We wrote about our Campaign against Nonsense Output Gaps (CANOO) last week.

Our campaign surveys output gaps from the IMF, European Commission and OECD, ...

using a cross-country perspective to see if gap estimates pass a “common sense” test.

Our test compares cumulative per capita growth in the last decade to gap numbers, ...

finding that Euro periphery output gaps are too narrow given weak or negative growth.

If we allow for sizable 2008 GDP drops and slower, but positive trend growth since, ...

we estimate periphery output gaps that are often twice as large as consensus numbers.

Euro periphery slack is likely still large, which helps explain still subdued core inflation.

The basic intuition behind our Campaign against Nonsense Output Gaps (CANOO) is to look at prevailing gap estimates through a cross-country lens, to see whether they pass a simple “common sense” test. We examine if countries that have seen strong per capita growth since the global financial crisis have output gap estimates that are systematically larger (GDP > potential) than countries where growth has lagged or been negative. This ends up not being the case, with countries that have seen strong growth often stacked above countries with weak growth. Simple examples are Germany and Spain, which according to the IMF have similar positive output gaps (GDP > potential), although the former has substantially outgrown the latter. Australia and Italy are another example. Both have similarly negative gaps (GDP < potential), even though Italy’s per capita GDP has shrunk, while Australia is up significantly. We propose an alternative methodology as a check for prevailing output gap estimates. We allow for a permanent GDP contraction in 2008, but assume positive, if lower, trend growth thereafter. This avoids the kind of “bending down” that prevailing potential GDP estimates exhibit, which is the economic equivalent of explaining away poor outcomes. Our alternative gaps are often twice as large (GDP < potential) than prevailing numbers, which suggests Euro periphery slack could still be very large.

Exhibit 1 shows IMF output gaps for 2019 on the horizontal axis, where a negative number gives, in percent, the amount that GDP is below potential. The vertical axis gives the cumulative change in real per capita GDP since 2007, where a negative value means contraction. Simple economic intuition says that countries with strong economic growth should also be more likely to have positive output gaps (GDP > potential), but that is not the case. Instead, strong growth countries are “stacked” above weak ones, so that output gaps – almost regardless of economic performance – are similar. Exhibit 2 shows the same is true for estimates from the European Commission, where Italy and Germany – to name just one example – have similar gaps even though the latter has significantly outgrown the former. Estimates from the OECD are no different (Exhibit 3), with Spain and the US
having similar output gaps despite very different growth. The underlying problem is that potential GDP estimates look a lot like moving averages, which “bend down” when activity is weak for long periods. That explains away cross-country differences in economic performance, even when those are economically meaningful. For example, it is possible that weak Euro periphery growth reflects policies that are too restrictive.

We propose an alternative approach to estimating potential. We allow for a permanent (5 percent) GDP drop in 2008, but thereafter assume trend growth stays positive, albeit at a slower pace. For Italy we assume trend growth is 1/3 of its 2001-07 pace (Exhibit 4). We assume the same for Spain (Exhibit 5). For Greece we assume 1/10 of the pre-crisis trend, while for Portugal, where pre-crisis growth was lowest, we assume 1/2. Exhibit 6 shows the resulting gaps (gray), which are often twice as large as those from the IMF, European Commission and OECD. Our approach obviously has short-comings, but its main advantage is to steer away from a “bending down” of potential GDP, which – in the end – is just as arbitrary as our linear extrapolation. We conclude Euro periphery slack is likely larger than conventional estimates allow.