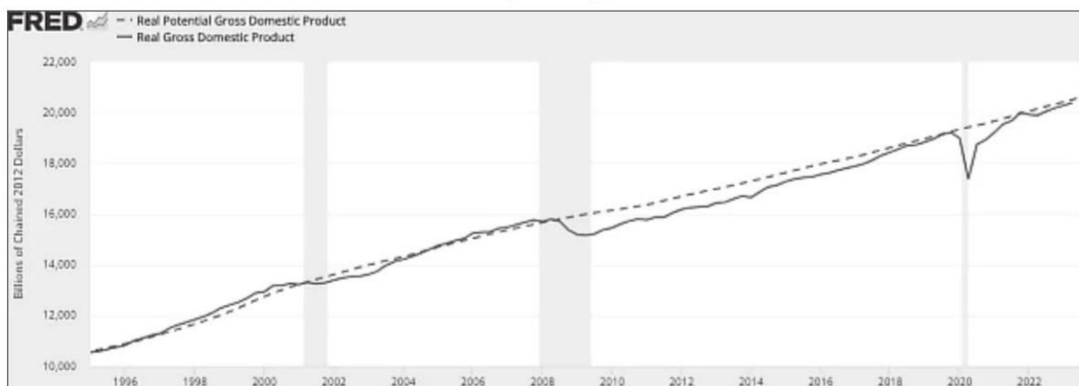
The economy's performance



How is the economy doing? You can't give a single straightforward answer to my question. Instead, your answer will depend on how you measure economic performance and on whether your measurement is above or below where you think it ought to be. You could use Real GDP, the most important measure of an economy's performance. It is a measure of the value of output constructed in such a way that it does not change because of inflation. So real GDP is a good measure of the economy's performance, but what should its value be?

Joe McGarrity

That value is given by real potential GDP. It is an estimate of what real GDP would be if all the inputs into the production process were utilized at rates that did not cause unwanted inflation. For instance, its calculations assume that all the workers who want to work can find jobs, while also assuming that firms do not enter into bidding wars to attract more workers into the labor market. Such bidding wars would have driven up wages and led to inflation.

The solid line in the accompanying graph shows real GDP since 1995, while the dashed line shows potential GDP over the same time period. The graph reveals four interesting outcomes. First, real GDP is generally pretty close to potential GDP. This is evidence of how efficiently the U.S. economy operates. Real GDP is usually close to where the experts think it would be if the economy were using its resources in a way that promoted the maximum sustainable rate of economic growth.

Second, actual real GDP is more likely to be under potential GDP than above it. Or put differently, the economy generally has the potential to produce more output without causing higher inflation.

Third, the gap between real GDP and potential GDP widens when there is a recession. The graph depicts the three most recent recessions with shaded areas. You will notice that during the recessions, real GDP drops while potential GDP remains relatively unaffected. This result is not surprising since a recession occurs when there is negative real GDP growth or a prolonged slowdown in real GDP growth. When the economy goes into a recession, it uses fewer workers and fewer of its other production inputs. These unemployed resources do not affect the potential GDP calculations because this measure calculates the value of output that would occur if these inputs were fully employed.

While the widening gaps between real and potential GDP that occur during recessions may be expected outcomes, few people have any expectations about how quickly these gaps will close after the recessions end. The pace varies. Generally, the gaps close quickly. The exception is for recessions caused by financial crises. The recession that started in the first quarter of 2008, often referred to as the Great Recession, occurred when many investment banks became insolvent. It took about 10 years for real GDP to get back close to potential GDP. The Great Depression, not shown in this graph, is the most famous example of a financial crisis that kept real GDP far below potential GDP for an extended time period.

Fourth, right now, real GDP is close to potential GDP. You may have noticed that this observation answers the question I posed at the beginning of this column: How is the economy doing?

The answer is that the economy is doing pretty well – at least if you limit your analysis to one measure of the economy's performance: real GDP. Inflation is another measure of the economy's performance that would be important to consider, but I have addressed that issue in previous columns.

I should make one big fat qualification to my analysis. Potential GDP is just an estimate. If the experts that create it are missing something, potential GDP might not provide the best benchmark. But even if these experts are systematically missing something, over short periods of time, they will continue to miss it. Therefore, even flawed measures of potential real GDP will spot changes in the output gap and be useful in analyzing fluctuations in real GDP.

Joe McGarrity is a professor of Economics at UCA. He can be reached at joem@uca.edu.