

TRENDS, CYCLES, AND CONVERGENCE

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Determining turning points in the business cycle is a difficult problem. Making sensible predictions concerning the growth path of an economy in the medium or long term is even harder. This paper explores what can be achieved by analysing and modeling time series observations on gross domestic product (GDP) and other macroeconomic time series.

Separating out trends and cycles is fundamental to a good deal of economic analysis. It is often done by applying filters in a rather arbitrary fashion. Thus the low-pass filter introduced by Hodrick and Prescott (1997) is frequently used to remove trends in situations in which it can create serious distortions (see Harvey and Jaeger, 1993; Cogley and Nason, 1995). The band-pass filter, recently introduced by Baxter and King (1999), can also result in distortions (see Murray, 2002).

Trends and cycles are best constructed using unobserved component, or structural, time series models. The parameters in such models are typically estimated by maximum likelihood, after which optimal estimates of the components are obtained by smoothing algorithms. The calculations are most easily performed by putting the model in state-space form.

The paper begins by discussing the basic ideas of structural time series models and reviewing the link with the Hodrick-Prescott (HP)

I am grateful to Vasco Carvalho for research assistance, to Rodrigo Caputo and Thomas Trimbur for helpful comments, and to Christian Johnson for his discussion at the conference. Much of the work reported was supported by the Economic and Social Research Council (ESRC) as part of a project on Dynamic Factor Analysis, grant number L138 25 1008.

Economic Growth: Sources, Trends, and Cycles, edited by Norman Loayza and Raimundo Soto, Santiago, Chile. © 2002 Central Bank of Chile.

filter. An extended class of cyclical models is then introduced. Harvey and Trimbur (2002) argue that these models enable the extraction of smoother cycles and that they lead to a more satisfactory decomposition into trend and cycle at the end of the series. The extraction of these generalised cycles is closely linked to the application of Butterworth band-pass filters. These filters are widely used in engineering but have only recently been introduced into economic statistics (see Gomez, 2001). The analysis of such filters reveals that a model yielding the equivalent of an ideal band-pass filter can be obtained as a limiting case. Fitting models with the generalised cyclical component to U.S. macroeconomic series illustrates the point about their yielding clearer and smoother cycles than are normally obtained.

Structural models can also be extended so as to include more than one cycle. A model with two cycles produces a plausible trend for quarterly Chilean GDP data.

Multivariate models are discussed in section 2. A related series with a more pronounced cycle, such as investment, may help in extracting a better cycle from GDP. Multivariate models can also be set up so as to handle economies that have converged and so have a stable relationship. These are called balanced growth models. However, the more relevant question for developing economies, such as Chile, is whether convergence is actually taking place. Section 3 examines ways of assessing and modeling convergence between two economies. A dynamic error-correction model is proposed and then extended so as to incorporate a mechanism that allows convergence to take place smoothly. Unobserved component and autoregressive versions of these models are fitted to per capita data on GDP in the United States and Japan.

Section 4 brings together the material from the earlier sections to set out bivariate models for the levels of two converging economies. The preferred models combine unobserved components with an error-correction mechanism and allow a decomposition into trend, cycle, and convergence components. This provides insight into what has happened in the past, enables the current state of an economy to be more accurately assessed, and gives a procedure for the prediction of future observations. The properties of these models are explored, and they are fitted to the Japanese and U.S. series. Finally, the scope for using these models for making medium-term predictions for Chile is assessed.

1. TIME SERIES MODELS FOR TRENDS AND CYCLES

1.1 Structural Time Series Models

The local linear trend model for a set of observations, y_t , $t = 1, \dots, T$, consists of stochastic trend and irregular components, that is,

$$y_t = \mu_t + \varepsilon_t, \quad t = 1, \dots, T. \quad (1)$$

The trend, μ_t , receives shocks to both its level and slope, so

$$\begin{aligned} \mu_t &= \mu_{t-1} + \beta_{t-1} + \eta_t, & \eta_t &\sim NID(0, \sigma_\eta^2), \\ \beta_t &= \beta_{t-1} + \zeta_t, & \zeta_t &\sim NID(0, \sigma_\zeta^2), \end{aligned} \quad (2)$$

where the irregular, level, and slope disturbances, ε_t , η_t , and ζ_t respectively, are mutually independent and the notation $NID(0, \sigma^2)$ denotes normally and independently distributed with mean zero and variance σ^2 . If both variances σ_η^2 and σ_ζ^2 are zero, the trend is deterministic. When only σ_ζ^2 is zero, the slope is fixed and the trend reduces to a random walk with drift

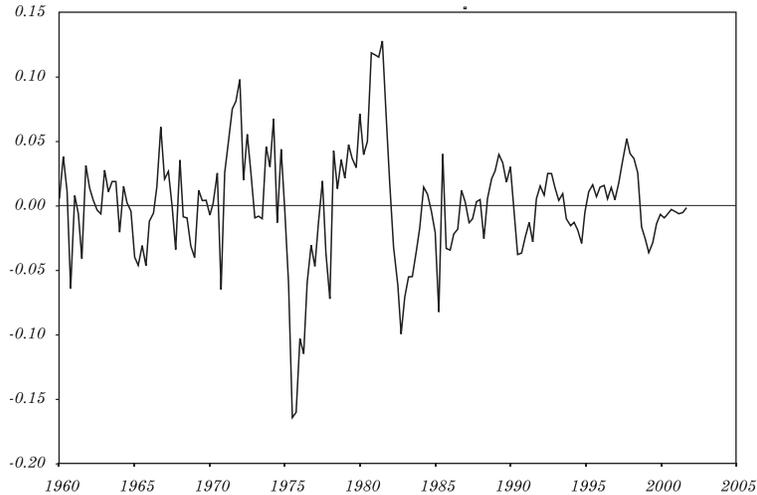
$$\mu_t^2 = \mu_{t-1} + \beta_{t-1} + \eta_t, \quad \eta_t \sim NID(0, \sigma_\eta^2), \quad (3)$$

Allowing σ_ζ^2 to be positive, but setting σ_η^2 to zero gives an integrated random walk (IRW) trend, which when estimated tends to be relatively smooth. This model is equivalent to a cubic spline and is often referred to as the smooth trend model.

The statistical treatment of unobserved component models is based on the state-space form (SSF). Once a model has been put in SSF, the Kalman filter yields estimators of the components based on current and past observations. Signal extraction refers to the estimation of components based on all the information in the sample. Signal extraction is based on smoothing recursions which run backward from the last observation. Predictions are made by extending the Kalman filter forward. Root-mean-square errors (RMSEs) can be computed for all estimators and prediction intervals constructed.

The unknown variance parameters are estimated by constructing a likelihood function from the one-step-ahead prediction errors, or innovations, produced by the Kalman filter. The likelihood function is maximized by an iterative procedure. The calculations can be done with

Figure 1. HP Filter for Chilean GDP, Using Seasonally Adjusted Data



the STAMP package of Koopman and others (2000). Once estimated, the fit of the model can be checked using standard time series diagnostics such as tests for residual serial correlation.

$$q = \sigma_{\eta}^2 / \sigma_{\epsilon}^2$$

HP filtering can be carried out by applying a signal extraction algorithm to a special case of the smooth trend model in which the signal-noise ratio, q , is set to 1/1600 for quarterly data. Figure 1 shows the cycle obtained from HP detrending of quarterly, seasonally adjusted data on GDP for Chile.¹ The result is a rather noisy series from which no clear message emerges, particularly toward the end. The HP filter applied to U.S. GDP is more satisfactory in that the business cycle emerges clearly, but again it is not clear what is happening at the end of the series; the HP cycle is very similar to the one shown later in figure 2.

