Comments to
THE EFFECT OF THE GLOBAL FINANCIAL CRISIS ON OECD POTENTIAL OUTPUT
by David Turner

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RESULTS AND IMPLICATIONS

• An insightful view of the crisis costs. Food for policy thought

• Measurement of crisis impact requires a proper counterfactual
  • Counterfactual based on potential GDP\textsubscript{pc} growth extrapolated trend
  • Compared to “ex post” potential growth estimates

• Stress that economic cycles are driven by imbalances and how they blur the picture
  • Impact is lower than alternatives based on actual GDP growth evolutions
  • The larger the imbalances the higher output costs

• Leads to key implications for the proper estimation of growth potential and output gaps:
  • Ex ante or real-time estimations should account for macroeconomic and financial imbalances (beyond inflation-unemployment)
    v.g. Borio, Disyayat, Juselius (2013) financial cycle
Revision of potential growth after the crisis have been substantial: difference between real time and ex post estimates

Real time potential output vs. current account balances

United States

Spain

Source: OECD Economic Outlook
...AND THE CORRELATION BETWEEN REAL TIME POTENTIAL GROWTH AND IMBALANCES

- In real time, potential growth estimates do not take into account (unsustainable) macro imbalances and they tended to increase as imbalances built up.

**Real time potential output vs. current account balances**

United States
- Real time potential growth
- Expost potential growth
- Current account balance over GDP (rhs)

Spain
- Real time potential growth
- Expost potential growth
- Current account balance over GDP (rhs)

Source: OECD Economic Outlook
**MOTIVATION. POTENTIAL GROWTH AND IMBALANCE INDICATORS**

- As a result (real time) potential growth IS correlated with the (ex-post) output gap…
- …and with other imbalance indicators, especially during the last decade

**Real time potential output and changes in selected macroeconomic indicators** (unweighted average of countries, 8 year rolling regression)

Sources: EC, CBO and AMECO
FACTORYING IN IMBALANCES = SUSTAINABLE GROWTH RATE. APPROACH

*Sustainable growth rates and output gap reassessment* WP BE 1313, forthcoming in SERIES

- Output *growth that does not widen or generate macroeconomic imbalances* (widely defined)

<table>
<thead>
<tr>
<th>Prices</th>
<th>Flows</th>
<th>Stocks</th>
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<tr>
<td>External sector</td>
<td>REER</td>
<td>Current Account</td>
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<td>Private Sector</td>
<td>CPI inflation</td>
<td>Private balance</td>
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<td>(private savings – private investment)</td>
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<td>Housing investment</td>
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<td>Non-tradable sector</td>
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<td>Public Sector</td>
<td>Public balance</td>
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<td>(public savings – public investment)</td>
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**FACTORING IN IMBALANCES = SUSTAINABLE GROWTH RATE. APPROACH**

- In practice: filter out imbalances in an analogous way to potential growth methodology = with some tweaks

<table>
<thead>
<tr>
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<th>Standard potential growth approach</th>
<th>Sustainable growth approach</th>
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<tr>
<td>Theoretical basis</td>
<td>Production function</td>
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<td>Imbalances</td>
<td>Inflation</td>
<td>Battery of external and domestic imbalances</td>
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<td>Production factors</td>
<td>K, L, TFP</td>
<td>(KP, KH)(^e), L, TFP</td>
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<td>Estimated equilibrium</td>
<td>Unemployment</td>
<td>All components</td>
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<td>Computation of x-output</td>
<td>Trend employment + adjustment of other factors</td>
<td>Trend in all factors, using imbalances. Weighted by quality of fit</td>
</tr>
</tbody>
</table>
• Sustained growth is uncorrelated with the imbalance indicators, which have turned out to be significant. Uncorrelated with inflation, too.

Sustainable output growth rates and changes in selected macroeconomic indicators (8 year rolling regression, 95% confidence level)

Sources: Alberola, Estrada and Santabárbara (2013)
• Sustainable growth estimates below OECD before and after the crisis (up to 2011). Reveals no correction of underlying imbalances (v.g. fiscal deficits)

Potential and Sustainable Growth Rates

Sources: OECD Economic Outlook and Alberola, Estrada and Santabárbara (2013)
FACTORYING IN IMBALANCES= SUSTAINABLE GROWTH RATE. RESULTS SPAIN

- In the case of Spain, the reduction is much smoother than in both real time and ex post.
- Reflects correction of imbalances (CAB in particular)
- Output gaps much wider prior and after the crisis.

Potential and Sustainable Growth Rates

Output gaps

Sources: OECD Economic Outlook and Alberola, Estrada and Santabárbara (2013)
FACToring in imbalances = sustainable growth rate. Results Spain

- N.B. The previous estimations are also ex post.
- What would be the real time, sustainable growth?. Similar results
- 2007 = Identification of imbalances → lower growth, larger imbalances

Potential and Sustainable Growth Rates

Output gaps

Sources: OECD Economic Outlook and Alberola, Estrada and Santabárbara (2014)
CONCLUSIONS

• Potential growth a key (non-observable) variable in policymaking
  • OECD and other institutions efforts to improve estimations
  • Reference to assess cruise speed of a economy….but fails to consider unsustainable imbalances
  • This is an important flaw

• A step towards considering macro imbalances
  • Embedded into traditional methodology
    • facilitates adoption/adaptation by those computing them
  • Caveats: black box, improve on multidimensional estimation…working on it