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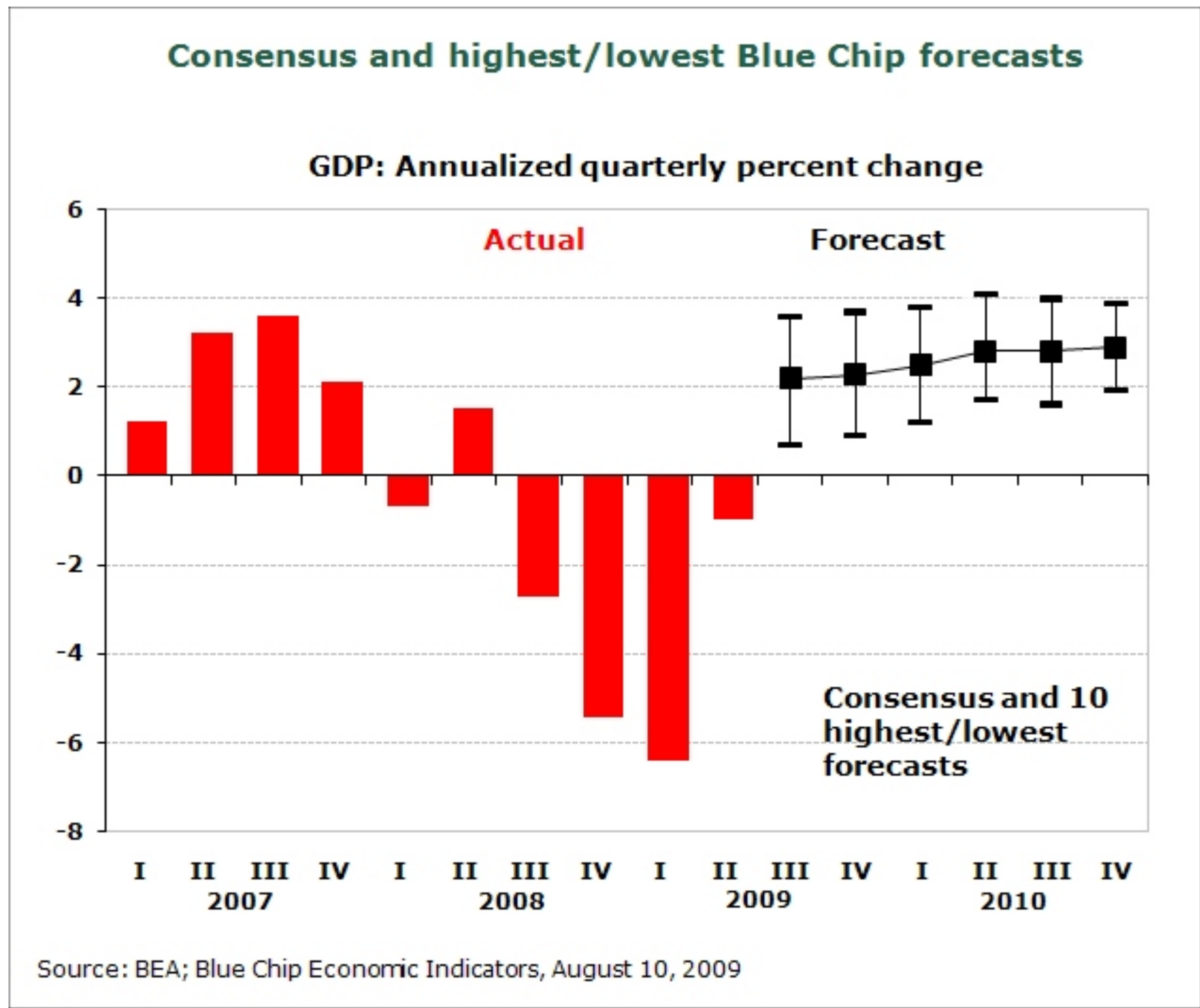
How fast can the economy grow?

