EU-Budget Rules Need Reform: Reference to Nonsense Output Gaps Keeps Economy Down

There is a much needed discussion in European policy circles about simplifying the budgetary surveillance process. One possible and much needed reform is to do away with the reference to „structural" budget deficits, as the „campaign against nonsense output gaps" has shown. Its protagonists have just issued another damming paper. ...

European budget rules are strict. They limit the "structural" budget deficit to 0.5 percent of gross domestic product (GDP). But they are also considered flexible when it comes to stimulating a sluggish economy. Then, according to EU rhetoric, higher deficits will be allowed. In reality, however, the EU Commission prevents this leniency, which should be quasi automatic, by the counter-intuitive way they estimate the "structural" deficit.

Only the part of the deficit that is not due to short-term economic fluctuations is considered "structural" in the sense of the budget rules. It is this structural part of the deficit only, that is assumed to reduce long-term debt sustainability.

In principle, the recourse to the structural deficit in the budget rules gives governments the freedom to accept higher deficits if - as in Italy - the economy is doing badly. Otherwise they would have to cut expenditures in the downturn and thereby reinforce the slump.

Rules Are Causing Pro-cyclical Budget Policies

In practice, however, the latter is exactly what they are forced to do. The sad reality is, that countries with poor economic development do not get any more lenient treatment than countries with economies that are running smoothly or are even booming.

But where have the margins gone that the fiscal rules provide according to the letter? The short answer is: They have been eliminated by the calculation model which the EU Commission uses to estimate the structural deficit.

Budget scope is only granted to countries who are diagnosed with an unfavourable situation in the business cycle, but not to those who are diagnosed to have low growth potential for "structural" reasons. If the diagnosis should be that weak growth is caused by structural factors, then there is no extra budget scope. There are, however, no objective criteria to distinguish the two cases, structurally caused weak growth versus weak growth caused by a temporary demand shortfall.

To help with the diagnosis, the commission is calculating a number for potential growth. This is the growth rate of the economy that supposedly would not lead to overheating or (increasing) under-utilization of production capacities.

This procedure is at the core of the issue. To get to this number, the commission simply calculates something which is akin to a moving average of past growth rates and calls this "potential growth".

It is this method of calculation which can produce the diagnosis of near-full utilization of resources, even at high rates of unemployment and low or zero growth rates.

Revealing Comparison

The problem can be illustrated by comparing Spain and Italy with Germany. German economic output has increased by a good 10 percent per capita since 2007, the Spanish one has stagnated, the Italian one has dropped significantly. Nevertheless, the model of the EU Commission diagnoses a Spanish economy running above potential and for Italy a minimal under-utilization of production capacities, very similar to Germany's. This goes together with double-digit unemployment rates in both southern countries and record low unemployment in Germany.

In the case of Spain, even an unemployment rate of over 20 percent at times did not prevent the Commission from diagnosing a slightly overheated job market - much to the (understandable) annoyance of the government in Madrid.

Economists and historians from the USA have put the spotlight on such inconsistencies with a "campaign against nonsense output gaps", which they started in Spring 2019 and keep going. The campaign goes by the acronym CANOO, on social media. The main initiators are Robin Brooks, chief economist at the Institute of International Finance (IIF), the industry association of major international banks, and his IIF colleague Greg Basile, as well as Adam Tooze. Tooze is a renowned historian at Columbia University with economics training.

> We look at output gaps through the lens of common sense.

The campaign is not only critical of the calculation method employed by the EU-Commission, but also of the one used by the International Monetary Fund (IMF), which produces similarly strange results. The calculation method of he industrial country association OECD is a tad more realistic. "We look at output gaps through the lens of common sense," write Brooks and Basile.

Through this lens they see countries with good economic development and low unemployment, which are said to be economically no different from countries with weak economic activity and high unemployment. And they see stubbornly low inflation rates, even though the respective economies are said to be on the verge of overheating.

Philipp Heimberger, an economist at the Vienna Institute for International Economic Comparisons (wiiw), strongly supports the Brooks and Tooze campaign. In 2017 and 2019 he wrote two studies - together with Jakob Kapeller and Jakob Huber – which feature prominently in the analysis of the Americans (see references below).

In a contribution for the German online magazine "Makronom" Heimberger recalculated in summer, how far gdp lags is below the level that would have resulted if the growth trend before the financial crisis had continued from 2009 to 2019. In Germany there is no gap, in Italy it is 16.5 percent, in Spain almost 30 percent, in Greece almost 50 percent.