Estimating the parameters of a smooth trend model for GDP will not usually result in an HP cycle, as there is nothing in the model to distinguish long-term from short-term movements. Short-term movements may be captured by including a serially correlated stationary

1. Seasonal adjustment was carried out using the basic X-12-ARIMA option in PcGive.

component, ψ_t , in the model. Thus,

(4)

An autoregressive process is often used for ψ_t , as in Kitagawa and Gersch (1996). Another possibility is the stochastic cycle

$$\begin{bmatrix} \psi_t \\ \psi_t^* \end{bmatrix} = \rho \begin{bmatrix} \cos \lambda_c & \sin \lambda_c \\ -\sin \lambda_c & \cos \lambda_c \end{bmatrix} \begin{bmatrix} \psi_{t-1} \\ \psi_{t-1}^* \end{bmatrix} + \begin{bmatrix} \kappa_t \\ \kappa_t^* \end{bmatrix}, \quad t = 1, \dots, T, \quad (5)$$

where λ_c is frequency in radians and κ_t and κ_t^* are two mutually independent white noise disturbances with zero means and common variance σ_κ^2 . Given the initial conditions that the vector $(\psi_t, \psi_t^*)'$ has zero mean and covariance matrix \mathbf{I} , it can be shown that for the process ψ_t is stationary and indeterministic with zero mean, variance σ_ψ^2 , and autocorrelation function

(6)

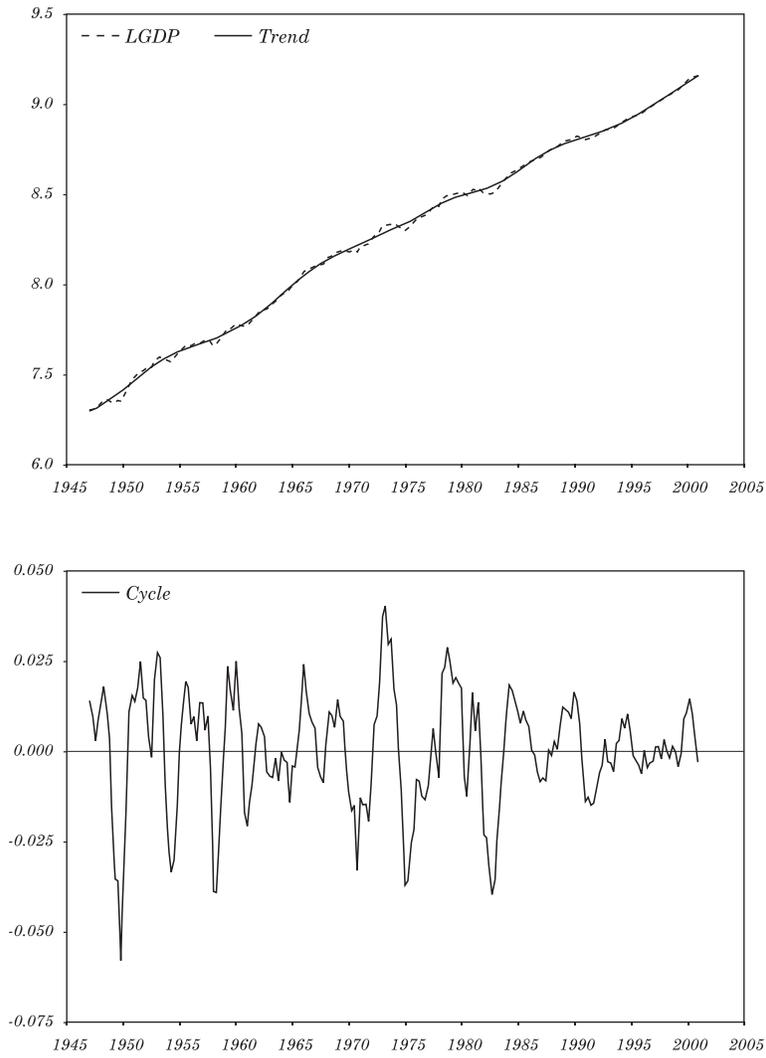
For $0 < \lambda_c < \pi$, the spectrum of ψ_t displays a peak, centered around λ_c , which becomes sharper as ρ moves closer to one. The period corresponding to λ_c is $2\pi / \lambda_c$. In the limiting cases when $\lambda_c = 0$ or π , ψ_t collapses to first-order autoregressive processes with coefficients ρ and minus ρ , respectively. More generally the reduced form is an ARMA(2,1) process in which the autoregressive part has complex roots. The complex root restriction can be very helpful in fitting a model, particularly if there is reason to include more than one cycle.

Harvey and Jaeger (1993) show that extracting a cycle from U.S. GDP using a smooth trend plus cycle model gives a very similar result to the HP filter. This correspondence continues to hold with the series shown in figure 2, which is from 1947:1 to 2001:3. The problem at the end of the series is apparent. The challenge is to devise models that are capable of giving a clearer breakdown into trend and cycle.

1.2 Extracting Smoother Cycles

The cycle extracted for U.S. GDP in figure 2 comes from a model in which the irregular variance is estimated to be zero. Thus, as with the HP filter, the cycle is the same as the detrended series. A clearer indication of the business cycle might be obtained by a model that manages

Figure 2. Trend and Cycle in U.S. GDP from a Structural Time Series Model



to force some of the stationary part of the series into the irregular component. The same idea is inherent in the notion of a band-pass filter centred on the business cycle frequencies (see Baxter and King, 1999).

The smoothness of a trend depends on the shape of the weighting function—the kernel—for extracting it and the signal-noise ratio. In the local linear trend model of equation 1, the weighting pattern for a random walk plus drift is a double exponential. For the integrated random walk trend the kernel decays more slowly; some examples can be found in Harvey and Trimbur (2002). Furthermore, if the IRW trend model is fitted, the signal-noise ratio is usually smaller than it is for a random walk with drift: the result is a wider bandwidth and a smoother trend. A similar device may be employed for the cycle. Thus the double, or second-order, stochastic cycle is

$$\begin{aligned} \begin{bmatrix} \Psi_t \\ \Psi_t^* \end{bmatrix} &= \rho \begin{bmatrix} \cos \lambda_c & \sin \lambda_c \\ -\sin \lambda_c & \cos \lambda_c \end{bmatrix} \begin{bmatrix} \Psi_{t-1} \\ \Psi_{t-1}^* \end{bmatrix} + \begin{bmatrix} \Psi_{\beta,t-1} \\ \Psi_{\beta,t-1}^* \end{bmatrix}, \\ \begin{bmatrix} \Psi_{\beta,t} \\ \Psi_{\beta,t}^* \end{bmatrix} &= \rho \begin{bmatrix} \cos \lambda_c & \sin \lambda_c \\ -\sin \lambda_c & \cos \lambda_c \end{bmatrix} \begin{bmatrix} \Psi_{\beta,t-1} \\ \Psi_{\beta,t-1}^* \end{bmatrix} + \begin{bmatrix} \kappa_t \\ \kappa_t^* \end{bmatrix}, \end{aligned} \quad (7)$$

where κ_t and κ_t^* are as in the first-order cycle, equation 5, and ρ and λ_c satisfy the same conditions.

