



Dipartimento
del Tesoro

Fiscal rules based on structural budget deficits. Can the methodology be improved?

Meeting on Assessing the European Fiscal Framework
Brussels, Bruegel seminar, November 17, 2014

Lorenzo Codogno

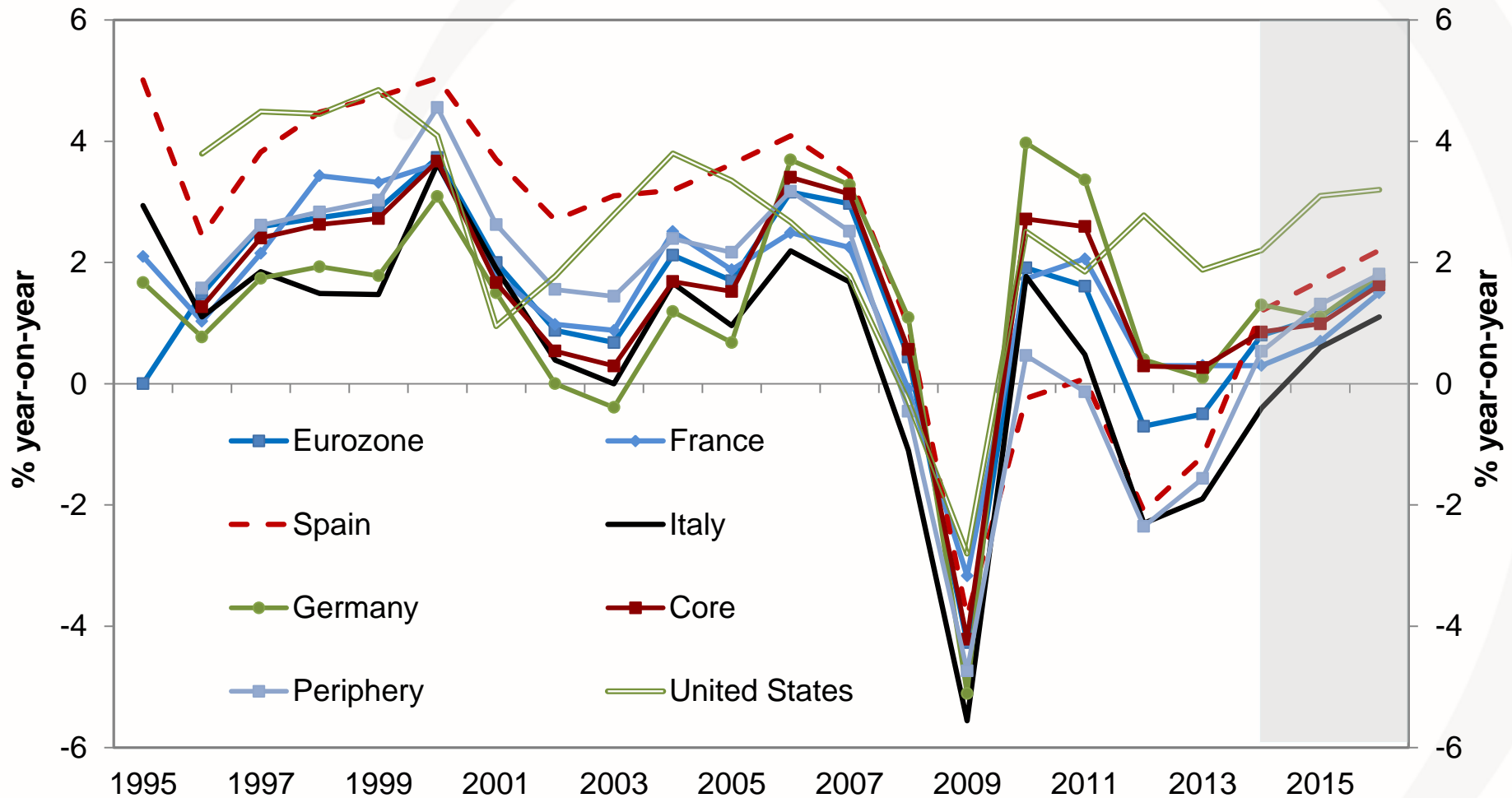
Italian Ministry of Economy and Finance



Fiscal rules: are they fit for prolonged stagnation?