Trend Turns into Structure

In each case, the EU model has revised the estimate of the production potential down almost in lockstep with realized growth rates. That means: All production losses are deemed as structural by the commission, none are caused by a lack of demand. Accordingly, they do not result from budget policies that are too tight and nothing can be done by Keynesian policies of demand management, i.e. spending more money.

As government revenues collapse because of the poor economic situation, governments don't get the break that was promised, but rather have to cut down spending or raise revenue at the same rate.

The reason for these constant downward revisions of production potential in tandem with poor economic development is hidden deep in the model makers' engine room. The main reason for this is a method of trying to

identify a long-term growth trend. Only deviations of the growth rate from this trend are considered to be cyclical fluctuations. The trend is determined using a so-called Kalman filter, which is, loosely speaking, a moving average of recent years.

This method emphasizes the recent past. If a growth weakness lasts for a few years, the growth trend is revised downwards very quickly. The weakness is then no longer considered cyclical but structural. The stated principle that one should not cut government expenditure in a downturn is thus overridden, while the public is told and still believes that it is respected.

EU Commission Defends Approach (halfheartedly)

Tooze and Brooks got the Commission to justify itself publicly in September. On the economics portal "Vox", high-ranking Commission representatives explain why their critics are "conceptually and empirically wrong" in arguing that the Commission is misjudging the financial supervision of the member states. The authors are Marco Buti, Director General for Economic and Financial Affairs, Werner Röger, Head of the Models Unit, and four other Commission economists.

In their response entitled "Potential output and EU fiscal surveillance", the Commission representatives do not address the main criticism that the calculation method would automatically reinterpret longer-lasting economic crises as weak growth potential. They argue that it is no wonder that the output gaps of Germany and Italy have developed in the same way despite the very different growth rates. According to them, this is because both growth and potential growth were three times higher in Germany than in Italy. They thus assume that their own estimate of potential, which has been attacked by the critics, is correct.

Critics are correspondingly unimpressed by the Commission's argument. "The article does not provide an answer to the central criticism of the campaign against nonsense output gaps", judges Philipp Heimberger: namely that the estimates of output gaps are quasi-automatically adjusted downwards in line with actual growth.

The critics' argument that permanently low inflation makes full utilization of production capacities implausible does also not stand, according to the Commission. Their explanation sounds quite lame, though: they say that there are many influences that have an impact on the inflation rate, including low wage increases and special influences such as falling oil prices.

Robin Brooks counters that core inflation rates, which are stubbornly low, largely exclude special factors. Low wage growth, which the Commission representatives cite as an explanation for low inflation, is used by Brooks as an argument for his own view: "Low wage growth is a recognized indicator of under-utilization of the labour potential and thus contradicts the thesis of full utilization of production capacity".

The Critics Pile On

Brooks, Heimberger and Tooze have teemed up, to write a joint paper with the title “Inflation-Consistent Output Gaps” (mimeo), which they have just released. They econometrically estimated the usual correlation of unemployment and inflation. More unemployment usually leads to lower wage demands and lower inflation. With this, they calculated the core-inflation rate that should prevail in different European countries, if production capacities were used normally. The result was much higher for many countries than actual inflation rates. They translated the shortfall into an estimate of the output gap of the respective countries.

> Our estimates imply that the fiscal stance in the Euro zone has been,and remains, too tight

The results are striking. For example, persistently low core inflation suggests Italy's GDP is around 7 percent below potential, far larger than the European Commission's gap that is near zero. Spain is similar. They find GDP is 5 percent below potential, while the European Commission says itis 1.5 percent above potential. Translating this output gaps into their own estimates of "structural" budget balances, they come up with budget surpluses of 0.7, 1.6 and 2 percent for Spain, Italy and Portugal, respectively. For Greece it is a staggering 4.4 percent, which is, however, not so far from the Commission's estimate of a structural surplus of 3.7 percent. They conclude: "Our estimates imply that the fiscal stance in the Euro zone has been,and remains, too tight. They might as well have said "much to tight".

The Issue Could Soon Haunt Germany

What has so far mainly been an issue for the southerners could soon become important for Germany, which is stubbornly resisting calls to make the budget rules more flexible and sensible. After all, not only the EU rules on budget control, but also the German rules on deficit limitation are based on the EU method for calculating the output gap. If the German economy should slide into recession after teetering on the brink of it for several quarters, those rules and the way the "structural" deficit is calculated, will start to bite. [12.02.2020]

References

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