

Global Macro Views – Campaign against Nonsense Output Gaps (CANOO)

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- Small output gap estimates for the Euro periphery make little sense, ...
- because they embed an assumption of negative trend growth post-2008.
- Allowing for a permanent output loss post-2008 and slower trend growth, ...
- we derive output gaps that are much larger than consensus estimates allow.
- Our larger output gap numbers are consistent with Phillips curve evidence, ...
- helping to explain why core inflation has remained so low in the periphery.

Consensus is that the degree of economic slack on the Euro periphery has diminished sharply since the global financial crisis. IMF output gap numbers are a good illustration of this. Estimates in the latest **World Economic Outlook** say that Spain’s 2019 output gap is +0.7 percent, meaning that GDP is slightly above potential, while Italy’s gap is -1.0 percent, i.e. GDP is a bit below potential. These numbers strain credulity when seen in a cross-country perspective. Exhibit 1 shows that the IMF’s output gap estimate for Spain is the same as Germany (horizontal axis), even though GDP per capita in the latter has grown a cumulative 12 percent since 2007, while Spain has registered only 1 percent growth (vertical axis). The same is true for Italy and Australia, which have similar output gap estimates, although Australian real GDP per person is up 10 percent since 2007, while Italy’s is down 8. This **Global Macro Views** examines the underlying assumptions going into small periphery output gap estimates and finds that they are implausibly adverse, implying negative trend growth in some cases over the last decade. Allowing for a permanent output loss post-2008 and trend growth that is a third of its 2001-7 pace, we find output gaps that are substantially larger than conventional estimates allow. Our estimates are backed up by evidence from Phillips curves, which show core inflation has not risen in a way consistent with “supposed” tightening in labor markets.

Exhibit 1. Consensus output gap numbers ...

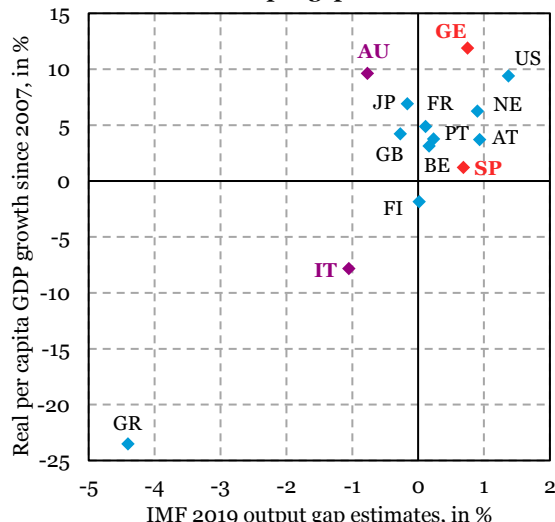
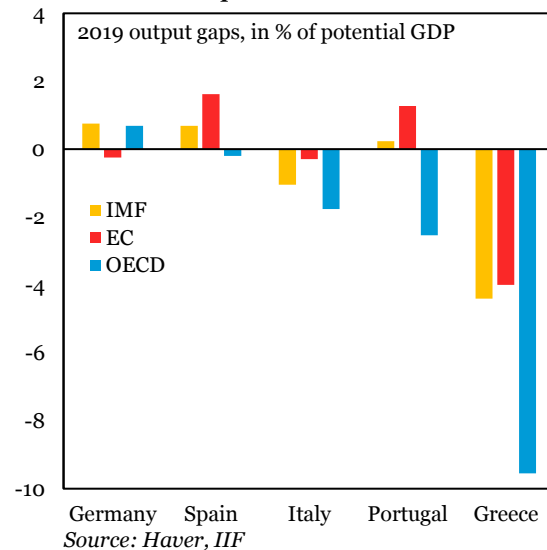


Exhibit 2. ... can be quite hard to rationalize.



Output gap estimates from the IMF, OECD and European Commission (EC) have a common theme, which is that the degree of economic slack on the Euro periphery is small (Exhibit 2). Indeed, the EC (red) says that Spain and Portugal have positive output gaps this year (GDP above potential), even as its estimate for Germany is slightly negative (GDP below potential). These estimates are hard to square with economic reality, given that Germany has substantially outgrown both places over the last decade. The underlying issue is that these numbers don’t capture “potential,” i.e. activity levels consistent with stable inflation, and instead seem to be more about capturing realized outcomes over the last decade. That has the effect of “explaining away” stagnant growth outcomes and economic slack, which we now illustrate for Italy. In the period from 2001-7, real GDP growth averaged 0.9 percent per year. Assuming a permanent output loss of 5 percent in 2008 and trend growth of a third of its pre-crisis level,

this puts potential GDP about 4 percent above actual (Exhibit 3), in contrast to IMF, EC and OECD estimates, which “bend down” to meet actual GDP, implying negative trend growth over the last decade. This seems an extreme assumption to us, which means that slack – and thus deflationary forces – are likely much larger than consensus allows.

