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Foreword to Special Edition of *The Economic and Social Review*

Eddie Casey
Irish Fiscal Advisory Council

Economic policymaking in Ireland has long been flying blind. Few, if any, reliable measures of the Irish business cycle were available before the last crisis. In fact, many estimates were deeply misleading in retrospect.

This is the situation the Irish Fiscal Advisory Council was facing in 2013 when it was given a mandate to endorse the government's official macroeconomic forecasts. Short-term forecasts looked to be within a reasonable range of possible outcomes. But estimates of medium-term growth and of the economy's cyclical position – based on the EU's Commonly Agreed Methodology – were deemed implausible, including by the Department of Finance. Yet, in the absence of alternatives, the Council found itself in the uncomfortable position of having to verify that the standard approach was, at minimum, correctly implemented.

The Commonly Agreed Methodology has many shortcomings, but perhaps most glaring is its implications for unemployment. In 2014, the approach suggested that the structural unemployment rate was close to the actual unemployment rate, at 12.4 per cent for 2013. The implications were stark: almost all of those unemployed were likely to remain so for a long time and would not contribute to sustainable economic growth.

If one were to have taken the Commonly Agreed Methodology estimates at face value, one might have concluded that the economy was already at capacity, the scope for a rapid recovery was exhausted, and faster-than-trend growth beyond this point would not be sustainable. From a policy perspective, lending the estimates at this time too much credibility might have suggested that tighter fiscal policy was warranted so as to prevent the economy from overheating. With only tentative signs that Ireland was emerging from the deepest economic crisis in its history and a substantial fiscal consolidation already undertaken, clearly something was wrong.

Recognising the need for more plausible estimates of the cycle, the Council urged the Department of Finance to develop a set of alternative approaches, while also committing resources to its own efforts. The objective was to provide estimates that might provide a fuller picture of the economy's cyclical position and of the economy's potential medium-term growth rates.

Fast forward to early 2018 and the Council was satisfied that it had made some inroads into developing alternatives that were useful on a number of fronts.

With its new toolkit, the Council was keen to engage with the wider economics community to further explore the area. Measuring the cycle would form the basis for the Council's second annual "Path for the Public Finances" conference, which took place in March 2018 in Dublin. International Perspectives were offered by Dr Garry Young, Director of Macroeconomic Modelling and Forecasting at the National Institute of Economic and Social Research, as well as by Dr Zsolt Darvas Senior Fellow at Bruegel. Additional domestic insights were offered by John McCarthy, Chief Economist at the Department of Finance, Dr Michael O' Grady, Senior Economist at the Central Bank of Ireland, and by two researchers at the Economic and Social Research Institute: Dr Adele Bergin and Dr Abian Garcia Rodriguez.

This special edition of *The Economic and Social Review* brings together some of the research that was presented at that conference. The papers included focus on several strands of potential output estimation and the implications for budgetary policy.

The Casey paper explores a number of methods for estimating potential output. A suite of models approach recognises the uncertainties involved by trying to amalgamate a number of different approaches rather than relying on any single answer, which is unlikely to be accurate in isolation. The measures focus on domestic economic activity, given its relatively more tax-rich nature. The results are stable, relatively uncomplicated in structure, and able to explain price and wage inflation. Most importantly, they are plausible from a broader economic perspective. The paper also looks at a range of tests to judge how useful the models selected are across a number of metrics, when compared to the standard Commonly Agreed Methodology.

The O'Grady paper uses a Bayesian model averaging approach to combine a number of possible models of potential output. The models are allowed to vary across three dimensions: the variables that are chosen; the manner in which the trend is distinguished from the cycle; and the assumptions about how errors are distributed. The paper finds unemployment and wage inflation to be key to estimates of the output gap, while tail events for Irish wage inflation and output movements are found to be more common than is often assumed. This is unsurprising, given Ireland's exposure to large macroeconomic shocks as a small open economy.

The Conroy and Casey paper focuses more deeply on the current account balance, which has gained popularity as a cyclical indicator following the financial crisis. However, the paper shows that the current account balance may be a misleading indicator in real time, given large revisions, most notably in trade data. They show evidence why revisions can be systematically biased and, hence, predictable.

The Lopresto and Young paper links the overriding issues concerning potential output estimation to budgetary policy. They put forward cogent reasons why uncertainty surrounding economic forecasts should be more explicitly recognised. Challenges in designing appropriate fiscal policy for today, while recognising the important – but uncertain – effects of the economic cycle on revenues and spending are key. One solution is "short-term discretion within a clear long-term framework". That is to say that fiscal policy should be relatively agnostic about short-run developments, allowing deficits to absorb shocks in the near term. A more robust approach might focus on risks around medium-term forecasts for the public finances. Rather than relying only on a central scenario for where the public finances are headed, one could pay more attention to, for example, the probability of remaining on a sustainable course, with assessments supported by independent watchdogs.

These papers are of immense value to Irish domestic fiscal policy. The Council is satisfied that some approaches to estimating potential output that have merit have been put in practice. But challenges remain. A sobering reminder is offered by researchers at the IMF (Blagrave *et al*., 2015) who note that perhaps the only reasonable goal for practitioners tasked with estimating the output gap is to arrive at estimates that are the "least bad" among a "host of mediocre choices".[1] They conclude that "there is no panacea to the problem of estimating potential output".

Since this event, the Department of Finance has also developed new work in the same vein and now uses alternative approaches to the Commonly Agreed Methodology. Budget 2019 represented the first clear use of these alternative estimates as the basis for the Department's assessments of the cycle and of medium term growth.

Continued research into the nature of the Irish economic cycle is vital. Real-time estimates of the cycle are still likely to be fraught with error. Procyclicality remains a shortcoming of many methods that has to be addressed. How the fiscal rules lean against its worst effects, while remaining simple, transparent, and enforceable remains at the heart of reforms to EU fiscal policy. A common charge is that estimates of the cycle may be unobservable, thus making them difficult to evaluate, but it is also possible that reliable estimates are incomputable in real time. This is especially true given data limitations, structural shocks, and the changing

[1]Blagrave, P., R. Garcia-Saltos, D. Laxton and F. Zhang, 2015. "A Simple Multivariate Filter for Estimating Potential Output". IMF Working Paper WP/15/79.

nature of the relationship with cyclical indicators such as inflation. It is also possible that we still need to refine our definitions of the cycle and our tools for estimating it.

With an expansion well underway, and risks evident in both directions, it is essential to understand these issues more so as to effectively design appropriate policy responses.