General classes of higher-order trends and cycles may be defined. A higher-order trend will give a nonlinear forecast function and so may not be attractive. On the other hand, higher-order cycles may have a degree of merit. Harvey and Trimbur (2002) define the n^{th} -order stochastic cycle, for positive integer n , as

$$\begin{aligned} \begin{bmatrix} \Psi_{1,t} \\ \Psi_{1,t}^* \end{bmatrix} &= \rho \begin{bmatrix} \cos \lambda_c & \sin \lambda_c \\ -\sin \lambda_c & \cos \lambda_c \end{bmatrix} \begin{bmatrix} \Psi_{1,t-1} \\ \Psi_{1,t-1}^* \end{bmatrix} + \begin{bmatrix} \kappa_t \\ 0 \end{bmatrix}, \\ \begin{bmatrix} \Psi_{i,t} \\ \Psi_{i,t}^* \end{bmatrix} &= \rho \begin{bmatrix} \cos \lambda_c & \sin \lambda_c \\ -\sin \lambda_c & \cos \lambda_c \end{bmatrix} \begin{bmatrix} \Psi_{i,t-1} \\ \Psi_{i,t-1}^* \end{bmatrix} + \begin{bmatrix} \Psi_{i-1,t} \\ 0 \end{bmatrix}, \quad i = 2, \dots, n. \end{aligned} \quad (8)$$

The fact that there is neither κ_t^* nor $\Psi_{i-1,t}^*$ is a matter of convenience in working out frequency domain properties. It enables one to write

$$\Psi_{i,t} = C(L)\Psi_{i-1,t}, \quad i = 2, \dots, n,$$

with $\psi_{1,t} = C(L)\kappa_t$, where

Repeated substitution yields

$$(9)$$

The power spectrum, for $\rho < 1$, is given directly from the spectral generating function as

$$f_{\psi}(\lambda; \rho, \lambda_c, n) = \left| C(e^{-i\lambda}) \right|^n \sigma_{\kappa}^2 / 2\pi$$

$$= \frac{\sigma_{\kappa}^2}{2\pi} \left[\frac{1 + \rho^2 \cos^2 \lambda_c - 2\rho \cos \lambda_c \cos \lambda}{1 + \rho^4 + 4\rho^2 \cos^2 \lambda_c - 4(\rho + \rho^3) \cos \lambda_c \cos \lambda + 2\rho^2 \cos 2\lambda} \right]^n. \quad (10)$$

As n increases, the shape of the spectrum becomes such that there is relatively less power at high frequencies.

If the cycle is embedded in white noise, that is,

$$(11)$$

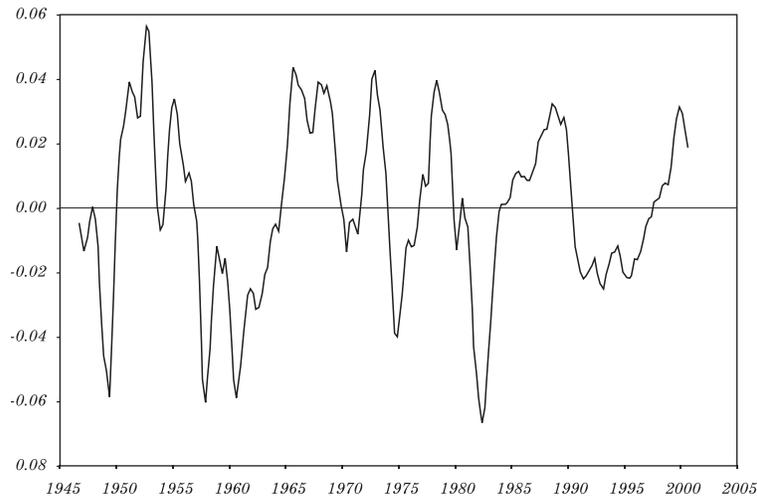
the gain function for extracting the cycle is found to be

$$(12)$$

where $q_{\kappa} = \sigma_{\kappa}^2 / \sigma_{\epsilon}^2$. The higher is n , the more a block of frequencies around λ_c is passed by the filter. When a model of the form of equation 11 is fitted, the irregular component tends to become bigger as n increases, the signal-noise ratio, q_{κ} , becomes smaller, and the estimated cycle tends to become smoother. Similar conclusions hold if the model contains a trend, as in equation 4.

$$\psi_{1,t} = \psi_{1,t} \left[\frac{C(L)}{1 - \rho L} \right]^n \left[\frac{\rho \cos \lambda_c}{1 - 2\rho \cos \lambda_c \cos \lambda + \rho^2} \right]^n$$

$$G(\lambda; \rho, \lambda_c) = \frac{q_{\kappa}}{1 + q_{\kappa} \left[\frac{\rho \cos \lambda_c}{1 - 2\rho \cos \lambda_c \cos \lambda + \rho^2} \right]^n}$$

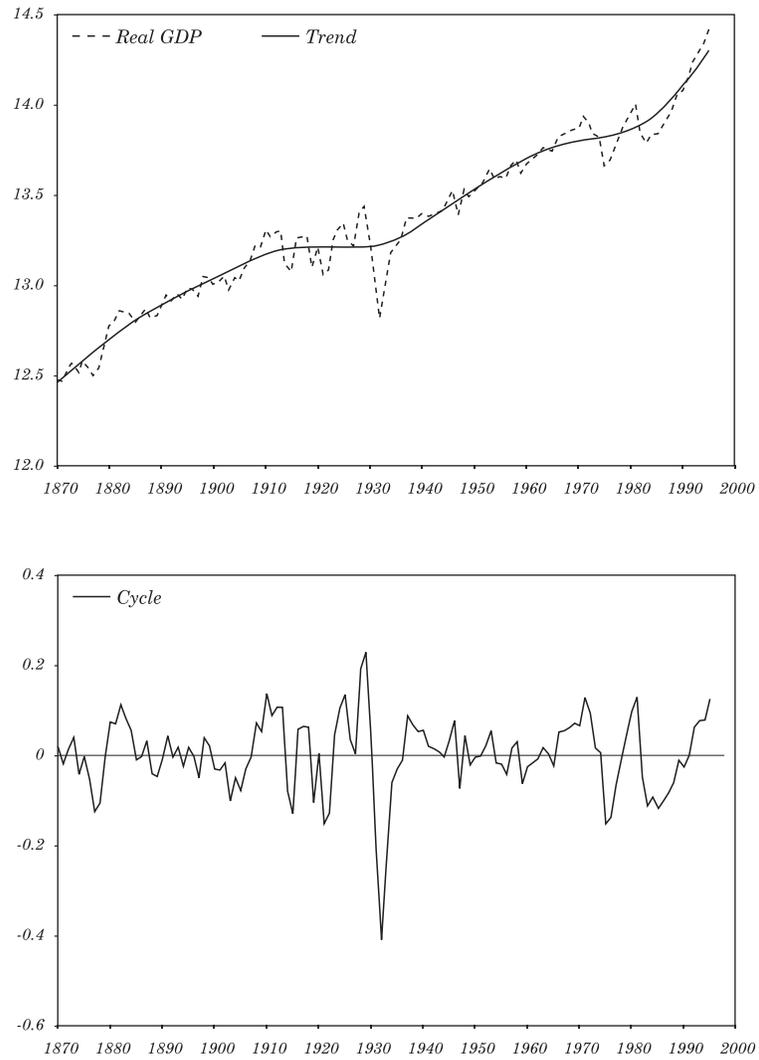
Figure 3. Second-Order Cycle for U.S. GDP

Gomez (2001) shows that the signal extraction filter for the cycle is a member of the Butterworth class if $\rho = 1$. More generally, Harvey and Trimbur (2002) refer to a filter obtained with $0 < \rho < 1$ as a generalised Butterworth band-pass filter of order n .

With ρ equal to one, the gain becomes more rectangular as n increases, and an ideal band-pass filter is obtained as a limiting case. Baxter and King (1999) argue for the desirability of ideal band-pass filters; they suggest how the filters may be approximated in the time domain by truncating weights beyond a certain lag and then modifying them so they sum to zero. A model containing a higher-order cycle can also approximate an ideal band-pass filter, but without sacrificing observations at the beginning and end of the series. The model suggests, however, that this may be unappealing, one reason being that the cycle is nonstationary. Business cycles are normally thought of as being stationary, so the additional flexibility resulting from the inclusion of the damping factor is an important generalisation.

Fitting a fully specified model consisting of trend, cycle, and irregular components, together with any other necessary components such as a seasonal, yields a filter that is optimal for extracting a cycle with clearly defined properties and that is consistent with the data. Root-mean-square errors of extracted components are also available, though the basic formulae do not make allowance for the parameters

Figure 4. Trend Fitted to Annual Chilean GDP, 1870–1995



having been estimated. The calculations may be programmed in Ox using the SsfPack set of subroutines documented in Koopman, Shephard, and Doornik (1999). Figure 3 shows the cycle extracted from U.S. GDP when $n = 2$. This cycle is smoother than the one shown in figure 2, and even more importantly, it gives a much clearer indication of the state of the economy at the end of the series. It appears that the United States is at the top of a boom, and there is a strong indication of a turning point.