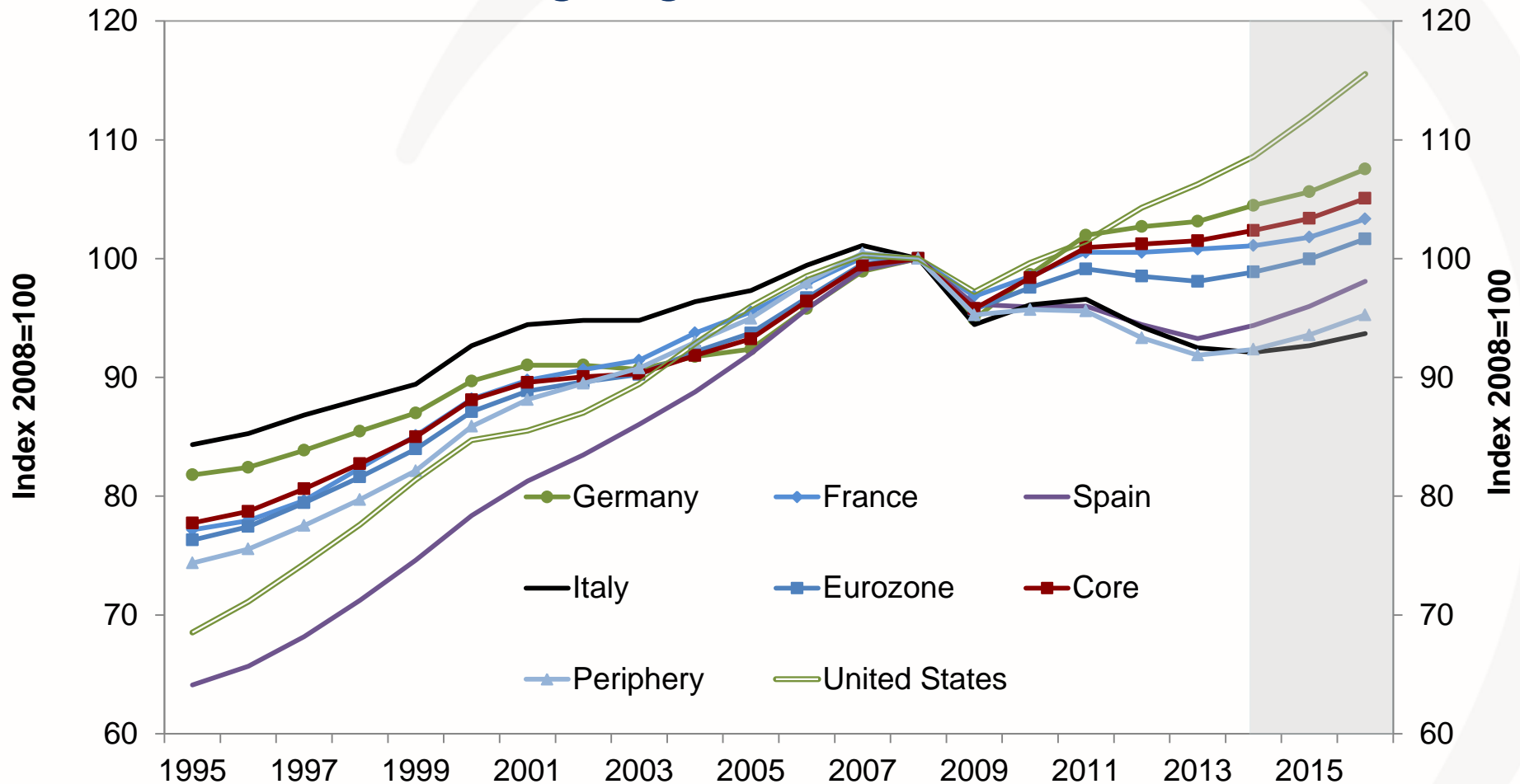
- **Supply-side reforms:** How can we provide incentives for reforms within the existing fiscal framework? Do CAB estimates need to consider the effects of reforms?
- **Lack of aggregate demand:** Is the current policy mix a correct stance for the Euro Area? Have CAB estimates factored in lack of demand?
- Are European fiscal rules appropriate for the current economic environment? Can **fiscal rules based on structural budget deficits** be improved?

What is the post-crisis potential of the economy?



