

Box C: Potential Output, Overheating and the Department's Commitment to Developing Alternatives to the Commonly Agreed Methodology (CAM)

Estimates of potential output and the output gap are important inputs into appropriate fiscal and macroeconomic policies. In many previous *Fiscal Assessment Reports*, the shortcomings of the CAM for estimating potential output for Ireland have been highlighted. The Department of Finance has highlighted problems with this methodology going back as far as 2003 (Department of Finance, 2003). Bergin and FitzGerald (2014) also provide a very useful discussion of these difficulties in the context of the structural balance.

The Council recognises the importance of estimates of potential output and the output gap for assessing the fiscal stance and for assessing medium-term forecasts produced by the Department. With this in mind, significant work has been completed in developing alternative estimates to the CAM (see IFAC, 2015b for a summary). A range of alternative estimates has been developed, using various macroeconomic indicators as inputs (GDP, GNP and domestic GVA). This approach of developing a range of indicators is in line with the Councils "suite of models" approach for short-term forecasts.¹ This is designed to reduce the risk of a single model giving a misleading signal. In addition to the formal models of potential output, the Council also examines a range of indicators that may point to potential imbalances in the economy. Charts of these indicators are examined and published as an appendix in each *Fiscal Assessment Report* (see Appendix C).

To date, the CAM remains the only publicly stated view of the Department of Finance on medium-term developments and the cyclical position of the Irish economy. Two changes are necessary, given the obvious shortcomings of this methodology. Firstly, the Department should develop alternative methodologies to the CAM that provide a coherent view of the supply-side. Secondly, the Department should state how its views of the medium term differ from those implied by CAM estimates.

In its April 2017 endorsement letter, the Council welcomed the Department's commitment to develop an alternative to the CAM for medium-term forecasts in the coming 12 months. As has been highlighted previously (IFAC, 2015b), it is not uncommon for finance ministries to publish alternative estimates of potential output or the output gap to the CAM. While there is some variation in the presentational approach, 9 of the 20 EU countries examined showed alternative estimates of potential output, or the output gap.

One of the shortcomings of the CAM is that, by design, the output gap is forced to close at the end of the forecast period. By contrast, the approach taken by the Council is to maintain a range of models of potential output (see Chapter 1 for details), as well as monitoring a range of potential indicators of imbalances in the economy (see Appendix C).

The overheating which occurred in the mid- to late-2000s gives a recent example of symptoms that can be identified. Rapid credit growth was a clear signal of unsustainable growth in the Irish economy. The rapid household credit growth was mainly for house purchase. While there has recently been strong increases in house prices, these have not, as of yet, been driven by household credit growth (in fact, Figure C.4. shows adjusted private sector credit to GDP falling since its peak in 2009). Given that macroprudential regulations have been introduced since the crisis, it seems less likely that unsustainable increases in credit will fuel overheating in the Irish economy in the near-term.

¹ Reporting a range of estimates also helps to show the uncertainty surrounding estimates of potential output or the output gap.

While unsustainable credit growth may be unlikely to contribute to an overheating economy in the near term, a response to persistent supply pressures in the housing market may do so. Estimates of the number of new housing units required to meet demand due to demographics and new household formation vary quite substantially. Regardless of what estimate is used, however, completions are likely to have been well below estimates of annual demand for some time.² Depending on the extent to which supply now falls short of demand levels, this lack of supply may have led to a significant build-up of pent-up demand, which could have contributed to the significant price increases recently observed.

While supply has yet to show strong evidence of a sharp response to potential significant pent-up demand in the residential property sector, if it were to do so, one could see employment and output in the sector increase rapidly. In the 2000s, the rise in labour demand from the construction sector had two impacts. Firstly, the additional demand for labour contributed to upward pressure on wages, thus leading to competitiveness losses. Secondly, as the economy was already at full employment, substantial inward migration occurred to meet this demand for relatively unskilled labour. Given that unemployment is rapidly falling, any substantial increases in construction related employment could tighten the labour market, in a comparable way to that observed in the mid-2000s. If there has indeed been a build-up of demand in excess of any supply response, it may be reasonable to expect that housing output could exceed equilibrium levels of output (i.e., annual demand) for some time. How the housing sector might then return to more normal levels of activity would have a significant bearing on the cyclical position of the economy. Given that construction activity is quite tax rich, significant changes in the construction sector output, as outlined above, could yield large changes in tax revenue, as was the case in the 2000s.

Another potential indicator of imbalances in the economy relates to its external trading position. As discussed in Box D, it has become increasingly difficult to interpret the current account of the balance of payments. It is hoped that the CSO's new current account indicator due in June may provide a better insight into the external trading position of the Irish economy. Regardless of estimates of the current account of the balance of payments, underlying net exports have contributed substantially to growth in recent times. One would expect that as the output gap closes and the unemployment rate gets close to its equilibrium level, wages may rise, thus putting pressure on competitiveness. This would be consistent with a transition to growth being more domestically focused. If large contributions from net exports were to continue over the next couple of years, the sustainability of this growth would have to be questioned.

² While figures for housing completions from the Department of Housing are often used, these figures relate to the number of units connected to the electricity network. This means that some vacant dwellings may be reconnected after a period and hence. Figures from the Census indicate that the housing stock increased by only 8,800 in five years. By contrast, completions data from the Department of Housing show 50,000 completions over this period, which depending on the assumed rate of obsolescence could imply a much bigger increase in the housing stock.