August 26, 2011

Lots of ground to cover: An update

If you have to discuss a difficult circumstance, I guess Jackson Hole, Wyo., is as nice as place as any to do so. This morning, as most folks know by now, Federal Reserve **Chairman Bernanke reiterated** the reason that most Federal Open Market Committee (FOMC) members support the expectation that policy rates will remain low for the next couple of years:

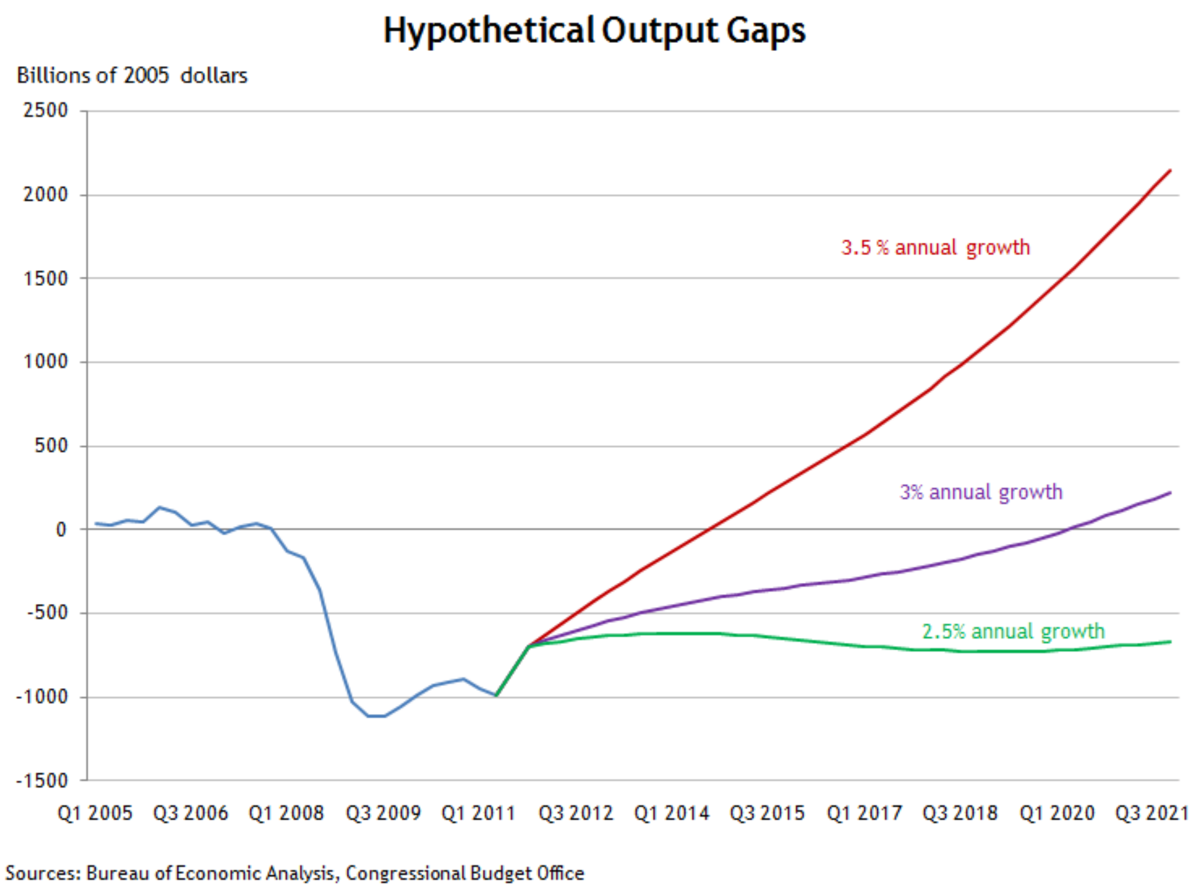
> "In light of its current outlook, the Committee recently decided to provide more specific forward guidance about its expectations for the future path of the federal funds rate. In particular, in the statement following our meeting earlier this month, we indicated that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. That is, in what the Committee judges to be the most likely scenarios for resource utilization and inflation in the medium term, the target for the federal funds rate would be held at its current low levels for at least two more years."

There are two pieces of information that emphasize the economy's recent weakness and potential slow growth going forward. The first is this week's revised forecasts and potential for gross domestic product (GDP) **from the Congressional Budget Office** (CBO), and the second is today's revision of second quarter GDP **from the U.S. Bureau of Economic Analysis** (BEA). Though estimates of potential GDP have not greatly changed, the CBO's downgrade in forecasts and BEA's report of much lower than potential growth in the second quarter have the current and prospective rates of resource utilization lower than when **macroblog covered the issue just about a month ago**.

Key to the CBO's estimates is a reasonably good outlook for GDP growth after we get past 2012:

> "For the 2013–2016 period, CBO projects that real GDP will grow by an average of 3.6 percent a year, considerably faster than potential output. That growth will bring the economy to a high rate of resource use (that is, completely close the gap between the economy's actual and potential output) by 2017."

The margin for slippage, though, is not great. Assuming that GDP ends 2011 having grown by about 2.3 percent—as projected by the CBO—here's a look at gaps between actual and potential GDP for different, seemingly plausible growth rates:



(enlarge)

Attaining 3.5 percent growth by next year moves the CBO's date for closing the output gap up by about a year. On the other hand, a fall in output growth to an average of 3 percent per year moves the date for eliminating resource slack back to 2020. If growth remains below that—well, let's hope it doesn't.

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