Source: Eurostat, BEA, European Commission (forecasts)

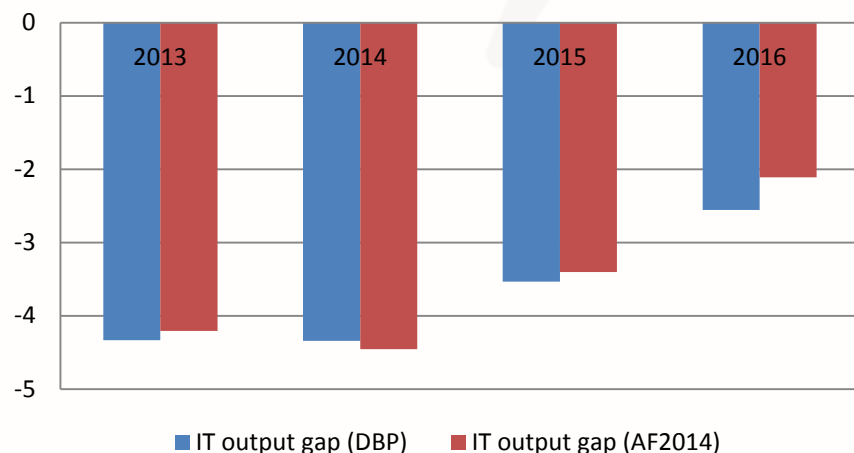
Are GDP level losses going to be recovered?



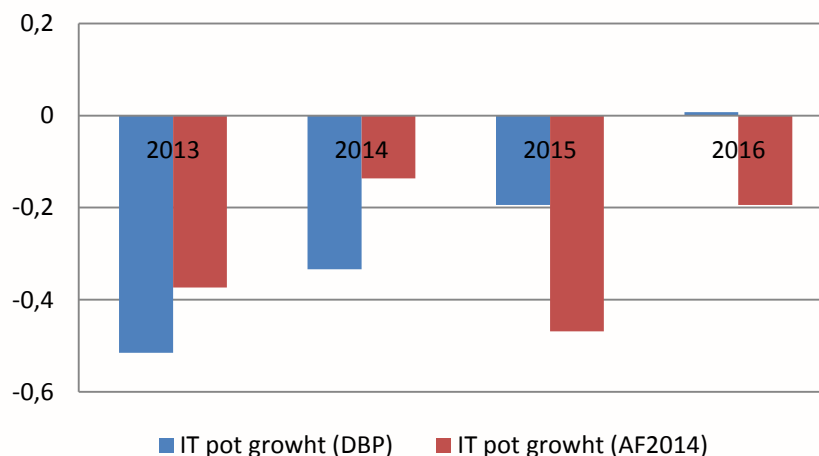
Source: Eurostat, BEA, European Commission (forecasts)

