

Global Macro Views – The Growing Debate over Output Gaps



INSTITUTE OF
INTERNATIONAL
FINANCE

October 3, 2019

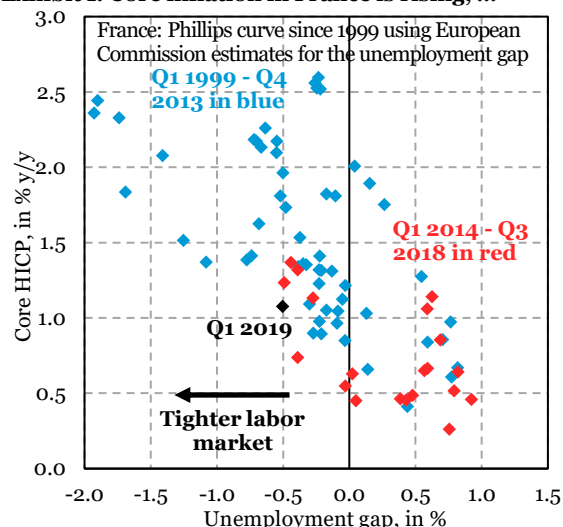
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- We started the Campaign against Nonsense Output Gaps (CANOO) earlier this year, ...
- arguing that consensus estimates for Euro periphery output gaps underestimate slack.
- Alongside the IMF and OECD, the European Commission provides such gap estimates, ...
- and has now responded to our campaign with a detailed article touching on key issues.
- European Commission estimates in many ways reflect the state-of-the-art in this area, ...
- and this **Global Macro Views** provides some perspectives from our CANOO campaign.

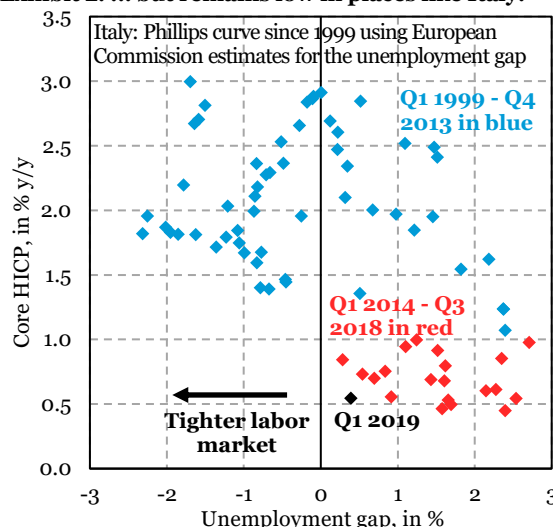
We began our Campaign against Nonsense Output Gaps (CANOO) [early](#) this year, arguing that widely-used estimates for Euro periphery output gaps, including from the IMF, the European Commission and OECD, [understate](#) the true degree of economic slack. Our focus has been on confronting “consensus” output gap estimates with data, to see how they stack up against simple macro screens. One such screen is the [Phillips](#) curve, where persistently low inflation suggests periphery gaps are still big. Another is to look through the lens of labor markets, where depressed [employment](#) among prime-age men points to sizable economic slack. Last week the European Commission responded to CANOO with an [article](#) making three points: (i) weak inflation reflects supply shocks like low oil and raw material prices, so doesn’t signal large gaps; (ii) the Euro zone current account surplus is similarly not an indicator that gaps are wide; and (iii) low potential is the reason Italy doesn’t have an output gap, even after many years of stagnant growth. A key objective of ours has always been to promote dialogue and debate, and this is exactly what the Commission, whose work on output gaps is state-of-the-art in many respects, does here. This **Global Macro Views** provides a CANOO perspective and a few discussion points.

Exhibit 1. Core inflation in France is rising, ...



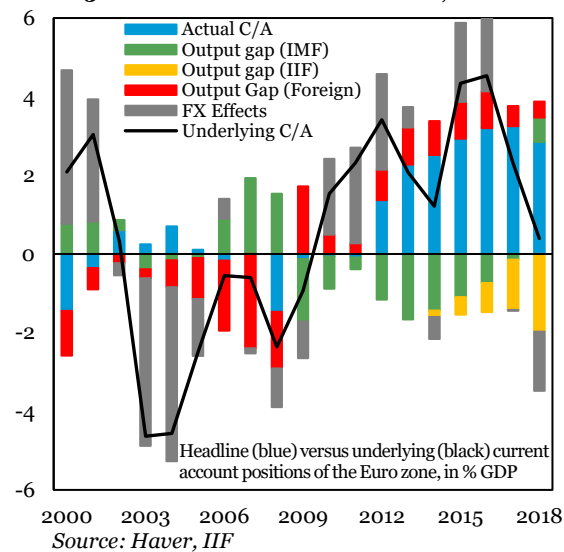
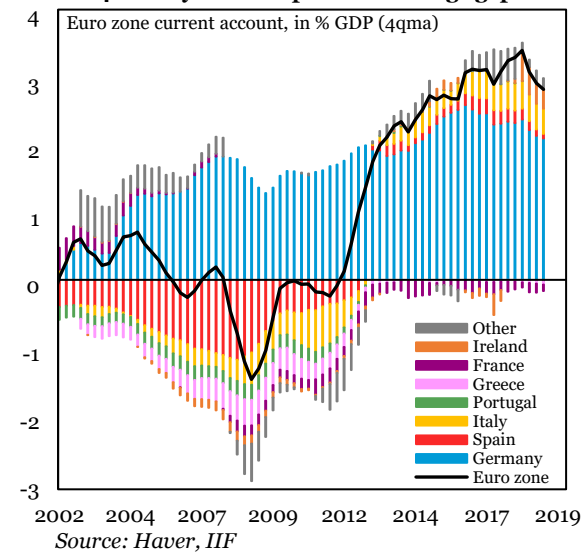
Source: Haver, IIF

Exhibit 2. ... but remains low in places like Italy.