1.3 Several Cycles: The Case of Chile

Fitting the trend plus cycle model to the logarithms of annual data on Chilean GDP from 1870 to 1995 (in 1995 pesos) gives the trend shown in figure 4. The period of the cycle is $P = 12.05$, with $\rho = 0.75$ and the signal-noise ratio, q_c , equal to 0.0056. Fitting the same model to the quarterly data set, 1960:1 to 2001:4, in real 1986 Chilean pesos, is less successful.² The recessions in the 1970s and 1980s are very pronounced, and because they so dominate the sample period, they become incorporated into the trend, leaving only very short-term movements in the cycle. Estimating a model with two cyclical components solves the problem, however. The first cycle, which picks up the major recessions, has a period of 10.66 years with $\rho = 0.97$, while the second has a period of just under three years and $\rho = 0.92$. If one uses the monthly series from January 1982 to July 2001, only the short-term cycle can be extracted. As can be seen from figure 1, the HP filter (applied to seasonally adjusted data) is unsatisfactory, as it yields a confusing mixture of short- and long-term cycles together with the noise from the irregular. The Baxter-King filter would be of little help, since it normally focuses on frequencies between six and thirty-two quarters.

Figure 5 shows the five components into which the series is decomposed. Of particular note is the fact that the economy is near the trough of the longer-term cycle. Figure 6 shows forecasts of the series, with one RMSE on either side, together with extrapolations of the two cycles. However, the forecasts for the two cycles should be interpreted with caution. While they pick up identifiable movements in the past and thereby allow a more satisfactory trend to be extracted, there is no reason to suppose that they will be a permanent feature of the Chilean economy; this applies particularly to the longer cycle.

2. The last two quarters are estimates.

The series has a seasonal component, which shows marked changes over the period; the graph of individual seasons is particularly informative. These changes are apparently due to the fact that the figures in the first part of the series are unofficial estimates. It is interesting to ponder on the effect of trying to tackle such movements with a non-model-based seasonal adjustment procedure such as the U.S. Census Bureau's X-12.

2. MULTIVARIATE MODELS AND BALANCED GROWTH

More precise information on the target series can sometimes be obtained by bringing in information in a related series. This is done by constructing a bivariate model. For example, because the cycle in investment is quite marked, it may help give a better estimate of the cycle in GDP. Several auxiliary series may be used in a multivariate systems, but the principle remains the same. The ideas of cointegration, common trends, and balanced growth are directly relevant to the potential gains in efficiency.

2.1 Bivariate Structural Time Series Models

The bivariate local level model is

$$\begin{aligned} y_{1t} &= \mu_{1t} + \psi_{1t} + \varepsilon_{1t}, \\ y_{2t} &= \mu_{2t} + \varepsilon_{2t}, \end{aligned}$$

(13)

The covariance matrix of (η_{1t}, η_{2t}) may be written

$$\Sigma_{\eta} = \begin{bmatrix} \sigma_{1\eta}^2 & \rho_{\eta} \sigma_{1\eta} \sigma_{2\eta} \\ \rho_{\eta} \sigma_{1\eta} \sigma_{2\eta} & \sigma_{2\eta}^2 \end{bmatrix},$$

where ρ_{η} is the correlation. More generally,

(14)

where μ_{it} is a local linear trend and ψ_{it} is a cycle, as defined earlier.

The similar cycle model, introduced by Harvey and Koopman (1997), allows the disturbances driving the cycles to be correlated across the series. The damping factor and the frequency, ρ and λ_c , are the same in all series, however, so the cycles in the different series have similar properties; in particular, their movements are centred around the same

Figure 5. Decomposition of Chilean Real GDP into Trend, Two Cycles, Seasonal and Irregular

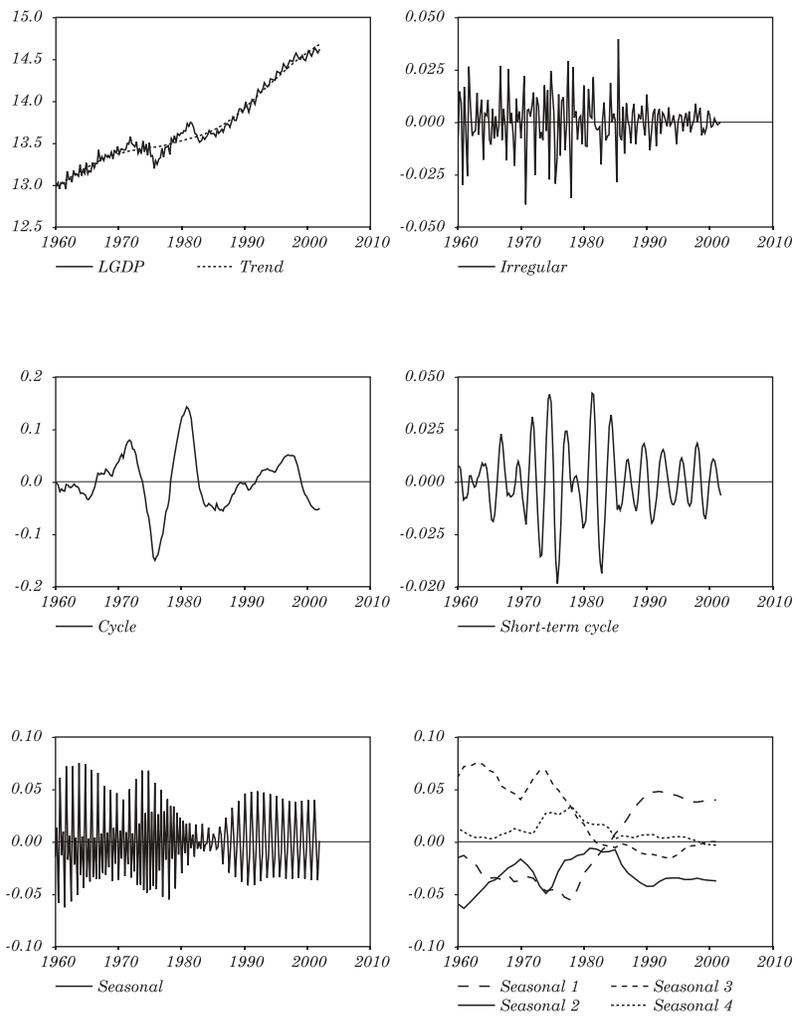
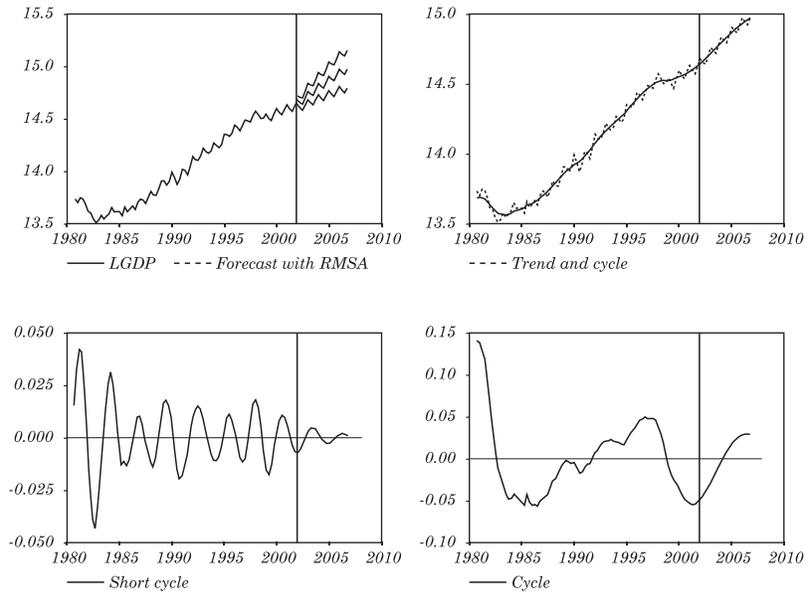


Figure 6. Forecasts for Chilean Real GDP

period. This seems eminently reasonable if the cyclical movements all arise from a similar source, such as an underlying business cycle. Furthermore, the restriction means that it is often easier to separate out trend and cycle movements when several series are jointly estimated.

