) and a stationary finite order ARMA \((p, q)\) process \( c_t \); these processes are conventionally termed “trend” and “cycle”, respectively, in the literature on business cycle analysis. The model is known as a UC model (hereafter, a UC-ARMA\((p, q)\) model). Formally, the model is defined as follows:

\[
y_t = \tau_t + c_t, \quad \tau_t = \mu + \tau_{t-1} + \eta_t, \quad \phi(L)c_t = \theta(L)\epsilon_t,
\]

where \( \phi(L) = 1 - \phi_1 L - \cdots - \phi_p L^p \) and \( \theta(L) = 1 + \theta_1 L + \cdots + \theta_q L^q \) are \( p \)th order AR and \( q \)th order MA polynomials, respectively, that satisfy the stationarity and invertibility conditions; that is, the modulus of the roots of \( \phi(z) = 0 \) and \( \theta(z) \) are all outside the unit circle.

From (1), we have

\[
\phi(L)(1-L)y_t = \phi(1)\mu + \phi(L)\eta_t + (1-L)\theta(L)\epsilon_t.
\]

The right-hand side of (2) is the sum of two MA processes whose innovations are correlated.\(^2\) However it can be shown that this part can be expressed by an MA \((q^*)\) process with the single innovation \( u_t \), where \( q^* = \max\{p, q + 1\} \) (see, for example,
Granger and Morris, 1976). This implies that \( y_t \) can alternatively be represented as an ARIMA\((p, q^*\) ) process, as follows:

\[
\phi(L)(1-L)y_t = \mu^* + \theta^*(L)e_t, \quad u_t \sim i.i.d(0, \sigma_u^2),
\]

where \( \mu^* \equiv \phi(1)\mu \), and \( \theta^*(L) \equiv 1 + \theta_1^* L + \cdots + \theta_q^* L^q \). Note that the AR coefficients in (2) and (3) are the same. This representation of the UC–ARMA\((p, q)\) model is commonly referred to as the ARIMA \((p, 1, q^*)\) reduced form.

MNZ point out that if one sets \( p = 2 \) and \( q = 0 \), then the parameters of the resulting UC–AR(2) model are uniquely identified from its ARIMA\((2, 1, 2)\) reduced form parameters. To see this, let \( \gamma_j \) denote the \( j \)th order autocovariance of the MA part of (3). The first three autocovariances, \( \gamma_0, \gamma_1 \), and \( \gamma_2 \), in terms of the ARIMA\((2, 1, 2)\) reduced form parameters, are given by \( \gamma_0 = \sigma_w^2(1+\theta_1^2+\theta_2^2) \), \( \gamma_1 = \sigma_w^2\theta_1^*(1+\theta_2^*) \), \( \gamma_2 = \sigma_w^2\theta_2^* \) and \( \gamma_j = 0 \) for \( j \geq 3 \). Given that the MA processes on the right-hand sides of (2) and (3) must be identical, we can express these autocovariances in terms of the UC model parameters, \( \sigma_n^2, \sigma_x^2 \), and \( \sigma_{ne} \), as:

\[
\gamma_0 = (1 + \phi_1^2 + \phi_2^2)\sigma_n^2 + 2\sigma_x^2 + 2(1 + \phi_1)\sigma_{ne},
\gamma_1 = (\phi_1\phi_2 - \phi_1)\sigma_n^2 - \sigma_x^2 + (\phi_2 - \phi_1 - 1)\sigma_{ne},
\gamma_2 = -\phi_2\sigma_n^2 - \phi_2\sigma_{ne}.
\]

(See MNZ for a detailed derivation of the equations in (4)). Thus, given the ARIMA\((2, 1, 2)\) reduced form parameters, which include \( \phi_1 \) and \( \phi_2 \), we can solve the three equations in (4) for the three unknown UC model parameters, \( \sigma_n^2, \sigma_x^2 \), and \( \sigma_{ne} \), uniquely. The correlation \( \rho \) is calculated as \( \rho = \sigma_{ne}/(\sigma_x\sigma_n) \).