Exhibit 3. Italy's output gap still looks large, ...

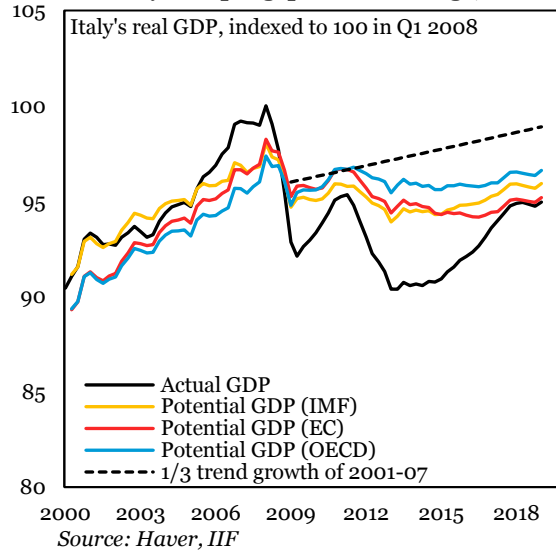
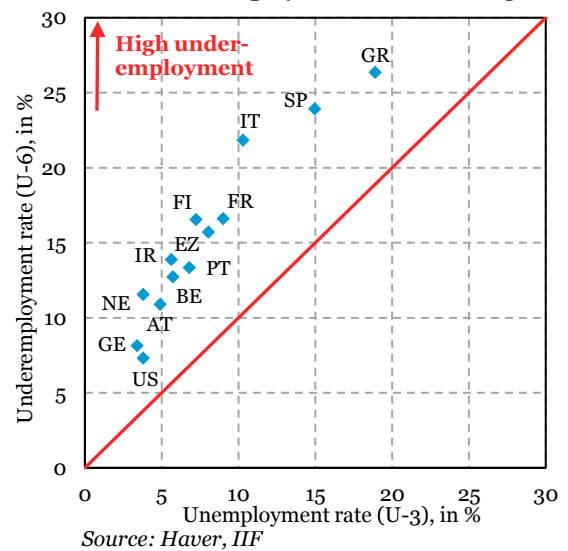


Exhibit 4. ... and unemployment is also still high.



This analysis is consistent with data from labor markets, where Exhibit 4 shows that underemployment remains very substantial on the Euro periphery. Indeed, standard estimates for structural unemployment have drifted up in the last 20 years for much of the Euro periphery (Exhibit 5), in contrast to Germany and the US, where perhaps the biggest macro surprise recently has been how low unemployment can fall without sparking rising inflation. Evidence from Euro zone Phillips curves is consistent with this. Core HICP inflation in Italy remains far below where history suggests it should be if EC structural unemployment estimates are to be believed (Exhibit 6). Slack and deflationary momentum remains large in the periphery.

Exhibit 5. Structural unemployment numbers ...

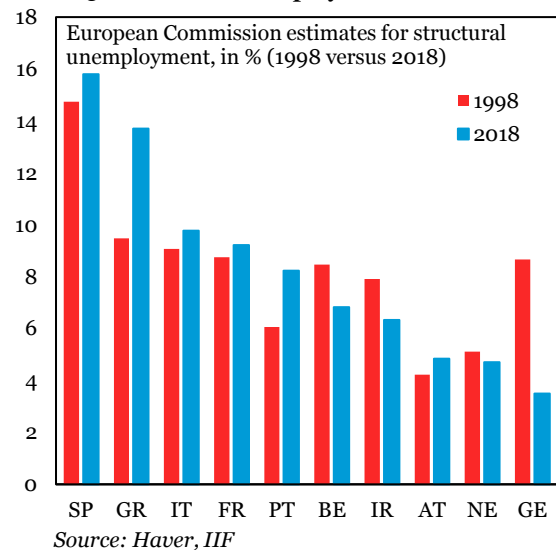


Exhibit 6. ... look too high given low inflation.

