

Measures of potential GDP in different theoretical contexts

Chiara Salvatori

Roma Tre University

Chapter 1. Potential output: definitions, theoretical foundations, and estimation methods

Summary

The first chapter of the thesis, after reviewing the theoretical foundations of the potential output notion, provides a review of the different estimation methods adopted for its calculation. This review offers an original classification of the potential output estimation methodologies, broader than those currently found in the literature. In fact, it considers both the historical and theoretical dimensions, including measures used in the past and no longer in use, or less known since never adopted at official level, as well as measures belonging to theoretical approaches different from the traditional one. Starting from the principle that potential output represents a maximum that can be achieved, the proposed classification is based on the constraint that identifies this maximum. This permits to divide estimation methods into three groups: those based on the availability of labour scarcity; those based on the availability of fixed equipment; and methods that extract the assessment of potential from the history of the actual output itself. This classification implies the presence, within the same group, of methods characterized by profoundly different theoretical views. This is the case of two methodologies widely used, both belonging to the first group: that currently in use by international institutions, central banks, and governments; and that proposed by Okun in 1962 and its variants. This reconstruction shows how broad the view of potential output can be and how much it can differ across different theoretical approaches. Over time, in fact, the view of potential output has changed from Okun's original idea that it corresponds to a conventionally measured goal of full employment, thus representing an upper limit to productive activity, to the current prevailing view in which actual output is considered to oscillate around potential due to the existence of equilibrium mechanisms that correct any divergences determined by demand. In the empirical part of the thesis, I propose a measure which revises and updates Okun's original method.