A problem occurs when \( p = 2 \) and \( q = 1 \); then \( y_t \) follows a UC–ARMA\((2, 1)\) process, and there is one additional parameter, namely, \( \theta_1 \), the MA(1) coefficient of the ARMA\((2, 1)\) cycle process. Although it is easy to show that its reduced form is also an ARIMA\((2, 1, 2)\) process, the four UC model parameters, \( \sigma_n^2, \sigma_{ne}, \sigma_x^2 \) and \( \theta_1 \) cannot be uniquely identified from its ARIMA \((2, 1, 2)\) reduced form parameters. To show this, we compare the autocovariances of the MA parts of the models. In terms of the UC model parameters, the autocovariances \( \gamma_j, j = 0, 1, 2 \) are:

\[
\gamma_0 = (1 + \phi_1^2 + \phi_2^2)\sigma_n^2 + 2(1 - \theta_1 + \theta_1^2)\sigma_x^2 + 2[1 + \phi_1 + \theta_1(\phi_2 - \phi_1)]\sigma_{ne},
\gamma_1 = (\phi_1\phi_2 - \phi_1)\sigma_n^2 - (1 - \theta_1^2)\sigma_x^2 + [\phi_2 - \phi_1 - 1 - \theta_1(\phi_2 - \phi_1 - 1)]\sigma_{ne},
\gamma_2 = -\phi_2\sigma_n^2 - \theta_1\sigma_x^2 - (\theta_1 + \phi_2)\sigma_{ne},
\]

where \( \theta_1 \) is the MA (1) coefficient of the ARMA\((2, 1)\) cycle process.

Note that there are only three equations for the four unknown UC model parameters, \( \sigma_n^2, \sigma_{ne}, \sigma_x^2 \) and \( \theta_1 \). Thus, the equations in (5) cannot be uniquely solved for these four UC model parameters. To solve these equations, we must impose a restriction, which we term an “identification restriction”, on \( \theta_1 \). For example, setting \( \theta_1 = 0 \) reduces the model to a UC–AR(2) model. This restriction is not testable because under the alternative hypothesis the model parameters are not identified.

In general, the order condition for identification of the UC–ARMA\((p, q)\) model is \( p \geq q + 2 \). The model parameters are just identified when this equality holds.
MNZ apply a UC–AR(2) model to U. S. quarterly real GDP data and find that the estimated correlation $\rho$ is significantly negative. However, the point of our paper is that the true data generating process may be the UC–AR(2, 1) model that is observationally equivalent to the UC–AR(2) model. In that case, one cannot identify $\rho$.

3 Methodology

In this section, we illustrate a simple method for finding an upper bound for the correlation given the unrestricted ARIMA model parameters. The basic idea is to examine how the value of the correlation implied by an unrestricted ARIMA model changes when we impose different identification restrictions.

Lengthy calculations can be used to solve the equations in (5) to obtain the following expressions for the three UC model parameters:

$$
\sigma_n^2 = \frac{\gamma_0 + 2\gamma_1 + 2\gamma_2}{(1 - \phi_1 - \phi_2)^2},
$$

$$
\sigma_\epsilon^2 = \frac{-2(1 - \phi_1 \theta_1 + \phi_1 + \phi_2 \theta_1)(\gamma_2 + \phi_2 \sigma_n^2) - (\theta_1 + \phi_2)\gamma_0 - (1 + \phi_1^2 + \phi_2^2)\sigma_n^2}{2\theta_1(1 - \phi_1 \theta_1 + \phi_1 + \phi_2 \theta_1) - 2(\theta_1 + \phi_2)(1 - \theta_1 + \theta_2^2)},
$$

$$
\sigma_{ne} = \frac{\theta_1 \gamma_0 - (1 + \phi_1^2 + \phi_2^2)\sigma_n^2 + 2(1 - \theta_1 + \theta_2^2)(\gamma_2 + \phi_2 \sigma_n^2)}{2\theta_1(1 - \phi_1 \theta_1 + \phi_1 + \phi_2 \theta_1) - 2(\theta_1 + \phi_2)(1 - \theta_1 + \theta_2^2)}.
$$

