One of the most common tools used to gauge the health of an economy, assess the degree of inflationary pressure and anticipate central bank decisions is the output gap, i.e. the difference between the total production of an economy and its potential. There are many measures and ways to estimate potential GDP. In the United States, one of the most popular measures is the one provided by the Congressional Budget Office (CBO). This non-partisan Congressional organization is especially known for its assessment of the federal government’s budget policies. In the semi-annual updates of its forecasts on public finances and the economy, the CBO releases what it considers to be the long-term trend in U.S. real GDP, also known as its potential.

The CBO’s recently released update reports weaker growth in the potential compared with previous estimates. The CBO uses two measures to evaluate growth in potential: growth in the labour force and growth in productivity. The CBO’s new calculations show lower-than-expected productivity increases during the recession and during the recovery (2008–2014). In addition, the following years (2015–2017) should be characterized by weaker growth in the labour force than forecast. The CBO therefore considers that over a 10-year period these two factors drove weaker-than-expected growth in the potential of the U.S. economy, and consequently, the level of the potential itself.

Our most recent forecasts did not suggest that the output gap would be fully closed by the end of the decade. The gap between the level of potential and forecasted real GDP growth can now quickly close in light of the downward revision of the level of potential. We now believe that the output gap will move from negative to positive starting in summer 2016.

**Implications:** The faster-than-expected closing of the output gap suggests that there will be a limit to the Federal Reserve’s (Fed) patience. The Fed still has a lot of latitude, but there is a risk that a positive output gap will trigger greater pressure on core inflation. In addition, weaker medium-term potential also implies a slower-growing economy. Accordingly, at the end of the monetary tightening, the interest rates necessary to slow the economy will not need to be as high as in the past.

Francis Généreux
Senior Economist