The recession may be ending (and may, in fact, have ended, according to the majority of economists recently surveyed by the *Wall Street Journal*) but, as Friday's consumer confidence report suggests, the uncertainty about the course of future growth is far from resolved. The most recent consensus forecast from the panel assembled for the monthly Blue Chip Economic Indicators does suggest a nice bounce back into positive growth territory, bringing to an end a four-quarter run of gross domestic product (GDP) contraction.



What remains interesting, however, is the range of disagreement about just how fast the recovery will be. The upper and lower black lines in the chart above delineate the 10 most optimistic forecasts (the upper lines) and the least optimistic forecasts (the lower lines) among the Blue Chip panel's 51 economists. Most interesting is the fact that some collection of theses economists are, in any given quarter, guessing that growth will not break a 2 percent annual pace before we exit 2010.

That uncertainty is compounded by an even more consequential uncertainty, lucidly emphasized recently by Menzie Chinn (here, here, and here): How fast *can* we grow before straining the economy's capacity? In other words, is slow growth the best we can expect given the economy's current potential?

The output gap—the difference between the current level of GDP and estimated potential—has long been standard fare in policy analysis. Over at iMFdirect, the International Monetary Fund's blog, Ajai Chopra explains why we care:

> "What would be merely a curiosity during better times—after all, potential output is a largely abstract concept measuring the level of output an economy can produce without undue strain on resources—has become a particular worry in the context of the global economic crisis…
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> "Right now, budget planners across Europe are scrambling to estimate the strength of the blow the crisis has dealt to public finances, and not knowing the growth potential of their economies greatly complicates their task. If they overestimate potential growth, they would underestimate the need for fiscal adjustment once the crisis has dissipated, raising thorny issues of fiscal sustainability in the longer run.
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> "Central bankers, too, are looking for guidance on the path of potential output. Their decision on when to start winding down current crisis policies depends on the difference between potential and actual output, the so-called output gap. If the output gap is closing faster because of a drop in potential, policymakers might decide to increase interest rates a little earlier and a little higher to prevent inflation from rising."

Economists also do not lack methods for estimating the output gap and, just in case the field is not crowded enough, Atlanta Fed economist Jim Nason has done some investigating of his own. Jim looked at a variety of statistical estimates of the output gap and arrived at what is now a pretty familiar conclusion. To wit, there is substantial variation in output gap estimates across the different methods, and I do mean substantial: The gap estimates for the second quarter of 2009 range from –0.5 to nearly –11 percent depending on which method is used. In other words, some methods imply the gap is very large, others say the gap is rather small.

I am tempted to invoke the ancient economists' chant, "noh-bah-de-noz," but real-life policymakers don't have that luxury. So we delve in the details and try to sort out what seems like the best approach. (If you have a technical bent, you can do the same with Jim's estimates by following this link.) As we sort it out, though, Ajai Chopra gives some sound advice:

> "As for central bankers, they should also act on the information they have, although researchers such as Athanasios Orphanides (now Governor of the Central Bank of Cyprus and member of the ECB's Governing Council) have sensibly suggested that central banks should tread carefully by reducing the importance of the output gap in their decision making.
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> "More generally, policymakers—be they in the central bank or in the ministry of finance—would do well by communicating their assumptions about potential output growth to the public."

With that in mind, I will leave you with the recent communication on the subject offered by Federal Reserve Bank of Atlanta President Dennis Lockhart:

> "Many observers see substantial slack in the economy that could persist for some years. Economists' more formal term for slack is "output gap." We at the Atlanta Fed see a meaningful output gap developing, but in our view it is smaller than would normally be associated with the weak pace of growth we expect over the next couple of years because all the obstacles to the natural pace of growth already mentioned have brought down the economy's potential for the medium term."

So, as President Lockhart indicates, mark us down, for now, on the low end of output gap scale.

Update: The San Francisco Fed's John Fernald and Kyle Matoba offer some related thoughts in the newest edition of the Bank's Economic Letter (hat tip to Econbrowser).

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