(6)

Note that the variance of the trend shock, $\sigma_n^2$, is identified and is equivalent to the long-run variance of the first differences of $\{y_t\}$. This result holds in general: for any UC–ARMA($p$, $q$) model, the variance of the trend shock is always identified as the long-run variance of the first differences; that is, $\sigma_n^2 = \psi(1)^2\sigma^2_u$, where $\psi(1) = \theta^*(1)/\phi(1)$. This was first pointed out by Cochrane (1988, p.908).

Note that given the ARIMA(2, 1, 2) reduced form parameters, the three UC model parameters above are functions of $\theta_1$. Hence, given $\theta_1$, these functions determine the values of the three UC model parameters that satisfy the equations in (5), from which we can calculate $\rho$. In this way, we can obtain an implicit relationship between the “identification restrictions” imposed on $\theta_1$ and the resulting values of the correlation $\rho$. Figure 2(a) plots such pairs of values for $\theta_1$ and $\rho$, given estimates of the ARIMA(2, 1, 2) model for U.S. quarterly real GDP, which are reported in the second column of Table 1.

The implied values of the correlations are all negative, and the upper bound of the correlation is around $-0.75$. The dashed line shows that if we restrict $\theta_1$ to be 0, in which case the UC–ARMA(2, 1) model reduces to the UC–AR(2) model, then the resulting implied correlation is around $-0.95$, which is lower than the estimate obtained by MNZ. This is because our data are different from theirs; in particular, our data cover a longer sample period (more details on the data set are given in the next section). Note that there are ranges of values for $\theta_1$ that imply correlations of less than $-1$, which thus violate the condition for positive definiteness of the
covariance matrix. This means that UC–ARMA(2, 1) models with values of \( \theta_1 \) in such ranges are inconsistent with the estimated unrestricted ARIMA(2, 1, 2) model. We refer to such values of \( \theta_1 \) as “improper identification restrictions”; values of \( \theta_1 \) at which \( |\rho| \leq 1 \) constitute “proper identification restrictions”. In the figure, we display values of \( \rho \) based only on values of \( \theta_1 \) in a particular range; this is because we confirmed that values for \( \theta_1 \) outside of the range are inconsistent with \( |\rho| \leq 1 \).

In this way, we can find an upper bound for the correlation parameter. The methodology can be easily extended for other unidentified UC models.

4 Empirical applications

In this section, we apply the proposed methodology to U.S. and U.K. quarterly real GDP data. These quarterly real GDP data cover the period from 1946:4 to 2006:3 (yielding 238 observations) for the U.S. and the period from 1955:4 to 2006:2 (yielding 202 observations) for the U.K. For these periods, Figure 1 shows the percentage growth rates in GDP.

Table 1 reports the estimates of the unrestricted ARIMA (2, 1, 2) model for each (logged) GDP series. Figure 2 graphs the implied relationships between \( \theta_1 \) and \( \rho \) for these GDP data, obtained by using the methodology described in the previous section. The implied values of the correlations are all negative for both countries. The upper bound for the correlation differs between the two countries; it is about \(-0.75\) for U.S. and \(-0.993\) for U.K. This implies that the two shocks are highly negatively correlated. Note that because these values are upper bounds, the actual correlations may be lower than these values. For the U.K. GDP data, it is worth noting that the range of \( \theta_1 \) values that satisfies the condition for positive definiteness of the covariance matrix (i.e., \( |\rho| \leq 1 \)) does not include \( \theta_1 = 0 \). This implies that, for the U.K., the restriction that \( \theta_1 = 0 \), under which the model reduces to the UC–AR(2) model, is inconsistent with the estimated unrestricted ARIMA models. In other words, the U.K. real GDP data do not support the UC – AR(2) specification.