Revisions are partly due to different forecast horizons

Output gaps



Potential Growth

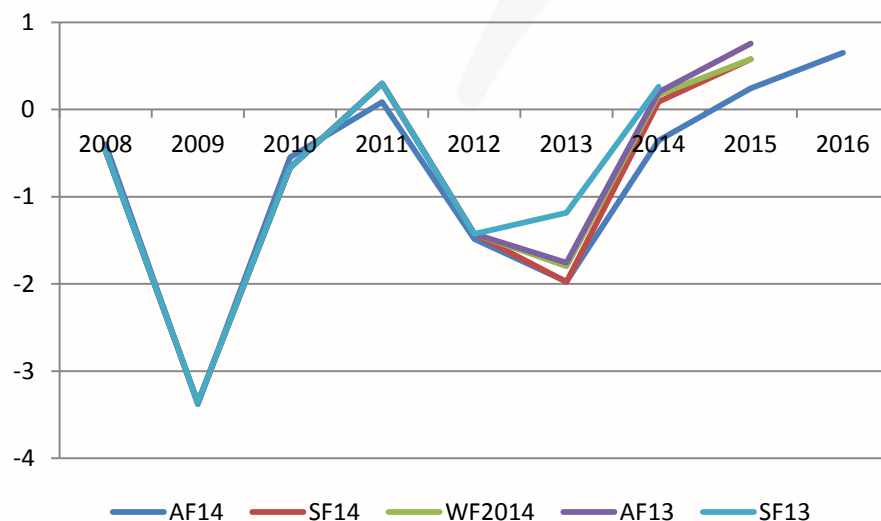


Source: IT 2015 Draft Budgetary Plan and 2014 Commission Autumn Forecasts

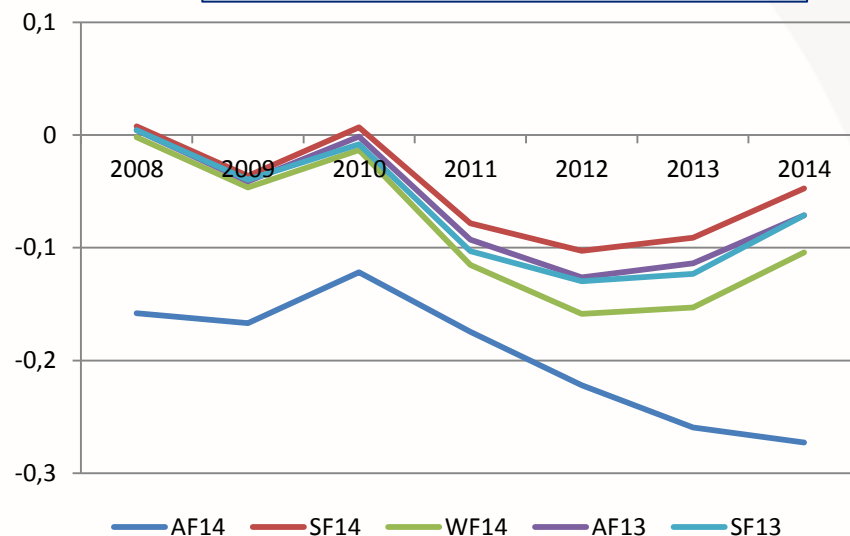
- **Very negative potential growth: hysteresis issue. How much is real and how much is derived from the model itself?**
- **AF2014 and DBP: very similar GDP growth forecasts for 2014-2016. Yet substantial differences in OG and potential growth.**
- **Different forecast horizon: 2018 for DBP vs 2016 for AF2014.**

Labour contributions to potential growth

Growth in total Hours



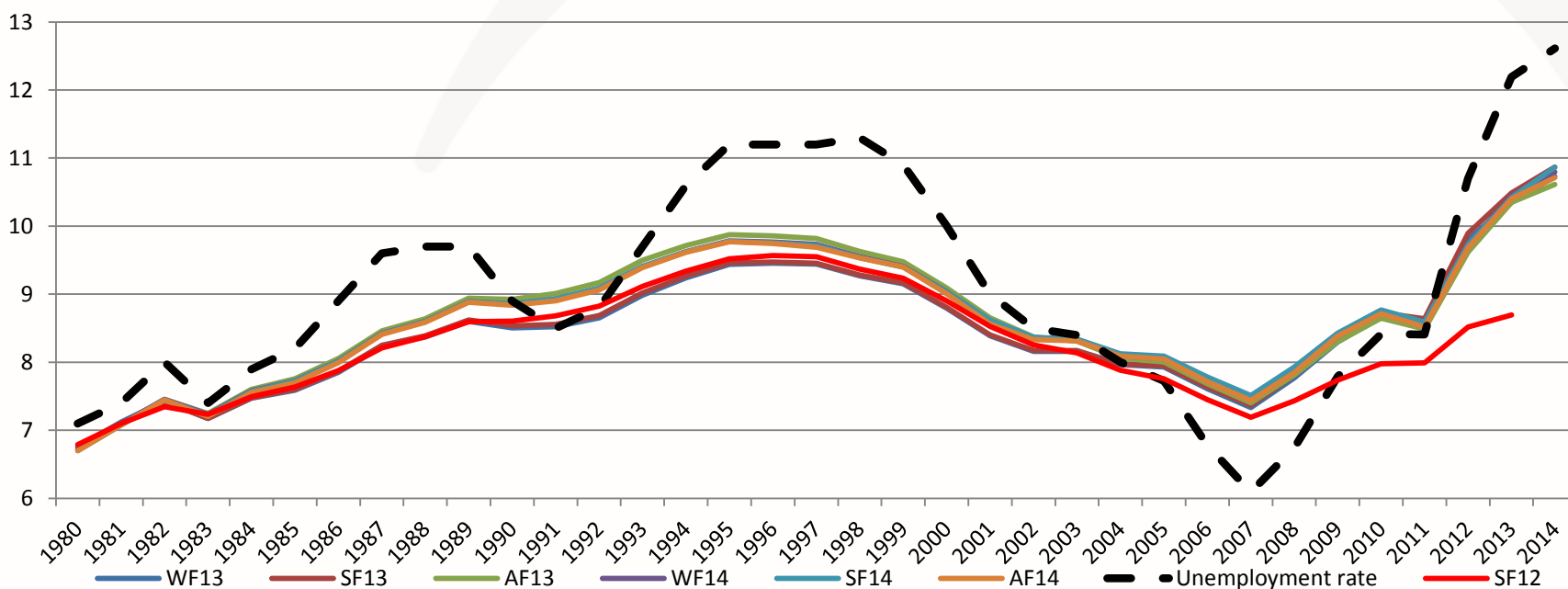
TFP contribution to Potential



Source: Commission Forecasts - different vintages

- Small revisions in total hours growth determine changes in the Solow Residual and, in turn, in TFP.
- For Italy need to check hours worked. There are probably inconsistencies due to “Cassa integrazione” (wage supplementation fund).

