

Response to Cottarelli et al. thesis that the "methodology agreed at EU level" underestimates potential output in Italy

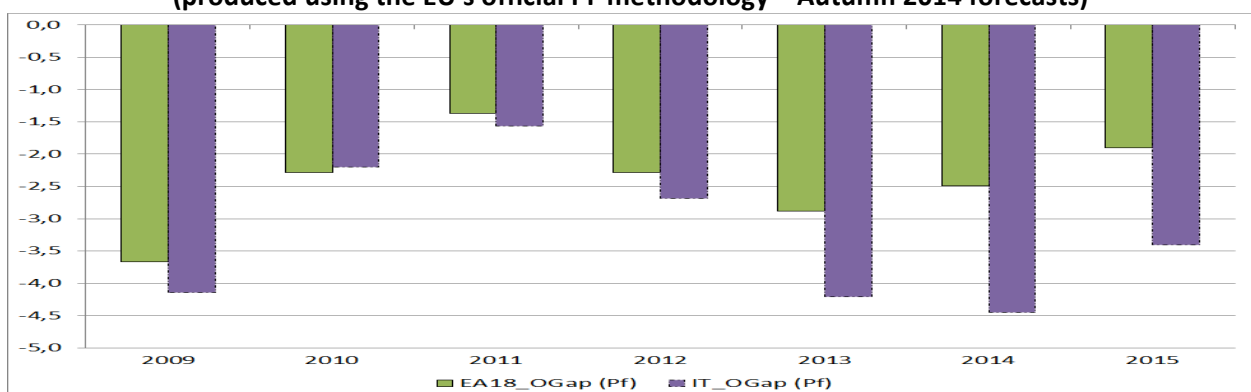
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Cottarelli et al. argue that the methodology agreed at EU level to calculate potential output underestimates Italian potential output, claiming that the methodology tends to substantially underestimate the extent of the economic cycle and to interpret, as structural, recent economic developments. In addition, it is suggested that the main factor driving the fall in Italian potential output is the EU's method for calculating structural unemployment.

In reacting to Cottarelli et al., we would firstly like to stress that the EU Commission's calculations of potential growth and output gaps are based on a commonly agreed, production function (PF), methodology which has been endorsed by all of the EU's 28 Member States. Since the primary use of the methodology is as an operational surveillance tool, equal treatment of all of the EU's Member States needs to be strictly assured by the Commission, with the method expected to produce unbiased estimates by seeking to avoid both false optimism or unjustified pessimism. Moreover, if one makes a comparison of EC Commission estimates for Italy's potential growth and output gaps over the period 2012-2015 with those of other international organisations, such as the IMF and the OECD, one finds a striking degree of consensus. For example, the latest Commission and IMF output gap point estimates for Italy are virtually identical in each year of the period 2012-2015, with all 3 organisations suggesting negative potential growth rates in Italy, of a similar order of magnitude, in both 2013 and 2014.

1. Does the EU methodology underestimate Italian potential growth ? Even before the onset of the financial crisis, Italian potential growth rates were already very low and were declining. In both the case of Italy and the Euro Area as a whole, potential growth rates declined by roughly 1% point between the periods 2001-2008 compared with 2009-2014. After all, as the Italian economy grew by only about half the Euro Area average in the decade running up to the crisis, it is not that surprising that its potential growth tilted into negative territory after such a large, persistent, negative shock¹. Consequently, there is nothing unusual regarding the extent of the decline in the Italian trends, relative to those of the Euro Area, concerning the potential growth rate effects of the financial crisis. As a result of these potential growth developments, slow growth in Italy is largely reflected in a more negative output gap². The protracted nature of the recession in Italy is also picked up by the PF methodology since the output gap for Italy is higher in 2014 compared with 2009, which is not the case for the Euro Area (Graph 1).

**Graph 1 : Output gap developments in Italy and the Euro Area
(produced using the EU's official PF methodology – Autumn 2014 forecasts)**