If we set the value of \( \theta_1 \) a priori to, for example, \( \theta_1 = 0 \), we can directly estimate the other three UC model parameters from a state space representation; this is because the identification condition is satisfied. However, the above result suggests that we should not arbitrarily choose the value of \( \theta_1 \). One would expect UC models estimated under different identification restrictions, particularly improper identification restrictions, to produce different trend and cycle estimates. To address this concern, we estimate the UC–AR(2, 1) model directly under different identification restrictions, including proper and improper restrictions, and then estimate the cycle and trend from these estimated UC models. In the estimation of UC models, we impose the positive definiteness condition on the covariance matrix parameters and impose the stationarity conditions on the AR(2) coefficients.

Table 2 reports the estimation results for the UC–AR(2, 1) model. The values of \( \theta_1 \) in the first row are the restrictions imposed in advance. The asterisks denote improper restrictions. When we impose proper restrictions, the values of the log-likelihoods are the same as those of the unrestricted ARIMA model and are higher than those obtained under improper restrictions. Figures 3 and 4 display the cycle
estimates for U.S. and U.K. real GDP, respectively. These are estimated by using Kalman filtering on the state space representation of the UC–ARMA(2, 1) model with estimated UC model parameters. For the U.S., Figures 3(a), (b) and (c) illustrate the cycle estimates from the UC models estimated under the restrictions \( \theta_1 = 0, \theta_1 = -0.5 \) and \( \theta_1 = 0.5 \), respectively. The restrictions, \( \theta_1 = 0 \) and \( \theta_1 = -0.5 \), are consistent with the estimated unrestricted ARIMA(2, 1, 2) model, whereas the restriction \( \theta_1 = 0.5 \) is not. The cycle estimates based on \( \theta_1 = 0 \) and \( \theta_1 = -0.5 \) are identical; however, the cycle estimates based on \( \theta_1 = 0.5 \) are substantially different from the other two. From Figure 4, findings for U.K. GDP are similar. Figures 4(a) and (b) illustrate the cycle estimates under proper identification restrictions and Figures 4(c) and (d) present the cycle estimates based on improper restrictions. The cycle estimates in (a) and (b) are identical. Although it is difficult to see visually, the cycle estimates in (c) differ from those in (a) and (b).

5 Conclusion

In this paper, we proposed a simple methodology for investigating the correlation between permanent and transitory shocks for unidentified UC models. Although one cannot estimate the correlation in this case, our methodology can be used to obtain an upper bound for the correlation. We applied our methodology to U.S. and U.K. real GDP data. It was found that the upper bounds of the correlations are negative for both countries. This implies that for these two countries, permanent and transitory shocks are strongly negatively correlated.

Our results raise questions about the conventional identification scheme for UC models, which involves setting the correlation parameter to zero. As argued by MNZ in the context of U.S. GDP, imposing such a restriction distorts the estimates of trend and cycle from UC models. Our results confirm this for the case of U.K. GDP. We also showed that the UC model with a stationary AR(2) cycle process is not supported by U.K. real GDP data.

Appendix: State space representation of the UC–AR(2, 1) model

We adopt the following state space representation of the UC–AR(2, 1) model for estimation of the model parameters and the cycle:

(Observation equation)

\[
y_t = \begin{bmatrix} 1 & 1 & 0 & 0 \end{bmatrix} \begin{bmatrix} \tau_t \\ c_t \\ c_{t-1} \\ \alpha_t \end{bmatrix},
\]
If our objective is only to estimate parameters, it is more convenient to use the following state space representation of the first difference

\[
\begin{bmatrix}
\Delta \tau_t \\
\Delta c_t \\
\Delta c_{t-1} \\
\Delta \alpha_t \\
\end{bmatrix} = \begin{bmatrix}
\mu \\
0 \\
0 \\
0 \\
\end{bmatrix} + \begin{bmatrix}
1 & 0 & 0 & 0 \\
0 & \phi_1 & -\phi_2 & \theta_1 \\
0 & 0 & 1 & 0 \\
0 & 0 & 0 & 0 \\
\end{bmatrix} \begin{bmatrix}
\Delta \tau_{t-1} \\
\Delta c_{t-1} \\
\Delta c_{t-2} \\
\Delta \alpha_{t-1} \\
\end{bmatrix} + \begin{bmatrix}
1 & 0 \\
0 & 1 \\
0 & 0 \\
0 & 1 \\
\end{bmatrix} \begin{bmatrix}
\eta_t \\
\epsilon_t \\
\end{bmatrix}.
\]