NAWRU revisions: impact of variance bounds as of SF12

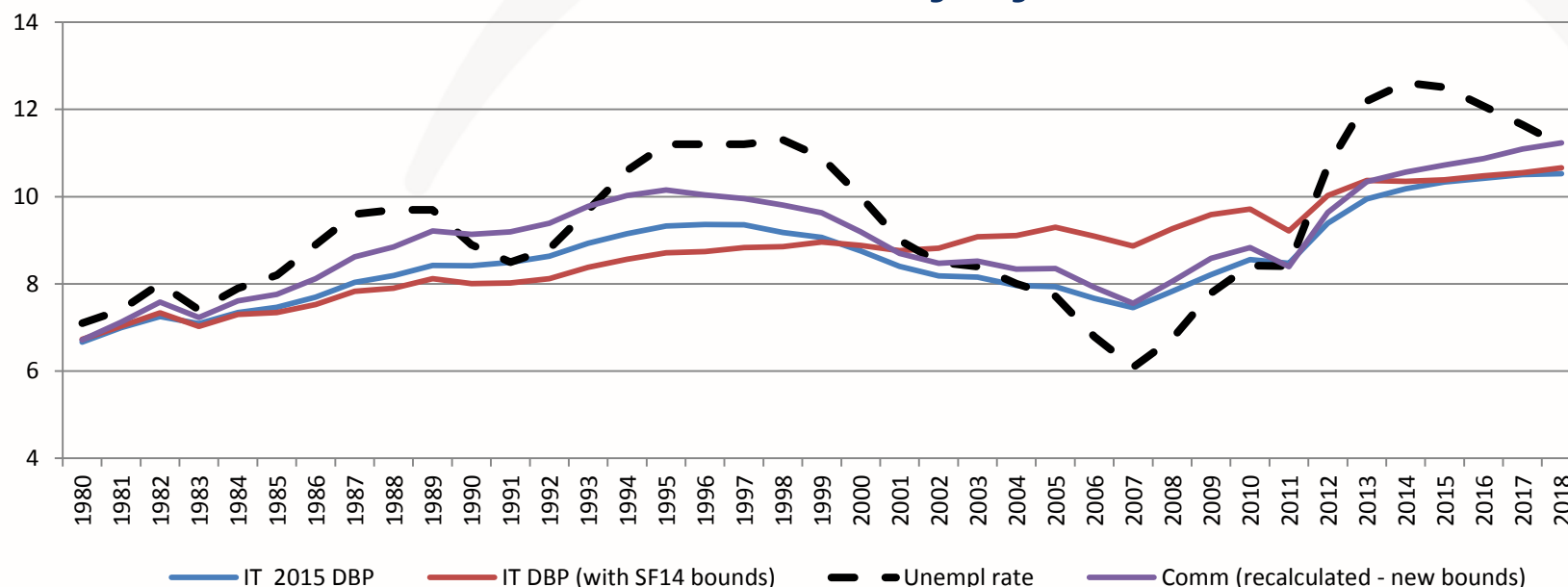


Source: Commission Forecasts - different vintages

- The 2012 rise in unemployment led to an upward revision of the NAWRU.
- For a given set of data, many combinations of variance bounds with different outcomes both for real time and forecast estimates.
- Large pro-cyclicality over the forecast period due to variance bounds.