2.2 Stability and Balanced Growth

In the balanced growth model, the same trend, μ_p , appears in the two series. Thus the bivariate local level model becomes

$$\begin{aligned} y_{1t} &= \mu_t + \alpha + \varepsilon_{1t}, & t &= 1, \dots, T. \\ y_{2t} &= \mu_t + \varepsilon_{2t}, \end{aligned} \quad (15)$$

In terms of equation 13, $\rho_\eta = 1$ and $\sigma_{1\eta} = \sigma_{2\eta}$. A corresponding property holds for the slope disturbance in the local linear trend.

The series have a stable relationship over time in that they are evolving in such a way that their difference, $y_{1t} - y_{2t}$, is stationary. In other words, the series are cointegrated with a known cointegrating vector. A

stability test of the null hypothesis of a stable relationship can be carried out using a stationarity test, such as the one proposed by Nyblom and Mäkeläinen (1983). Under the null hypothesis, the limiting distribution of the test statistic is Cramér-von Mises. The test can be modified so as to include a nonparametric correction for serial correlation, as in Kwiatkowski and others (1992). Parametric adjustments can also be made. If there are no constant terms in equation 15, that is, $\alpha = 0$, then the series contain an identical common trend. The test statistic is constructed without the mean subtracted, and its asymptotic distribution under the null comes from a different member of the Cramér-von Mises family.

The common trend restriction is a strong one, but it can lead to considerable gains in the efficiency with which components in the target series are estimated. An analysis can be found in Harvey and Chung (2000) in connection with the estimation of the underlying change in the level of unemployment. The paper also demonstrates how state-space methods can be used to combine information produced at different sampling intervals. Thus, in the case of the United Kingdom, quarterly survey data are combined with monthly claimant count figures to produce a better estimate of the underlying change in unemployment.

2.3 Japan and the United States

Models with smooth trends were fitted to the logarithms of quarterly, seasonally adjusted data on real GDP per capita in the United States and Japan over the period 1961:1 to 2000:1. The data were obtained from the Organization for Economic Cooperation and Development (OECD) *Main Economic Indicators* and the population series were constructed as quarterly moving averages of annual figures spread over all four quarters. The series are in 1990 U.S. dollars; the choice of conversion date, of course, affects the gap between the series, but it is otherwise irrelevant.

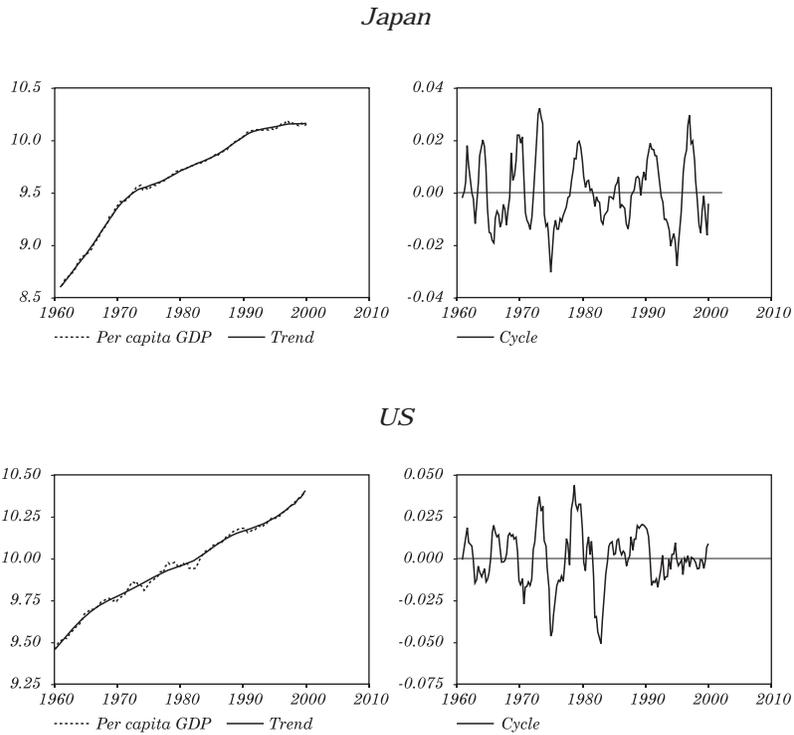
Fitting a univariate model to Japan does not yield a satisfactory cycle.³ By contrast, it becomes much more like the United States cycle in the similar cycle bivariate model. Table 1 shows the estimates of the parameters, obtained using STAMP, together with the standard error (SE) for each equation and the Box-Ljung statistic, $Q(P)$, based on the first P residual autocorrelations. The correlations between the slope, cycle, and irregular disturbances were -0.143 , 0.274 , and 1 , respectively. The period of 27.07 quarters corresponds to 6.77 years.

3. The cycle is almost nonstationary, with $\rho = 0.998$, while the period is only 2.97 years.

Table 1. Bivariate Model for Japan and the United States

Component/Fit	Hyperparameter	Japan	United States
Trend	$\sigma_{\zeta}(x10^{-3})$	1.638	0.907
Cycle	$\sigma_{\kappa}(x10^{-3})$	7.177	7.642
	$\sigma_{\psi}(x10^{-3})$	17.22	18.34
	ρ	0.91	0.91
	Period ($2\pi/\lambda_c$)	27.07	27.07
Irregular	$\sigma_{\varepsilon}(x10^{-3})$	4.380	0.174
Equation standard error	$SE(x10^{-3})$	11.144	9.058
Box-Ljung statistic	$Q(11)$	11.766	14.719

Figure 7. Trends and Cycles from a Bivariate Structural Time Series Model



The extracted cycles are shown in figure 7. Their presence means that the trends are quite smooth. The forecasts will clearly diverge, however, as there is virtually no growth in Japan at the end of the series. This issue is taken up in section 4, when a convergence model is fitted.

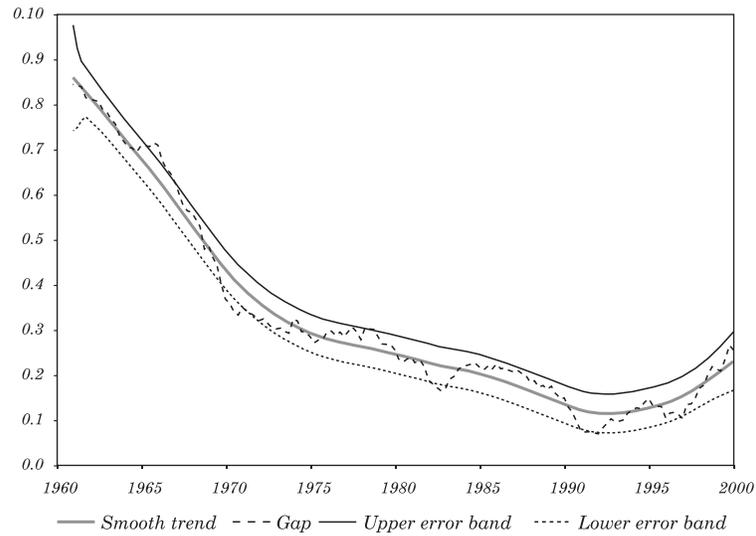
3. MODELS OF CONVERGING ECONOMIES

Two countries have converged if the difference between them is stable. If initial conditions are unimportant, stability implies that the difference between the series, y_t , is stationary for virtually the whole period. If the mean of y_t is zero, the countries are in a state of absolute convergence. If the mean, α , is not zero, they exhibit *conditional or relative convergence*. This is a possibility if one entertains the existence of increasing costs of convergence and possible barriers to absolute convergence (see, for example, Bernard and Durlauf, 1996). The limiting growth paths for the regions are then parallel, differing by α .