This is because then all state variables are stationary and we avoid the problem of initialization. See Durbin and Koopman (2001) for more details of state space models.
References


Table 1: Estimates of the ARIMA (2, 1, 2) parameters

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<th>U.S.</th>
<th>U.K.</th>
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<td>$\phi_1$</td>
<td>1.3635</td>
<td>0.5605</td>
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<td></td>
<td>(0.1447)</td>
<td>(0.0972)</td>
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<tr>
<td>$\phi_2$</td>
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<td></td>
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<td>(0.0981)</td>
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<tr>
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<td>$\mu$</td>
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<td>$L$</td>
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<td>-105.14</td>
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Note: the following ARIMA(2, 1, 2) model was estimated by using exact maximum likelihood estimation:

$$\phi(L)(\Delta y_t - \mu) = \theta(L)u_t, \quad u_t \sim NID(0, \sigma_u^2),$$

where $\phi(L) = 1 - \phi_1 L - \phi_2 L^2$, and $\theta^*(L) = 1 + \theta_1^* L + \theta_2^* L^2$. Standard errors are in parentheses. The rows with $\sigma_{lrv}^2$, $\sigma_{ucv}^2$, and $\psi(1)$ display estimates of the long-run variance, the unconditional variance and the (cumulated) impulse response measure, namely, $\psi(1) = \theta^*(1)/\phi(1)$, respectively. The last row reports the log-likelihood.
Table 2: Estimates of the UC–ARMA(2, 1) parameters

<table>
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<tr>
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<td>-316.69</td>
<td>-105.14</td>
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</table>

Note: the following UC–ARMA(2, 1) model was estimated by maximum likelihood estimation from a state space representation:

\[ y_t = \tau_t + c_t, \quad \tau_t = \mu + \tau_{t-1} + \eta_t, \quad \phi(L)c_t = \theta(L)\epsilon_t \]

\[ \eta_t \sim i.i.d. N(0, \sigma^2_\eta), \quad \epsilon_t \sim i.i.d. N(0, \sigma^2_\epsilon), \quad corr(\eta_t, \epsilon_{t\pm k}) = \begin{cases} \rho \sigma_\eta \sigma_\epsilon & \text{for } k = 0, \\ 0 & \text{otherwise,} \end{cases} \]

where \( \phi(L) = 1 - \phi_1 L - \phi_2 L^2 \), and \( \theta(L) = 1 + \theta_1 L \). The value of \( \theta_1 \) was set before estimation. For estimation, we imposed the condition for positive definiteness on the covariance matrix parameters and imposed the stationarity conditions for the AR(2) coefficients. The last row reports the value of the log-likelihood.
Figure 1: Growth rates of U.S. and U.K. real GDP

(a) U.S.

(b) U.K.

Figure 2: Implied relationship between the correlation and the MA(1) parameter

(a) U.S.

(b) U.K.
Figure 3: Percentage deviation from trend of U.S. real GDP

Note: these figures represent the cycle estimates from the UC models estimated under the following restrictions on $\theta_i$: $\theta_i = 0$ for (a); $\theta_i = 0.5$ for (b); and $\theta_i = -0.5$ for (c).
Figure 4: Percentage deviation from trend of U.K. real GDP

Note: these figures represent the cycle estimates from the UC models estimated under the following restrictions on \( \theta_i \): \( \theta_i = 0.16 \) for (a); \( \theta_i = 0.22 \) for (b); \( \theta_i = 0 \) for (c) and \( \theta_i = -0.5 \) for (d).