SOURCES OF REVISIONS

IT NAWRU estimates: Discretionary cycle variance bound

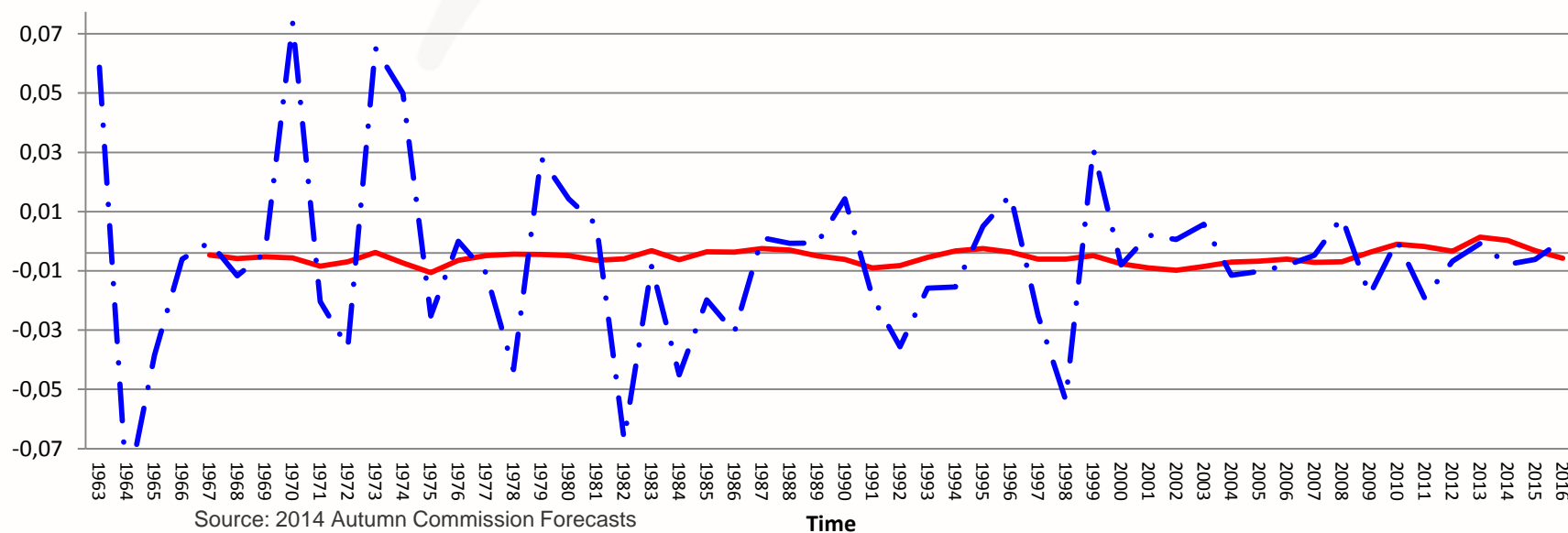


Source: Italian 2015 DBP and Commission recalculation

- With higher variance bounds, DBP NAWRU are more stable at the end of the forecast period (partly due to the expected impact of structural reforms).
- With lower variance bounds, NAWRU recalculated by Commission increases at the end of forecast period (no apparent meaning).

Phillips curve: very poor fit for Italy

Observations (---) and fitted values



- Phillips curve for Italy must be completely revisited.
- Solution: anchored inflation expectations as in new OECD model?

NAWRU estimates on Italy

- Too much **discretion** in managing variance parameters.
- For Italy, the **pro-ciclicity of NAWRU** is due to the interaction between trend and cycle bounds.
- Different **estimation strategies**: the Commission (Italy) decreases (increases) cycle bound variances over time increasing (stabilising) NAWRU over the forecast period → need to find ways to reconcile the two strategies.
- Need to better reflect on the **underlying macroeconomic assumptions**.
- Explore new models such as the one of the **OECD**.

Potential labour contribution

$$\bar{L}_t = PARTS_t * POPW_t * HOURST_t * (1 - NAWRU_t)$$

- With the exception of the NAWRU, each variable is **extrapolated “out of sample”** by univariate autoregressive models and then filtered with HP filter.
- A univariate extrapolation process increases the **probability of forecast errors** even in real time.
- Need for a **multivariate method** for estimating the whole potential labour contribution (e.g. vector autoregressive model).
- Quarterly frequency to combine timely statistical information.

Can procedural improvements be introduced?

- **Extend the Commission forecast horizon:** same horizon for MSs and Commission estimates (possibly the one included in Stability and Convergence programmes).
- **Decentralised process:** give to Commission's country desks the possibility to estimate potential output and make the underlying macroeconomic assumptions.
- **Discuss EC/MS forecast beforehand:** wider OGWG mandate.
- **No recalculation** by the Commission of MSs' estimates, especially when these estimates are certified by fiscal councils.

CONCLUSIONS

Can the CAB methodology be improved?

- **Well-identified drawbacks** mainly due to potential output and output gap measurement. We have to live with them.
- CAB are very **volatile** indicators subject to **deep revisions** which have become larger in recent years. The objective of any change in the methodology should be to limit volatility and revisions, and thus the risk of **excessively tight pro-cyclical policies**.
- Promising results at the OECD.
- **Economic judgement** must play a role.