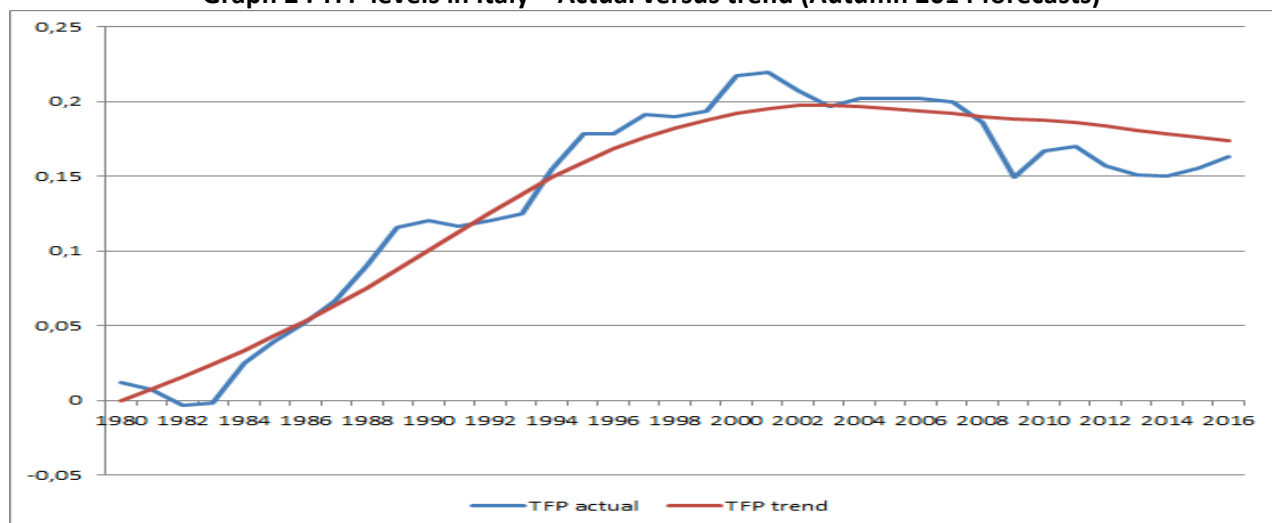


¹ Note : A recent NBER Working Paper by L.M. Ball (2014) ("Long-term damage from the great recession in OECD countries" NBER Working Paper 20185), showing results from IMF and OECD estimates, confirms the roughly 1% point decline in potential growth rates for Italy due to the crisis. This paper also states that "the recent recessions have had dire effects on economies' productive capacity. In most countries, the fall in potential relative to its pre-crisis trend has been almost as large as the fall in actual output...the countries with the deepest recessions have also experienced the greatest long-term damage".

² Regarding output gaps, we would like to point out that the EU's commonly agreed PF methodology produces much more negative output gaps for both Italy and the Euro Area, compared with the previously used HP filter methodology – if the EU had continued with the HP filter approach it would now be producing substantially lower negative output gaps for both Italy and the Euro Area.

Major reason for low negative potential growth in Italy is low productivity growth : The low Italian growth rate before the crisis is driven by a very poor productivity performance. For us the best measure of structural productivity developments is trend TFP. As shown in Graph 2 the level of actual TFP in Italy peaked in 2001 and has never reached that level again - not even in the boom years before the financial crisis. In 2009, TFP was strongly hit again and has remained at a low level ever since.

Graph 2 : TFP levels in Italy – Actual versus trend (Autumn 2014 forecasts)



2. Does the EU methodology overestimate structural unemployment (i.e. the NAWRU – the "non-accelerating wage rate of unemployment") in Italy ? Concerning the NAWRU, one often used argument in the case of Italy is that the NAWRU is too high and follows unemployment too closely. It is indeed the case that the NAWRU has increased from a trough of 7 1/2% in 2007 to 10 3/4% in 2014 (whilst actual unemployment increased from roughly 6% to 12 1/2%, thereby implying that roughly 50% of the increase is non-cyclical). Comparing this to historical variations of the NAWRU with the actual unemployment rate, this is not an extraordinary increase, with for example a similar ratio of roughly 50%, between actual and NAWRU changes, evident over the period 1981 to 1995, which is also a period with a protracted increase in the actual unemployment rate.

Cottarelli et al. argue that an increase in the Italian NAWRU is unjustified since structural labour market indicators do not point to a structural worsening of the labour market in Italy. We think that this is an incomplete argument, since in our view movements in the NAWRU are not fully explained by structural labour market indicators, with the NAWRU also indicating how the labour market responds to negative (and positive) shocks, i.e. the NAWRU can increase even with unchanged labour market institutions because of the adjustment rigidities implied by these labour market institutions (nominal and real wage rigidities). Thus the Phillips curve identifies an unemployment gap from the degree to which real unit labour costs respond to the increase in the unemployment rate. In this respect, Italy is not performing very well. Despite a strong increase in actual unemployment between 2007 and 2014, real unit labour costs have increased more in Italy than in the Euro Area. There are other crisis affected countries in the Euro Area, such as Spain, Greece, Portugal and Ireland which have strongly reduced their real unit labour costs over the period between 2008 and 2014 and for which we therefore identify a larger unemployment gap.