Suppose now that one wishes to model the process of convergence. If two economies are converging, the model for y_t will have the property that forecasts converge to α . The models set up below are able to satisfy this condition, and they become stationary for economies that have converged.

3.1 Stylized Facts

It is possible to consider stylized facts without positing a particular mechanism for convergence. The difference, y_t , is assumed to be made up of a stochastic trend or level, μ_t , together with other components such as cycle and irregular, as in equation 4. The smoothed estimates of the trend describe the time path reflecting the long-run difference between the two economies. Simply plotting this time path may be very informative. For example, figure 8 shows the difference in the trend of per capita GDP between the United States and Japan obtained by fitting a smooth trend, that is, with σ_η^2 set to zero, plus cycle model using the STAMP package of Koopman and others (2000). Additional tests can be carried out to determine whether the gap between the two economies has narrowed significantly or whether the gap is zero, that is, $\mu_T = 0$, indicating that absolute convergence has taken place. The result can be seen from the graph, which shows a confidence interval of two RMSEs. The level in the trend at the end of the sample is 0.230 with an RMSE of 0.032 giving a t value of 7.10. Although Japan came close to catching up with the United States in the early 1990s, the movement since then has been in the opposite direction.

Figure 8. US-Japan Gap Modeled by a Smooth Trend

3.2 Error-Correction Mechanism

$$y_t = \alpha + \mu_t,$$

The use of nonstationary components to model convergence is apparently contradictory, since once convergence has taken place the series are stationary. I now show how an error-correction mechanism (ECM) can be used to capture convergence dynamics instead of approximating the process by a stochastic trend.

The simplest model is

$$(16)$$

with a fixed initial value, μ_0 . This is not constructed as a model of a stable contrast, but rather as a model of transitional dynamics in a situation in which the initial value is some way from zero. If $\phi < 1$, the gap tends to narrow over time. It makes little sense to have ϕ negative, so I assume that $\phi > 0$. Of course, when the initial conditions have worked themselves out, the series becomes stationary. The equivalent error-correction (EC) representation for μ_t is

$$\Delta y_t = (\phi - 1)(y_{t-1} - \alpha) + \eta_t = \delta + (\phi - 1)y_{t-1} + \eta_t, \quad t = 2, \dots, T, \quad (17)$$

where $\delta = \alpha(1 - \phi)$. This can be interpreted as saying that for data in logarithms, the expected growth rate in the current period is a negative fraction of the gap between the two economies after allowing for the permanent difference, α . For example, with $\phi = 0.98$ and a ratio of 1.65 in income per capita, which corresponds to a gap in logarithms of 0.5, the difference in growth rates is 1 percent. Some idea of what different values of ϕ imply about the closing of the gap can be obtained by noting that the τ -step-ahead forecast from an AR(1) model is ϕ^τ times the current value. Thus ϕ^τ is the fraction of the gap expected to remain after τ time periods.

Written in the EC form (equation 17), the model accords with the notion of convergence in the cross-sectional literature, as expounded by Barro and Sala-i-Martin (1992) and others, except that there the growth rate is taken to be a linear function of the initial value, giving a model that is internally inconsistent over time (see Evans and Karras, 1996, p. 253).

The ECM may be generalised to allow for richer dynamics. Within an autoregressive framework, equation 17 may be augmented with lagged values of differenced observations. Fitting such a model to the U.S.-Japan series without the constant gives

$$\hat{\Delta y}_t = 0.0029 \Delta y_t - 0.0156 y_{t-1} + 0.127 \Delta y_{t-1} + 0.083 \Delta y_{t-2} + 0.136 \Delta y_{t-3} + 0.128 \Delta y_{t-4}.$$

(0.0019) (0.0056) (0.061) (0.083) (0.083)

The constant standard error (SE) (here equal to $\hat{\sigma}_\eta$), is 0.0126, and $Q(11)$, the Box-Ljung statistic based on eleven residual autocorrelations, is 7.29. Under the null hypothesis of correct specification, the asymptotic distribution of this statistic is χ^2_6 . With a constant added to the right-hand side

with SE = 0.0125 and $Q(11) = 6.84$. The estimate of ϕ has fallen from 0.991 to 0.984. The t statistic of the constant is -1.54 , and the implied value of α is 0.187. None of the lagged differences is statistically significant at the 5 percent level. With no lags, the estimate of ϕ was 0.979, and the implied value of α was 0.143. However, there was evidence of residual serial correlation with $Q(11) = 25.14$.

3.3 Unobserved Components and Smooth Convergence

The unobserved components (UC) approach is to add cycle and irregular components to the error-correction mechanism. This avoids confounding the transitional dynamics of convergence with short-term steady-state dynamics. Thus

$$y_t = \alpha + \mu_t + \psi_t + \varepsilon_t, \quad \mu_t = \phi\mu_{t-1} + \eta_t, \quad t = 1, \dots, T. \quad (18)$$

Estimation is effected by using the state-space form with a diffuse prior for μ_t (as though it were nonstationary). Although α is regarded as a fixed parameter, it can also be estimated by including it in the state vector with a diffuse prior. Care must be taken since α is not identified when ϕ is unity. A likelihood ratio (LR) test of the null hypothesis that $\alpha = 0$ can be carried out, but to ensure comparability of likelihood, the one for the unrestricted model must be calculated by treating α as fixed.

Smother transitional dynamics can be achieved by specifying μ_t in equation 18 as

$$\begin{aligned} \mu_t &= \phi\mu_{t-1} + \beta_{t-1}, & t = 1, \dots, T. \\ \beta_t &= \phi\beta_{t-1} + \zeta_t, \end{aligned} \quad (19)$$

$$\begin{aligned} \Delta\mu_t &\equiv (\phi - 1)\mu_{t-1} + \beta_{t-1} \\ \Delta\beta_t &= (\phi - 1)\beta_{t-1} + \zeta_t, \end{aligned}$$

If the model is written with what might be termed a second-order ECM, that is,

(20)

then a convergence mechanism is clearly operating on both the gap in the level and the gap in the growth rate. Alternatively, this second-order ECM can be expressed as

showing that the underlying change depends not only on the gap, but also on the change in the previous time period. This means that changes take place more smoothly. Note that the model is a special case of the second-order cycle of equation 7, obtained by setting $\lambda_c = 0$.

Table 2. Univariate Model for Difference between the United States and Japan

<i>Component/Fit</i>	<i>Hyperparameter</i>	<i>Absolute</i>	<i>Relative</i>	<i>Trend</i>
Convergence	$\sigma_{\zeta}(x10^{-3})$	1.933	1.286	1.244
	ϕ	0.963	0.943	1 (fixed)
Cycle	$\sigma_{\kappa}(x10^{-3})$	11.33	11.51	11.25
	ρ_c	0.94	0.96	0.95
	Period ($2\pi/\lambda_c$)	50.51	50.14	50.91
Irregular	$\sigma_{\varepsilon}(x10^{-3})$	0.014	0.071	1.54
Gap	α	0 (fixed)	0.180	—
Equation standard error	$SE(x10^{-3})$	12.7	12.4	12.8
Box-Ljung statistic	$Q(11)$	11.54	1.85	9.37

The model is equivalent to an AR(2) process with both roots equal to ϕ . Obviously, the condition for stationarity is $|\phi| < 1$. With a value of ϕ close to one, μ_t will behave in a similar way to the smooth trend shown in figure 8. On the other hand, the first-order ECM behaves rather like a random walk specification and tracks the observations closely, leaving little scope for the addition of short-term nontransitional components. An important feature of the second-order model is that if the convergence process stalls sufficiently, the forecast function indicates that the gap can be expected to widen in the short run.