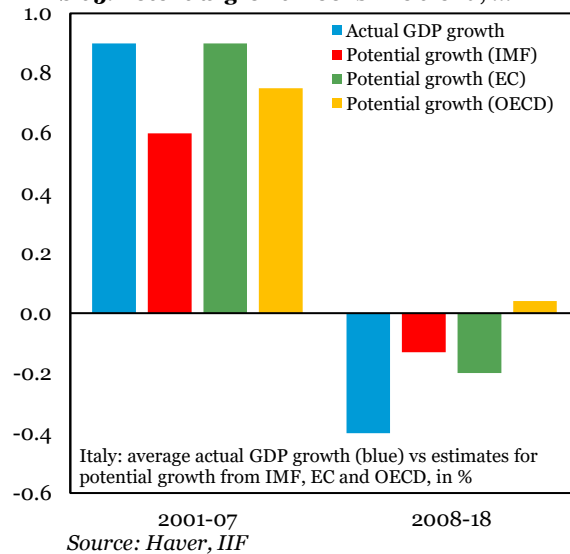
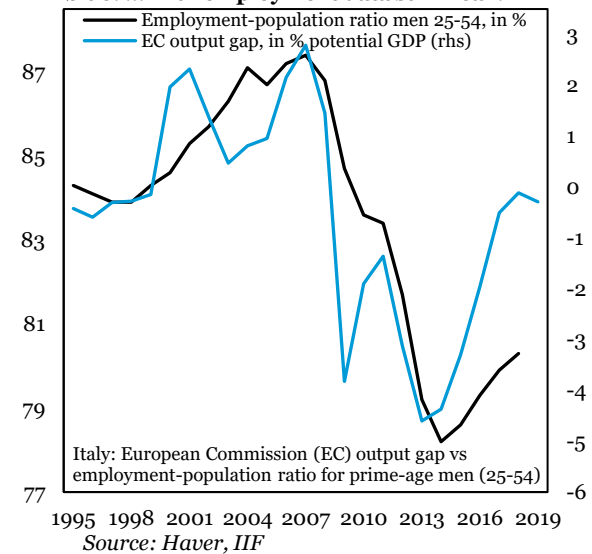


Source: Haver, IIF

The Commission is right to say supply shocks can distort the inflation picture, sometimes for considerable periods of time. For one thing, that’s why we use core HICP inflation, which reduces the role that supply shocks play. For another, and more importantly, our focus is on the divergence of core inflation between the Euro zone core and periphery. Countries like France and Italy face similar supply shocks, but the link between core inflation and the unemployment gap (calculated using Commission NAIRU estimates) is different. Core inflation in France rises in line with a tightening labor market (Exhibit 1), while it doesn’t for Italy (Exhibit 2). This cross-country perspective “within” the Euro zone reduces the distortive effects from supply shocks. It also supports the Commission NAIRU estimate for France, while suggesting that Euro periphery NAIRUs, including for Italy, may be lower than Commission estimates allow.

Exhibit 3. The Euro zone current account, ...**Exhibit 4. ... may be in surplus due to large gaps.**

Our focus on the current account is somewhat [different](#). If we accept the possibility that the Euro zone still has a sizable output gap – assume two percent (GDP below potential) for the sake of argument – does demand compression on the Euro periphery explain the emergence of the current account surplus? When we use standard trade elasticities to “close” this kind of gap, the underlying, cyclically-adjusted current account is near balance (Exhibit 3), which argues that much of the Euro zone surplus reflects an internal imbalance (domestic demand compression and large output gaps), not an external misalignment (Euro undervaluation). This is consistent with the evolution of the Euro zone current account, where the move into surplus has been powered by periphery deficits switching into surplus (Exhibit 4).

Exhibit 5. Potential growth looks like trend, ...**Exhibit 6. ... with employment data still weak.**

The last Commission point is the most important. It is quite right that Italy’s trend growth has slowed sharply from before the global financial crisis (Exhibit 5). The key question is whether this slowing reflects a drop in “potential,” as opposed to lasting fall-out from the 2011/2 sovereign debt crisis, which depressed investment and employment. One perspective on this is employment for prime-age men (to control for rising female participation over time), which suggests that Italy’s output gap is larger than Commission estimates allow (Exhibit 6). All that said, the Commission is right to emphasize the meaningful uncertainty surrounding any kind of slack estimate, in addition to the considerable degrees of flexibility that apply to its surveillance and fiscal assessments.