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Bah humbug

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The output gap and inflation: most of the feedback I received on last week's blog focused not on my criticism of the OBR for failing to run its output gap estimates against an inflation yardstick but on the shortcomings of the output gap as a determinant of inflation. This is interesting since the output gap is defined in terms of inflation and yet, as George Buckley's SBE Rybzynski-prize-winning essay showed, the effect of the output gap on inflation appears to be waning (while the effects of global factors and the exchange rate appear to be growing). That may be true (and my criticism of the OBR hasty) but it does not make estimates of the output gap any the less elusive. The experience of the 1990s recovery was that early estimates of the output gap were pessimistic and that, once a decent recovery is under way, the supply side of the economy is able to surprise on the upside. I would expect no less this time around.

Those whom the gods wish to destroy they first make mad: if the maxim is true then the euro area took a big step towards break-up / collapse this weekend. Germany's insistence on a new fiscal compact with increased surveillance (shades of other people's lives), automatic correction mechanisms and fines for non-compliance is economic madness of the first order. As the experience of the financial crisis has shown, if for whatever reason (which may be beyond the control of Government) activity collapses so does the tax base. In a fixed exchange rate regime, where devaluation cannot take up the slack, attempts to limit the effects on the public finances are likely to lead to weaker output with a further adverse feedback on the public finances. Still, if it allows the ECB to take the necessary steps to keep the euro area show on the road, we can live with fiscal compact fiction for a few more months.

With best wishes for Christmas and the New Year: the blog will resume on 5 January.

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The output gap and inflation

Last week I criticised the OBR for making no attempt to relate its historical measure of the output gap to the path of CPI inflation over the same historical timescale. In particular I queried the OBR's assessment that output was consistently above trend in the second half of the 1990s when inflation was trending lower and in the first half of the 2000s when inflation showed no obvious trend in either direction. The implication was that if the OBR estimates of the historical output gap were too pessimistic then perhaps its current estimate of 2.5% in 11q3 (which had been revised down from 4% at the time of the Budget) was also too pessimistic.

The response of my readers was interesting. It was not to agree or disagree with my argument that the OBR should have run its estimates of the output gap against an inflation yardstick. Rather it was to note the shortcomings of the output gap as a determinant of inflation. Perhaps, readers suggested, as far as inflation is concerned, we should be looking at the global output gap since trends in global commodity prices such as oil and food are key short-term determinants of inflation. Perhaps I was looking at the wrong (CPI) measure of inflation and should have used a measure that included, say, asset prices. Or perhaps, though whisper it softly, the output gap is not a very good determinant of inflation over the medium term.

The first point is valid. It is immediately obvious that the inflationary experience of the last year owes nothing at all to the output gap, since there is near-universal agreement that output is below trend (though estimates of trend have been revised steadily lower to accommodate the disappointing productivity performance of the last few years), and (almost) everything to the pick-up in global food and energy price inflation augmented by the fall in the exchange rate (and the 1pp increase in VAT in January 2011). Similarly, as I noted last week, the disinflationary experience of the 1990s and 2000s owed a great deal to falling global goods prices brought about by a huge supply side shock (the entry of China into the global economy).

The second point is also fair since inflationary pressures that come, for example, from excess credit creation are more likely to show up in asset prices than in the goods & services covered by the CPI.

But it is the third point that is really interesting. Since the output gap and trend or potential GDP are defined in terms of inflation – and I quoted the OBR's definition last week ('the difference between the current level of activity in the economy and the potential level it could sustain while keeping inflation stable in the long term'), how can the output gap not be a good indicator of inflation over the medium term? And, if we accept that it isn't a good indicator of inflation over the medium term, how can we measure the output gap in the first place?

This is all getting a bit circular / tautological. If there is a general approach it is to measure the output gap directly either using a variety of cyclical indicators (the OBR approach) or by using various statistical techniques. The measure of the output gap so obtained might then be used in an equation to explain inflation. For example, George Buckley in his Rybzynski-prize-winning SBE essay last year (Spare a thought for spare capacity) estimated an equation that explained CPI inflation by the output gap, inflation expectations and global commodity prices. Interestingly he found that the effect of spare capacity, whether measured by the OECD series for the output gap or by the rate of unemployment, had waned through time.

The logic of basing a fiscal target on trend GDP and the output gap is not to do with inflation but with the effect of the cycle on, and the medium-term sustainability of, the public finances. George Osborne's mandate (a surplus on the structural current budget over the medium term) recognises the importance of the economic cycle with regard to the public finances. It says that when the economy is on trend and the cycle is having a neutral effect there should be a surplus on the current budget. Any borrowing would then be solely for investment (aka Gordon Brown's golden rule) – a sustainable position.

The theory is excellent but, as we saw in the Autumn Statement, it puts an incredible amount of weight on the OBR's ability to measure the output gap today and, just as importantly, its course over the next five years. If, as George Buckley's research suggests, the effect of the output gap on inflation is waning, I may have been hasty in my criticism of the OBR for not checking its measure against inflation. But that does not make the output gap any less elusive in practice. The experience of the 1990s recovery was that early estimates of the output gap were pessimistic and that, once a decent recovery is under way, the supply side of the economy is able to surprise on the upside. I would expect no less this time around.

Those whom the Gods wish to destroy they first make mad

I am repeatedly asked whether the euro (area) will survive and, if so, in what form. I have always answered that from the outset the whole motivation of the euro area has been political and that since, as I see it, the politicians remain committed to keeping the whole (current) show on the road, they will negotiate a way through the present morass. Now, as my use of the ancient proverb suggests, I am not so sure.