Estimating the first-order UC model of equation 18 resulted in relatively small values for the cycle and irregular variances. The same thing happened when a random walk trend was fitted in the preliminary model, instead of a smooth trend. The dominance of the transitional component over the cycle and irregular means that the model is not too far from a simple ECM, as in equation 17. The convergence parameter, ϕ , is 0.984 for absolute convergence and 0.977 when α is estimated. The estimate of α is 0.134, but the LR statistic is 3.33, which is not significant against a χ_1^2 distribution.

The second-order convergence model (equation 20) fared much better insofar as it was able to separate out a cyclical component. The results are shown in table 2. The smoothed path of μ_t is very similar to that shown in figure 8. The parameters obtained when the smooth trend was fitted to give figure 8 are shown in the last column. The estimate of α , 0.180, now has a statistically significant LR statistic of 6.46.

I argued in section 2 that the higher-order cycles of equation 8 may be more clearly defined in that they cut out more high frequencies.

Such cycles could also be used in equation 18, although they may be more effective in the bivariate models described in the next section.

4. BIVARIATE MODELS FOR THE LEVELS OF CONVERGING ECONOMIES

The previous section devised a mechanism for capturing convergence between two economies. This section explores how this mechanism can be incorporated into a bivariate model for the levels of converging economies. The aim is to extract trend and convergence components and to make forecasts that take convergence to a common trend into account. The extension to multivariate modeling is not covered, but a discussion can be found in Harvey and Carvalho (2002).

4.1 Bivariate Error-Correction Mechanism

A bivariate model for two converging economies can be set up as

(21)

$$\begin{aligned} \Delta Y_{1t} &= \phi_1(Y_{2,t-1} - Y_{1,t-1}) + \phi_2 Y_{1,t-1} + \epsilon_{1t} \\ \Delta Y_{2t} &= \phi_2(Y_{1,t-1} - Y_{2,t-1}) + \phi_1 Y_{2,t-1} + \epsilon_{2t} \end{aligned}$$

where y_{it} denotes, for example, per capita output for economy i at time t . Absolute convergence and no growth is initially assumed for simplicity. The growth rate of the first economy thus depends on the gap between its level and that of the second economy and vice versa.

The model corresponds to the first-order vector autoregression

(22)

The roots of the transition matrix,

are one and $\phi_1 + \phi_2 - 1$. The condition for the second root to lie inside the unit circle is $0 < \phi_1 + \phi_2 < 2$. This being the case, the long-run forecasts

converge to the same value, that is,

(23)

where $\bar{\phi} = \phi_2 / (\phi_1 + \phi_2)$.

The model of equation 22 can be transformed to

where $\phi = 1 - (\phi_1 + \phi_2)$ and

$$\bar{y}_{\phi t} = \bar{\phi} y_{1t} + (1 - \bar{\phi}) y_{2t}. \quad (24)$$

The disturbance $\bar{\eta}_{\phi t}$ is defined similarly. The first equation corresponds to the univariate convergence equation 17, since it is an ECM for the difference $y_{1t} - y_{2t}$. In the second equation, the weighted sum follows a random walk and, as is clear from equation 23, this is the growth path to which the two economies are converging.

Parameterising the model in terms of $\bar{\phi}$ and ϕ has some attractions. The stability condition is $|\phi| < 1$, though it makes little sense to have ϕ negative. It seems desirable (though not essential for stability) to have $0 < \phi < 1$. This condition implies that ϕ_1 and ϕ_2 are both greater than or equal to zero. Note that if $\phi = 1$, then $\bar{\phi}$ is not identified.

Benchmark Model

Setting $\phi_2 = 0$ (or $\phi_1 = 0$) implies that country one (two) converges to country two (one), the benchmark country. Provided ϕ_1 is positive, $\phi_2 = 0$ does not imply a second unit root, so a test of this hypothesis can be based on standard distribution theory. Note that $y_{1t-1} - y_{2t-1}$ is stationary (the variables are cointegrated) in equation 21.

Trend and Constant

The model may be extended so as to include a common deterministic trend and a constant, α , to allow for relative convergence. Thus

(25)

where

$$\begin{aligned}\Delta\mu_{1t} &= \phi_1 (\mu_{2,t-1} - \mu_{1,t-1}) + \eta_{1t}, \\ \Delta\mu_{2t} &= \phi_2 (\mu_{1,t-1} - \mu_{2,t-1}) + \eta_{2t}.\end{aligned}\tag{26}$$

The gap, $y_{2t} - y_{1t}$, is as in equation 16, except that the sign of α is different (this is more convenient for what follows). Substituting for μ_{1t} and μ_{2t} gives

$$(27)$$

Note that the weighted average of equation 24 is a random walk with a drift of β and that the gap, $y_{2t} - y_{1t}$, is as in equation 17.

4.2 Autoregressive Models

The dynamics in equation 27 may be extended by adding lagged differences to the right-hand side of the equations and re-arranging to give

$$\begin{aligned}\frac{\Delta y_t}{\Delta y_{1t}} &\equiv \frac{\beta - \phi_1 \alpha + \phi_1 (y_{2,t-1} - y_{1,t-1})}{\delta_1 - \phi_1 (y_{1,t-1} - y_{2,t-1})} \\ \Delta y_{2t} &= \beta + \phi_2 \alpha + \phi_2 (y_{1,t-1} - y_{2,t-1}) \\ \Delta y_{2t} &= \delta_2 - \phi_2 (y_{1,t-1} - y_{2,t-1})\end{aligned}$$

where $\delta_i = \beta \left[1 - \sum_{j=1}^p (\phi_{i1j}^\dagger + \phi_{i2j}^\dagger) \right] + (-1)^i \phi_i \alpha, i = 1, 2$. The parameters α and β can be identified from the estimated constants once estimates of ϕ_1 and ϕ_2 have been obtained. The model belongs to the vector error-correction mechanism (VECM) class. The cointegrating vector is known, and ML estimation can be carried out by ordinary least squares (OLS) since the regressors are the same in each equation. If α is set to zero, then the restriction that the slopes are the same would need to be enforced.

In the benchmark model, ϕ_i is set to zero in one equation, such that β is identified from that equation. Using the estimate of β , an estimate of the parameter α can be extracted from the estimated constant in the other equation. There should, in theory, be gains from seemingly unrelated regressions estimation, although in practice it seems to make little difference here.

A bivariate model was estimated for the United States and Japan with $p = 4$. For Japan, $\tilde{\phi}_1 = 0.0184$ while for the United States, $\tilde{\phi}_1 = -0.0046$. The model is stable, but the negative sign for $\tilde{\phi}_1$ suggests that it should be set to zero, as in a benchmark model. Indeed the t statistic is only 0.937; this is asymptotically standard normal provided ϕ_1 is positive. The benchmark model gave an estimate of ϕ_1 equal to 0.0176, corresponding to $\phi = 0.9824$. From the estimates of the constants, α and β are estimated as 0.140 and 0.0062, respectively. The estimate of β corresponds to an annual growth rate of 2.6 percent. Recall that the univariate estimate of α from modeling the difference as an autoregression was 0.143.

4.3 Unobserved Components

Embedding the ECM within a UC model by adding a cycle and an irregular to equation 25 gives

(28)

If ψ_{1t} and ψ_{2t} are modeled as similar cycles, subtracting y_{1t} from y_{2t} in equation 28 gives a univariate model of the form of equation 18. The vector $(\mu_{1t}, \mu_{2t})'$ may be initialized with a diffuse prior in the SSP. The parameters α and β may also be included in the state and initialized with a diffuse prior, though to compare likelihoods they should be treated as fixed. Note that if $\phi_1 = \phi_2 = 0$, then there is no convergence. The pure trend model of section 2 is then obtained, provided α is set to zero. A balanced growth model is obtained, however, if η_{1t} and η_{2t} are perfectly correlated with the same variance.

