Improving fiscal policy in the EU. The case for independent forecasts

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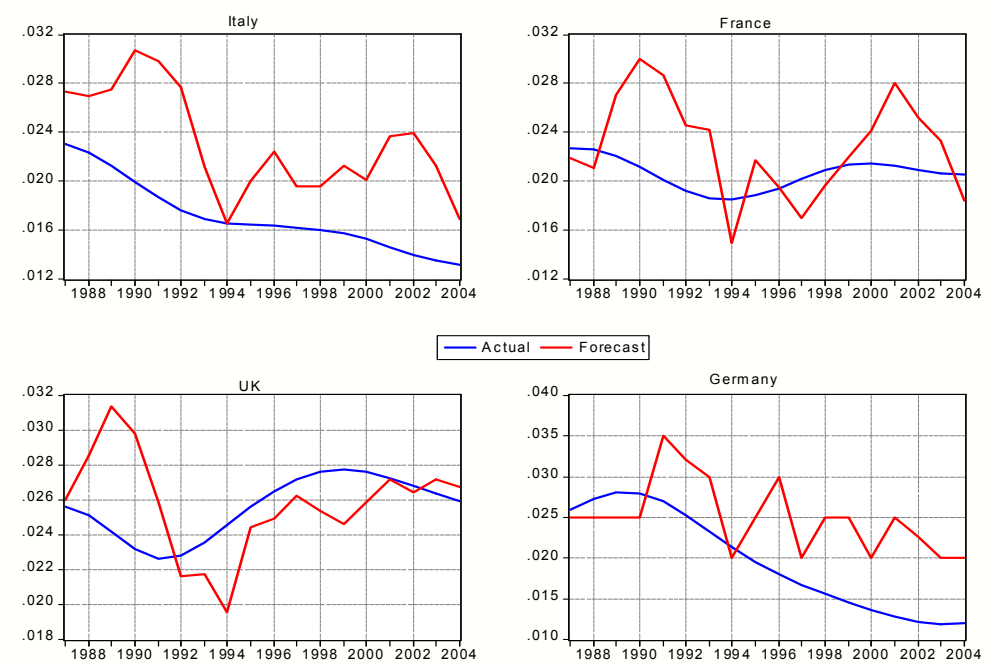
October 6, 2005

This paper makes a case for independent forecasts on the output gap by

(a) providing evidence that the official forecasts on economic growth provided by member countries are biased

(b) claiming that such bias is inefficient in that affects the behaviour of fiscal policy makers and it determines an attitude for over-expansionary fiscal policy.



Actual Potential Output Growth and Official Forecast

Actual Potential Output Growth (For all countries)

Hodrick and Prescott Filter using full sample information (1960-2005)

Forecast of Potential Output Growth

Recursive extraction of HP-filter from official forecasts (Italy, France and UK)

For any possible sample 1960:1986+t (t=1...19)

1. Add official growth forecast to historical GDP level in temporary series

2. Estimate ARIMA model for historical data plus official growth forecast

3. Forecasting 3 additional years beyond official forecast (end-point bias)

4. HP-filter of extended series

5. Store one-step ahead forecast of HP-filtered output growth into separate series

OR, Use official forecast of Potential Output Growth (Germany)

Observation 1(Italy, France and UK)

The Recursive Extraction of HP filter from official forecast differes from the actual series for two reasons

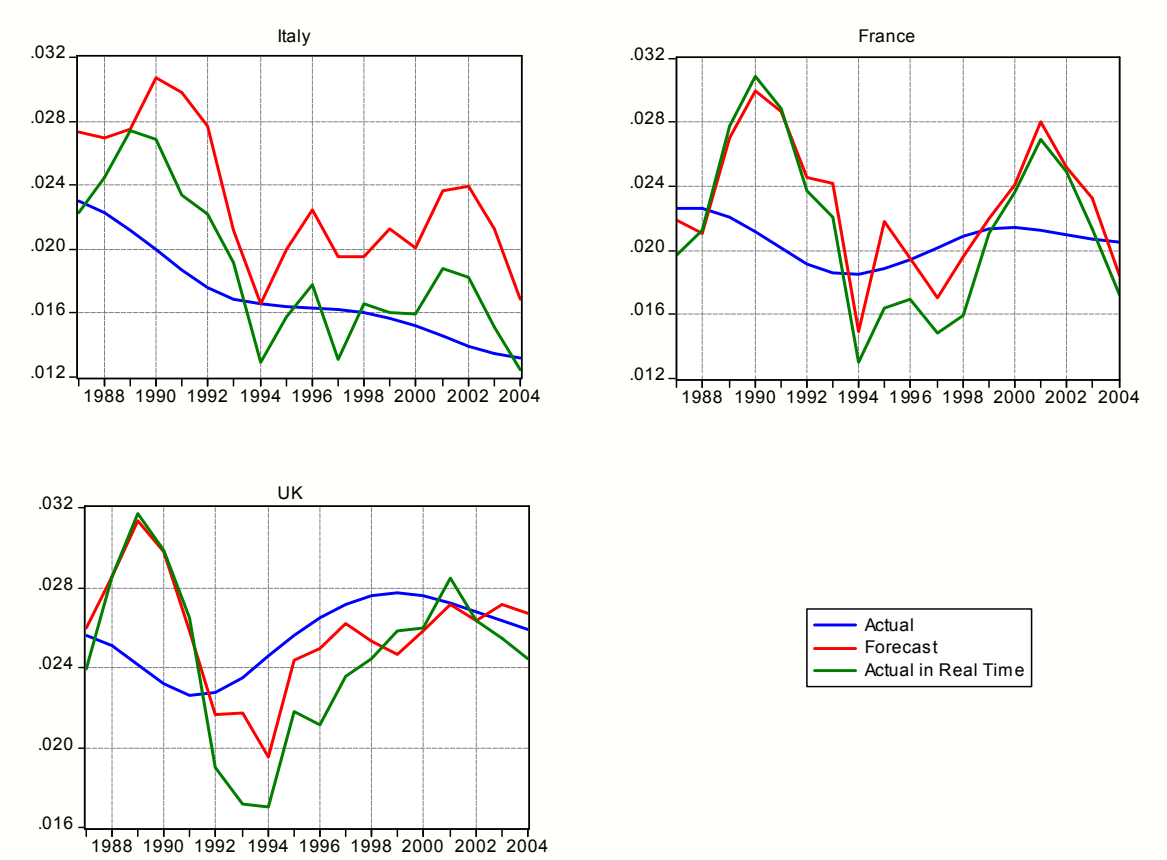
1. Expectations

2. Use of a measure of potential output constructed in real-time, while the actual data for potential output are not in real time(The HP filter uses full sample info)

Observation 2 (Germany)

1. The procedure assumes that the official forecast of potential output are forecast for the HP filtered output.

The Importance of Observation 1 (Can this be intepreted as the equivalent for Fiscal Policy of the point Orphanides made on monetary policy ?)



The fiscal reaction function

$$
\begin{aligned}
capb_t &= \beta_1 + \beta_2 \left(\frac{\Delta Y_t^p}{Y_t^p} - E_{t-1} \frac{\Delta Y_t^p}{Y_t^p} \right) + \\
&\quad \sum \beta_{3,i} d_{t-i} + \sum \beta_{4,i} b_{t-i} + e_t
\end{aligned}
$$

1. Observational Equivalence, what happens when the output gap in real time is used ?

2. Why are $\beta_{3,i}, \beta_{4,i}$ not affected ?

3. Endogeneity ?