The response of the politicians to the sovereign debt crisis that has engulfed the euro area appears to be not that the original Maastricht criteria and the ensuing Stability & Growth Pact were ill-conceived and inapplicable in an economic crisis but that they should be tightened and made legally binding with fines for those countries that stray from the path of fiscal rectitude.

The weekend's deal in Brussels included a new fiscal compact which is to apply to the 17 countries of the euro zone and to the nine euro area outsiders (all except the UK) provided their national Parliaments agree. They key features of the fiscal compact are:

general government budgets shall be in balance or surplus (in practice this is deemed to mean keeping the structural deficit to 0.5% of GDP);

an automatic correction mechanism to be triggered in the event of deviation;

a strict convergence plan agreed in advance with, and monitored by, the Commission for those countries currently not meeting the budget balance criterion (for all I know this means all of them); and

the current system as embodied in the Excessive Deficit Procedure will be modified to include automatic sanctions as soon as a member country breaches the 3% deficit limit.

If there is one lesson that politicians of all hues and in all countries might have been expected to learn from recent experience, it is that in a financial crisis fiscal rules do not work and that, if applied, they are bound to make the crisis worse, not better.

Take the UK for an example. In 2007-08, the financial year before the crisis fully broke, PSNB was 2.4% of GDP with a current budget deficit of 0.3% of GDP. At the time HMT estimated that the economy was a

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little above trend so that the structural deficits were 0.2-0.3pp higher but comfortably below 3% for PSNB and only 0.1pp above the 0.5% structural (general government) current deficit that the new fiscal compact specifies. The stock of government debt was equivalent to less than 40% of GDP, one of the lowest in the EU. (Commentators have frequently noted the irony of the UK being one of the few countries who would have passed both the 3% and 60% limits embodied in the Maastricht criteria and the Stability and Growth Pact.)

We all know what happened next. The financial crisis, which had its origins in the US sub-prime housing market, sparked a global recession characterised by a collapse of world trade. The sharp fall in output reduced the tax base (in countries like the UK, which relied heavily on taxes on housing transactions and from the financial sector, the composition of the fall in output aggravated the effect). As a result PSNB mushroomed, peaking at 11.2% of GDP in 2009-10 while the debt-GDP ratio is heading to a peak of just under 80%. Overall the UK suffered a 9pp increase in PSNB relative to GDP so even if we entered the crisis in great shape (as we did on the debt-income ratio) we would still have exited it with deficits that would have activated the automatic corrective mechanisms of the fiscal compact.

This is exactly what did happen within the euro area in countries like Ireland. Ahead of the crisis, the Irish housing market had benefited from the 2% interest rates set by the ECB and the public finances appeared very healthy on the back of this. Since then there has been a collapse in receipts and, because of their membership of the euro, a loss of competitiveness that has worsened the recession and required even more drastic austerity measures than we in the UK have had to introduce.

The details are largely irrelevant. The simple message is stark: if, for whatever reason (which may be outside the control of Government), output collapses then so too does the tax base. In a fixed exchange rate regime, where the devaluation / export-led escape route is not available, efforts to correct this by cutting spending or raising taxes can/will make things worse by leading to a further fall in output. This is clearly what has happened in Greece where all attempts to bring the budget deficit back under control have so far had minimal effect.

In these circumstances the only rational response is to allow the budget deficit to rise rather than to make the recession worse by a premature attempt to correct the shortfall. This seemingly is lost on the

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Europeans who have signed up for the new fiscal compact with its fiscal discipline and its surveillance procedures (shades of other people's lives) and its automatic sanctions and its correction mechanisms.

Does this collective descent into madness threaten the collapse or break-up of the euro area? I am tempted to answer in the affirmative except that reason is likely to prevail. This is what Anatole Kaletsky thinks; writing in yesterday's Times, he noted that 'it is arithmetically impossible for all the countries in the eurozone simultaneously to deflate their way out of a debt crisis … By imposing permanent austerity on the whole eurozone, the fiscal compact would guarantee permanent depression. And that in turn guarantees that the treaty supposedly agreed last Friday will never see the light of day'.

Simon Jenkins in Tuesday's Guardian took a more apocalyptic stance: 'Under the new "treaty" such [budgetary] disciplines will be doubled and trebled, and blamed on one country, Germany. It must be likely that electorates will refuse to submit. Bond markets will seize up, public spending collapse, unemployment and emigration soar and streets descend into chaos'.

In any case, as the markets have swiftly recognised, the near-term survival of the euro area has precious little to do with what they decide to do about budgetary positions in the medium term. The fiscal compact is the price that Germany is demanding to (allow the ECB to) keep the show on the road. Since, in the interests of survival, 26 countries are prepared to sign up for this madness, I assume the political will is still there to muddle through at least until the next meeting in three months time.

Q4 – still looking positive

This week's data reinforce the message I set out last week that Q4 is more likely to see a small positive number than a small negative number. Retail sales volumes may have fallen 0.4% in November but October was revised up so that Oct-Nov combined were 1% above the Q3 average. December will have to be truly awful for volumes not to be up in Q4 as a whole. Similarly, while the headlines were on unemployment reaching its highest level since 1994, employment rose 38k in September, more than reversing August's fall. Total hours worked rose from 913.7m to 918m, the highest since February. On both counts Q3 ended with a bit of momentum which should run through to Q4.

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