A smooth stochastic trend can replace the random walk with common drift. This is most natural if a second-order model for the convergence dynamics, generalising equation 20, is adopted. This yields

$$\begin{aligned} y_{1t} &= \alpha + \mu_{1t} + \psi_{1t} + \varepsilon_{1t}, \\ y_{2t} &= \mu_{2t} + \psi_{2t} + \varepsilon_{2t}. \end{aligned} \quad (29)$$

$$\begin{aligned} \mu_{1t} &= (1 - \phi_1)\mu_{1,t-1} + \phi_1\mu_{2,t-1} + \beta_{1,t-1}, \\ \beta_{1t} &= (1 - \phi_1)\beta_{1,t-1} + \phi_1\beta_{2,t-1} + \zeta_{1,t}, \\ \mu_{2t} &= (1 - \phi_2)\mu_{2,t-1} + \phi_2\mu_{1,t-1} + \beta_{2,t-1}, \\ \beta_{2t} &= (1 - \phi_2)\beta_{2,t-1} + \phi_2\beta_{1,t-1} + \zeta_{2,t}. \end{aligned} \quad (30)$$

Again, if $\phi_1 = \phi_2 = 0$, then there is no convergence, but a balanced growth model is obtained if ζ_{1T} and ζ_{2T} are perfectly correlated with the same variance.

If the second economy is taken to be a benchmark, then $\phi_2 = 0$ in the last two equations of 30. In this case, μ_{2t} is a smooth trend and the gap is $y_{1t} - y_{2t}$. The implied model for $y_{1t} - y_{2t}$ is as in equation 18, with μ_t replaced by $\mu_{1t} - \mu_{2t}$.

4.4 UC Model for Japan and the United States

The smooth stochastic trends model fitted in subsection 2.3 gives an indication of the kind of results which might be expected from a convergence model and can provide starting values for some of the parameters. As already noted, the model is a limiting case which results when $\phi_1 = \phi_2 = 0$ and $\alpha = 0$.

The results of fitting the bivariate convergence model (equations 29 and 30) can be found in Harvey and Carvalho (2002). The model was estimated with the United States taken as the benchmark, with α set to zero and α unrestricted. When the more general model with no restrictions on ϕ_1 and ϕ_2 was estimated, it collapsed to the benchmark model. This is consistent with what was found when the bivariate autoregressive model was fitted.

The main features are as follows:

—The cycle parameters are similar to those obtained with the bivariate pure trend model reported in table 1, and the fitted cycles seem to provide a more satisfactory decomposition than was obtained for the univariate model for the difference.

—The estimate of α is only slightly smaller than the one obtained in the univariate gap model. Again there is clear evidence of relative convergence.

—The estimated convergence component, $\mu_{1t} - \mu_{2t}$, assigned to Japan is very similar to the smoothed gap shown in figure 8.

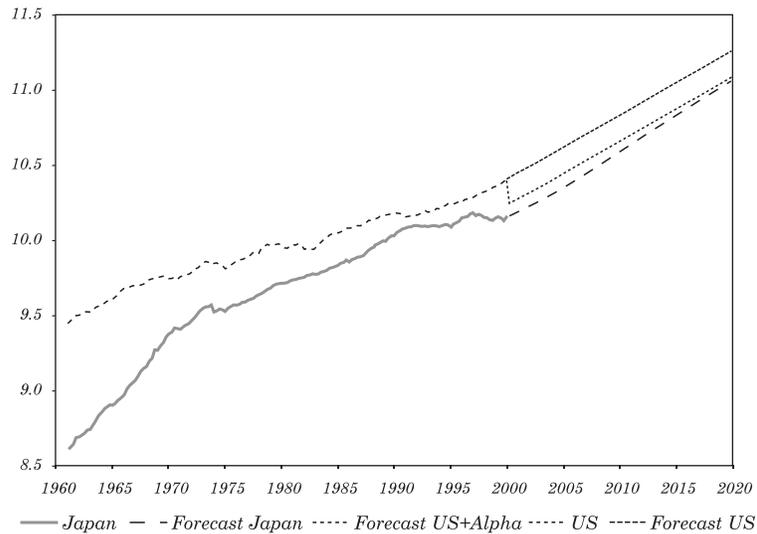
—Figure 9 shows the forecasts for the two countries. It can be seen that they converge to the same growth path, μ_p , but at a constant distance, α , apart. The estimated value of α is -0.174 , implying that the level of Japanese per capita GDP is about 16 percent below that of the United States.

$$\hat{\mu}_{1t}^\dagger = \mu_{1t} - \mu_{2t}$$

4.5 Chile and the United States

The difference between Chilean and U.S. GDP is characterized by an enormous swing in favour of the United States during the 1960s and 1970s, followed by an equally strong movement in favour of Chile.

Figure 9. Forecasts for Bivariate Model with Relative Convergence



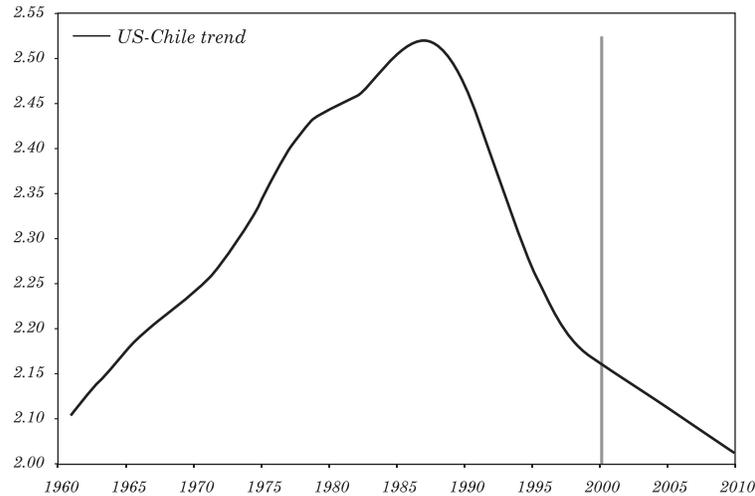
This makes modeling any kind of convergence process extremely difficult. The difficulty is compounded by the fact that the cyclical processes in the two countries have little in common. In the case of Chile, the structural time series model for quarterly per capita GDP is virtually the same as the one fitted to GDP in section 2. Extracting a trend and then subtracting from the United States trend yields the pattern shown in figure 10. Both series are in 1986 U.S. dollars. The forecasts are simply extrapolations made using the smooth trend model.⁴

5. CONCLUSION

This article has described an extension to the class of structural time series models which allows more clearly defined cycles to be extracted from economic time series. This was illustrated with U.S. GDP. The attraction of this model-based approach is that the filters implicitly defined by the model are consistent with each other and with the

4. Fitting a smooth trend model results in only the slope disturbance being nonzero. This is not surprising since the series is constructed from two estimated smooth trends.

Figure 10. Difference in Underlying Levels of U.S. and Chilean Real Per Capita GDP, in Logarithms



data. Furthermore, they automatically adapt to the ends of the sample, and root-mean-square errors can be calculated, if desired. The models can also be used to gain insight into the more ad hoc filters used in business cycle analysis, indicating when it might be appropriate to use them and when they can lead to serious distortions of the kind that can arise for the HP filter and band-pass filters. The preferred model for Chilean GDP has two cycles, both of which have a direct and meaningful interpretation in terms of economic activity. This decomposition could not have been achieved by an ad hoc filter.

Bivariate structural time series models allow the information on another series to be taken into account in order to extract better information from a target series. Joint modeling of different countries may also be useful. For example, a bivariate model of Japanese and U.S. GDP appears to give a more informative decomposition of Japanese GDP. The model used can be extended to include a convergence mechanism. This yields more coherent forecasts for the levels of GDP in the two countries.

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